

## 2020, WEA OnLine Conference

### TRADE WARS Economic, political and theoretical implications

Discussion Forum from 5th October to 5th December, 2020

#### America's Trade Deficits Blame U.S. Policies – Starting with Tax Laws

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**ABSTRACT:** This conference paper is a follow up to American Trade Deficits and the Unidirectionality Error, (Austin, 2019) which explained that main-stream economists have badly misunderstood or misrepresented the cause of U.S. trade deficits.

For over 15 years, the United States has been locked in an escalating and seemingly endless trade war with political allies and adversaries. Whatever the cause, the consequences of U.S. trade deficits<sup>3</sup> have been stark. The deficits helped hollow out American industrial capacity and substantially reduced job creation. This paper makes no political prognosis about changes in U.S. trade policies, but Covid-related supply-chain disruptions have exacerbated these tensions.

The paper shows why reducing American trade deficits requires American policy changes, rather than actions by its trading partners, as is commonly assumed. The only feasible policies to “re-shoring” manufacturing and reduce trade deficits must reverse the policies and incentives that initially drove off-shoring and the deficits. That means reducing the financial inflows that are the root cause of trade deficits. Any other policies are futile and must logically fail. But directly reducing such inflows has been previously unacceptable to American elites and policymakers.

Trade imbalances must equal their financing. That is an immutable identity. But the direction of causality has changed in recent decades. Today, U.S. trade deficits are caused by large and persistent inflows of foreign financing (savings). Because the economics profession’s balance-of-payments theories are based on outdated premises, they mislead policymakers and the public.

Some countries deliberately seek trade surpluses to stabilize and grow their own economies. While U.S. officials complain, those countries walked through doors that the American Government opened and adamantly refused to allow to shut. The best examples are perverse tax incentives for financial inflows, such as 26 CFR §1.895-1 and 26 U.S.C §871(h)(1) that increase the trade deficit. The United States even attracts these inflows by helping foreigners conceal their American income from their home tax authorities.

Effective American policies to reduce U.S. trade deficits will reduce trade surpluses elsewhere. That will implicitly force structural adjustments to reduce the Global Savings Glut at its sources.

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<sup>1</sup> The author has no conflicts of interest regarding any institutional affiliations and material in this paper.

<sup>2</sup> The author would like to thank, among others, John Hansen, Michael Joffe, John Mueller, Matthew Klein, Michael Pettis, Amir Sufi, Ludwig Straub, Atif Mian, Warren Coats, Rich Danker, and Kurt Schuler for helpful comments and criticisms. Any remaining errors are strictly the fault of the author.

<sup>3</sup> The term “trade deficits” is used throughout for the sake of simplicity. The more inclusive term “current account,” includes other transactions and services, but is less intuitive for non-economists. Similarly, we ignore the relatively tiny “capital account” (new definition) currently lumped into the new “Capital and Financial Accounts.”

## Section I: Introduction

For over 15 years, the United States has struggled with large and unwanted trade deficits and the consequent decline of its industrial base. The deficits were the result of a combination of two factors: a global glut of savings, and policy choices by U.S. authorities to passively allow other countries to vent those surplus savings in U.S. financial markets. Either one, without the other, would not have caused the deficits.

Many mainstream economists still fail to fully accept that all external balances are determined simultaneously (Austin 2019). That may be why the United States still allows and even privileges the financial inflows that overvalue the dollar and finance the trade deficit. However, the Covid pandemic has altered the U.S. political calculus. In particular, offshoring and increased import penetration has reduced America's one-time near self-reliance and hampered its ability to scale up production of critical supplies (Chuin-Wei, 2020) (Bradsher, 2020) (Gibson, 2020). It is possible that the United States could be pushed to make radical policy changes. But only policies that reverse the macroeconomic conditions and incentives that caused offshoring and trade deficits will accomplish the desired results. This paper will explain that to accomplish these goals, policies must reduce the large financial inflows that finance the deficits.

This paper is strongly influenced by the insights of Hobson. Before Keynes, there was the proto-Keynesian John A. Hobson. Not always remembered today, Hobson was the self-confessed economic heretic who is the true father of the modern idea of insufficient aggregate demand.

Keynes built on Hobson's work and improved upon it in some ways, but neglected some aspects of Hobson's work and even regressed. Today, concern over secular stagnation has given new relevance to Hobson's seminal work, The Physiology of Industry (Mummery & Hobson, 1889).

In particular, here are three Hobsonian points that have been lost or neglected by Keynes and his mainstream successors.

1. Surplus savings are savings greater than needed to fund productive investment. Oversaving can be structural and persistent, as well as cyclical. Income concentration is a primary cause of oversaving.
2. Surplus savings fund bad investment or waste, household debt, cause recession or stagnation.
3. Surplus savings can be exported.

Hobson developed the last point in his theory of imperialism (Hobson, 1902). He called the growth of excess savings the "taproot of imperialism." But a century after oversavings drove new colonial acquisitions, the export of savings manifests itself in a very different manner, focused on the United States. A second curious contrast is that this time, a large portion of the surplus savings originate in developing countries that previously were the conquests of the 19<sup>th</sup> century imperialists.

Because mainstream economists have not fully and clearly accepted the three Hobsonian points, or accept them only in the breach, their analysis is often inappropriate to the facts. Standard macroeconomic models assume capital/savings are scarce. However, when a country has a savings glut, whether domestic or imported, such models do not work. Policy recommendations derived from those models are unlikely to work either.

Shrinking the U.S. trade deficit requires cutting the inflows of foreign savings that finance them. The actual remedies are simple; repeal the special tax exemptions that attract foreign money. Then require foreigners to pay taxes on the income from their American financial assets either to

their home countries or to the American government. Give them national treatment. If they do not go away, give them less favorable treatment until the deficits are reduced or balanced.

This is intended as a nontechnical analysis aimed at noneconomists and a basic review for economists that explains common analytical errors in standard analyses. It emphasizes why only policies that reduce financial inflows can effectively reduce trade deficits.

This paper will build on groundbreaking insights from (Mian, et al., 2020) and (Klein & Pettis, 2020). The empirical work of Mian et al, confirms the anecdotal evidence that high domestic and imported savings financed an enormous and unsustainable increase in debt among poor and middle-class Americans. More surprising, the high levels of available financing are associated with weak real investment. Klein and Pettis explore the domestic institutions and policies that actually explain savings gluts.

## **Section II: Financial Flows and Trade Imbalances**

Noneconomists, if they think about it at all, might believe that international financial and trade balances are unrelated to one another. Nothing could be further from the truth. Without financing (including transfers), the only way to pay for imports is with exports and the only way to accept payment for exports is by accepting imports: trade must be balanced to the penny.

We intuitively understand that to spend more than we earn, we must borrow the difference. What is very surprising and counterintuitive is that trade surpluses **must** be financed by lending the difference. If a trade-surplus country spends all of its export revenues on imports, its trade surplus vanishes. That is why trade surpluses **must** be financed. If the exporter keeps any export revenue, even as dollars saved under mattresses, that is a form of lending. If, and when, the exporter spends the cash, it calls in the loan. Conversely, if a foreign country wishes to save dollars (or repay dollar debt), it must run a trade surplus to obtain the dollars.

When foreigners lend to America, they typically exchange their own currency for dollars or use their dollar export earnings to buy U.S. bonds or make deposits in U.S. banks. This finances the U.S. trade deficit and, by one mechanism or another, the trade deficit adjusts to match its financing. Most commonly, the financing raises the relative value of the dollar and American goods, and makes American manufacturing less competitive.

Subsidies, trade deals, import quotas and tariffs can change the commodity composition of trade, protect key industrial sectors, and alter bilateral balances, but cannot reduce trade deficits unless they reduce financial inflows. Similarly, one cannot have net financial inflows without incurring trade deficits. Assertions to the contrary are fantasy.

## **Section III: Savings and Investment**

Capitalism is distinguished from other economic systems by its ability to mobilize savings into productive capital (goods and services that produce more goods and services); hence the name “capitalism.”

Capital investment, and the technologies embodied in it, have been major drivers of economic growth for *at least* the last 300 years. Not only does capital contribute to the income of its owners, but according to standard economic growth theory, it increases the productivity and income of workers, as well as labor’s *share* of total income. Thus, the more capital that is accumulated, the greater the general prosperity.

