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Balance of Trade, Balance of Power

How the Trade Deficit Reflects U.S. Influence in the World

By Daniel Griswold and Andreas Freytag

EXECUTIVE SUMMARY

The U.S. trade deficit is a misunderstood symbol of U.S. economic strength and influence in the world. The deficit is not driven by unfair trade abroad or industrial weakness at home and, as the Trump years show, cannot be "fixed" through higher tariffs. Instead, the trade deficit is driven by a persistent net inflow of foreign capital, which reduces interest rates and fuels economic output. Contrary to myth, the trade deficit is not a cause of deindustrialization or a loss of manufacturing jobs. In fact, the current balance of trade points to America's continuing influence in global affairs—as a haven for global investment, as a robust producer and buyer of global goods and services, and as the provider of a strong dollar that remains at the center of the global economy. Policymakers should reject measures that restrict trade and foreign investment and instead seek to expand America's commercial ties to the rest of the world.

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INTRODUCTION

Critics of U.S. trade policy focus much of their concern on the persistent trade deficit. Former president Donald Trump and others argue that the deficit reflects economic weakness, hurts manufacturing, and proves that major trading partners, notably China and the European Union (EU), engage in unfair trade practices.[1] The Trump administration's response was to either impose or threaten higher tariffs, and many of those increased duties remain in place well into the Biden administration.

In reality, the trade deficit is driven by deeper macroeconomic trends in the United States, primarily the levels of national savings and investment, that are immune to changes in trade policy.[2] The deficit is not a symptom of weakness in manufacturing or the overall economy, or of unfair trade practices abroad, but a manifestation of underlying strength, enhancing U.S. "soft power" in the world during a time of rising tension with global rivals such as Russia and China.

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Concerns about the trade deficit are myopic and do not fully account for the benefits of expanding trade. In particular, both the causes and supposed consequences of the trade deficit are misunderstood, leading to wrong and self-damaging policy conclusions. We explain the causes and consequences of the trade deficit, contrasting the U.S. case with trade surplus countries such as Germany, including the impact on manufacturing output and employment. We also explain how the balance of trade, in fact, points to the nation's strength as a haven for global investment, to robust trade in goods and services, and to a strong dollar that remains at the center of the global economy. And finally, we briefly recommend policy steps to build on the nation's underlying commercial and geopolitical strengths.

Box 1

National accounts and the balance of payments

The national income accounts identity leads to a simple set of equations:

(1) national income = consumption + savings

(2) national income = consumption + investment + exports – imports

By equalizing (1) and (2), we get (3):

(3) exports minus imports = savings minus investments, which alternatively can be expressed as

(4) current account = financial account + changes in foreign exchange reserves.

The current account includes trade in goods as well as trade in services, investment income, and unilateral transfers. By this broader measure of trade, since 2008 the United States has been running a modest bilateral current account surplus with the European Union.* Thus, focusing on trade in goods exclusively is misleading. For more information on the national income accounts identity and the balance of payments, see Paul R. Krugman, Maurice Obstfeld, and Marc Melitz, *International Economics: Theory and Policy*, 12th ed. (Harlow, UK: Pearson, 2022).

*Matthias Diermeier, Michael Hüther, and Markos Jung, "It's Business Models, Stupid!," Institut der Deutschen Wirtschaft, IW-Kurzbericht no. 33, June 11, 2018.

WHAT DETERMINES THE U.S. TRADE DEFICIT?

The U.S. balance of trade in goods and, more broadly, the current account, have been in deficit for decades. Year after year, Americans buy more goods in global markets than they sell. This is not a problem to be solved with tariffs or other trade measures, but the result of deeper economic realities in the economy that could reasonably be seen as signs of strength. The United States can only run a persistent deficit in its current account because it runs an equally persistent surplus in the financial account, which measures the flow of capital across the border. More investment flows into the United States each year than flows out, on net, in large part because the United States remains a safe and profitable haven for the world's savings. The investment, in turn, fuels growth and job creation.

The size of the current account deficit is determined by the national level of savings and investment. This can be

seen by examining the national income accounts identity, as explained in Box 1. According to the identity, the national income is used either to consume or to save; no other use is possible. The national income is created by producing consumption goods and services, investment, and exports (minus imports, which contribute to production but are not counted in domestic production). These are the exclusive drivers of national income.

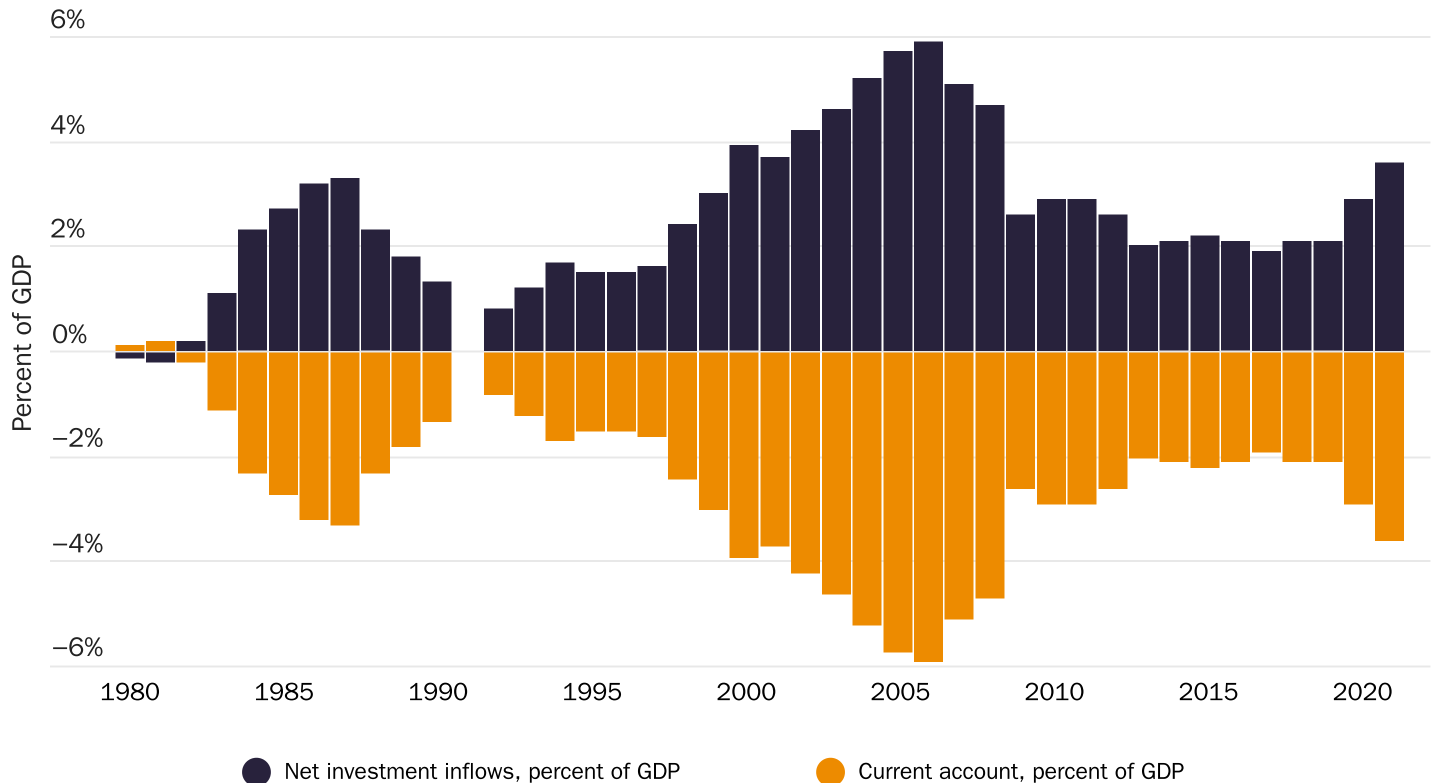
As a consequence of this identity, the current account and the financial account always balance each other. A current account deficit will be accompanied by a net inflow of foreign investment capital and vice versa.[3] As seen in Figure 1, the ebb and flow of the current account deficit in recent decades has been exactly mirrored by the net inflow of foreign capital into the United States. When net capital inflows rise, as they did in the early 1980s and again from the mid-1990s to the mid-2000s, the current account deficit increases in tandem. When net investment declines, which is usually associated with recessions, the current account deficit contracts. This inverse relationship of net investment inflows and current account deficits is driven by the inescapable logic of the national income account.

