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Trade conflict does not improve US current account

US current account deficits for more than 25 years

The USA has posted current account deficits every year since 1982, except in 1991. Especially exchange of goods contributes to the deficit.

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Savings and investments drive the current account

New trade agreements and the introduction of punitive tariffs will not eliminate the deficit as the current account balance is, basically, determined by the balance between a country's total savings and investments.

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Strong demand for dollars keeps funding costs low

The growing government budget deficit tends to increase the US current account deficit, but strong international demand for dollars helps to keep funding costs down.

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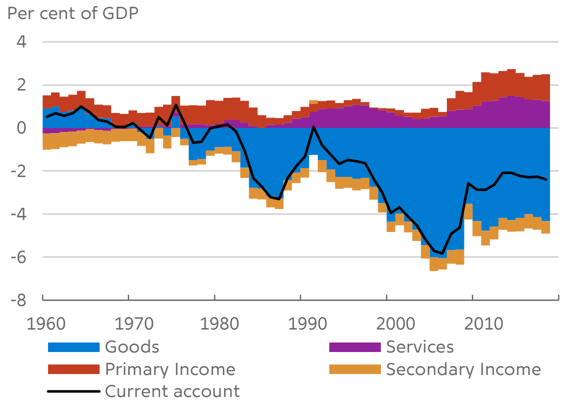
The current account is important economically and politically

The current account is an important indicator of how a country's economy is developing. This is because it makes it possible to assess whether imbalances are building up. When a country saves less than it invests, the deficit must be financed by other countries. This means that the country in question has a deficit on the current account of the balance of payments, which is a compilation of the exchange of goods, services and income with rest of the world. Unsustainable deficits may lead to currency pressure and inflationary pressure. It has been seen in Denmark in the 1980s, in several South East Asian countries in the 1990s, in some euro area countries after the financial crisis and in Argentina and Turkey last year. The USA has been running current account deficits for decades but has been able to finance the deficits at low costs, one reason being the international role of the dollar.

The current account also has considerable political significance. Historically, loss of jobs in industries exposed to competition from imports has led to increased scepticism in relation to international trade and globalisation. The US President, Donald Trump, has an explicit objective of reducing the trade deficit – i.e. the deficit on trade in goods with the rest of the world – by renegotiating trade agreements with a view to achieving better market access and introducing punitive tariffs as a means of pressure.

Sustained US current account deficit Chart 1



Note: Primary income is investment and wage income, while secondary income includes transfers between US and foreign entities, e.g. pensions, insurance premia and transfers to and from families abroad.
Source: Bureau of Economic Analysis.

US current account deficits for more than 25 years

The USA has posted current account deficits every year since 1982, except in 1991, cf. Chart 1. The deficit was reduced in the wake of the financial crisis and has subsequently stabilised at just over 2 per cent of GDP. In 2018, the aggregate deficit was 491 billion dollars, corresponding to 2.4 per cent of GDP.

Especially the exchange of goods contributes to the deficit. In 2018, the USA exported goods for approximately 1,670 billion dollars, while imports amounted to just over 2,560 billion. Aircraft, medical equipment, oil and agricultural produce are the largest export items, while US imports of goods are dominated by computers and telecommunications, clothing, electronic equipment, automobiles and crude oil. Increased US focus on extraction of shale gas and oil in the last decade makes a positive contribution of around 250 billion dollars a year to the trade balance (IHS Markit, 2018).

While trade in goods shows a deficit, the USA posts a surplus from trade in services, especially intellectual property rights, financial services and travel. The USA also has a surplus from exchange of investment and wage income with the rest of the world, while other income, which includes e.g. migrants' transfers to their families at home, results in a deficit.