Economists have traditionally regarded capital and savings as perpetually scarce. “Tradition” is

used literally here, “the transmission of customs or beliefs from generation to generation, or the fact of being passed on in this way.” Historically, capital scarcity was the normal condition of society as observed by the classical economists, such as Adam Smith. Over the generations, capital scarcity has become folk wisdom among many economists and policymakers. Today however, there is concern about a contrary problem: “a savings glut.”

This has important policy implications. If saving rates are low relative to available investment opportunities, then policies that boost savings promote growth. Such policies match the self-interest of those who need to save or are able to save a large proportion of their income and those who derive a large portion of their income from previous savings (including inheritances).

But policies intended to encourage capital accumulation and growth often are ineffective or even counterproductive. One reason is that the underlying analysis is riddled with “terminological inexactitudes,” or what logicians would call “Fallacies of Ambiguity.” The term “investment” has multiple definitions that often cause confusion and sloppy reasoning, even among well-respected economists. These definitions are important, not only for economists’ formal models, but, for the “mental models” that people use to visualize the economy. To understand the financial flows that cause trade imbalances, several precise definitions must be laid out.

Definition #1 (I<sub>#1</sub>): The type of “*Investment*” politicians and policymakers want to make the economy grow faster is “*expenditure on new productive capacity.*” This is “*real investment.*”

In the GDP statistics of the National Income and Product Accounts, investment expenditures is a slightly broader category that also includes business inventories. This definition is essentially a residual category.

Definition #2 (I<sub>#2</sub>): “*Investment*” is all final production that is not classified as something else, including unsold goods. Definition #2 can be divided into two subcategories:

- #2a (I<sub>#2a</sub>): “*Profitable investment*” or “*Desired investment.*”
- #2b (I<sub>#2b</sub>): “*Unprofitable investment*” or “*Undesired Investment.*”

I<sub>#2b</sub> could also be called “Unsustainable Investment” because firms will reduce their output or investment to eliminate it.

Keynesian tradition is to consider #2b to be excess inventories of goods. A more Hobsonian approach includes investment in excess capacity that is misallocated or unneeded because effective demand is insufficient to justify increased productive capacity. This broader definition corresponds better to recent experiences, for example the dot-com bubble of the late 1990s or the excess capacity of China’s state-owned enterprises.

These strict economic definitions exclude the purchase of *existing* capital or land which transfers the ownership of capital rather than creating more.

There is another type of “investment” in common parlance that is very different from the economic definitions above. But first we must define saving.

“*Saving*” is that portion of current disposable income not spent on consumption. It provides the financing and resources to create productive capital. Low saving restricts investment. This leads us to another definition of investment.

Definition #3: “*Financial investment*” is the transfer or allocation of savings among financial instruments and individuals.

Financial investment is a very misleading term, because it falsely implies a direct increase in the capital stock. An “investment” in the stock market or bank certificate of deposit does not add to the stock of productive capital. The former is just an exchange of bank deposits for equities and the latter is just a loan to the bank. It’s up to the bank how it’s used. The bank may use it to finance productive business investment, consumer lending, or excess reserves. Consumer borrowing and spending is an act of dissaving that cancels out the original act of saving. Because of the potential dissaving, it cannot be assumed that a new act of saving or inward transfer of savings will finance new capital investment; it could alternatively could finance dissaving.

Similarly, the term “financial capital,” or even the term “capital” used in that sense, is deceptive or ambiguous if it falsely implies real capital.<sup>4</sup> The financial inflows that cause trade deficits are incoming transfers of savings, not expenditures on productive investment as included in the definition I<sub>#2a</sub>. This is not nitpicking or pedantry. In the U.S. case, very little incoming “*foreign investment*” directly contributes to the America’s stock of real capital. Even what the United States statistically classifies as “Foreign Direct Investment” (FDI) is largely something else. Usually, only three to four percent of FDI involves the establishment or expansion of U.S. businesses (U.S. Bureau of Economic Analysis, 2020). The rest is paper investment, largely bank deposits used to acquire control of existing U.S. businesses and their existing real capital. In many countries, the meaning of FDI may be even more dubious and less connected to real economic activity (Blanchard & Acalien, 2016).

#### **Section IV: Savings Gluts and International Financial Flows**

If the idea of surplus savings seems counterintuitive, desiring a trade surplus should be even more counterintuitive.

- A trade-surplus country consumes *less* than its income; it has a lower standard of living.
- If savings are scarce, then exporting precious savings is a burden.

The true benefit of the trade surplus is the economic stimulus that comes from exchanging the surplus savings and getting the foreign customers. In short, if a country cannot productively invest its savings they are toxic industrial waste.

Historical conditions may not be eternal. Until the Great Depression and John Maynard Keynes, anyone (notably Hobson) who doubted the “more saving is better” doctrine was considered a crackpot or heretic. But in a Keynesian world, high savings are a risk. Invest them *all*, and the economy thrives and grows quickly. Fail to invest them *all* and the economy may stall. Keynes’ General Theory argued that an increase in collective saving (spending less) can reduce the need for additional productive capital.

If real capital and savings are scarce, these problems and ensuing recessions are usually temporary and mild. The standard Keynesian remedy for recession is fiscal policy: the government borrows and spends the surplus savings. Borrowing and spending is the opposite of saving – dissaving. So the government’s dissaving cancels out the private sector’s surplus saving. But governments fear high debt levels are unsustainable.

Keynes’ cyclical focus was in some ways a step back from Hobson. Some of the most notable economic events of the past quarter-century reflect Hobson’s insights. Concerns about the

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<sup>4</sup> Because of their historical usage, the misuse of the terms “capital” and “investment” is sometimes unavoidable. Terms like “capital controls,” “capital account,” or “foreign investment” can be misnomers.

structural threat of secular stagnation lack of investment opportunities are just as much Hobson's Point #1 as Alvin Hansen's. Similarly, the frequent asset bubbles that we see reflect Hobson's Point #2 about the misallocation of investment. It is important to remember that savings is the flow demand for assets, real or financial. Oversaving and assets shortages are actually the same thing. Unlike (Hansen, 1939) or (Keynes, 1937) who tended to see the problem as one of declining or stable populations and technology limiting the opportunity for new investment, Hobson focused on the flip side; income concentration causing high saving.

Analyzing oversaving and its consequences requires using the correct investment definitions. Take the simple closed-economy case. People often simply write "Saving = Investment."

1.  $S = I_{\#2}$  (Savings = All Investment) This is the "Savings-Investment Identity."

Equation 1 is always true. But "Saving = Investment" can also be an equilibrium condition.

2.  $S = I_{\#2a}$  (Savings = Profitable Investment): the economy is in equilibrium.

3.  $S > I_{\#2a}$  (Savings > Profitable Investment): the economy contracts. This is a *savings glut*.

The difference between Equations 1 and 2 is definition  $I_{\#2}$  or  $I_{\#2a}$ . Conflating the two is a serious logical error. Equation 1,  $S = I_{\#2}$ , *always* holds, but Equality 2,  $S = I_{\#2a}$ , may not. In the savings glut case, economic output may shrink.

Balance can be restored by either reducing savings or increasing investment. If capital is scarce, and credit markets are functional, the problem can work itself out through interest rate adjustments. But if capital and savings are abundant, the problem can persist.

In an open economy, if  $S > I_{\#2a}$ , there is another alternative to recessions and stagnation: vent the surplus savings abroad. For capital scarce countries, this can work out well. As the stream of surplus savings flows (is lent) from one country to the next, two things happen. The savings can be channeled into new, productive investment in the (willing) recipient country. Simultaneously, the lending will finance (cause) trade imbalances. The lending country runs a trade surplus and the borrower runs a trade deficit. The trade surplus transforms the lender's surplus goods and savings into exports. The trade deficit will allow the borrowing country to temporarily consume and invest more than its own production. This can benefit both countries.

We now rewrite the equilibrium condition #1 by adding the term  $F$  representing the outflow of financing (saving) which will finance a trade surplus. A negative  $F$  is an inflow and corresponds to a trade deficit.

4.  $S - F = I_{\#2a}$  (Domestic Savings – Financial Outflow = Profitable Domestic Investment)

Note that  $F$  is an outflow of savings, even if it is labeled "outward foreign investment," and goes on the left-hand side, not the right. Economies can thus be stabilized by exporting their savings surplus and running trade surpluses.