Differences among countries in aggregated financial transfers leads to an international shift of purchasing power as well as real and nominal exchange rate movements. A country with net capital inflows (i.e., savings are lower than investments) will tend to experience a real appreciation of its currency over time, which encourages imports and discourages exports (everything else being equal). The opposite happens in a country with net capital outflows. It will tend to experience a real depreciation of its currency over time, thus stimulating exports and reducing imports. America's ability to attract foreign investment has been enhanced over the decades by the role of the dollar as the preferred reserve currency for central banks. During times of rising economic uncertainty, such as during the current conflict in Ukraine, dollar-denominated investments gain appeal as a "safe haven."

The demographic structure of an economy will also influence the current account. In the United States, a relatively younger population compared to other Western nations

Figure 1

The annual size of the U.S. current account deficit is mirrored by the annual net inflow of foreign investment



Source: "Table 1.1: U.S. International Transactions," Interactive Data, Bureau of Economic Analysis, September 22, 2022.
Notes: Net foreign investment includes direct investment, portfolio investment, and other investment assets. In 1991, the current account balance was a positive $2.9 billion, or 0.05 percent of GDP.

tends to save a smaller share of its income, while the business sector tends to save and invest at a higher level. The resulting shortage of savings relative to investment demand drives the current account deficit. Germany, in contrast, has a relatively older population. The supply of labor and human capital is in relative decline while the savings rate remains high, at least as long as most people remain below retirement age. As an aging society, Germans invest a larger part of their savings abroad, creating net capital outflows and a trade surplus. Like the U.S. current account deficit, the German current account surplus is the rational result of underlying economic and demographic factors.

Is a Current Account Deficit a Problem?

If the trade balance is driven by underlying macroeconomic factors, as the national income accounts analysis shows, then the trade deficit is not a problem that can be fixed by trade policy. The U.S. deficit is not a sign of economic weakness, uncompetitive firms, or "unfair" trade policies abroad. Trade policy will only affect the trade balance if it changes the national level of savings and/or investment. The same applies to the competitiveness of firms.[4] Instead, the current account deficit reflects the net inflow of foreign capital and the continuing appeal of the United States as a haven for foreign investment.

Maintaining a high level of domestic investment can be positive for job creation and employment. Foreign direct investment (FDI) can create good-paying jobs through expanded productive capacity and innovation. A major share of inward direct investment to the United States flows into manufacturing, including the international automotive sector. Nearly eight million Americans work for foreign-owned affiliates in the United States in jobs that pay significantly above the national average wage. Critics of trade have downplayed the importance of FDI because most of it comes in the form of mergers with, and acquisitions of, existing U.S. firms, rather than building new plants through "greenfield" investments. But as the Cato Institute's Scott Lincicome has noted, even FDI mergers and acquisitions inject additional capital into the economy and encourage further investment in domestic firms that may then draw foreign partners in the future. Foreign acquisitions also typically lead to improved production methods and greater investment in research and development.[5]

The economy also benefits from a net inflow of portfolio investment, in which foreigners acquire noncontrolling minority shares in assets such as stocks, bonds, and bank deposits. The inflow of portfolio investment can stimulate economic activity by keeping interest rates lower than they would be otherwise and preventing the "crowding out" of domestic investment by huge federal budget deficits. Research shows that foreign portfolio investment in Treasury notes and other assets is correlated with lower long-term interest rates, including mortgage rates, which stimulates private sector borrowing, investment, and economic activity.[6]

"A major share of inward direct investment to the United States flows into manufacturing. Nearly eight million Americans work for foreign-owned affiliates in the United States in jobs that pay significantly above the national average wage."

Despite this analysis, many people, including former president Donald Trump, assert that the trade deficit is the result of unfairly high tariffs imposed by other countries on American exports. They wrongly claim that the trade deficit can be reduced by raising U.S. tariffs to reciprocal levels, forcing other countries to lower their tariffs, or implementing other trade balancing measures, such as quotas or import certificates. Changes in trade policy only rarely affect the level of domestic savings and investment. Higher U.S. tariffs, such as those imposed by the Trump administration against China and other trading partners, do not affect the trade balance. In fact, additional tariffs may cause the exchange rate to strengthen by reducing the outflow of dollars and driving up the dollar's value on foreign exchange markets, making exports relatively more expensive and imports more price competitive. A cross-country comparison by Caroline Freund of the Peterson Institute for International Economics found that nations that impose higher average tariff rates on imports tend to have higher trade deficits than nations that impose lower average tariffs.[7] Higher tariffs tend to reduce both imports and exports, thereby decreasing domestic welfare.

As seen in Figure 2, the tariffs imposed by the Trump administration beginning in early 2018 had no discernible impact on the relative size of the trade deficit. As a share of gross domestic product, the trade deficit in goods during the Trump administration did not significantly change from its share during the preceding Obama administration, despite imposition of a wide range of tariffs. During the last full year under the Obama administration, the goods deficit stood at 4.0 percent of GDP; during the four years of the Trump administration, the goods deficit averaged 4.2 percent of GDP.[8] The higher tariffs that the administration imposed only benefited a small segment of import-competing industries at the expense of exporting firms, import-consuming industries, and almost all household consumers. In sum, higher tariffs did exactly what the economics literature predicted they would do: impose net economic harm without changing the current account balance.

