››› US trade policy targets symptoms, not causes

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Trade flows and, hence, trade and current account balances are the result of economic decisions on the supply and demand side. International competitiveness, illustrated not least by the development of unit labour costs, is an important factor. US competitiveness clearly needs to improve, including in the SME sector. But in essence, high current account surpluses or deficits are symptomatic of a significant imbalance between domestic saving and investment.

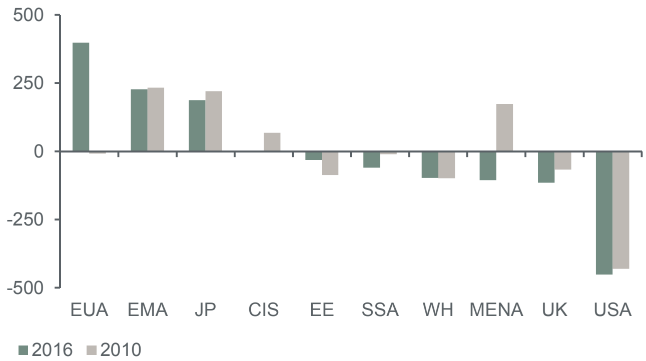
Trade and current account balances are therefore of a structural nature. As they are also indicative of global imbalances, reducing surpluses or deficits in global trade is definitely a sensible move. But tariffs and the adoption of protectionist measures are the wrong way to achieve this. What is required instead are measures that address the structural causes of global imbalances.

Current account deficits or surpluses are being debated more intensely again, particularly in light of the increasingly protectionist trade policy of the US administration. Once again it is becoming apparent that the character of current-account balances is often misinterpreted.

The US current account deficit, however, is a good starting point for the analysis. Indeed, it shows that the US has amassed the largest current account deficit of all the world's countries, while Europe and Asia have generated the highest surpluses (Figure 1). The driving factor that determines how the current-account balance evolves is the development of exports and imports.[1] Current account surpluses, which are usually caused by trade surpluses[2], are often viewed as a sign of economic strength and competitiveness because, after all, the exported products are obviously highly sought-after abroad. Current-account deficits, on the other hand, are often seen as the opposite. In the case of the US this is made more difficult by the fact that its president regards the US current account deficit as a consequence of other countries' unfair trade practices. He argues that high import tariffs imposed by other countries (e.g. on automobiles) are driving the US current account into deficit and that this has to be corrected through high reciprocal tariffs.

Figure 1: Current account balances

USD in billions



EUA=euro area, EMA=Emerging Asia, JP=Japan, CIS=Commonwealth of Independent States, EE=Emerging Europe, SSA=Sub-Saharan Africa, WH=western hemisphere, MENA=Middle East and North Africa.

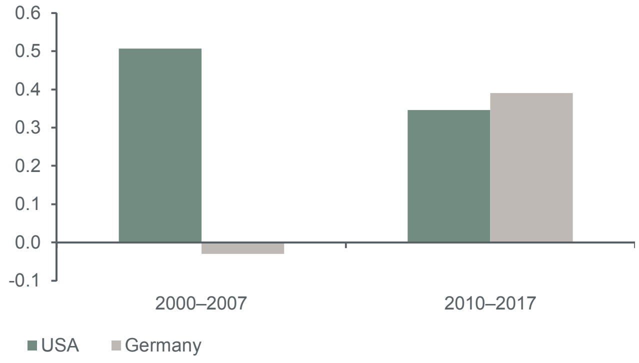
Source: IMF

High international competitiveness is, of course, a driver that can boost (net) export activity. Before the financial crisis, Germany benefited from the fact that domestic unit labour costs rose only little and even dropped as a consequence of labour market reforms ('Agenda 2010'). At the same time, unit labour costs in the US increased (Figure 2a, left) and resulted in the US losing their (cost-based) competitive advantage in the mid-2000s. It is hardly surprising that during this time Germany's current account surplus expanded significantly while the US deficit increased (Figure 2b, left).