But what if, globally, there are not enough qualified and willing borrowers to absorb the surplus savings? This brings us to Hobson's Point #3: The export of surplus savings, the Economic Taproot of Imperialism (Hobson 1902, Chapter VI). In Hobson's day, that meant that the relatively advanced countries of the time acquired colonies. Today, countries at almost all levels of development take advantage of open financial markets to push out their extra savings. Ironically, their favorite destination is the United States.

In 2005, Ben Bernanke, prior to becoming Federal Reserve Board Chairman, coined the term

“Global Savings Glut” to explain of America’s unprecedentedly large current account deficits. Bernanke described his analysis as “somewhat unconventional,” although it was actually just a consistent application of textbook theory. He stated that the root cause of U.S. current account deficits was surprisingly high levels of savings in some developing countries, primarily Asian, that pursued export-led growth strategies. Bernanke argued that because the origins of the problem were external to the United States, there were few effective U.S. policy responses available. America, and other trade deficit economies, needed to endure and wait for poorer countries to resume their theoretically expected role of international borrowers.

Most mainstream economists accepted Bernanke’s analysis. A cynic might argue that this was because Bernanke had not challenged the norms and conventions of polite economists and had avoided advocating any difficult policy decisions. Thus, he avoided disrupting the status quo.

A key takeaway is that the inflows that cause trade deficits need not correspond to American economic needs or conditions. They can be generated by conditions or policies in other countries and conflict with U.S. economic needs. We now know that the consequences of these savings inflows would manifest themselves in the Great Recession/Global Financial Crisis. The crisis happened with a speed and scale that none would have guessed two years earlier in 2005. The trade surplus countries had not only transferred their surplus savings to the United States; they had transferred the consequences: financial imbalances and a powerful recessionary impulse.

Such recessions led to major U.S. fiscal stimulus packages in 2001 and 2009. Just as trade deficits reduce aggregate demand, fiscal deficits are intended to restore aggregate demand. Thus, in effect, trade deficits can cause fiscal deficits.

However, both trade and fiscal deficits *ceteris paribus* tend to increase aggregate debt without increasing debt carrying capacity; maintaining aggregate output comes at the cost of increasing financial fragility. In theory, the sequence can work in reverse if the trade deficit can be reduced and fiscal stimulus withdrawn; maintaining output while reducing debt accumulation.

A brilliant paper by Mian, Strump, and Sufi (2020) has quantitatively demonstrated that the dissaving of less affluent households may be, at least at times, the most dynamic and important factor in macroeconomic adjustment. Even economists who have suspected, based on anecdotal evidence, that consumer borrowing is more important than commonly acknowledged, will probably find the magnitudes quite surprising.

The authors quantified the links between the increased income of the richest Americans on the dissaving and debt accumulation by the non-rich. They show that the savings glut of America’s rich and the inflow of the Global Savings Glut did not raise real investment rates. Instead, net investment rates fell. The counterpart of the savings influx was dissaving of the bottom 90 percent of the U.S. income distribution and a much smaller increase in government debt.

Below is Figure 7 from Mian et al showing the accumulated change in aggregate saving from 1983 – 2015 relative to 1973 – 1982 levels. The positive values are net saving of the top 1%, the next 9%, the foreign sector and reductions in net investment. By construction and definition, they are equal in magnitude to the dissaving of the bottom 90%, the government deficit, and a residual error term.

What is clear is the large increase in gross savings has not resulted in higher investment levels. It has been matched by large dissaving among the less wealthy.

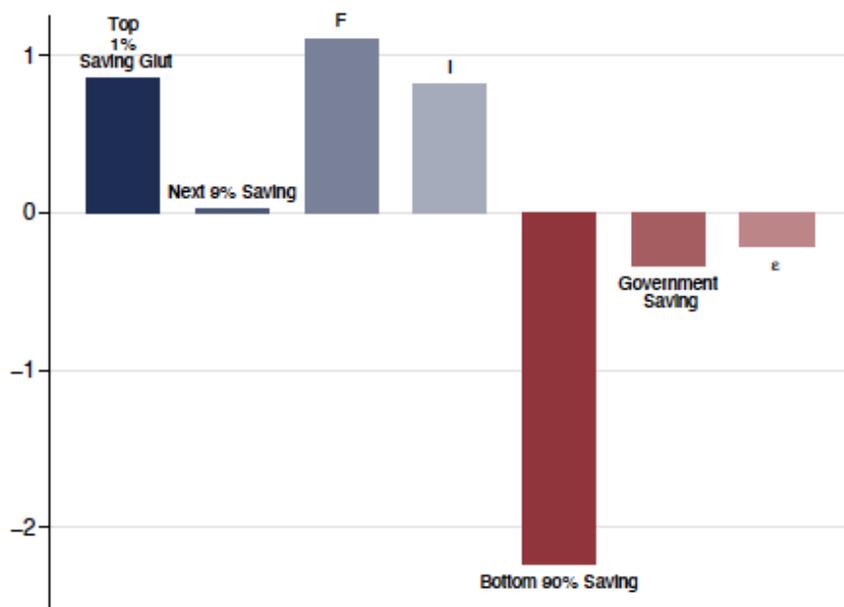
This has earthshaking implications for economic theory. The standard textbook macroeconomic

adjustment process is misleading. Models must be incomplete to be tractable. The issue is what to omit. Public discourse focused briefly on household borrowing after the Global Financial Crisis, but economists still neglect its role in the macroeconomic adjustment process.

The results of Mian et al show that dissaving, especially personal borrowing should not be simply aggregated into a single net private savings term “S.” Generations of economists have been taught that lower interest rates increase demand by increasing investment expenditure. As Keynes (Keynes, 1964) put it:

..a relatively weak propensity to consume (high saving) helps to cause unemployment by requiring and not receiving the accompaniment of a compensating volume of new investment.

**Figure 7: Absorption of the Accumulated Saving Glut of Rich**



Keynes believed that the required “compensating volume of investment” could be induced by a reduction in interest rates. Economists tend to assume an upward sloping savings curve with respect to real interest rates (although the justification for this in the standard intertemporal optimization models was always ambiguous). Thus, falling interest rates eliminate surplus savings (and avoid recession) by inducing both higher investment

and lower *gross* savings.

Now we must consider that there is a third, major equilibrating mechanism; aggregate demand is restored by a fall in some combination of interest rates and/or prudential standards that induces (allows) more household borrowing. Mian et al. indicates that in recent American experience, household borrowing is the most important medium-term macroeconomic adjustment mechanism. Increased household debt does not create growth in repayment capacity and may not be sustainable. So enhanced-saving policies intended to stimulate growth not only fail to increase real investment, but may saddle the economy with an additional problem: consumer debt. Aggregating gross saving and dissaving into a single term in macroeconomic equilibrium conditions veils the role of debt and dissaving in the macroeconomic adjustment process. Changing the aggregation of our models is a means to a more important end: changing how we think of macroeconomic adjustment and balance.

### **Section V: Why America Cannot Just Stop Borrowing**

President Trump rails against trade deficits. It is in U.S. economic interest to stop borrowing.

Hence, the continued borrowing seems paradoxical. The short explanation is other countries want to lend and rid themselves of surplus savings. A complete inventory of reasons for the ongoing American borrowing would be rather long and complicated. So, let us focus on three important reasons, especially a very surprising one.

Reason #1 is the mechanics of international borrowing and lending, especially in the U.S. case, are very different from the individual and private credit transactions with which we are all personally familiar. A private credit transaction is a deliberate and consensual act by lender and borrower, but Uncle Sam does not fill out a loan application at the People's Bank of China.

Instead, anyone not under U.S. Government sanctions has unrestricted access to the American financial system. Foreigners can keep their savings in U.S. banks deposits or exchange their deposits for U.S. stocks or bonds. The transferred savings earn income and finance American trade deficits. Private foreign individuals may put their money in U.S. assets for a variety of reasons besides earning income: because it is the proceeds of criminal activity, because their home financial systems cannot intermediate savings adequately, for safe haven against political risks, or to evade taxes. For whatever reason foreigners choose buy U.S. assets, they determine how much America borrows abroad. But these reasons have little to do with whether America needs or can absorb more savings.