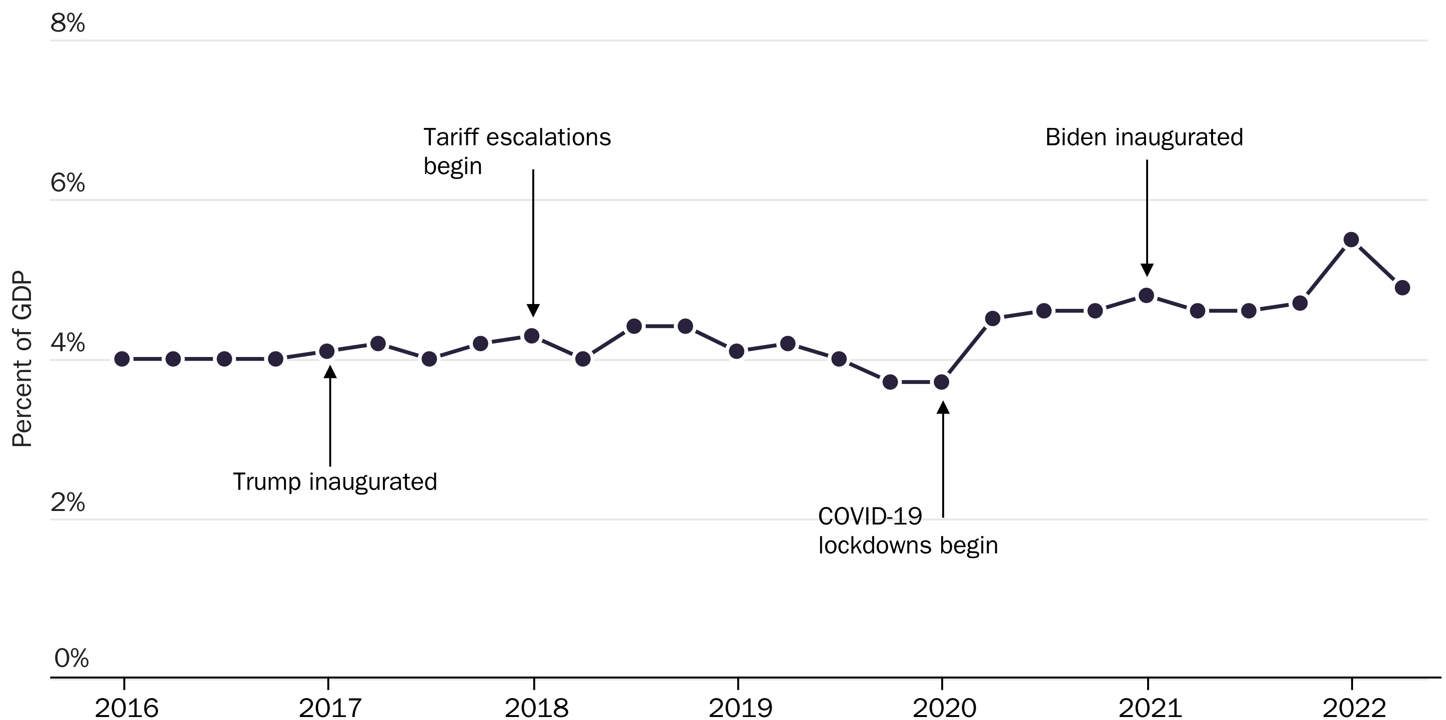
While a persistent current account surplus or deficit is a poor indicator of good or bad national trade policy, it can be a sign of underlying macroeconomic problems. The trade deficit may be higher than it optimally should be, not because of other countries' unfair practices but because of lower-than-optimal savings in the United States. Unprecedented federal budget deficits reduce the level of national savings, creating a larger trade deficit as foreign investment in Treasury bonds drives up the financial account surplus.

A nation's current account surplus can also be higher than optimal because of systemic underinvestment in its domestic economy. It has been frequently and rightly observed that Germany does not invest enough in its private economy and public infrastructure.[9] For demographic and other reasons, Germany should be a trade surplus country, but that surplus is probably higher than it should be, not because of beggar-thy-neighbor trade policies, but because the country is in urgent need of more investment in industry and infrastructure.

In sum, the current deficit reflects its attractiveness for foreign capital and is—in principle—not a cause of concern. Similarly, seen comprehensively, Germany should

Figure 2

The U.S. trade deficit in goods did not change significantly from Q1 2016 to Q2 2022, despite the Trump administration's tariffs



Sources: U.S. Bureau of Economic Analysis and Chad P. Bown and Melina Kolb, "Trump's Trade War Timeline: An Up-to-Date Guide," Peterson Institute for International Economics, June 21, 2022.

Note: The sharp increase in the U.S. trade deficit in 2022 was driven by increased demand for imports as the economy bounced back from shutdowns related to COVID-19. See Ana Swanson, "America's Trade Deficit Surged in 2022, Nearing $1 Trillion," *New York Times*, February 8, 2023.

have a current account surplus, but a slightly lower one than it has in reality.

The Meaninglessness of Bilateral Trade Deficits

When critics are not focusing on the overall trade deficit, they call attention to persistent bilateral trade deficits with key trading partners such as China and the European Union. But bilateral imbalances are even less meaningful than the general balance in trade. American citizens and firms deal with partners all over the world. There is no rational economic reason why Americans should be expected to sell exactly the same value of goods and services to people in a particular foreign nation than they buy from them.

To illustrate this point, let us conduct a thought experiment: imagine the world consists of three countries with limited but generally balanced trade. Germany is only buying oil from Saudi Arabia and only selling machines to the United States, which itself is only selling telecommunications equipment to Saudi Arabia. Germany runs a bilateral trade deficit with Saudi Arabia, Saudi Arabia with the United States, and the United States with Germany. Each country has balanced trade with the world, but deficits and surpluses with individual trading partners. The bilateral deficits can reflect perfectly normal comparative advantages and preferences.

> "Tariffs will generally succeed only in shifting bilateral deficits to other trading partners. The 'improvement' in the bilateral trade balance with China during the Trump administration was more than offset by increasing deficits with other major trading partners."