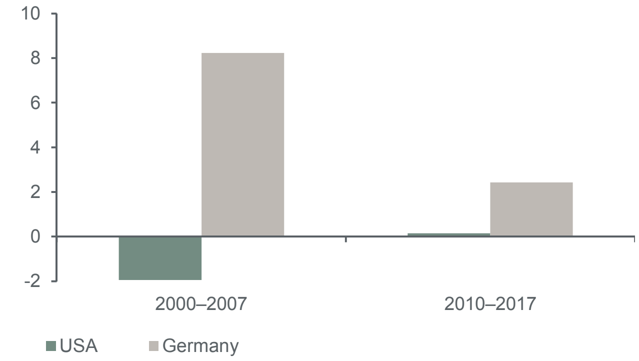
This trend did not continue after the crisis and Germany's price competitiveness ceased to improve. Unit labour costs in Germany even rose slightly higher than in the US (Figure 2a, right) but Germany's current-account surplus still continued to grow, if no longer at the same pace (Figure 2b, right). Evidently, Germany's foreign trade surplus remains on an expansionary trend.

Figure 2: Unit labour costs and current-account balance

a) Unit labour costs: Average annual variation in per cent



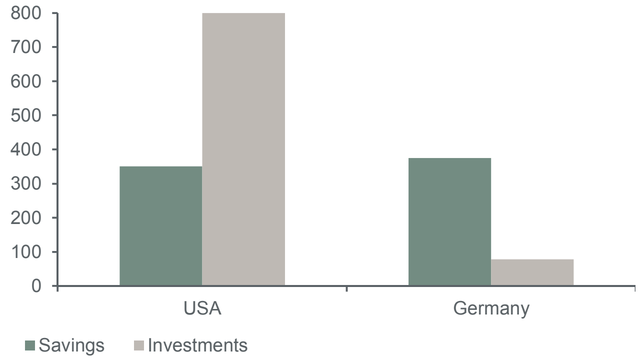
b) Current account balance: Total variation, percentage points to GDP



Sources: OECD, Feri, KfW Research

Figure 3: Savings and investments

2017, USD in billions



Sources: BEA, Destatis, KfW Research

Current-account deficits are not a sign of weakness but of external borrowing

The reason is that current-account balances are not just the result of international competitiveness and, hence, export prowess but also of decisions from the domestic demand side. If an economy demands more goods and services than it produces domestically, the gap can be closed only with imports. In the US that gap was more than half a trillion US dollars in 2017. It simply means that the US – as a country that had no exports to ship to this amount – had to borrow the same amount in additional funds from other countries. That means credit supplied from abroad actually enabled demanders in the US to fully realise their investment and consumption plans in the first place. Therefore, current-account deficits are not defeats that need to be prevented or eliminated. Lenders are those regions in the world that generate current-account surpluses. Germany, for example, produced around USD 0.3 trillion more in goods in 2017 than it consumed domestically. This correlation can also be expressed in these words: Germany saves more than it invests and lends these ‘surplus savings’ to countries that have current-account deficits such as the US (Figure 3).

On that basis, current-account balances are an expression of global imbalances that result from disproportions between investment and saving which, in turn, are a consequence of savings (and hence consumption), as well as investment decisions made in the respective countries. The steady growth of receivables from foreign creditors may be the result of, for example, a declining wage share which forces households to save more, or from a domestic investment backlog. Deficits with foreign countries may be the result of, for example, excessive consumption fuelled by economic-policy decisions such as tax cuts.