The U.S. Government has actively refused to prevent or regulate these inflows. Doing so would require a full re-examination of conventional economic doctrine. Mainstream American economists, on both sides of the political spectrum, have championed free movement of "capital" across borders.

When the post-Second World War financial system was created, Keynes strongly advocated stringent controls on capital movement. The International Monetary Fund's (IMF) Articles of Agreement include an explicitly enumerated right to control flows of international "capital." But the United States, then the world's paramount exporter and industrial power favored eliminating controls. Over time, the U.S. position predominated. Just prior to the Asian Financial Crisis of 1997, the U.S. and other industrial countries nearly succeeded in restricting the formal right of IMF members to use "capital controls." But whatever the written rules, an unwritten rule prohibiting restrictions on international financial flows has been vigorously enforced with rare grudging exceptions for developing countries.

Reason #2 is the dollar's "exorbitant privilege" as a reserve currency. The dollar plays several international roles. Because it is commonly used in international transactions and international contracts are commonly denominated in dollars, Americans conveniently avoid changing money. That role is what allows the United States to impose economic sanctions on countries like Iran.

Other roles are often conflated with the dollar's reserve currency role. The reserve currency role, *strictly speaking*, means that foreign central banks buy and hold dollars. If they want trade surpluses, they can intervene directly by buying dollars and safe American financial assets, such as Treasury bonds. This finances their trade surpluses and keeps the U.S. dollar prices of their currency and exports cheap. This is called "exchange-rate management," or less favorably, "exchange rate manipulation." This transfers surplus savings to the American seller of the bonds as bank deposits. The bond is basically a loan from the foreign government to the American bond issuer. If the surplus savings could not be invested at home, that problem, and its consequences, have been relocated to America. The direct effects are lower U.S. interest rates, an overvalued dollar, and trade deficits. The indirect effects may include instability in American

financial markets. The U.S. Government passively accepts those decisions and tries to adjust and compensate as best it can, often by running larger budget deficits.

Some call the dollar's reserve role an "exorbitant privilege." No one else wants that "privilege." Calling it a "privilege" is the same con that Tom Sawyer used to get the other kids to do his work, paint his fence, and pay for the honor. It was amusing, but Tom played them for fools. Is the "exorbitant privilege" really a privilege or just a vain man's status symbol? Is everybody else just happy to let America have the honor of sitting at the head of the table so that it can pick up the check? Is it really a privilege to borrow and spend the money instead of earning the money yourself by making the things you buy?

Reason #3 is that foreigners get preferential access to the U.S. financial system. A surprising reason that foreign money pours into the United States and finances the trade deficit is that American tax law subsidizes it! Putting your money in America instead of your home country is far more attractive because, if you do, you don't have to pay U.S. taxes. As a bonus, the American Government often avoids reporting the income to your home country tax collectors (and sometimes the criminal authorities).

**26 CFR §1.895-1** (Legal Information Institute, 1975) exempts income of foreign central banks on obligations of the United States. Central banks (including China's and Japan's), buy and hold foreign financial assets as reserves when they want to manipulate their exchange rates. It's one of the definitions of exchange rate manipulation under U.S. law. While the President fulminates and many Democrats hyperventilate over exchange-rate manipulation, 26 CFR §1.895-1 tax subsidizes it.

While it is difficult to know how much revenue repealing a tax break can produce, a quick back-of-the-envelope estimate generates a nice, round number. Foreign central banks hold roughly \$4 trillion in qualifying U.S. reserves. Using a 2.5 percent average interest rate on U.S. Treasury obligations, that produces \$100 billion in income. A 30 percent tax rate would generate \$30 billion (about a quarter from China and Japan each). Of course, if foreigners stop sending as much money to America, the tax revenue may be less, but the trade deficit will shrink.

**26 U.S.C. §871(h)(1)** (Legal Information Institute, 1984) exempts portfolio interest income received by nonresident aliens from U.S. sources. If an American owns a corporate bond, she gets an IRS Form-1099 and pays taxes on the interest. But if she sells it to a German, the interest income disappears from the U.S. tax base and is no longer reported to the IRS. In fact, to the dismay of many other governments, the United States does not generally reciprocate the type of information gathering and sharing it demands for its own tax authorities. So, that income is effectively tax-free. Think-tankers on the left have criticized this provision on fairness and tax evasion grounds (Tax Justice Network, 2020), but the deleterious economic effects are not fully appreciated. These exemptions are granted to foreigners who can't even vote in U.S. elections. It chews up a large portion of the U.S. tax base and complicates tax administration. It *incentivizes* trade deficits and foreign lending into the U.S. financial system.

Ironically, although U.S. policy in recent decades has consistently opposed capital controls (controls on international financing and investment), a residency-based tax provision like 26 U.S.C. §871(h)(1) *is a capital control*. Nobody notices because the United States aims the gun backwards and defeats its own economic objectives.

## **Section VI: Effective Policy Options Open to the U.S.**

The economics of reducing U.S. trade deficits are fairly straightforward; there are many options. America simply needs to decouple itself from the current financial arrangements that require it to absorb foreign surplus savings.

There are, however, two broad categories of self-imposed constraints. The first is the political power of vested interests. No one can forecast whether that hurdle can be cleared. The second constraint is an economics profession ideologically committed to allowing and facilitating free capital movement and international investment, even though those are misnomers. Until the U.S. political system and government accepts that it does not want the inflow of surplus savings, the economic and financial consequences will persist. In turn, the impetus to political change will persist.

If the political decision is made to reduce trade deficits, the key is accepting that the financial inflows that cause trade deficits are not real investment. Once that is done, the strategy is to cut the PIPES (Privileges, Immunities, Preferences, Exemptions, and Subsidies) through which the unwanted foreign savings flow. All else will fail.

The most obvious measures are the elimination or reversal of the tax incentives established to encourage the inflows, starting with 26 CFR §1.895-1, 26 U.S.C. §871(h)(1), including exemptions from tax withholding given to foreigners. If the beneficial owners have tax-exempt status under bilateral tax treaties, the income could be withheld and refunded to the home country's tax authorities, so that the income would still be taxed. In essence, foreigners buying U.S. financial assets will either get national treatment or taxed by their home authorities.

This should be unobjectionable on legal or equity grounds since the United States has the sovereign right to aggressively tax U.S.-source income except when exempt under tax treaties. Even then, tax treaties can be abrogated or renegotiated for chronic trade-surplus countries. Tax treaties are meant to protect cross-border financial income from double taxation, but without information sharing, the money is often effectively shielded from *any* taxation. The United States has been criticized by others for its favorable tax treatment of U.S. income of foreign residents and failure to share information with other governments. These reforms may even be popular with other governments. But they cannot happen unless there is a realization that current tax law and policy is destructive of broader U.S. economic interests. And America can have it both ways: the rule of law and impartial tax administration.

The difficulty with such policies is their novelty. It is uncertain just how sensitive these flows are to taxation and how quickly any changes will happen. The objective is a medium-term adjustment, not a disruptive shock. While some capacity exists to increase the output of tradeable goods, the United States needs to rebuild much of its tradeable-goods sector. It was built once and can be rebuilt. U.S. multinationals built these capabilities in China from scratch. The issue is time. However market economies adjust; that's their purpose. The new policy measures need to be inaugurated cautiously and calibrated upwards. Just announcing that foreign-owned U.S. assets are part of the tax base may immediately reduce the inflows.

The elimination of positive tax discrimination may be sufficient. If it is not, the United States has many other potential tools to moderate the inflows. An example is the Market Access Charge (MAC) proposed in Section 5 of the (Baldwin-Hawley, 2019) bill introduced in the U.S. Congress. The MAC is a tax on the initial purchase of U.S. assets by a foreign buyer. It would be

set and subsequently readjusted to a level intended to eliminate the U.S. current account balance within five years. Other methods are available, but all the ones that work will moderate the financial inflows.

## **Section VII: Consequences for the Rest of the World**

For about 25 years, America has been the global macroeconomic-balancing mechanism. The rest of the world has become collectively dependent on the U.S. role. For America, this is neither politically nor economically sustainable. Eventually it must change. The sooner that happens, the better for everyone.

Initially, the other Anglophone trade-deficit countries – the UK, Canada, Australia, and New Zealand, will be forced to follow suit or lose control of their trade deficits. The UK is, in fact, *by design*, a primary destination for foreign oligarchs and money of questionable origin. The UK's Overseas Territories and Crown Dependencies are among the most secretive banking jurisdictions (Tax Justice Network, 2020), but presumably the deposits of those banks flow elsewhere.