Bilateral deficits can regularly appear and disappear depending on shifting productivity and specialization among trading partners. For example, the European Union ran significant bilateral trade deficits with several East Asian emerging economies through the 1990s, but those bilateral deficits disappeared when China more fully entered the world market in the 2000s. The EU's bilateral deficit with China grew sharply after 2000 as customers and producers in the EU shifted their demand from their former East Asian suppliers to Chinese companies.[10] The shift in bilateral balances did not significantly change the EU's overall trade balance, while EU residents strongly benefitted from the lower import costs from the new market participant. This does not pose any threat or create a problem, as long as the relations do not create any dependencies that affect national security.[11]

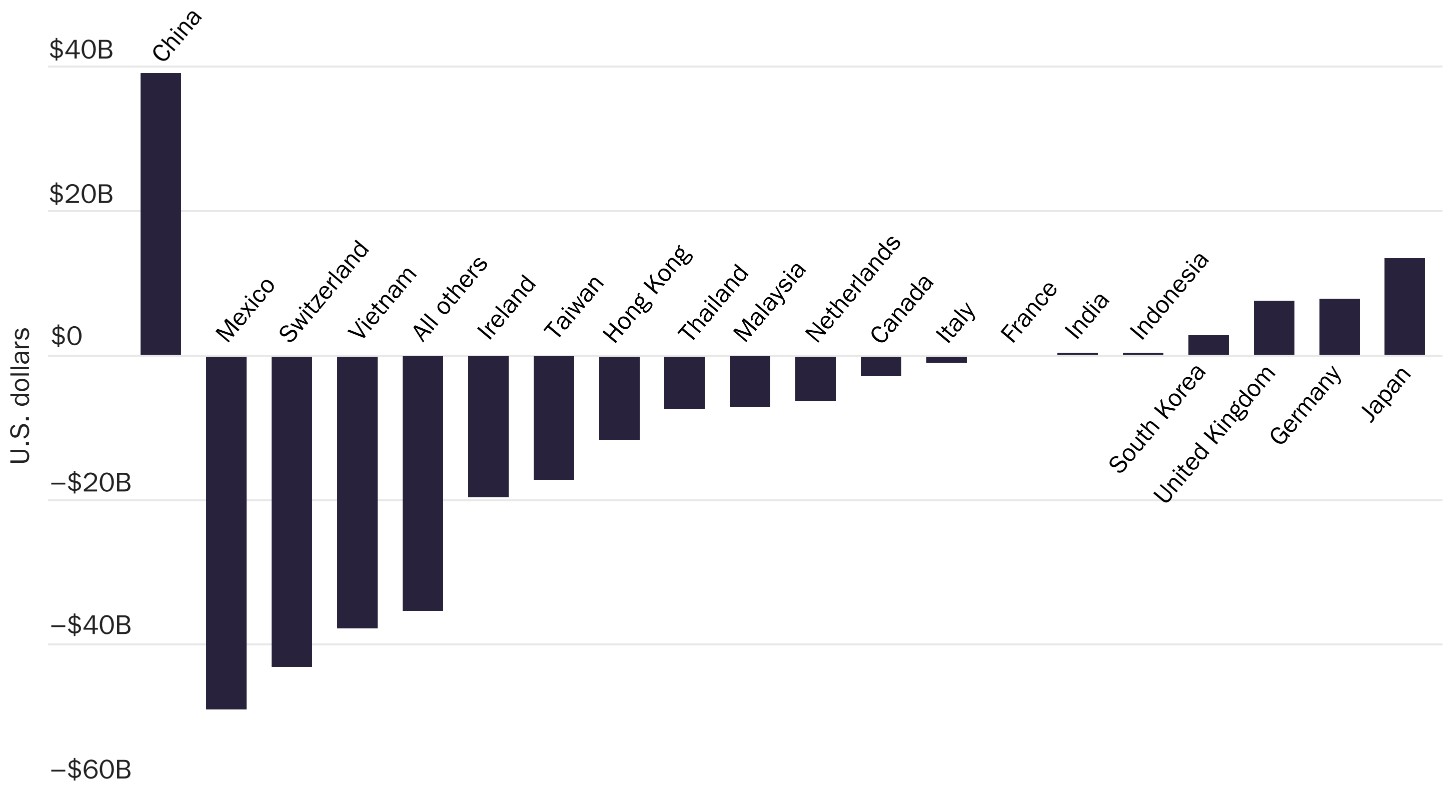
Beginning in 2018, the Trump administration imposed new tariffs on both China and the European Union. But those tariffs predictably did not reduce the overall trade imbalance and had limited impact on the bilateral deficit. Such tariffs will generally succeed only in shifting bilateral deficits to other trading partners. As Figure 3 shows, the "improvement" in the bilateral trade balance with China during the Trump administration was more than offset by increasing deficits with other major trading partners. As the bilateral goods deficit with China shrank by $38.7. billion between 2016 and 2020, the overall deficit grew by $167 billion. Bilateral deficits with Mexico and Switzerland both increased by more than $40 billion, while the combined deficit with three emerging East Asian economies—Vietnam, Thailand, and Malaysia—increased by $51.9 billion, more than offsetting the decrease in the deficit with China.

Tariffs also reduce overall trade by inviting retaliation against U.S. exports and reducing domestic purchasing power because of higher prices imposed on consumers and import-using industries. Tariffs also reduce overall trade by affecting the exchange rate: if foreigners find it more difficult to earn dollars by selling in the U.S. market, they will find it more difficult to obtain dollars to purchase American exports.

To summarize, the trade balance, as well as the current account, are not driven by trade policy measures, but by millions of individual decisions affecting the national rate of savings and investment. Those decisions drive net capital flows, which cause exchange rate fluctuations that can change the competitiveness of single firms and sectors. These changes may require policy actions affecting the general macroeconomy, but a trade balance is not a threat in itself and cannot be "fixed" with trade measures. Raising trade barriers only increases economic distortions or creates new ones without changing the overall balance of trade.

Figure 3

Change in the bilateral goods trade balance by country, 2016–2020. During the Trump administration, the decrease in the bilateral trade deficit with China was more than offset by increases in bilateral trade deficits with other countries



Source: "U.S. Trade in Goods by Country," U.S. Census Bureau, October 5, 2022.

Note: The bilateral goods deficit with France grew from $15.6 billion in 2016 to $15.7 billion in 2020.

