Two of the supposed indicators of the economy’s health—the trade deficit (or balance) and the federal budget deficit (or balance)—are constantly under the media spotlight, yet they are actually among the least important and most unreliable indicators that we have. This is not to say that each is unimportant, or that reaching a trade balance or a budget balance by 2002 would be unwelcome, but only that the two balances are among the least significant and most unreliable indicators of the economy’s health and prospects.

Why then do they get so much attention in the media, in public discussion, and in political debate? If they are not so important, what are the other more important indicators of economic performance, and why do they receive so little attention?

The obvious answer to the first question is probably the most accurate one. Because the trade and budget balances appear to be simple, easy to measure and understand, they give politicians something to talk about that they and voters can readily relate to: “Your family has to keep a balanced budget—why not your government?” On examination, however, this turns out to be a case of looking for a lost key under the street light instead of where the key fell.

Another question is, why are these two balances really of less importance than their publicity would suggest? There is an unspoken, and

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erroneous, assumption that a trade deficit is bad for a country's economy. Remember Pat Buchanan standing on the pier decrying Japanese imports? The facts are that economies often, and indeed typically, prosper while experiencing large trade deficits, and conversely, their performance can lag badly while they are amassing large trade surpluses.

A quick look at the record, as Al Smith used to say, illustrates the point: The economies of the United States, Hong Kong, and South Korea have all prospered for most of the past decade, and more recently Poland, the Philippines, Turkey, and Croatia have been doing likewise, while following the same pattern: high growth and substantial trade deficits. On the other side of the ledger, Japan and Russia exemplify the reverse trend—poor, lagging economic performance while running up large trade surpluses. The German and French economies reflect similar predicaments.

The explanation for these seemingly counterintuitive situations is that a trade deficit (i.e., an import surplus) often reflects the strong demands of a booming economy for investment, consumption, and intermediate goods. Conversely, a trade surplus often reflects the weak demands of a depressed, deflationary economy in which internal savings outstrip the availability of domestic opportunities for profitable investment.

Moreover, the way we measure a trade balance is an artifact of another age: Now, and in the future, much of what is labeled as trade represents transactions among the international subsidiaries of the same parent company. But even apart from measurement flaws, the trade balance implies very little that is important in divining the health of a nation's economy.

Similarly, the federal budget balance or deficit, despite the inflated political rhetoric of recent years, carries with it very little significance about the economy's performance and outlook. It does not take a rocket scientist, or a chess-playing machine, to know that tax revenues fall and transfer payments rise when the economy is doing poorly, and vice versa when the economy prospers. Putting aside the fact that if private companies measured their profit and loss the way the Federal Government keeps its books (i.e., by counting borrowing as revenue and running no capital account), they would no doubt at-
tract attention from the criminal division of the SEC—the existence of a budget balance or deficit doesn’t indicate anything crucial about the health of an economy.

One vital fact ignored by the budget balance—one which has great significance for the economy’s overall performance—is the level of spending at which the balance (or deficit) occurs. For example, a budget deficit incurred at a spending level that represents a relatively (by modern standards) modest share of GDP, say 30 percent (the U.S. level), may be a much more favorable economic indicator than a budget balance that is incurred at a spending level that is a much larger share of the GDP, say 45–50 percent, as is the case in most European economies.

There is another important consideration overlooked in the debate about a balanced budget: the proportion of any given budget that is allocated for public investment in road and productive infrastructure, rather than in transfer payments.

So the federal budget balance, like the trade balance, is of limited significance in assessing the economic health of a nation. In the case of Japan, for example, it seems quite clear that the recently enacted tax increases, designed to reduce Japan’s budget deficit, may hinder rather than help in getting that economy moving again, while tax reductions might contribute to such an outcome, even if the deficit rose as a consequence.

If the two balances, trade and federal, are not the most important and reliable indicators of economic performance and prospects, what are the preferable harbingers of things to come? These would include the rate of growth in productivity (both labor productivity and “total factor productivity”) insofar as we are able to measure it in an economy in which information is a key input; the economy’s “openness” to competition (in terms of numbers of new start-up firms, openness to competition from imports, and limited and clear regulatory restrictions); the level and growth of employment opportunities; the state and progress of the educational system; the stability and predictability of the money supply, the price level, and the currency’s exchange value; the level and rates of change in domestic savings and investments; and, as a summary, aggregate measure, the economy’s rate of real economic growth.
Each of these indicators, and the final one as an overall measure of
economic performance, carries with it more significance with respect
to how well an economy is doing and its future prospects than the
twin balances that are typically in the media spotlight. These are not
where the real keys to the economy are to be found. The real keys
don’t have a sound bite facility; they are harder to deal with, harder
to measure, more difficult to explain and understand, and more
complicated to discuss. “Why can’t the Government balance its
checkbook?” gets us where we live—especially since none of us could
keep our own books on the government model and stay out of the
poorhouse. But it is not the right question if we are really interested
in how the economy is doing, and how it will do in the future.

Postaudit

_The basic point remains valid: namely, that the trade and budget
deficits are less significant indicators of an economy’s health and
progress than the dozen other indicators referred to at the end of the
essay._