President Trump's trade initiatives

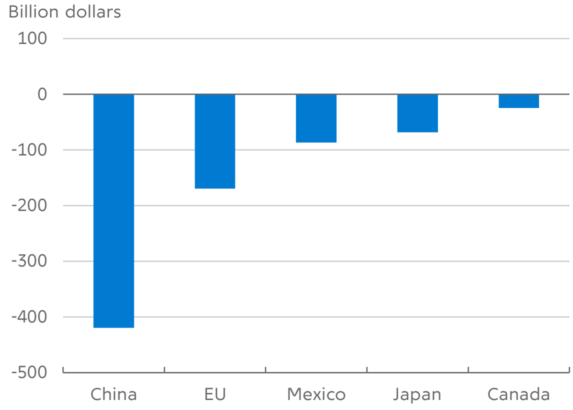
President Trump has made reduction of the US trade deficit a political priority. Under the slogan "Buy American", the US administration is renegotiating trade agreements and confronting trading partners with punitive tariffs. Focus is on the USA's bilateral deficit vis-à-vis selected trading partners, and especially China, the EU, Mexico, Canada and Japan are under pressure, cf. Chart 2.

However, bilateral deficits do not have significant macroeconomic relevance as highlighted from several sides.[1] What is important is the difference between a nation's total income and its expenditure, i.e. the balance of payments. By contrast, the balance with individual countries or parts of the balance of payments, e.g. the trade balance, is far less relevant.

In addition, increased tariffs are generally considered a poor solution for reducing the current account deficit, especially bilateral deficits, cf. IMF (2019b). Tariffs on imports from individual trading partners, mainly entails a shift in trade patterns, but not a reduction in the overall deficit.

For small countries, including Denmark, it is important that trade is not negotiated bilaterally, but that multilateral trade agreements are concluded. It ensures a level playing field and stability, which is a prerequisite for long-term investment. Rule-based international cooperation is therefore very important for a small open economy like Denmark.

Large US trade deficit vis-à-vis China Chart 2



Note: The USA's surplus/deficit from trade in goods with selected countries in 2018.
Source: Bureau of Economic Analysis.

Agreement with Canada and Mexico
The US administration has negotiated a new trade agreement with Canada and Mexico – the USMCA (United States-Mexico-Canada Agreement), which will replace the NAFTA (North American Free Trade Agreement). The new agreement does not create a free trade area such as e.g. the EU single market. Among other things, it provides an increased incentive to produce cars in the USA, but it also provides better protection of intellectual property rights and better access to the Canadian dairy market for American producers. This reflects how the USA under the current administration has shifted its focus from *free trade* to *managed trade*, cf. e.g. Hufbauer and Jung (2019).

Calculations by the independent US International Trade Commission show that implementation of the agreement is expected to reduce the deficit on the balance of goods and services vis-à-vis Canada and Mexico by a mere 1.8 billion dollars. In other words, the USMCA will have only a marginal impact on the overall US current account deficit of just over 490 billion dollars. The new trade agreement has not yet been ratified by Congress and hence it has not taken effect.

Continued trade conflict with China
The US administration considers the US trade deficit with China to be unreasonably large. They argue that US tariffs on imports from China typically are lower than Chinese tariffs on imports from the USA. Furthermore, the US administration asses that China is not complying with the international rules, especially when it comes to respecting intellectual property rights. According to the OECD/EUIPO (2019), some 80 per cent of all counterfeit goods seized in 2016 came from either China or Hong Kong. Violations of rules, including intellectual property abuse, are usually dealt with through the World Trade Organization (WTO), but the USA has chosen to negotiate bilaterally.

The USA has introduced several rounds of punitive tariffs on imports of goods from China. This may lead to improvement of the bilateral trade balance between the USA and China, but the trade balances with other countries will deteriorate correspond-

1 Nobel prize receiver Robert Solow has explained the irrelevance of bilateral trade balances as follows: "I have a chronic deficit with my barber, who doesn't buy a darned thing from me". See also Mankiw (2007).