TRADE DEFICITS AND THE U.S. INDUSTRIAL BASE

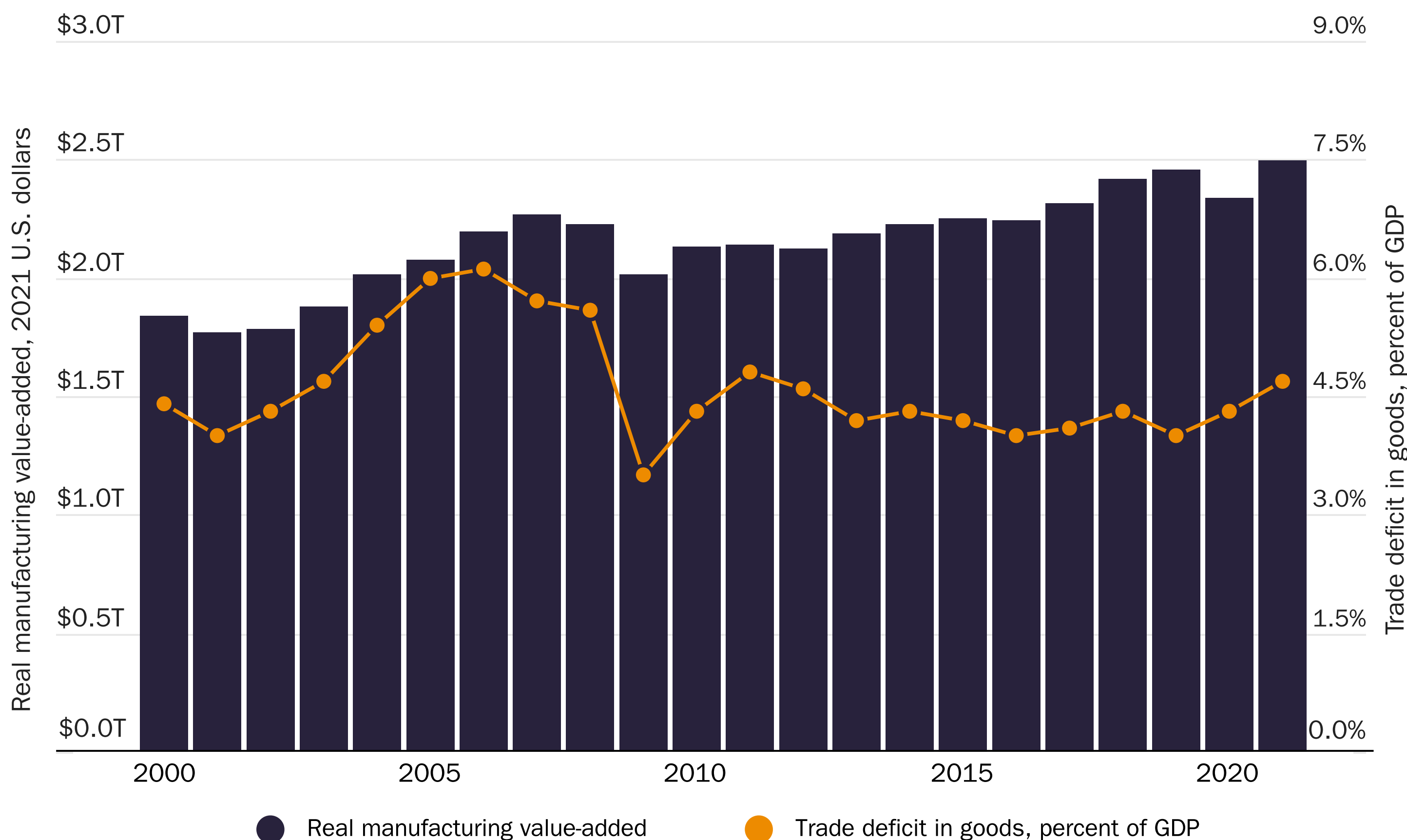
The myth endures that years of trade deficits in manufactured goods have caused a hollowing out of the U.S. manufacturing sector and, by implication, a weakening of national security. Critics of American trade policy argue that freer trade in goods has left the United States vulnerable to unfair trade practices by other nations. They charge that financially, the United States has been forced to absorb the world's excess savings and production, thus discouraging manufacturing output while driving up the value of the U.S. dollar and the trade deficit.

In reality, manufacturing output, as measured by domestic value-added, has expanded in the past two decades along with persistent annual deficits in merchandise trade. In 2021, as the merchandise trade deficit continued to exceed 4 percent of GDP, manufacturing value reached a record high of $2.563 trillion. As Figure 4 shows, real U.S. manufacturing value-added rose in the past two decades by more than a third, from $1.84 trillion in 2000 to $2.5 trillion in 2021. Meanwhile, the merchandise trade deficit as a share of GDP has fluctuated within a range of 3.5 to 6.1 percent of GDP. While certain regions of the country have seen a decline in their traditional manufacturing sectors, a persistent trade deficit is no barrier to expanding manufacturing output in the United States overall.

Critics of a more open U.S. trade policy point to ongoing deficits in certain categories such as advanced technology products (ATP).[12] According to the Commerce Department's definition of ATP, in 2021 the United States ran a deficit in the sector of $196 billion, with exports of $357 billion and imports of $553 billion. But this broad indicator fails to capture the leading role of the United States in research and development and production in a range of higher-end technology sectors. Within ATP, the United States runs surpluses in aerospace, life sciences, and electronics. The biggest deficit by far is in information and communications, which at $206 billion exceeds the overall deficit in ATP. This category includes smartphones,

Figure 4

Amidst persistent merchandise trade deficits, U.S. real manufacturing value-added expanded significantly between 2000 and 2021



Sources: "Value Added by Industry," Interactive Data, Bureau of Economic Analysis, September 29, 2022; and "Table 1.1: U.S. International Transactions," Interactive Data, Bureau of Economic Analysis, September 22, 2022.

a ubiquitous consumer technology often assembled in China—a low-skilled activity—but containing a large share of U.S. proprietary technology and value-added.[13] When actual value-added is considered, deficits in such advanced technology products shrink significantly. And, of course, American companies, such as Apple, derive massive revenues from sales of these same imported products, which they use to employ tens of thousands of Americans in engineering, management, design, marketing, and other high-skilled services.[14] Thus, the ATP trade balance says essentially nothing about the United States' actual place in the global technology ecosystem.

Neither can the persistent U.S. trade deficit be blamed for the long-term decline in manufacturing employment. The number of jobs in manufacturing as a share of overall employment has been steadily declining in the United States since the early 1950s, decades before the era of large trade deficits.[15] The primary explanation is not trade or declining output but rising productivity. As American firms increasingly automate and shift production to higher-end, more capital-intensive goods, they are able to produce more value-added with fewer workers. A more competitive manufacturing sector may, in fact, employ fewer workers because of automation and other production efficiencies.

The relative decline of manufacturing employment has played out in virtually all major trading nations, whether they typically run trade deficits or trade surpluses. In a study of 60 countries over the period 1995 to 2011, Robert Z. Lawrence, a professor of international trade and investment at Harvard University and a senior fellow at the Peterson Institute for International Economics, found that trade surpluses or smaller trade deficits do not mean more manufacturing jobs.

In fact, Lawrence found that those countries with the largest manufacturing trade surpluses actually experienced a slightly larger decline in manufacturing employment as a

share of total employment compared to countries with the largest manufacturing trade deficits:

> Of 60 countries surveyed, those with the 10 largest manufacturing trade surpluses experienced an average decline in their share of manufacturing employment in total employment of 3.8 percentage points. Surprisingly, in the countries with the 10 largest manufacturing trade deficits, the share of manufacturing employment declined by only 3.3 percentage points.[16]

Among the trade surplus countries, the share of employment in manufacturing during the surveyed time period fell by 5.4 percentage points in South Korea and by 4.9 percentage points in Germany.

> "Behind the numbers of the U.S. trade accounts is the underappreciated sophistication of the economy. American exporters are world leaders in higher-end products such as civilian aircraft, industrial machines, microprocessors, scientific and medical equipment, pharmaceuticals, and chemicals."

