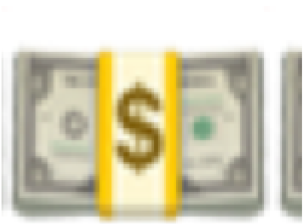

The Upside of a Balance of Trade Deficit

[Update December 3: sometime this week I expect to add to this article including international income accounting details.]

Taiwan's Foxconn announced they will build a $10 billion factory in Wisconsin. Eventually the plant will employ 10,000 workers. Part of the reason Foxconn can make this investment is the U.S. balance of trade deficit with Taiwan. That deficit creates a net financial inflow into the U.S. Some of that inflow will be the Foxconn plant. In the financial account this is recorded as "foreign direct investment" (FDI).

The current account balance plus the capital account balance must equal the financial account balance. This is the fundamental international economic accounting identity. Luckily for us, the capital account balance is usually pretty small. That lets us focus on the current account and the financial account. And the result is straightforward, if not widely understood: a current account deficit must be matched by a financial account surplus. The U.S. runs a current account deficit vis-à-vis Taiwan. Therefore, we must run a financial account surplus vis-à-vis Taiwan.

The implications are staggering, but we need to understand some details first. So go get another cup of coffee – studying accounting always puts me to sleep. And remember, this is accounting. All the relationships described here are identities and definitions. In what follows the U.S. will be the home country and Taiwan will be the foreign country. To avoid repeating the tedious phrase “goods and services” let’s just call them “products.”

Balancing Act

Each account has a balance. For example, most of the current account balance is the balance of trade, equal to exports minus imports. Exports are products produced in the U.S. and sold in Taiwan. An export creates a flow of a product from the U.S. to Taiwan AND a flow of spending from Taiwan to the U.S. Similarly, imports are products produced in Taiwan and sold in the U.S. An import creates a flow of a product from Taiwan to the U.S. AND a flow of spending from the U.S. to Taiwan.

But what about the financial account? For accounting purposes, what matters is the flow of spending. An export creates a flow of spending from Taiwan to the U.S. The financial account equivalent is the purchase of a U.S. asset by a Taiwanese entity. Thus, when Sony bought Columbia Pictures Entertainment in 1989 that created a financial inflow (debit entry) for the U.S. Putting it bluntly, a country finances it’s trade deficit by selling assets to foreign countries. (As an aside, some economists argue that the U.S. has a comparative advantage at creating assets. If they’re correct, running a balance of trade deficit is actually a good strategy.)

For example, suppose you are vacationing in Belize. You drop into a bar on Secret Beach and buy a beer for $2.50. Like many small tourist destinations, Belize accepts U.S. dollars as well as their currency, the Belize dollar. Because you are not a resident of Belize, your purchase counts as an import to the U.S. An increase in imports increases both the balance of trade deficit and the current account deficit. Offsetting this transaction is the $2.50 the bar now has – an asset for the Belize financial account and a liability for the U.S. financial account.

Current, Capital, and Financial Account Balances

A current account deficit must be matched by a (roughly) equal net sale of home assets to the foreign country. Those can be real estate, U.S. government securities, and many other physical and financial assets. The proposed Foxconn project is FDI. The numerous vehicle assembly lines built by BMW, VW, Toyota, Honda, and others are also FDI. And FDI creates jobs in America. ("Investment" as used by economists means physical capital. Foxconn building a new factory in the U.S. is investment. Foxconn buying $100 million in U.S. government securities is not investment, but is still recorded as a financial account transaction.)

At least since 2003 the U.S. has run consistent balance of trade deficits vis-à-vis Taiwan. These have ranged from $5.4 billion to $15.2 billion. (The mean over that period was $10.4 billion.)

In 2016 the current account deficit was $21.2 billion. That means Taiwan residents – businesses, individuals, government agencies – bought roughly $21.2 billion in U.S. assets. About $0.3 billion of that was FDI. (The current account balance is the balance of trade plus net income receipts. In 2016 net income receipts were –$12.4 billion.)

The Statistical Discrepancy

Measuring these variables is difficult. It's even harder because of smuggling and other illegal activities. For example, suppose someone arrives at a U.S. airport with checked luggage containing $100,000 in hundred dollar bills. That will probably not be measured in the balance of payments accounts.

That's why there is always a statistical discrepancy, the difference between the current account balance and the financial account balance. This item has many names, some of which are not suitable for printing here. “A measure of our ignorance” is pretty good, however. The books have to balance. The statistical discrepancy takes care of that.