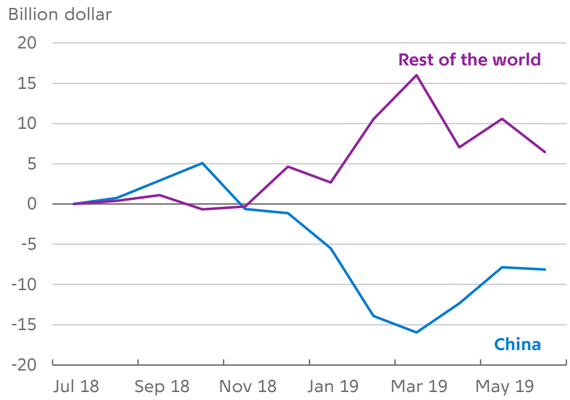
ingly. The US economist and Nobel laureate Joseph Stiglitz provides this example: the USA may sell more natural gas to and purchase fewer washing machines from China, but the USA will also sell less natural gas to and purchase more washing machines from other countries. So the punitive tariffs will simply lead to a shift in global trading patterns (known as *trade diversion*), which may increase the prices of certain goods marginally, but it will not alter the USA's underlying imbalance vis-à-vis other countries. The IMF (2019) reaches a similar conclusion, and recent US trade data also illustrates this correlation, cf. Chart 3.

Furthermore, a drop in Chinese exports may slow growth of the Chinese economy. That typically leads to a weaker Chinese currency, as has already happened. A weaker currency partially counters higher tariffs, although the effect is probably small, cf. IMF (2019b).

The development of global value chains also means that higher tariffs on imports from China hit major US multinationals, as many of their intermediate products and final goods are manufactured in China. Hence, higher US tariffs impede the competitiveness of US firms, which in turn may reduce incomes and employment in the USA.

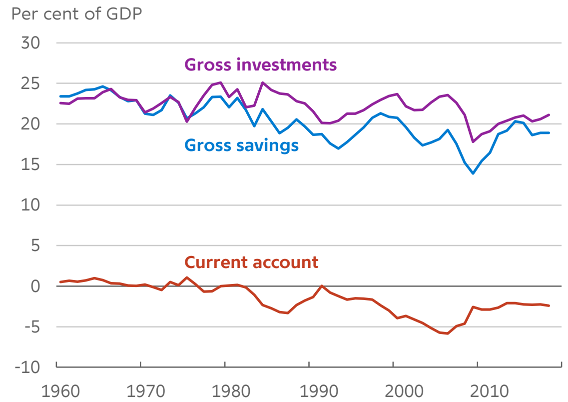
At present, the majority of imports of goods from China to the US are subject to a significant punitive tariff between 10 and 30 per cent. Part of the tariff is scheduled to go into effect only after December 15 to protect US consumers from higher prices during the Christmas shopping. China has responded by introducing punitive tariff on the majority of US imports. The USA and China are still negotiating a trade agreement, but the risk of a protracted trade conflict cannot be ruled out.

Punitive tariffs change trading patterns Chart 3



Note: Changes in US imports of goods since July 2018.
Source: United States Census Bureau.

Low US savings Chart 4



Note: Different sources and minor capital transfers, etc. mean that the difference between savings and investments does not precisely match the current account balance.
Source: Bureau of Economic Analysis.

What drives the US current account deficit?

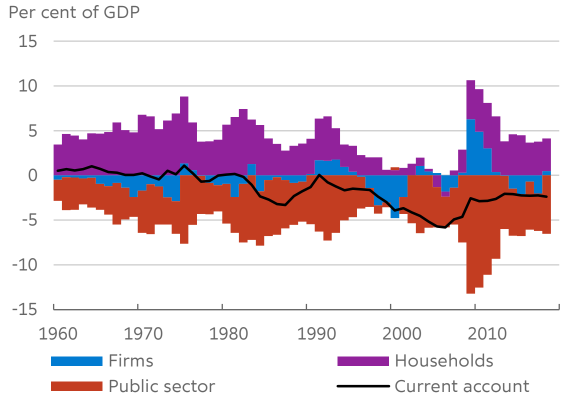
There are several reasons why the USA has been running sustained current account deficits. One possible explanation is that capital is in demand in the USA as the Americans save up too little (partly on account of high private consumption and large public deficit) compared with what they invest (Stiglitz, 2018), cf. Chart 4.