In addition, Lawrence found that a shrinking trade deficit or a rising surplus did not restore manufacturing jobs. Countries in which the manufacturing trade balance moved in a positive direction experienced declines in the share of manufacturing employment that were as large as the employment declines in countries in which the balance moved in a negative direction.[17]

The U.S. trade deficit may be a source or result of other challenges in the economy, as noted above, but deindustrialization is not among them. In fact, in light of the increasing geopolitical competition in the world between the West and its rivals Russia and China, the current balance of trade is arguably a symbol of enduring American strength and advantage.

HOW THE TRADE BALANCE REFLECTS U.S. STRENGTH AND INFLUENCE

Beneath the headline number of the trade deficit lies evidence of America's continued economic strength and influence in the world, including a projection of soft power in its growing competition with Russia and China. The U.S. trade balance is not a source or symptom of weakness, but a reflection of underlying strengths of America's still relatively open economic system. A more comprehensive look at America's commercial accounts with the world shows the economic sophistication of the economy, the importance of the freedom to import, its enduring attraction as a safe and profitable haven for the world's capital, and the continued dominance of the U.S. dollar—all of which enhance America's influence in the world.

The United States Specializes in High-End Goods and Services

Behind the numbers of the U.S. trade accounts is the underappreciated sophistication of the economy. American exporters are world leaders in higher-end products such as civilian aircraft, industrial machines, microprocessors, scientific and medical equipment, pharmaceuticals, and chemicals. The large domestic production capacity in these higher-end sectors is a better measure of economic strength than the misleading trade deficit in advanced technology products. In services trade, American firms are among world leaders in business services (primarily business and management consulting); research and development services; and financial services such as financial management and credit card and other credit-related services. Services such as semiconductor and artificial intelligence design, in turn, strengthen the manufacturing sector. The United States runs a large annual surplus in royalties for the use of intellectual property, chiefly for industrial processes, computer software, trademarks, and movies and television programming.[18] According to an Export Quality Index compiled by the International Monetary Fund, the United States ranked among the top 10 out of more than 160 nations surveyed. The United States tied for 6th place in the rankings, alongside trade surplus countries such as Japan and Germany. The United States ranked far ahead of China (tied for 42nd) and Russia (ranked 98th).[19]

Imports Boost American Industry and Influence

Another sign of strength in the U.S. balance of payments is the nation's openness to imports. The United States is the world's largest market for the rest of the world's exports of goods and services. Since the end of World War II, this status has enhanced America's influence over global trade rules and alliances. Access to globally priced imports also benefits consumers and domestic producers who depend on imports and global supply chains to produce competitively priced products. The economy is stronger and more resilient because of the ability of American companies to source semiconductors and other critical components from a broad range of global suppliers. This is true of the defense sector as well as private industry.

> "Tariffs enacted to reduce the trade deficit are not only economic folly but a self-inflicted sanction that weakens our ability to protect our own economic interests and project our influence in the world."

For those reasons, a trade surplus can actually betray weakness in an economy to the extent that it shows an inability to import crucial goods and commodities. In the most compelling recent example, Russia has seen its balance of payments position improve markedly since it launched its illegal invasion of Ukraine in February 2022. But the sharp drop in imports forced on it by Western sanctions has hurt both its domestic economy and its ability to prosecute the war. *New York Times* columnist and Nobel economist Paul Krugman noted this fact in a May 2022 column:

> [Russia's] surging balance of payments surplus is actually a sign of weakness, not strength—it largely reflects a plunge in Russia's imports, which even state-backed analysts say is crippling its economy. Russia is, in effect, making a lot of money selling oil and gas, but finding it hard to use that money to buy the things it needs, reportedly including crucial components used in the production of tanks and other military equipment.
>
> Why is Russia apparently having so much trouble buying essential goods? Part of the answer is that many of the world's democracies have banned sales to Russia of a variety of goods—weapons, of course, but also industrial components that can, directly or indirectly, be used to produce weapons.
>
> [. . .]
>
> Russia's trade surplus is a sign of weakness, not strength; its exports are sadly holding up well despite its pariah status, but its economy is being crippled by a cutoff of imports.
>
> And this in turn means that Putin is losing the economic as well as the military war.[20]

The lesson here for policymakers is that a trade deficit is not a sign of either economic or strategic weakness. Imports play an important role in both the civilian and military side of the economy. The fact that the military, as well as households, can source goods and services from the rest of the world is a blessing to the nation, not a weakness to be remedied. Tariffs enacted to reduce the trade deficit are not only economic folly but a self-inflicted sanction that weakens our ability to protect our own economic interests and project our influence in the world.[21]

The United States Attracts Global Investment

For reasons explained above, the trade deficit is, by its very nature, evidence of the continuing attraction of the United States as a haven for global investment. The trade deficit is made possible, and in fact driven by, a net surplus of capital investment flowing into the U.S. economy year after year. This is true of direct investment, where the investor retains a measure of control of the firm's management, but it is especially true of portfolio investment.

In recent years, the United States has run large deficits in the current account, offset by large surpluses in the financial account. As Table 1 shows, an average annual deficit in goods of $907.9 billion in the five-year period from 2017 to 2021 has been partially offset by surpluses in services trade and primary income—interest, dividends, and profits from foreign

Table 1

While the U.S. current account deficit was the largest in the world from 2017 to 2021, it was offset by the largest surplus in net foreign investment (amounts are in billions of U.S. dollars)

International transactions	United States	China	Japan	Russia	Euro area
Goods trade, balance	–$907.91	$464.57	$19.66	$151.85	$362.33
Services trade, balance	$278.37	–$212.94	–$19.60	–$26.99	$80.72
Primary income, balance	$211.87	–$79.45	$188.47	–$42.80	$75.52
Secondary income, balance	–$124.92	$4.19	–$19.21	–$7.83	–$176.56
Balance on current account	**–$542.58**	**$176.37**	**$169.31**	**$74.23**	**$342.00**
Direct investment, net	$85.92	$95.14	–$143.06	–$8.51	–$90.58
Portfolio investment, net	$182.69	$68.16	$6.08	–$8.86	–$341.73
Other investment, net	$276.46	–$108.42	$17.86	–$21.73	$166.33
Balance on financial account	**$545.06**	**$54.88**	**–$119.12**	**–$39.10**	**–$265.97**
Net errors and omissions	$8.00	–$167.76	–$5.66	$1.30	$14.53

Source: "Data Tables: 1. Balance of Payments Analytic Presentation by Country," Balance of Payments and International Investment Position Statistics, International Monetary Fund.
Note: Balances are an average of 2017–2021 to smooth annual fluctuations.

investments. The United States typically runs a deficit in secondary income, which includes foreign aid and remittances.