Tariffs do not solve the problem

It will never be possible to fully balance investments and savings, nor exports and imports, on a global scale. But reducing global imbalances should nevertheless be on the agenda, particularly when they grow too large. Deficit countries can become excessively dependent on capital inflows from certain countries. The latter is less of a problem for the US, where the dollar as a global key and reserve currency virtually rules out the threat of sudden stops in capital flows. For developing and emerging countries, however, excessively high current account deficits and a resulting excessive dependence on capital inflows can indeed pose a heightened risk. And steadily growing external debt will one day also weaken the credibility of the US and the role of the US dollar in international capital markets. Thus, the US president has brought up a relevant problem by addressing the topic of current-account balances. But because it has structural causes it cannot be constructively resolved on a long-term and sustainable basis with trade policy and especially not with tariffs.

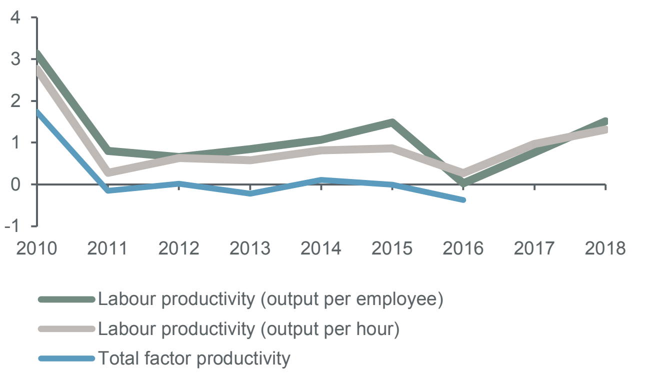
Tariffs can limit trade flows and force the reduction of deficits. At best, they can lead to import substitution – by ramping up production at existing local businesses or through increased direct investment. But this approach to reducing imbalances has high long-term costs. Tariffs increase the prices of imported goods; they do not protect young, emerging sectors but less productive sectors instead. Less international competitive pressure leads to inefficient use of scarce resources and leaves the economy less flexible. Important value chains suffer or disappear. This also affects the involved US businesses, including those whose procurement is not even directly subject to tariff policy but which need such inputs for their production and have to bear higher costs as a result. It further diminishes the already low productivity of the US economy and hence its competitiveness. Besides, tariffs increase consumer prices through higher production costs. This primarily affects poorer households which spend a particularly large portion of their income on consumption.

Americans, save more. Germans, invest more.
A better way is to address the structural causes of imbalances. But since they are a global phenomenon it is not just up to a single country to remove or reduce them. All must participate:

- Improving international competitiveness should be high on the US agenda. To achieve this it will have to improve productivity, which reduces unit labour costs. After the crisis, productivity growth in the US was very weak and – measured by total factor productivity – nearly came to a standstill. This trend does not appear to have continued in 2017 and an improvement is forecast for 2018 as well (Figure 4). Despite these improvements, however, productivity gains are too low to compensate rising incomes and thereby dampen the rise in unit labour costs. The tariff measures that have been and may still be adopted by the US administration, however, are not suited for strengthening productivity and improving competitiveness and they call into question the expected productivity gains.

Figure 4: Variations in productivity

Per cent year-on-year

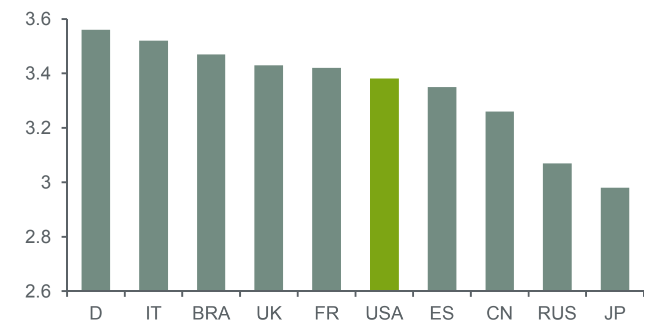


Source: Conference Board

- Germany's export strength manifests itself not just in the global presence of large corporations, for example in the machinery and plant building and automotive sector, but also in a strong and export-oriented SME sector that has many 'hidden champions': relatively unknown SMEs that are market leaders in their field. The US has ground to make up here. The relatively low export orientation of US SMEs is in part a reflection of the vast domestic market. At the same time, their international competitiveness has a great deal of catch-up potential. The KfW Competitiveness Indicator shows that small and medium-sized enterprises in the US consider themselves to lag far behind traditionally strong export economies such as Germany in various aspects of international competitiveness. For example, they see themselves at a greater disadvantage than German SMEs from poor infrastructure or policy uncertainty. At the same time, they see their products as being significantly less innovative. (Figure 5).