Developing countries will be either delighted, or rightfully terrified, that torrents of unwanted savings will be diverted to them. Each country's position will depend on whether it wants to increase or reduce its external deficit. If they follow the U.S. lead, they will have options (called "capital flow management" by the IMF) to either deflect the flows or negotiate more advantageous terms.

Without the United States to absorb the surplus savings, eventually the burden of adjustment will return to its countries of origin: the trade-surplus countries. Klein and Pettis (2020) give an excellent description of the economic policies that helped concentrate wealth and create the Global Savings Glut, not only in trade-surplus countries, Germany and China, but America. Their concluding chapter describes what other countries will have to do if the United States ends its role as the great global balancing mechanism. In short, their working and middle classes will have to accept a higher standard of living and consumption.

Klein and Pettis believe unilateral U.S. action to stop the inflow of unwanted funds would be too painful and disruptive for the rest of the world. Instead, they advocate dramatic changes in trade-surplus countries' domestic policies that would eliminate the savings glut.

However, there is a major weakness in their position. American presidents have asked nicely since the Clinton Administration for help reducing the trade deficits and have either been ignored or scorned. Baring U.S. action to stop the financial inflows, there is no reason to expect that will change. If and when the political decision is made to begin reducing the inflows, the two realistically possible choices are either: (1) A rapid and mutually advantageous adjustment, or (2) A sudden shock. The latter will eventually occur if the present situation continues until enough damage has been done to the American economy that the system collapses.

Unilateral U.S. measures to control the inflow of the Global Savings Glut would push the world closer to the first option. If properly designed, that would allow the surplus countries three to five years to adjust. Depending on how quickly they respond, that could be enough. But the end result should be politically popular improvements in living standards. The problem is that for either political or ideological reasons, they have refused these reforms thus far.

## **Section VIII: Summary and Conclusions**

Today, surplus saving that the U.S. economy does not need flows in from economies that need it even less. It not only causes trade deficits, but harms the financial and industrial sector. It drives U.S. interest rates towards historic lows while the Fed worries that ultra-low interest rates trigger financial instability. American savers suffer (especially retirees living on their savings) and consumers are burdened with debt. Economists worry about the “zero lower bound” rendering monetary policy ineffective. Yet American tax policy subsidizes this!

America’s position is constant from each presidential administration to the next, regardless of party. In this respect, America has shunned the routine hypocrisy that defends the self-interests of nations. Donald Trump is obsessed by the trade deficit and resulting deindustrialization of America. He proclaims an “America First” policy. And yet, the U.S. Treasury’s institutional bias for a “strong” (i.e. overvalued) dollar endures. This allows other countries to do the opposite. They undervalue their currencies to make their exports cheaper. Therefore, American wares are overpriced and uncompetitive on world markets and its factories can no longer stay in business. U.S. trade negotiators seem unaware that the financial inflows prevent any adjustment of the exchange rate or trade deficit. While the Trump Administration seems to delight in violating many of the norms and conventions of American politics, including those of the old Republican Establishment, it has not actually challenged the intellectual inertia of America’s policy elites.

Impelled by doctrinal imperatives of its mainstream economics, the United States even advocates against its own interests. It wants China to open its financial markets and eliminate its controls on outward movements of domestic savings. It is clear that such an action would open the floodgates for Chinese savings and flight capital. The end result would be larger U.S. trade deficits and probably greater imbalances in U.S. financial markets.

In fairness, under fixed-exchange-rate systems or if capital is scarce, measures to encourage financial inflows may serve legitimate national interests, even if at other countries’ expense. But today, they are obsolete and destructive government economic interventions. Eliminate them and America’s trade imbalances will shrink. We have met the enemy and he is us! For America, that is good news.

Why? Because China and Germany have conflicting interests and no compelling incentive to help. However, America has the incentive and means to act unilaterally. No need to seek the cooperation of other governments. America’s problem is that it doesn’t even understand the consequences of its own tax code.

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## **APPENDIX: Graphic Representation of Balance-of-Payment Equilibrium**

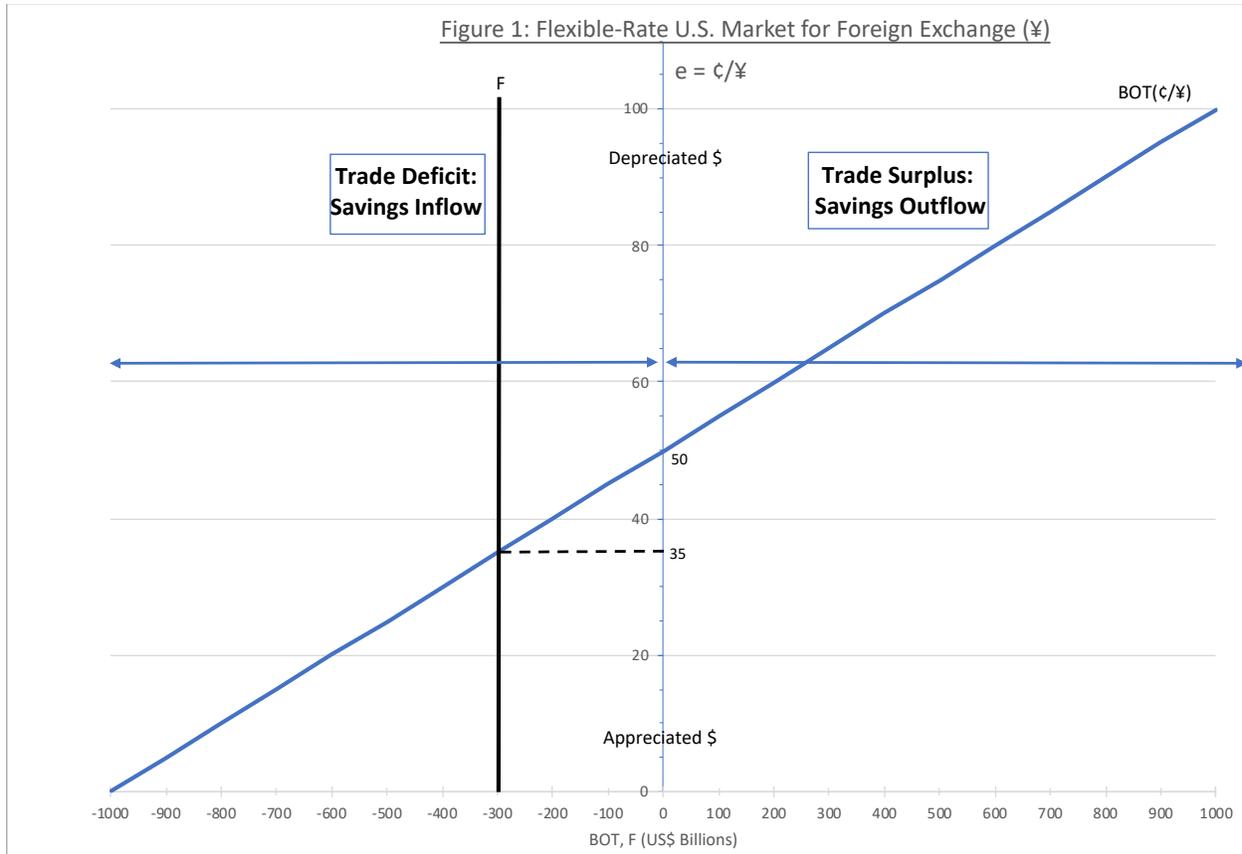
The current international system is a mix of currency regimes. The United States has a quasi-floating exchange rate. Even as U.S. authorities complain about currency manipulation, they passively accept many countries unilaterally pegging their exchange rates to the dollar.

This paper focuses primarily on the causes and consequences of U.S. trade deficits and the corresponding financial flows during the past 25 years. The flexible-exchange case described here is very simplified; arguably a limiting case. It assumes that America has completely open financial markets, and that the rest of the world has a savings glut. Financial inflows to the United States are determined exclusively by external conditions, meaning that the model allows for no endogeneity for financial flows. Today, these are very realistic stylized facts for the United States. Forty years ago, before the savings glut, financial inflows would have been more

responsive to domestic American conditions and this analysis would not have been appropriate.