The mirror image of the current account deficit is the annual net inflow of foreign investment. These flows can swing sharply from year to year depending on investor sentiment, but the general trend over recent years and decades has been a net inflow of both foreign direct and portfolio investment into the United States. In the most recent five years, the net inflow of FDI to the United States, on average, has been $85.9 billion annually, accompanied by a net $182.7 billion inflow in portfolio investment. The surplus has been even higher in other investments, which include bank deposits and loans, reflecting the strength of the U.S. banking sector.

The financial account surplus demonstrates confidence in the United States as a haven for global savings. Foreign investment keeps interest rates lower in the United States than they would be otherwise and provides capital to launch new businesses, to fuel research and development, and to expand output for existing firms. The United States remains the world's top recipient of global investment. As a comparison of balance of payment data in Table 1 shows, the United States is indeed an outlier in running a large current account deficit compared to the other main geostrategic powers. But the United States is also an outlier in its ability to attract a large net inflow of portfolio investment and other investments year after year.[22]

Another strength of the economy is the relative profitability of U.S. investments abroad. In the past five years, the surplus on primary income has averaged $212 billion a year. Only Japan is close to the United States in generating this net stream of income year after year on its overseas investments. And those investments abroad enable American producers to reach a much wider market for their goods and services. According to the most recent data, U.S.-owned affiliates abroad sell more than 88 percent of their goods and services in local or third-nation markets, not in exports back to the United States.[23]

America's net earnings from abroad are all the more impressive considering that the stock of foreign-owned investment in the United States is larger than the stock of American-owned assets abroad. At the end of 2021, foreigners owned $53.2 trillion of assets in the United States, compared to the $35.1 trillion of assets Americans owned abroad.[24] Yet Americans have reaped a larger annual average return from their overseas investments than what they have paid out to foreign investors in the United States.

One explanation for this seeming paradox is that foreign investors are willing to accept a lower return on their

U.S. assets in return for the greater security and liquidity they enjoy from investing in the United States. Foreign investors are attracted by the sophisticated, huge, and comparatively free U.S. financial markets and—despite recent strains—the still strong institutions and rule of law in the United States. This is why investment in the United States and the value of the dollar tend to strengthen in times of global crisis or uncertainty, including our current moment. The abiding confidence of global investors remains one of America's greatest national assets—and the trade balance is a symptom of that strength.

The U.S. Dollar Remains the World's Dominant Currency

Another strength of the United States revealed in the trade data is the continued global attractiveness of the U.S. dollar as a medium of exchange and a store of value. Nearly 60 percent of the world's known currency reserves held by central banks are in dollars. That share is down about 10 percentage points in the last decade, but the dollar is still the world's dominant currency. The next most popular currency for reserves is the euro, at 21 percent. The Chinese renminbi has been growing as a reserve currency, but its share remains small because of China's lack of commitment to transparency and economic reform and a relatively closed capital account that does not allow easy convertibility to other currencies.[25]

> "The importance of the dollar enhances the government's ability to enforce sanctions against Russia, Iran, and other rogue regimes by restricting access to dollar denominated loans and commercial transactions."

The dollar also remains the world's most popular currency for global trade. According to the Federal Reserve, between 1999 and 2019, the dollar accounted for 96 percent of trade invoiced in the Americas, 74 percent in the Asia-Pacific, and 79 percent in the rest of the world. The lone exception is Europe, where the euro predominates.[26]

American paper currency is one of America's top exports. According to the U.S. Federal Reserve Board, in the first quarter of 2021, foreigners held $950 billion in U.S. currency notes. In fact, foreigners hold 45 percent of all paper U.S. currency, including two-thirds of all $100 bills. Those bills are especially attractive in countries suffering from financial instability and for people who want to hide their transactions from local authorities. For Americans, the bills represent an interest-free loan from the world. It also saves the federal government about $20 billion to $30 billion a year in interest that does not need to be paid. If the dollars remain in circulation abroad indefinitely, Americans have received hundreds of billions in goods and services from the rest the world in exchange for pieces of paper that cost a small fraction of that to produce.[27]

A strong dollar can negatively impact the bottom line of U.S. exporters and multinational companies, but it also benefits American consumers and import-consuming businesses. For the nation as a whole, the strength of the dollar reflects the continued attractiveness of the United States as a relatively stable haven for global savings. The importance of the dollar also enhances the government's ability to enforce sanctions against Russia, Iran, and other rogue regimes by restricting access to dollar-denominated loans and commercial transactions.

CONCLUSION: BUILDING ON AMERICA'S STRENGTH

A broader understanding of the causes of the U.S. trade deficit and the underlying strength of the U.S. commercial relations with the rest of the world should discourage policymakers from raising barriers to international commerce. Interventions such as tariffs on imports and taxes on foreign capital flows would deny Americans the benefits of engagement in the global economy while curbing U.S. influence on the world stage.[28]

A more open economy would both stimulate economic performance while strengthening our ties to allies and increasing our influence in the world. This had been a consensus in Washington in the decades after World War II, but it is worth renewing our national commitment as tensions continue to rise with rivals such as China and Russia. A commitment to openness would strengthen channels of influence such as robust U.S. exports and imports, the continued attractiveness

of the United States as a home for foreign investment, and the strength and appeal of the U.S. dollar as the world's most important currency.

> "Policymakers should resist any effort to impose taxes on international investment flows or new regulations that would unnecessarily restrict either incoming or outgoing direct investment."

Specifically, the president and Congress should work together to keep the economy open to global commerce. Congress should pass laws to lower barriers to trade and investment while the president should lift tariffs that have been administratively imposed so that American firms and households can import goods at more competitive prices. The president should also pursue trade agreements with other countries that are willing to eliminate virtually all bilateral barriers to commerce. This would include seeking to join the Comprehensive and Progressive Trans-Pacific Partnership, which would open markets while deepening U.S. ties to nations in East Asia, and striking bilateral agreements with other major trading partners and allies such as the United Kingdom.[29]

If policymakers are concerned about the trade deficit, they should seek to use policy levers that would more directly influence the balance of trade. One such lever would be to reduce the federal government's huge annual budget deficit, which reduces the level of national savings and competes with U.S. exports and foreign investment for international dollars. Policymakers in Washington should work together to curb the growth in federal spending, including entitlements, while reforming the federal tax code to promote private-sector savings. A smaller federal budget deficit will not necessarily lead directly to a smaller trade deficit—levels of private savings and investment are also important factors—but it would make the United States relatively less dependent on foreign savings to fund domestic investments.[30]

As for the U.S. dollar, policymakers can commit to policies that keep U.S. capital markets relatively free and liquid and that maintain the dollar's full convertibility. They should resist any effort to impose taxes on international investment flows or new regulations that would unnecessarily restrict either incoming or outgoing direct investment. Any changes to the Committee on Foreign Investment in the United States should be aimed at well-defined concerns about national security. The Federal Reserve Board should seek to lower inflation and maintain the currency's stable value.

The economic arguments for an open economy are deeply rooted and amply supported by current evidence and analysis. When looking at the balance of trade, we can add to these arguments the strong role of commercial relations in promoting America's interests and influence abroad at a time of rising global challenges.

