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Mark Perry, an economics professor at the University of Michigan, recently pointed out that in 2009 the U.S. economy had the world’s largest manufacturing sector. (The most recent data show that China’s sector edged out the United States because of our slow economic recovery.) Every year since 2004 U.S. manufacturing output, in constant 2005 dollars, has exceeded $2 trillion. Perry notes that this is double the U.S. manufacturing output of the early 1970s. If U.S. manufacturing alone were an economy, notes Perry, it would be the sixth-largest economy in the world.

But is the sector too small? In an article titled “Yes, American Manufacturing Really Is in Trouble” (Huffington Post, February 11), free-trade critic Ian Fletcher says it is.

To judge whether a sector of the economy is too small, we need criteria. Fletcher writes: “Unfortunately, the only rational standard for how much America should produce is how much Americans wish to consume. Because the only way to consume is either to produce what you wish to consume, or produce something else you can exchange for it” (italics in original).

But if that were the only way, Fletcher should be content—yet he’s not. Why not? Because, as he well recognizes, it’s not the only way, and that’s why he wrote his article. He notes two ways that we consume what we get from foreigners besides selling them goods and services: 1) by selling them assets (these assets are produced, but that’s not what he means) or 2) by borrowing. He objects to both.
He writes: “And this is where American manufacturing is clearly falling short, because America is running a huge trade deficit in manufactured goods, and we don’t produce enough of anything else (raw materials, services) to cover the gap. So instead we borrow and sell off existing assets to pay for imports.”

Fletcher’s ideal is becoming clear: The “right” amount of manufacturing is achieved when the amount the United States spends on other countries’ manufactured goods (and I think he means to include raw materials and services) just equals the amount foreigners spend on our manufactured goods, services, and raw materials. In short, Fletcher’s ideal is a zero trade balance.

He’s almost right that if we have a trade deficit, which we do, we will have to borrow from foreigners or sell assets. Why almost? Because Fletcher leaves out two other possibilities. First is that foreigners will want to invest directly in the United States. Second is that they will want to hang on to some dollars: The U.S. dollar is still the closest thing there is to a world currency.

It’s true that the increases in foreign direct investment in the United States and in dollars held are substantially smaller now than the sale of assets and the increase in borrowing. So let’s grant that most of the trade deficit will be paid for with borrowing and asset sales. What’s wrong with that? In a later article, “The Biggest Bubble of All Has Yet to Pop” (Huffington Post, February 17), Fletcher explains: Americans will own fewer assets. That does seem like a problem, doesn’t it? Let’s dig further.

If the capital stock is growing quickly enough, even if foreigners own more of it, Americans might own more too. It’s true that private investment has declined, something likely due to President Obama and Congress making investors unsure about health care and other regulations in the future. Between 2008 and 2009 the value of the U.S. capital stock fell by about 2 percent. By the end of 2009 foreigners owned about $21.1 trillion of the $48.5 trillion U.S. capital stock—over 40 percent. Sounds scary, right? But it overlooks that Americans own $18.4 trillion of the rest of the world’s capital stock. So the U.S. “net international investment position” was negative $2.7 trillion, or less than 6 percent of the U.S. capital stock. Interestingly, even though “our” ownership of “their” capital is less than theirs of ours, in 2009 “we” made $121 billion more on them than they made on us. That suggests the U.S. government’s data underestimate the value of U.S. investments abroad or overestimate the value of foreign investments here, or both.

**Bonds and the Trade Deficit**

One of the main U.S. assets that foreigners invest in is Treasury bonds. If the federal government reduced its budget deficit, now running at more than $1 trillion annually, there would be fewer bonds for foreigners to buy. That wouldn’t necessarily cause our trade deficit to fall because if foreigners see
private U.S. assets—corporate bonds, for example—as good substitutes for U.S. government bonds, they might simply shift to buying more. Still, private assets are unlikely to be a perfect substitute for government debt, and so reducing the budget deficit would probably reduce the trade deficit somewhat.

It’s also true that if we Americans increased the percentage of our income that we save, we would buy some of those bonds and buy fewer foreign goods and services, again reducing the trade deficit.

Fletcher recognizes these facts. In his February 17 article he writes: “It is indeed true that if we take our low savings rate as a given and ask whether we would be better off with foreign-financed investment or no investment at all, then foreign-financed investment is better.”

But Fletcher doesn’t want to take this low rate of saving as given. He wants a higher rate. Fine. There are two ways to accomplish this. The first is to reduce the budget deficits of the U.S. federal, state, and local governments. In 2009 they totaled a whopping $1.272 trillion, which exceeded net private saving (personal and corporate) of $945 billion. The result: a negative saving rate for the economy as a whole. Have the government spend less, and the net saving rate would probably increase. It’s still not clear, though, that we would manufacture more.

The second way to increase saving and thus reduce the role of foreign investment is for us individually to spend less and save more. Fletcher seems to like this idea, asserting that “domestically-financed investment is obviously better because then Americans, rather than foreigners, will own the investments and receive the returns they generate.” But how can he know whether it’s better for you to buy an iPhone or to put more money in your IRA? He doesn’t. Neither do I. I’m more humble than Fletcher: I want you to be able to choose. Do I trust your choice? Not necessarily. But I think you have the right to make even bad choices.

So what is my criterion for the “right” size of the manufacturing sector? Simple. The right amount of manufacturing is the amount that would be achieved if the government did nothing to distort people’s choices. Let’s focus on getting rid of government distortions and not attack the symptoms, if they are indeed symptoms, of those distortions.
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