A smaller current account deficit therefore requires fewer investments and/or greater savings. Reduction of investments lowers the production capacity and growth potential and is typically not recommended. So often the conclusion is that savings should be increased in the USA. This can be done by e.g. reducing the fiscal deficit, as the public sector makes the primary contribution to the external financing requirement, cf. Chart 5. That requires higher taxes and/or lower public consumption. If the private sector is to increase savings, it will probably require higher interest rates.

Another explanation could be that other countries have increased their savings surpluses (e.g. because the Chinese are saving for their old age) and have been willing to finance US consumption by holding still more US bonds (Pettis, 2018). This phenomenon is part of what is known as the *global savings glut*.

Add to this the role of the dollar as a global reserve currency and the primary instrument for international transactions. This means that many countries hold considerable dollar reserves, which increases demand for US financial assets. Finally, well-functioning and liquid capital markets with strong oversight and security as regards the amount invested have contributed to making the USA attractive for investors. So based on this explanation, demand for US assets is generated by foreign investors. This contributes significantly to keeping funding costs for consumption and investments down, thereby driving the US current account deficit.

The external financing need is primarily ascribable to the public sector Figur 5



Anm.: US net lending broken down by sector, i.e. the financial savings surplus/deficit of each sector.
Kilde: Bureau of Economic Analysis.

The tax reform puts the current account under further pressure

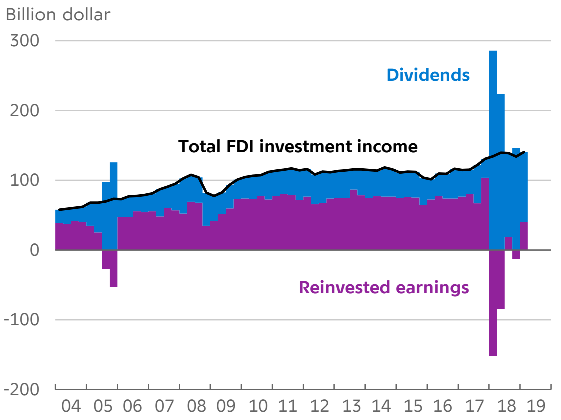
The US tax reform adopted in December 2017 has an impact on the current account. As the tax reform is underfinanced, it has increased the US federal budget deficit, which is expected to increase further in the coming years. The independent Congressional Budget Office (CBO) estimates that the budget deficit will exceed 1,100 billion dollars, or 4.7 per cent of GDP, in 2022 (from around 780 billion, or 3.9 per cent of GDP, in 2018). If the US private sector does not increase its financial savings correspondingly, this will cause the current account deficit to grow.

Broadly speaking, the tax reform abolished the taxation of dividends from foreign subsidiaries. This led to a substantial increase in dividend payments from foreign entities in early 2018, cf. Chart 6. An equivalent pattern was seen in 2005, when the *American Jobs Creation Act of 2004* introduced a one-year reduction of the tax rate for repatriation of dividends by US multinationals.

However, the large dividend payments do not affect the current account balance. Investment income from foreign direct investment (FDI) in equity is given by the operating profits of the foreign entities in a given period, which is distributed between dividends and reinvested earnings. This means that large dividend payments from foreign entities will lead to registration of substantially negative reinvested earnings. So the overall effect is just a reallocation between dividend payments and reinvested earnings, while aggregate investment income remains unchanged.

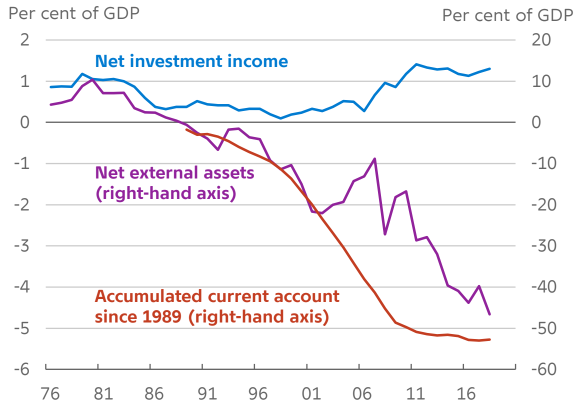
Due to changes in international taxation rules, the tax reform has made it less attractive for US firms to produce abroad. For example, it has become possible to tax intellectual property rights held by foreign subsidiaries. This improves the trade balance, but is not expected to change the current account balance, as investment income, including dividends and reinvested earnings from foreign entities, is expected to deteriorate correspondingly. So the outcome is a redistribution between current account items.