A graphic representation: Take the example of a two-country world consisting of China and the United States. Figure 1 (below) shows the foreign-exchange market from the U.S. perspective. The vertical axis represents the exchange rate,  $e$ , the dollar price of RMBs, expressed as US¢ per RMB (¢/¥). The horizontal axis shows both the U.S. trade balance as a function of the exchange rate,  $BOT(e)$ , and Financial (Savings) Outflows,  $F$ . As the exchange rate rises, imports decrease, exports increase, and so does the balance of trade (the Marshall-Lerner condition holds).

A.1  $BOT(e) \equiv XUS(e) - MUS(e)$ , where U.S. Exports  $\equiv XUS$ , Imports  $\equiv MUS$



This relationship is represented by the curve labeled  $BOT(\text{¢}/\text{¥})$ . In this hypothetical case, trade would be balanced at an exchange rate of  $50\text{¢}/\text{¥}$  or  $\text{US}\$1 = \text{RMB}2$ . The vertical line  $F$  represents all financial outflows from the United States, including the official settlements balance (net sales of U.S. assets to foreign central banks). These flows are considered exogenous: they respond to neither the U.S. trade deficit nor the exchange rate. A positive value of  $F$  finances an outflow of savings. A negative value of  $F$  represents a net inflow and finances a trade deficit.

Notice that the vertical axis crosses the horizontal axis at point  $(0,0)$ . Values on the horizontal axis to the left of that are negative and positive to the right. As shown here,  $F$  is assumed to be independent of the *level* of the exchange rate.

For the balance of payments to be in equilibrium:

A.2  $BOT(e) = F \leftrightarrow BOT(e) - F = 0$ .

This simply means that the US balance of trade must equal its financing and is what allows us to measure both BOT and F on the same horizontal axis.<sup>5</sup> If financial inflows increase (outflows decrease), the vertical F line moves towards the left, which finances a larger U.S. trade *deficit*.

Whenever  $BOT < F$ , there is a shortage of foreign currency in the United States and the exchange rate,  $e$ , must appreciate (move toward the bottom of the vertical axis). Conversely, if  $BOT > F$ , there is a surplus of foreign currency in the United States and the exchange rate,  $e$ , must depreciate (move toward the top of the vertical axis). In the example shown in Figure 1, the F and BOT curves intersect at  $e = 35\text{¢}/\text{RMB}$  which implies that  $BOT = F = - \$300$  billion.

Policy actions, *inter alia*, tariffs, quotas, subsidies, domestic content requirements etc, can move the BOT curve to the right or left. This can change the commodity composition of trade, the direction of trade, the volume of trade, and will change the exchange rate. But only a change in its financing, F, can change the size of the equilibrium trade balance. Some of these other changes may be trade-policy objectives, such as protecting specific industries. But the benefits to the favored industry can only come at the expense of other domestic industries.

Fixed-Exchange-Rate Systems: The focus of this paper is the current, mostly flexible, exchange-rate-system in which almost all currencies are either flexible or are fixed to another currency's flexible exchange rate. It is essential to point out that Equation A.2 also holds in fixed-exchange rate systems, but the determination of F and the adjustment process are different.

In the flexible-rate system in Figure 1, financial flows, F, are determined independently of the trade balance. In a fixed-rate system, the net financial flows are essentially determined by the trade balance. That is because the central bank makes a commitment to buy and sell reserves to balance the foreign-exchange market. It must cover not only the foreign exchange demand for the trade deficit, but net financial outflows, F. If private financial inflows cover trade deficits, the demand on central bank reserves may be minimal. If not the demands on the central bank may be unsustainable. On the other side, trade surplus countries may be able to accumulate reserves indefinitely. The key point is that if private financial flows does not finance the trade balance, the central bank will intervene to finance the trade balance as the residual financier. This makes the F curve in the diagram horizontal at the central bank's chosen exchange rate.

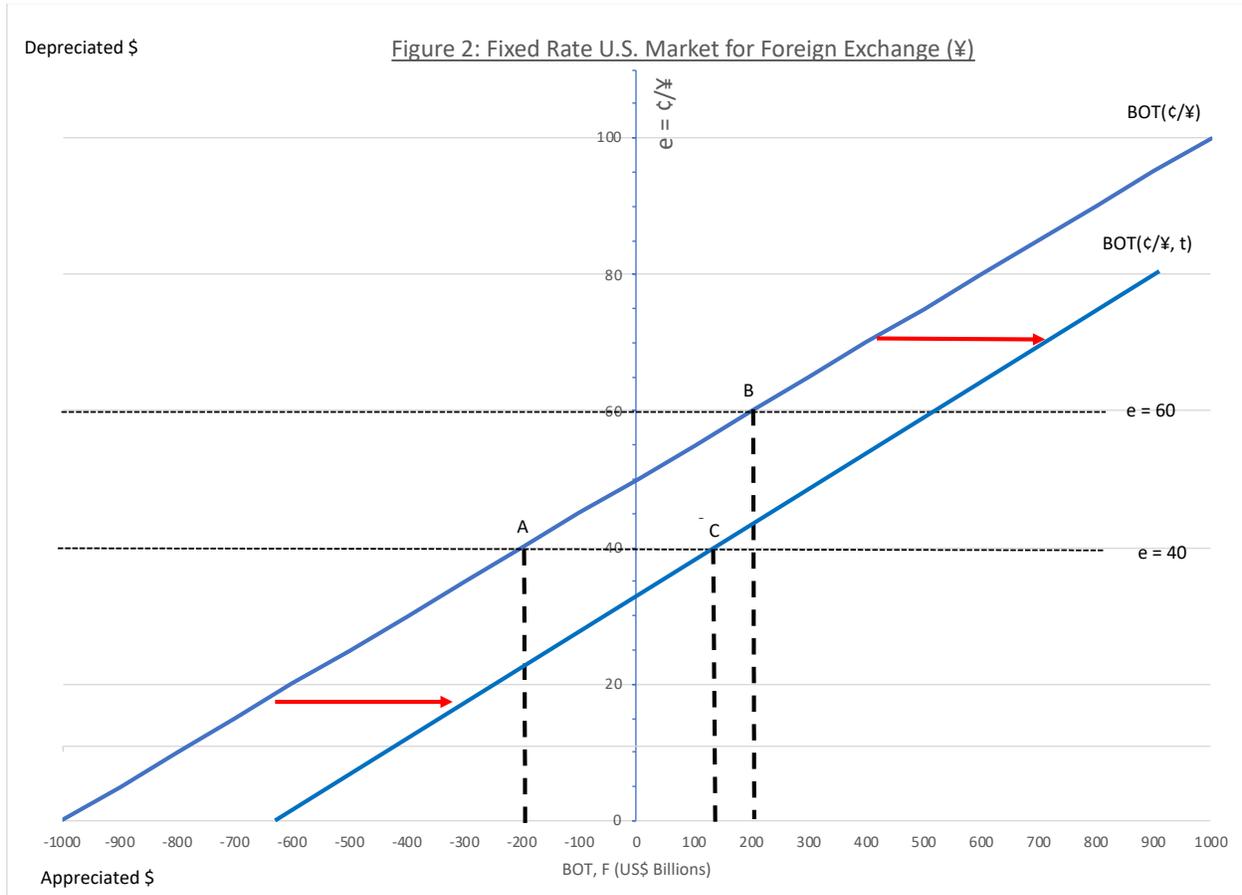
This is represented in Figure 2 (below). It represents a fixed exchange rate system with a discretionary central bank and the power to sterilize foreign reserve changes. It shows two BOT curves. The one on the left,  $BOT(\text{¢}/\text{¥})$ , involves no tariffs; the one to the right,  $BOT(\text{¢}/\text{¥}, t)$ , is similar, but includes an import tariff,  $t$ , that shifts the trade balance to the right.

Compare two possible equilibria, A and B on  $BOT(\text{¢}/\text{¥})$ . Point A is at the appreciated rate  $40\text{¢}/\text{RMB}$  and B is at the depreciated rate  $60\text{¢}/\text{RMB}$ . If the United States chooses A, it has a negative trade balance and needs a negative financial outflow (an inflow). The government must sell the necessary foreign exchange if private inflows are insufficient, assuming that the government has sufficient reserves. The Fed could also tighten domestic credit conditions to attract more private inflows, or some combination of the two. If the United States chooses Point B, the exchange rate is more depreciated and the economy has a trade surplus, requiring the government to buy reserves. This is sustainable as long as sufficient domestic saving are mobilized to finance reserve purchases.