NOTES

1. See, for example, Nick Timiraos, "Trump Adviser Peter Navarro: Trade Deficits Endanger U.S. National Security," *Wall Street Journal*, March 6, 2017; and Jeff Cox, "China Trade Deficit Has Cost the US 3.7 Million Jobs This Century, Report Says," CNBC, January 2020.

2. See Caroline Freund, "Three Ways to Reduce a Trade Deficit," Peterson Institute for International Economics, November 6, 2017; and Gregory Mankiw, "Surprising Truths about Trade Deficits," *New York Times*, October 7, 2018.

3. It is important to note that the current account consists of several sub-balances: trade in goods; trade in services; income on assets held abroad (or held by foreigners in the United States); and transfers (mostly official development aid and remittances).

4. Paul R. Krugman, "Competitiveness: A Dangerous Obsession" *Foreign Affairs*, March/April 1994, pp. 29–44.

5. Scott Lincicome, "In Praise of Foreign Direct Investment–(Almost) All of It," *The Dispatch*, April 14, 2021.

6. Francis E. Warnock and Veronica Cacdac Warnock, "International Capital Flows and U.S. Interest Rates," National Bureau of Economic Research Working Paper no. 12560,

October 2006; and Tilahun Ayanou, "Foreign Capital Inflows to the USA and Mortgage Interest Rates," *Journal of Housing Economics* 34 (December 2016): 1–14.

7. Caroline Freund, "Countries with Higher Tariffs Have Larger Trade Deficits," Peterson Institute for International Economics, May 8, 2017.

8. "Trade in Goods with World, Not Seasonally Adjusted," U.S. Census Bureau, November 3, 2022.

9. See, for instance: Maurice Obstfeld, "Eine Bedrohung der globalen Finanzstabilität," *Welt*, August 6, 2018.

10. Andreas Freytag, "Should Europe Really Worry about Its Trade Deficit with China?," *VoxEU*, May 19, 2008.

11. Such dependencies have become obvious during the Russian aggression toward Ukraine. However, they have nothing to do with trade balances but with trade structures. The lesson is not to aim at reducing a bilateral trade deficit, but to diversify the supply chains—both for firms and for countries. As a side effect, such diversification may affect bilateral balances.

12. See, for instance, Oren Cass, "Chipping Away at Globalization Is a Smart Move," *CNN*, July 27, 2022; and Oren Cass, "Putting Dynamism in Its Place," *National Affairs* 39 (Spring 2019): 3–17.

13. B. Ravikumar and Brian Reinbold, "Is Value-Added Trade a Better Measure of Global Trade?," *On the Economy* (blog), Federal Reserve Bank of St. Louis, April 9, 2019.

14. Scott Lincicome and Alfredo Carrillo Obregon, "The Case for Free Trade Remains Inside Your Pocket," *Cato at Liberty* (blog), Cato Institute, September 9, 2022.

15. Daniel Griswold, "Fail or Flourish: American Workers, Globalization, and Automation," Mercatus Center, January 2020, pp. 17–19.

16. Robert Z. Lawrence, "Manufacturing Employment Declined More in Countries with Large Trade Surpluses than Deficits," Peterson Institute for International Economics, October 7, 2020; and Robert Z. Lawrence, "Trade Surplus or Deficit? Neither Matters for Changes in Manufacturing Employment Shares," Peterson Institute for International Economics, Working Paper 20-15, September 2020.

17. Robert Z. Lawrence, "Will Smaller Trade Deficits Bring Back Manufacturing Jobs?," *Trade and Investment Policy Watch* (blog), Peterson Institute for International Economics, September 17, 2020.

18. Daniel Griswold, "Plumbing America's Balance of Trade," Mercatus Center, March 2017, pp. 9–11.

19. "Export Diversification and Quality Index," IMF Data, International Monetary Fund, July 7, 2017.

20. Paul Krugman, "How the West Is Strangling Putin's Economy," *New York Times*, May 19, 2022.

21. This argument was pithily summarized by the 19th-century American reformer Henry George, who wrote: "What protection teaches us, is to do to ourselves in time of peace what enemies seek to do to us in time of war." Quoted from Henry George, *Protection and Free Trade* (New York: Doubleday, Page & Company, 1905).

22. For balance-of-payment figures for individual economies, see "Data Tables: 1. Balance of Payments Analytic Presentation by Country," Balance of Payments and International Investment Position Statistics, International Monetary Fund.

23. Zhi Wang et al., "Tracing Value Added in the Presence of Foreign Direct Investment," National Bureau of Economic Research, Working Paper no. 29335, October 2021.

24. "U.S. International Investment Position, Fourth Quarter and Year 2021," news release, U.S. Bureau of Economic Analysis, March 29, 2022.

25. Serkan Arslanalp, Barry Eichengreen, and Chima Simpson-Bell, "Dollar Dominance and the Rise of Nontraditional Reserve Currencies," *IMF Blog*, International Monetary Fund, June 1, 2022.

26. Carol Bertaut, Bastian von Beschwitz, and Stephanie Curcuru, "The International Role of the U.S. Dollar," FEDS Notes, Board of Governors of the Federal Reserve System, October 6, 2021.

27. Christopher J. Neely, "The Innocent Greenbacks Abroad: U.S. Currency Held Internationally," *On the Economy* (blog), Federal Reserve Bank of St. Louis, October 18, 2022.

28. See, for example, Michael Stumo, "How to Bound the American Market," American Compass, April, 1, 2022; and Competitive Dollar for Jobs and Prosperity Act, S. 2357, 116th Cong. (2019).

29. See Daniel J. Ikenson, Simon Lester, Scott Lincicome, Daniel R. Pearson, and K. William Watson, "Should Free Traders Support the Trans- Pacific Partnership? An Assessment of America's Largest Preferential Trade Agreement," Cato Institute Working Paper no. 39, September 12, 2016;

and Daniel Griswold, “Leading the Way with a US-UK Free Trade Agreement,” Mercatus Center, October 30, 2018.

30. The link appeared to be strong with the “twin deficits” in the mid-1980s. Under the Reagan administration, the United States reduced tax rates and deregulated, thereby increasing the budget deficit and attracting foreign capital, which had the effect of increasing the current account deficit. But since then, there has been no discernable relationship between the fiscal and current account balances. As a rule, everything else being equal, a reduction of the budget deficit will lead to a diminished, or even zero current account deficit. See Barbara Dluhosch, Andreas Freytag, and Malte Krüger, *International Competitiveness and the Balance of Payments* (Cheltenham, UK: Edward Elgar, 1996), p. 144ff; and Carl Zulauf and David Orden, “America’s Twin Deficits since 1980,” Farmdoc Daily, Department of Agricultural and Consumer Economics, University of Illinois at Urbana–Champaign, January 25, 2019.

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