The Real Winners and Losers in a Trade War

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"It is a curious thing about the language used in a trade war. Tariffs are frequently referred to as protectionist measures. Tariffs do in fact offer protection, as they protect consumers from low prices."

– Economist Milton Friedman

A flour salesman walked into a bakery one day and said to the owner, "Hello sir, my company produces the best flour in the world. We produce it with raw materials from my country, so your own wheat stores are not depleted. We mill it in our factories, so your air is not polluted. My workers grind it and pack it, so your citizens can be employed in higher-value work. We ship it to you on our ships, so your ships are free for other purposes. Lastly, I want to sell my product to you for below the cost at which you could produce it yourself. Would you like to buy some?" The bakery owner thought for a minute, and replied, "Fine, as long as I can pay you in store credit only." The flour salesman readily agreed, and both men walked away happy.

Does this sound like a good deal for the salesman or his company? It certainly does not. Yet this is exactly the good deal that the U.S. receives when we run a "trade deficit," or what may be more accurately called a "goods surplus" if you are transacting on the side of the U.S. While all the talk these days seems to be around the subject that running a trade deficit is detrimental to the U.S. and its workers, there are many arguments that have been made over the last few hundred years that go against the idea of trade protection.

The "store credit" idea is a very powerful part of the deal above, and one that is rarely thought of as a significant benefit to the buyer of foreign goods. When we purchase foreign-made goods, we purchase them with dollars. What then happens to those dollars? They can be spent immediately in the U.S. to purchase other goods, or they can be shipped back to the goods-producing country. They may even be used to purchase goods in other countries. However, even if the dollars bounce around the world economy for a while, they will eventually find their way back to the U.S. to purchase our goods and services. This is the only country where they have purchasing value, so the "store credit" that we used to buy goods from other countries will eventually be redeemed at our "store." The dollars may even be used to purchase goods made from the cheap raw materials that were sold to us below cost in the first place.

Then why have the perceived benefits of tariffs and protectionist trade policy continually endured over the preceding many centuries? Because the benefits of tariffs are small but visible, while the detriments and costs are large but invisible. If we protect our domestic steel industry, then a small group of steelworkers may not lose their jobs, and steelworkers are an identifiable voting bloc that can show up at the polls. The much larger group of "consumers who will pay an extra 10 dollars per washing machine due to tariffs" is not a distinct voting bloc. This group is not identifiable, and no one will march on Washington, D.C. to get their 10 dollars back.

A small group with strong incentives can usually outmaneuver a large group with small incentives, at least in the short term. However, the essence of protectionist tariffs is that they benefit a small group of workers at the expense of a large group of consumers. The essence of free trade is that it benefits a large group of consumers at the expense of a small group of workers.

Some investors worry about the harmful effects of a trade deficit as well. A *budget deficit*, where a government spends more than it receives in taxes, can be a legitimate problem for the health and credit rating of the country in the long run. However, a *trade deficit* is not necessarily a bad thing and does not say much about either country's economic strength or its future economic well-being. For example, if your neighbor owns a grocery store and you own a shoe store, and you spend $200 a month at his store and he spends only $50 at yours, that is a trade deficit, and may seem unfair to you. However, it says nothing about the health or future viability of his business, or yours. You can both thrive if you offer value to enough other customers by focusing on what you do well and earning profits that exceed costs.