Large-scale repatriation of foreign profits after the tax reform Chart 6



Note: Seasonally adjusted quarterly data for investment income from FDI. Investment income is operating profits of the foreign entities and is distributed betwwen dividends and reinvested earnings. If dividend payments in a given period exceed the operating profit, reinvested earnings will be negative.
Source: Bureau of Economic Analysis.

Positive investment income despite large net external liabilities Chart 7



Note: Exchange rate adjustments and other value adjustments mean that the development in net assets may deviate from the development in the accumulated current account.
Source: Bureau of Economic Analysis.

Positive investment income despite large foreign debt

Given the sustained current account deficits, the US net foreign debt has increased. US external assets and liabilities shows that the value of non-residents' assets in the USA exceeds the value of US external assets by almost 10,000 billion dollars, corresponding to nearly 50 per cent of GDP, cf. Chart 7. This basically matches the accumulated current account since 1989, when US external assets and liabilities were more or less equal in size.

It is remarkable that despite the large net external liabilities, the USA has posted positive net investment income for decades. This contributes to the sustainability of the current account deficit.

The composition of US assets and liabilities is not the primary explanation for the positive net investment income. Instead, it is ascribable to the return on US foreign assets compared with the return on equivalent assets in the USA. The difference is mainly attributable to the rate of return, i.e. income as a percentage of the value of the investment, on US FDI having been on average 3.9 percentage points higher than the rate of return on FDI in the USA since 2005.

Taxation may provide an explanation to the excess US return on FDI. If, say, a US parent company pays an artificially high price for goods and services provided by a foreign subsidiary, profits are channelled from the USA to another country, where corporate taxes are typically much lower. This manoeuvre causes the US goods and trade balances to deteriorate, while investment income improves correspondingly. So the overall balance of payments is not affected. Bosworth, Collins and Chodorow-Reich (2007) estimate that around 1/3 of the excess return on US FDI is attributable to factors related to taxation.

Another explanation could be that the value of US FDI is underestimated in the statistical compilations. The term *dark matter* is used to describe the unmeasured value of US FDI (Hausmann, 2018). This could be e.g. knowhow, R&D and branding. According to this theory, the value of US FDI would increase substantially if these factors were included in the compilation and hence the rate of return on US FDI would decline towards the rate of return on FDI in the USA. Dark matter also means that Americans' net assets are actually larger than stated in the official statistics, as there are large capital gains on foreign assets that have not been recorded. The official US current account deficit is thereby partly offset by capital gains, and the challenges of having a current account may be less than believed by many analysts.

Future perspectives

The Trump administration's focus on renegotiation of trade agreements and punitive tariffs will not significantly improve the US current account deficit.

By contrast, it could result in a loss of income for American consumers if tariffs impede the exploitation of comparative advantages.

Going forward the accommodative fiscal policy in the form of tax cuts and increased public spending will put further pressure on the current account due to increased domestic demand. There are no indications that fiscal policy will be tightened or other initiatives will be launched which will increase national savings after the 2020 presidential election. A new US recession could dampen consumption and thereby reduce the current account deficit, but it does not look as if the US can turn the deficit into a surplus in the foreseeable future.

Combined with the global savings glut, the status of the dollar as an international reserve currency helps to ensure that the costs of funding the continued current account deficits and the accumulated foreign debt are low. 62 per cent of international debt issuances are in dollars, and the currency is used in 40 per cent of all international payments. Calculations show that the 10-year US Treasury yield would be approximately 0.8 percentage point higher in the absence of the large capital inflows from abroad (Warnock and Warnock, 2009). Although the European Commission is working to strengthen the international role of the euro, the dollar is likely to retain its status as the leading international currency and consequently US funding costs can also be expected to remain low in future.

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