Trump *Economics* Lesson

He misunderstands the U.S. current account.

By Martin T. Braml and Gabriel J. Felbermayr

The U.S. president's objective to "make America great again" contradicts the simple fact that the United States is by a wide margin the richest economic power in the world. Its per capita income exceeds Germany's by almost 20 percent, Korea's by almost 50 percent, and China's by a striking 250 percent. It is by almost 50 percent higher than the European Union's average. If those countries treat the United States unfairly, very little of that is visible in the data.

Here is the trillion dollar question: How is it possible that the current U.S. president can picture the richest country in the world as a piggy bank being robbed by its trade partners, and millions of people believe that narrative? The answer has to do with deep and widely shared misconceptions about the nature of the U.S. economy and the willingness to blame foreigners for troubles within the United States which, above everything, have to do with a scandalously high level of economic inequality.

GOODS TRADE VERSUS CURRENT ACCOUNT

Whenever the U.S. president laments about international economics, he focuses very narrowly on trade in goods. Indeed, according to official statistics, the United States ran a deficit in goods trade of US$811 billion in 2017. This view is insufficient and misleading. The United States has a strong comparative advantage in services industries. So, quite in line with classical trade theories, the United States is a net importer of goods

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There are multiple reasons why the U.S. current account deficit is sustainable.

but a net exporter of services. In fact, its services trade surplus amounted to US$242 billion in 2017. The focus on activities which the United States is particularly good at has served the country well—see the international income statistics. Services exporters offer skill-intensive, high-paid jobs. Their export success secures U.S. technological leadership in the relevant areas of the twenty-first century. Who wants to build fridges or washers—frontier products of the 1950s—if the future belongs to driverless cars and airborne logistics powered by drones?

The surplus in services trade underestimates the true performance of U.S. services firms on global markets. Clearly, U.S. firms can serve foreign markets in two broad ways: either by exporting from America to the foreign economy, or by establishing a foreign affiliate. Only the former mode is captured by standard trade statistics. The latter gives rise to what international balance of payments conventions call "primary income": profits earned by American multinationals from their foreign activities. The U.S. primary income balance amounted to a US$217 billion surplus in 2017. So, trade in goods and services together with investment (and some transfers referred to as secondary income) lead to a current account deficit of about US$466 billion. Since 1982, the balance of the current account was negative every single year; in 2017, it amounted to about 2.4 percent of U.S. GDP, but it was as high as 5.8 percent in 2006.

So, the external balance of the U.S. economy looks by no means as bad as a narrow focus on the goods trade would suggest, and the current account deficit is actually relatively low compared to the size of the U.S. economy, at least by historical standards.

UNDERSTANDING THE EU SINGLE MARKET

With respect to the European Union, it is important to understand two main principles of the European Single Market: first, there are no artificial barriers to trade within the ESM, and, second, its members have common tariffs towards all third parties. The first principle not only translates into zero tariff rates, but also covers non-tariff barriers to trade including both goods and service markets. Moreover, it allows full mobility of labor and capital. The second principle prevents arbitrage using the ESM and potential tariff differences to third parties, making the ESM a customs union. Hence, trade policy is an exclusive competence of the European Union and not subject to member states' policy. As a consequence, bilateral current account statistics pertaining to the United States and single ESM member states are economically meaningless. For example, every BMW car that Germany exports consists to a large extent of other member states' value-added. Similarly, a BMW car manufactured in Spartanburg, South Carolina, contains seat covers produced from Lear Corp. in Southfield, Michigan. South Carolina would then be the exporter and Michigan does not show up in any export statistics. The only difference is that bilateral trade statistics between the United States and Germany exist, where the car value shows up as gross export from Germany regardless of the Eastern European value-added content. In fact, it is not a German but an ESM export. Conversely, the ESM has no bilateral trade statistics with either South Carolina or Michigan. Hence, no one can differentiate between the origins from U.S. imports. But this is for good reason: it is completely irrelevant.

The highly unequal distribution of income and wealth is not the result of bad trade deals.

The same logic applies when it comes to U.S. service imports. Companies such as Google and Starbucks operate from Ireland or the Netherlands, respectively, to serve the entire ESM. Germany, by contrast, does not directly import U.S. services at a large scale but from Ireland and the Netherlands. These countries import from the United States more than they domestically need only for the purpose of re-exporting to other ESM member states. This is the accounting perspective, but from an economic perspective, the final consumption occurs in Germany and German income is spent on U.S. service imports.

As mentioned above, firms can choose to serve foreign markets via exports from foreign affiliates. In understanding the firms' choice between these options,

understanding another detail of the ESM is crucial: EU member states still set their tax rates independently. This results in enormous tax differences. Due to tax reasons (at least until the 2018 tax reform), U.S. companies have moved intangible goods, such as patents, to their foreign subsidiaries, particularly those located in Ireland and the Netherlands. Affiliates located in other EU member states and all over the world, including those from the United States, buy these services and pay royalties, license fees, and so on. This shifts corporate profits to countries such as Ireland and the Netherlands. Roughly speaking, due to corporate tax planning, a huge part of the U.S. surplus in trade in services is converted into a surplus of primary income. The boom of the digital economy and the utilization of so-called patent-boxes (tax-saving schemes that are popular among some European countries) generate primary income instead of direct service exports. Nevertheless, jobs behind this primary income are created in the United States.