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<sup>5</sup> The graph represents the true, "God's-Eye," values of BOT and F, not the values produced by statistical agencies. Statistical agencies include "errors and omissions."

Assume at exchange rate  $e = 40$ , the government imposes a system of tariffs to improve the trade balance and conserve foreign exchange reserves. The BOT curve shifts right from  $BOT(c/\text{¥})$  to  $BOT(c/\text{¥}, t)$  and the equilibrium from Point A to Point C. The trade balance improves from a deficit of - \$200 billion to a surplus of \$100 billion. This also changes the central bank's role from seller of foreign exchange reserves to buyer – which is more sustainable.

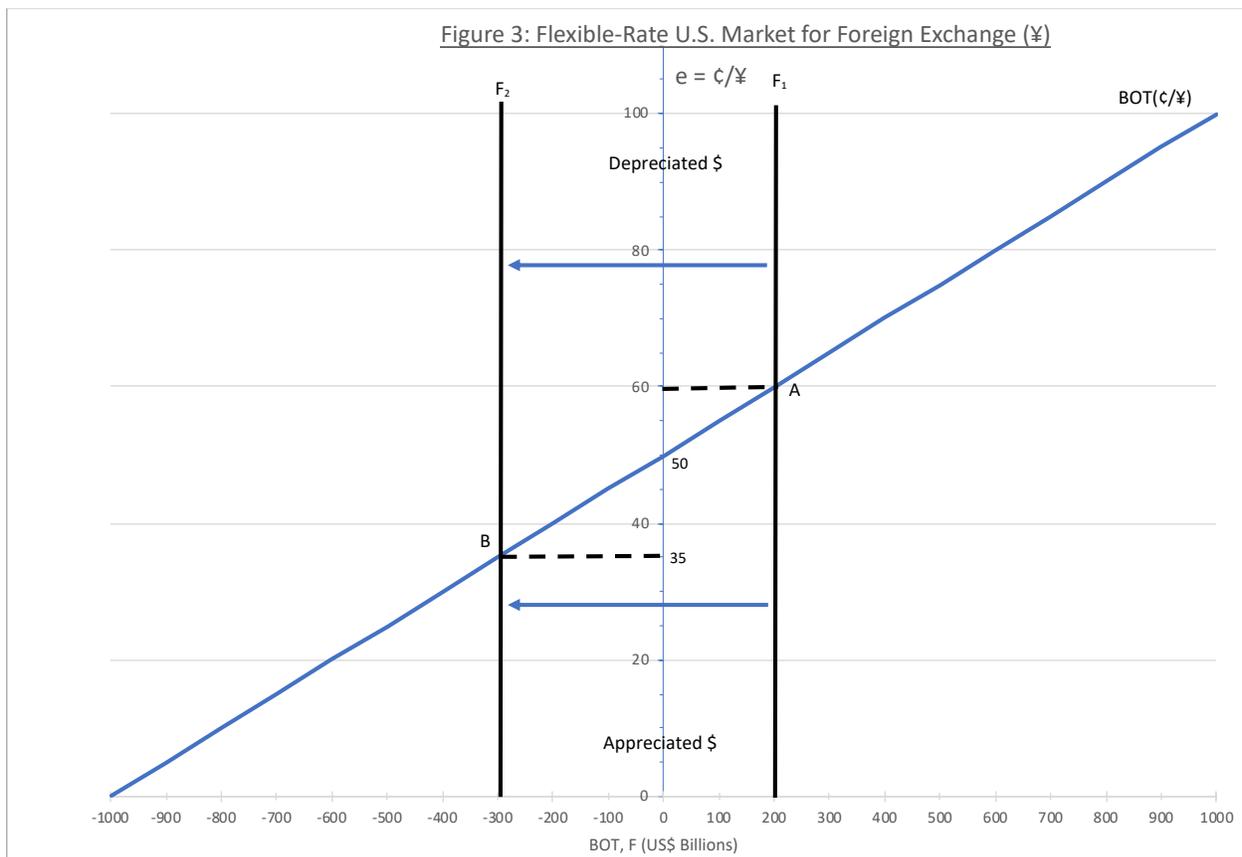


Why do tariffs work in the fixed-rate system shown in Figure 2, but not in the flexible-rate system in Figure 1? Because the fixed-rate systems automatically finance trade-balance changes. The F-curve is horizontal (infinitely elastic) at the given exchange rate. The flexible-rate case does not have an automatic financing mechanism: the F-curve is vertical (perfectly inelastic).

Over the past quarter century, the demand for U.S. dollar reserves has been a major contributor of financial flows to the U.S. economy. Some central banks have built war chests of reserves in case of crisis or sudden reversals of financial inflows. Other cases involved deliberate attempts by savings-surplus countries to undervalue their currencies.

The effect of increasing reserve demand on the dollar's exchange rate and the U.S. trade balance is shown in Figure 3. Purchases of dollar reserves are a financial inflow (negative outflow) to the United States. If the foreign country (China in this example) depreciates its currency from  $60\text{¢}/\text{RMB}$ , (a Chinese depreciation is a U.S. appreciation), moving from Equilibrium A to B in order to run a trade surplus. To make this happen, the Chinese central bank must provide an equal amount of financing, moving the financing curve leftward from  $F1$  to  $F2$ , exactly matching the swing in the trade balance. If the Chinese central bank does not buy up the surplus dollars

from its exporters, there will be an excess supply of dollars on private markets and the dollar would depreciate. To reduce the burden in its central bank, China could relax its controls on financial outflows, allowing its private sector to help finance the depreciation.

