CARLSON FINANCIAL MANAGEMENT

Balance of Trade

We have been hearing a lot about the balance of trade lately. America's is in deficit, it has been for decades and the president promises to do something about it. The term can be confusing because journalists' use of it is often imprecise. 'Balance of trade', balance of services', 'current account' and 'balance of payments' may all be used interchangeably while each in fact has a quite precise meaning. Balance of trade generally refers to the difference between all goods and services exported and all that are imported. Before 1993 the phrase only referred to material goods, services were generally ignored in the calculation. On the basis of tangible goods alone the United States' balance of trade is an enormous negative. In 2017 the country exported about $1.5T (trillion) and imported $2.3T, an imbalance of $800B (billion). That is greater than the entire gross domestic product of Saudi Arabia or Switzerland.

America does much better with services. When a foreigner pays an American company to transport goods, usually to the foreigner's own country, that is an American export of service. When a foreigner comes to study at an American university that is an export of educational service. A tourist contributes to the services sector of the host country. When a domestic bank performs any transaction for a foreign company that is an export of financial service. These then are the mainstays of America's service export economy: transport, travel, education, financial services and one last one which is extremely important- charges for the use of intellectual property. Those include royalties for copyrights, patents and trademarks, payments for computer software and charges for the use of industrial processes. The United States has a surplus in its balance of services. It exports nearly $800B of service while importing slightly more than $540B.

In discussions of the trade balance you will often see the term 'current account'. The current account includes the balance of goods and services but adds two more categories. The first is investment income and one part of that is 'direct investment'. When General Motors has a factory and service organization in China the company is acting as a direct investor. It is still a General Motors operation, which just happens to be in a foreign country. Any profit from this installation shows up in the national foreign trade account as investment income. The second part is portfolio investment. This means the simple ownership of shares or bonds, which may be owned by a corporation or an individual. Dividends and interest show up in the national account as investment income.

The final category is simply called ‘secondary income’, presumably because it does not come directly from economic activity. When a person receives a pension from one country but lives in another that money is called ‘secondary income’. When U.S. personnel are stationed abroad the money they spend is treated as the other side of the secondary income ledger and is often labelled ‘current transfer’. Similarly with foreign aid, which can be either government to government assistance or the activities of international charitable organizations. If the money is spent in a foreign country it is called a current transfer.

The last big amount in this category is remittances. A resident of one country sends money to another in a foreign country. Usually this is family related. In 2017 American residents sent $48B to individuals who live in another country.

America does well with its investment account. Last year she earned $926B in income from foreign investment while paying out only $708B in profits, dividends and interest

The secondary account, however, is not so favorable. The U.S. government has installations all over the world

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and additionally funds a lot of foreign aid programs. American based charitable organizations collect money here then transfer it to third world places. As a rich country America has millions of residents who send money back to the country of origin. There is not so much in the opposite direction. The balance of America’s secondary income account in 2017 was a negative $118B; $154B came in while $272B went out.

When we add all this up we get a number somewhat greater than negative $440B for 2017. This is the balance of payments, which is essentially the balance in the current account. Since the year 2000 America’s average annual balance of payments deficit has averaged slightly over $500B.

At first blush America’s foreign accounts look like those of a third world country. Foreigners are owed a huge amount of money, they hold a large amount of domestic productive capacity and there is a very large imbalance in the trade of material goods. The two areas in which U.S. exports are at least equal to imports are agriculture and raw materials or semi-finished goods. This includes petroleum and natural gas, which are now big exports. Manufactured products is where the big discrepancies lie. America imports $110B more of capital goods, the kind of machines that make machinery and construction equipment, than it exports. She imports $360B worth of autos and trucks, while exporting just about $160B. America imports thirteen times as much clothing as it exports, twice as much pharmaceuticals, four times more household goods and appliances and four times more computers.

There are, however, a few sophisticated arenas in which the U.S. shows its strength. America is good at educating others, foreign students spent $42B here in 2017; telling others what to do, $79B worth of export of professional and management consulting service; purveying intellectual property, $128B in 2017; and managing the rest of the world’s money, $110B of financial services in the same year.

The other side of the current account ledger is the financial account, sometimes called the capital account. Since America chronically has a negative balance of payments the money to pay for it has to come from somewhere and that somewhere is foreign investment in the U.S. This can be direct investment, portfolio investment in stocks or bonds, foreign deposits in U.S. banks or just straight out loans. Not surprisingly foreigners own much more of America than America owns of them, the difference is about $8T. Thirty years ago there was actually a positive financial account balance. Things started to go downhill in the 90’s and really began to accelerate in the first two decades of this century. The cumulative deficit hovered between $1.5 and $2.5T in the years before the Great Recession, then began its meteoric rise to today's $8T.

Direct investment, bank deposits and various financial assets are almost equally held by the U.S. and foreign holders. Nearly the entire imbalance is in portfolio investment and most of that is in bonds and loans. In 2017 foreigners acquired $794B of American bonds and loans while the U.S. got $461B of bonds and loans from the rest of the world. The difference, $334B, is about $100B shy of the entire balance of payments deficit. Excess foreign deposits make up a good part of the rest. What this tells us is that the world sees the U.S. as a good credit risk but so far as profitability, the thing that results from equity investment, it is pretty ordinary, a 'mature market'.

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