Figure 5: KfW Competitiveness Indicator, sub-aspect degree of product innovation

1 = significantly lower, 5 = significantly higher



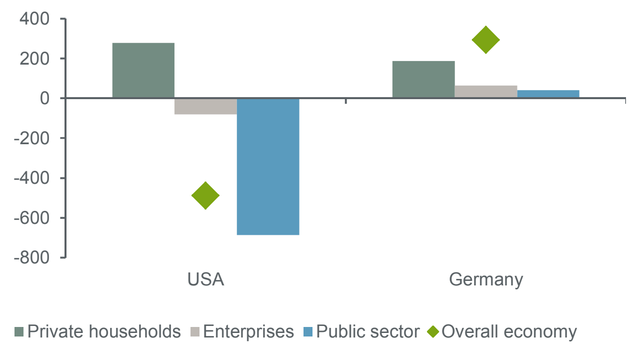
Source: KfW Competitiveness Indicator 2016

- As mentioned, current account deficits are an expression of a surplus in investment demand compared with available funds, meaning savings. Reducing the US current account deficit therefore requires an increase in the country's overall national savings rate. But the policy of the US administration is geared to the exact opposite. The deficits are currently being additionally increased through a cyclically unnecessary expansionary fiscal policy and combined with the goal of expanding investment. The net lending / net borrowing position of the US, that is the (negative) gap between saving and investment, and thus the current account deficit can only widen further as a result (Figure 6).

- Conversely, in some surplus countries the (excessively) high saving rate is an expression of economic policy failures. In Germany, the positive fiscal balance is bolstered by significant public and private investment restraint. This is particularly noticeable in the corporate sector, which has evolved from a classic deficit into a surplus sector and is thus additionally driving the growth in accounts receivable from abroad (Figure 6). Today no domestic sector in Germany would still be willing to borrow in net terms on balance. It is clear that the rest of the world has to assume this role and that this necessarily generates an enormous current-account surplus for Germany. This could be fixed through more investment incentives, such as improved depreciation arrangements or a greater willingness of the state to invest – even if it means accepting a minor public budget deficit.

Figure 6: Net lending / net borrowing by sector

2017, USD in billions



Sources: BEA, Destatis, KfW Research

- Globalisation also requires social support mechanisms. As a wealthy economy, the US in particular needs an active labour market and social policy of the kind we know in Germany and Europe. That would create opportunities for dampening negative effects of globalisation and stop income gaps from widening further.

Conclusion: Economic insight is needed

Adopting tariffs to reduce current-account deficits, and thus basically trade deficits, is not a good idea. It may work in the short term but the long-term structural costs are high. Tariffs in particular do nothing to change the underlying drivers of a national economy's external position. These are essentially the consumption and investment decisions of households and businesses – both in the deficit countries and in the surplus countries. Global imbalances can therefore not be unilaterally rectified with tariffs. It would be a major achievement if countries with a high current account surplus set incentives that increased domestic demand and encouraged the state to invest more and if deficit countries curbed new borrowing. ■

[1] The current account is made up of the trade and services account, primary income flows (e.g. cross-border income from work and investment) and secondary income flows (unrequited payments such as immigrant worker remittances).

[2] Here the terms trade balance account and trade balance surplus / deficit include exports and imports of services although the official balance of payments regime (BOP 6) depicts the balance of trade (for goods) and the balance of services as separate balances within the current account.