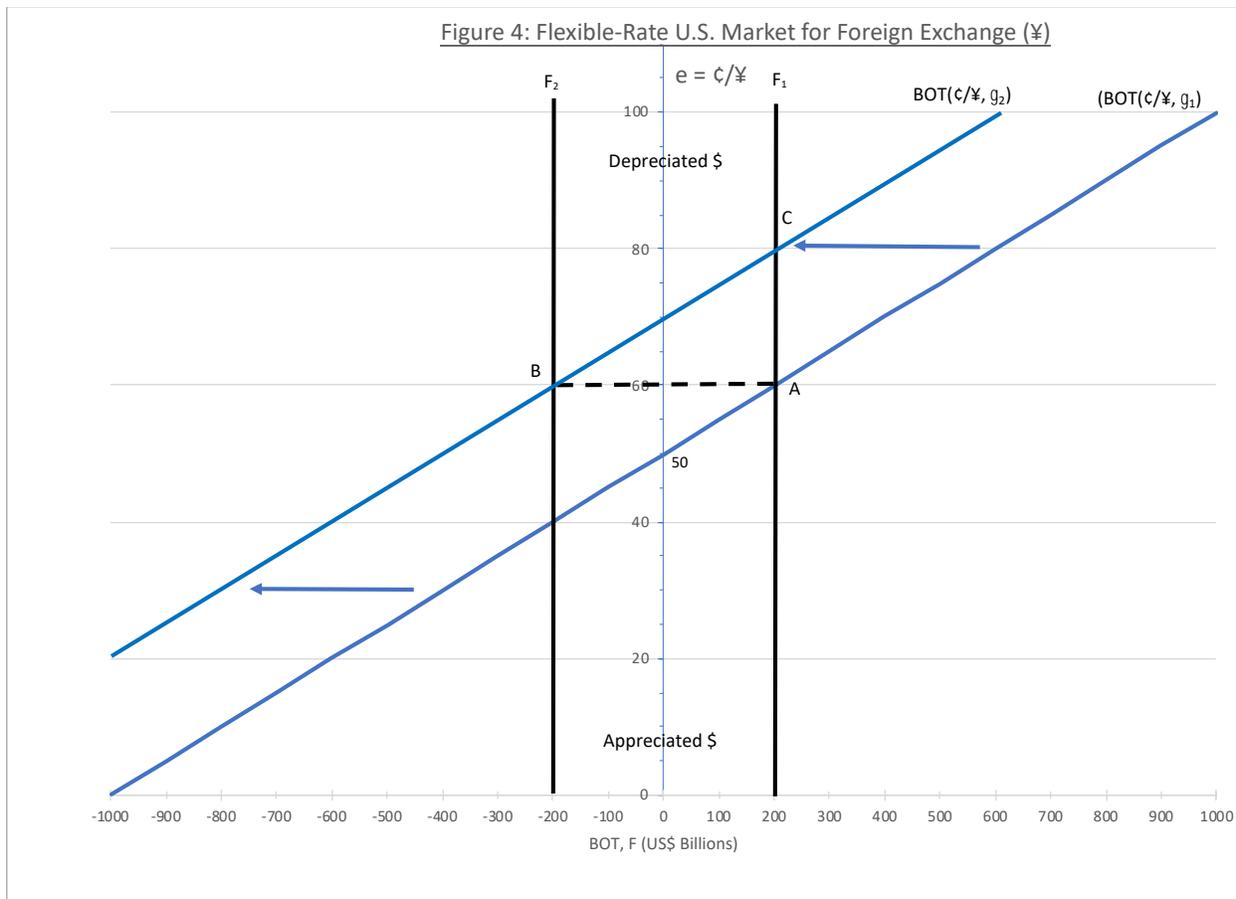


Alternatively, Chinese goods could become more competitive at any given exchange rate due to an increase in manufacturing productivity. Now let the trade balance relationship be described by the curve  $BOT(\text{¢/¥}, \gamma)$ .  $\gamma$  represents the relative productivity of the Chinese manufacturing sector compared to American manufacturing. Figure 4 (below) shows the BOT curve shifting left due to an increase in  $\gamma$  from  $\gamma_1$  to  $\gamma_2$ , indicating a lower U.S. trade balance at any exchange rate.

Originally, the system is at Equilibrium A at the rate of 60¢/RMB. Does the system move to Equilibrium B or C? If China does not intervene in foreign exchange markets to keep the RMB from appreciating (dollar depreciating), it will be like the flexible-rate system. The equilibrium point will move up along the original  $F_1$  curve to Equilibrium C. The trade balance will be unchanged, but the exchange rate will adjust. But if China wants to defend the exchange rate and allow its trade balance to improve, this will shift the financial flows curve,  $F$ , from  $F_1$  to  $F_2$ . In effect, whenever China picks an exchange rate, it is picking an equivalent commitment to finance the trade balance. Only a country with abundant or surplus savings would want to commit itself to financing a large trade surplus.

The examples shown in Figures 3 and 4 demonstrate why that under the current international system/non-system of mixed (and often incompatible) exchange-rate policies, the United States has been unable to reduce its trade deficits. Any policy to reduce or eliminate the trade balance, such as tariffs, quotas, subsidies, domestic content requirements, ***must fail*** if it does not reduce

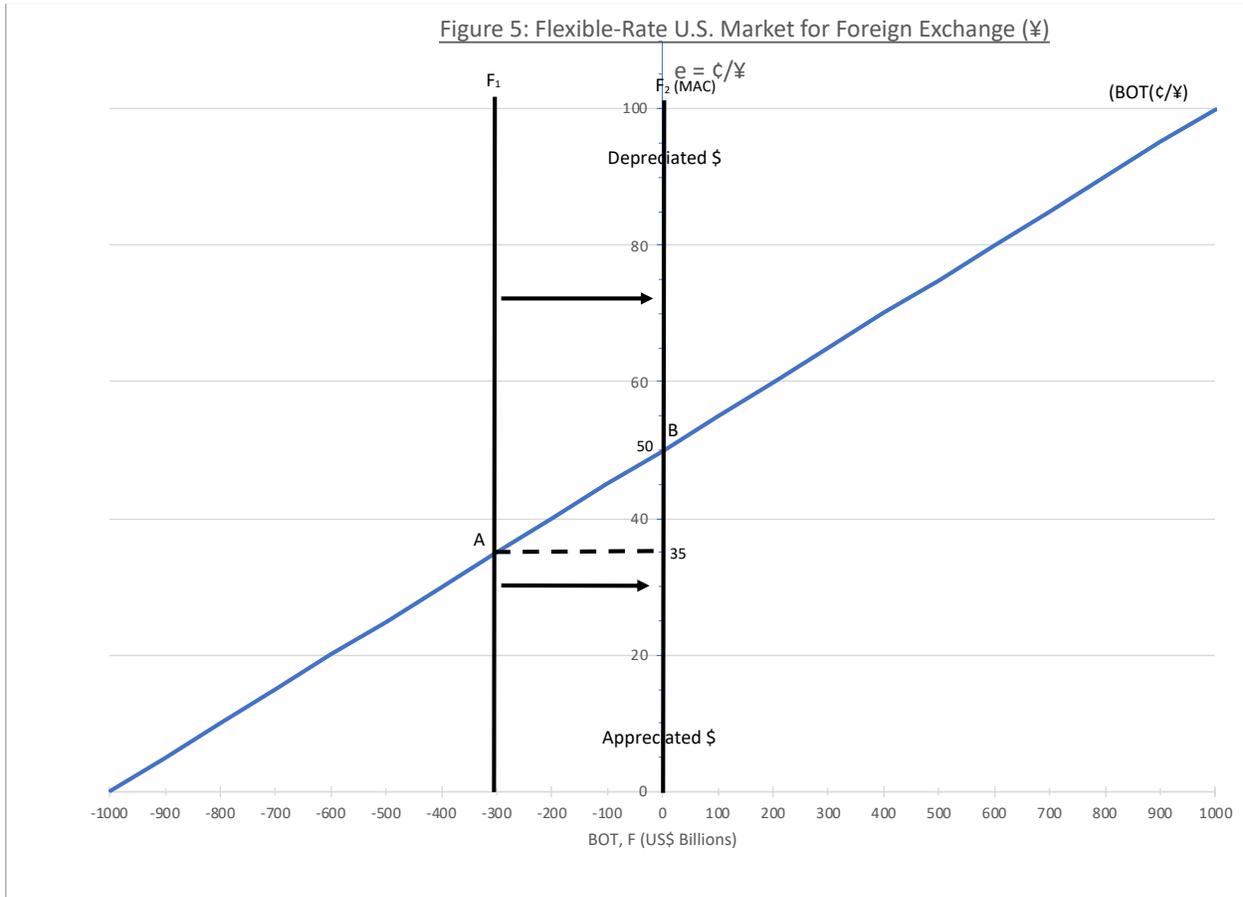
capital inflows ( $F$ ). Such policies *might have worked* under an historical fixed exchange rate system because the central bank would have provided the necessary financing. But, it will not work today. The fact that politicians keep trying ineffective remedies may say something about their mainstream economic advisors.



If a country wishes to target a specific trade-deficit reduction, it is picking a point on the BOT curve. If it knows the exact position of that point, it can target the exchange rate and control financial inflows to the corresponding level or it can target the desired level of financial flows, equal to the desired trade balance and accept the corresponding exchange rate. That is the standard economic choice: controlling the price and allowing quantities to vary or controlling the quantity and letting the price vary. The two policies are in some way equivalent. The real difference is that exchange-rate targeting is a means to an end: the trade-balance goal. That may be more difficult if the adjustment process requires undershooting the equilibrium exchange rate. And the authorities may not know in advance the desired exchange-rate level.

But a policy like the MAC, mentioned in Section VII, if properly designed and administered, disincentivizes foreign purchases of U.S. financial assets. Figure 5 (below) represents the imposition or increase of a MAC that moves the  $F$  curve to the right until it reaches its target level ( $F = \text{trade balance} = 0$ ) on the horizontal axis at Point B and an exchange rate of  $60\text{¢}/\text{RMB}$ . The catch is that, in order to reach the financial inflows target, the appropriate level of the MAC will need to be initially estimated and then re-adjusted. So the MAC becomes the price that adjusts to meet the quantitative target for financial inflows. All other effective policies will work in the same manner, by moving the  $F$  curve.

The real differences between the two approaches is that the MAC or increased taxes on unwanted capital inflows is a credible and direct method of raising government revenue until the government gets what it wants. As long as the government avoids abusing the revenue source, the external accounts and the exchange rates should settle down to something relatively stable and flexible, without the volatility of large speculative financial flows.



On the other hand, if financial inflows remain unregulated and undiscouraged, it is not clear what credible and effective tools there are to reach targeted exchange rates.

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