A BALANCED ECONOMIC RELATIONSHIP

Now we are ready for a closer look at the U.S. bilateral current account *vis-à-vis* the European Union: the U.S. deficit in trade in goods (US$153 billion in 2017) is more than over-compensated by surpluses in service trade (US$51 billion) and investment income (US$106 billion). Including the (small) balance on secondary income, this sums up to a U.S. current surplus of US$14 billion in 2017. (Interestingly, a large share of secondary income gained by the United States in 2017 was made up of fines paid by EU companies such as Volkswagen.) This is not a statistical artefact—the United States has had a surplus every year since 2009. If we take bilateral surpluses as evidence for whether a country wins or loses from trade (which one should not), it is the United States that takes advantage rather than the other way around. The accusation that the European Union was set up to take advantage of America in trade is simply not supported by data.

WHY THE UNITED STATES CAN SUSTAIN ITS DEFICIT

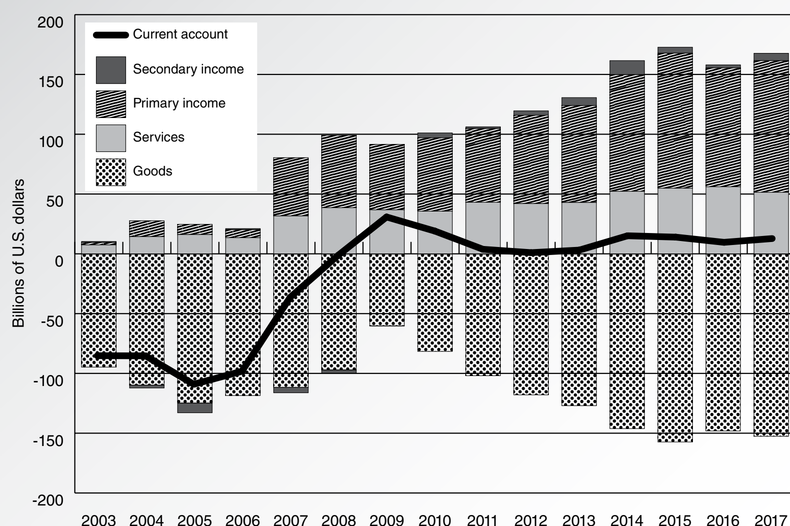
Okay, the 2.4 percent of GDP current account deficit of the United States does not appear to be driven by the European Union. But bilateral positions are not really meaningful in a multilateral world. And the overall U.S. deficit is a very real fact. Is it a problem? Or, in other words, is it permanently sustainable?

Continuous U.S. current account deficits lead to a build-up of foreign indebtedness. And indeed, U.S. liabilities to foreigners exceed U.S. foreign asset positions by far. According to the Bureau of Economic Analysis, the net foreign asset position of the United States in 2017 was a negative US$8,000 billion, or about 40 percent of the U.S. GDP. At the same time, the United States earns positive net investment income (US$217 billion). The return on U.S. assets in the European Union yielded 7.8 percent in 2017, while the return on EU assets in the United States was just 4.5 percent. If the United States can maintain this differential, it will be able to permanently import more than it exports (and consume more than it produces): a privilege to its citizens.

Indeed, economists have long dubbed the United States the venture capitalist of the world, as it collects low interest-bearing savings and invests in high-yield projects. This is just one manifestation of what former French President Charles de Gaulle called the exorbitant privilege: U.S. firms do not bear any foreign exchange risk as they can conduct their foreign business in dollars. Additionally, the United States generates excessive seigniorage revenues as the dollar is still the most important reserve currency in the balance sheet of all major central banks.

We can conclude that there are multiple reasons why the U.S. current account deficit of 2.4 percent of GDP is sustainable. First, the U.S. economy grows in terms of population,

Figure 1 Current account components of the U.S. with the EU



Source: Ifo Institute based on data from Bureau of Economic Analysis.

The relatively poor suffer most in trade wars.

so it can easily pay back its debt in later periods. Second, the United States is the most innovative economy in the world. This naturally attracts investments. Third, it controls the currency which the world uses to transact and to accumulate reserves.

IT'S THE DISTRIBUTION, STUPID

If all this is true, why does the Trumpian view of the world find so many followers? Many Americans feel left behind, and there are good reasons for it. But the highly unequal distribution of income and wealth is not the result of bad trade deals that led to an impoverishment of the U.S. working class. In the absence of a stable welfare system—one of the few areas where the authors believe Europe has a tremendous advantage over the United States—the decline of certain industries, and regions with high exposure to these industries, causes severe social damage. The history of industrialization is, however, a history of job destruction and creation that has gone on for at least 250 years. This process is mainly due to technological progress; trade plays only a minor role.

The Trump narrative may be part of an ingenious plot to divert voters' attention away from America's real problem: high inequality and stagnating income for many, while, at the same time, the United States is and has been the richest economy of the world. Scapegoating foreigners will not heal the internal rift. Quite the opposite: economic history shows that the relatively poor suffer most in trade wars. ◆