	A	B	C
1	**Table 1.2. U.S. International Transactions, Expanded Detail**		
2	[Millions of dollars]		
3	Bureau of Economic Analysis		
4	Release Date: September 19, 2017 - Next Release Date: December 19, 2017		
5			
6	**Line**		**2016**
7		**Current account**	
8	**1**	**Exports of goods and services and income receipts (credits)**	**$3,157,241**
9	2	Exports of goods and services	$2,208,072
10	23	Primary income receipts	$813,977
11		Secondary income (current transfer) receipts /2/	$135,192
12	**31**	**Imports of goods and services and income payments (debits)**	**$3,608,926**
13	32	Imports of goods and services	$2,712,866
14	52	Primary income payments	$640,751
15	58	Secondary income (current transfer) payments /2/	$255,309
16		**Capital account**	
17	**59**	**Capital transfer receipts and other credits**	**$0**
18	**60**	**Capital transfer payments and other debits**	**$59**
19		**Financial account**	
20	**61**	**Net U.S. acquisition of financial assets excluding financial derivatives (net increase in assets / financial outflow (+))**	**$347,891**
21	62	Direct investment assets	$311,581
22	65	Portfolio investment assets	$40,638
23	70	Other investment assets	-$6,418
24	75	Reserve assets	$2,090
25	**84**	**Net U.S. incurrence of liabilities excluding financial derivatives (net increase in liabilities / financial inflow (+))**	**$741,394**
26	85	Direct investment liabilities	$479,415
27	88	Portfolio investment liabilities	$237,367
28	93	Other investment liabilities	$24,612
29	**99**	**Financial derivatives other than reserves, net transactions /3/**	**$15,817**
30		**Statistical discrepancy**	
31	**100**	**Statistical discrepancy /4/**	**$74,059**
32		**Balances**	
33	**101**	**Balance on current account (line 1 less line 31) /5/**	**-$451,685**
34	102	Balance on goods and services (line 2 less line 32)	-$504,794
35	105	Balance on primary income (line 23 less line 52)	$173,226
36	106	Balance on secondary income (line 30 less line 58)	-$120,117
37	**107**	**Balance on capital account (line 59 less line 60) /5/**	**-$59**
38	**108**	**Net lending (+) or net borrowing (-) from current- and capital-account transactions (line 101 plus line 107) /6/**	**-$451,744**
39	**109**	**Net lending (+) or net borrowing (-) from financial-account transactions (line 61 less line 84 plus line 99) /6/**	**-$377,686**

US international accounts 2016 (click for larger image)

U.S. Bureau of Economic Analysis, “Table 1.2 U.S. International Transactions, Expanded Detail,” (accessed October 25, 2017).

Business Fixed Investment

The same economists who know the relationship between the current account and the financial account will also tell you that attributing any single FDI event to the current account balance is, well, foolish. But consider the counterfactual.

If U.S. trade with Taiwan had been balanced (current account balance equals zero), there would not have been excess dollars in Taiwan that needed to be used to buy something. Without the trade deficit, it’s unlikely that Foxconn would invest in Wisconsin.

A country’s business fixed investment involves putting up buildings and stocking them with all sorts of office and factory equipment. This investment is financed by a country’s savings. Financial intermediaries channel those savings to investments through many channels: loans, mutual funds, direct stock purchases, bonds, and so on. The three sources of savings are personal, government, and foreign. (A government budget surplus adds to savings, while a deficit subtracts.)

We know U.S. residents don’t save very much. And the last government budget surplus was in 2000. Since 1971 the U.S. has run an international current account deficit for all but seven years. But that means we have experienced a net international financial account inflow. This has kept U.S. business fixed investment growing. Since 1991 U.S. net investment has grown by 2.2 percent per year. For better or worse, the net financial inflow has also partly financed the government budget deficit.

Business fixed investment is important. It creates new buildings (residential and nonresidential construction), puts office equipment and machines into the nonresidential buildings (equipment acquisition) and creates intellectual property (yes, IP is included in the national income accounts as part of investment spending). All of this is business fixed investment. New buildings and equipment improve productivity, leading to higher wages. New equipment is often technologically superior to items it is replacing, This also increases productivity. Eighty years ago John Maynard Keynes developed the idea of the investment multiplier: a dollar spent on business fixed investment actually increases total GDP by more than one dollar.

If we balanced the current account, we would also balance the international financial account. And U.S. business fixed investment would grow at an even slower rate than has been the case in recent years. Is that really what we want?