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Economics Group

WELLS FARGO SECURITIES

Special Commentary

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Brother, Can You Spare a Dime? Financing the U.S. Current Account Deficit

Executive Summary

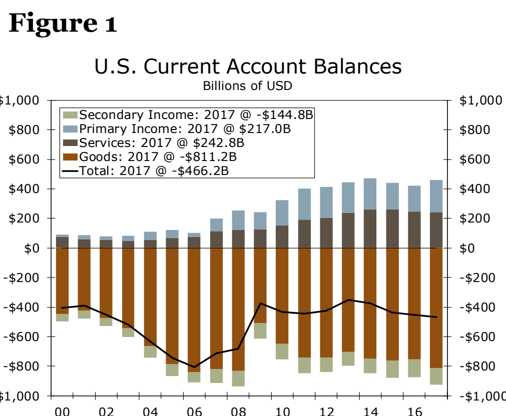
The U.S. current account deficit widened to a nine-year high in 2017, and we expect that the red ink will climb further going forward. Fortunately, foreigners remain willing financiers of the American current account deficit. FDI inflows exceeded $300 billion for the third consecutive year, and foreign net purchases of American securities jumped to their highest level since the record year of 2007. We look for modest dollar depreciation in coming quarters. But a full-blown rout of the greenback does not seem likely, unless something happens that leads foreigners to significantly reassess American economic prospects in coming years.

U.S. Current Account Deficit Reached Nine-Year High in 2017

Surpluses in services and primary income partially offset the gaping deficit in trade in goods.

Recently released data show that the red ink in the U.S. current account totaled $466 billion in 2017, the largest deficit in nine years (Figure 1). The gaping deficit in international trade in goods ($811 billion) was partially offset by a sizeable surplus in international trade in services ($243 billion). In addition, the United States had a surplus in its primary income balance. That is, the income that Americans earned on their overseas investments last year exceeded the income that U.S. households, businesses and government needed to pay to foreigners on their American asset holdings by $217 billion. The United States also had a modest deficit ($145 billion) in its secondary income balance (e.g., unilateral government transfers to foreign economies, workers' remittances, etc.).

Figure 1



Source: U.S. Department of Commerce and Wells Fargo Securities

In a previous report, we wrote that "the red ink in the current account likely will widen further going forward due, at least in part, to recent tax legislation."[1] We also noted that we did not view widening

[1] **See "U.S. Trade Deficit Widening: Trouble Brewing?" (January 8, 2018). All Wells Fargo reports referenced herein are available upon request.**

This report is available on wellsfargo.com/economics and on Bloomberg WFRE.

deficits as much of a "problem," at least not for the foreseeable future. That is, "foreigners seem quite willing to finance the red ink in America's trade accounts," which they do via their purchases of American assets. To corroborate our previous claim about the willingness of foreigners to finance U.S. current account deficits, we drill down into the recently released balance-of-payments data for insights into foreign purchases of U.S. assets.

Foreign Purchases of American Assets Rebounded in 2017

FDI inflows were strong again in 2017.

Foreign net purchases of American assets and U.S. net purchases of foreign assets can be lumped into two broad categories: direct investment and portfolio investment. Foreign direct investment (FDI) in the United States totaled $349 billion in 2017 (Figure 2). Although not quite as strong as the record inflows that were registered in the preceding two years, 2017 was still clearly a good year in terms of FDI in the United States. But American foreign direct investment abroad exceeded inbound FDI inflows for the first time in three years in 2017.

Figure 2

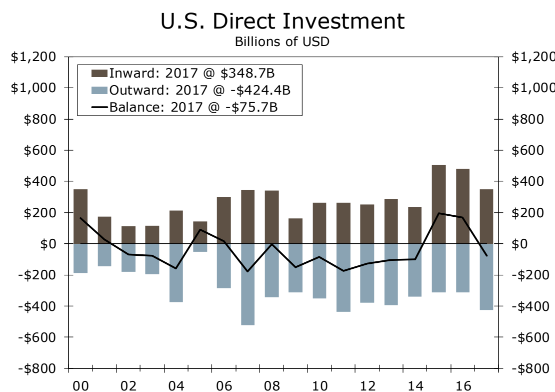
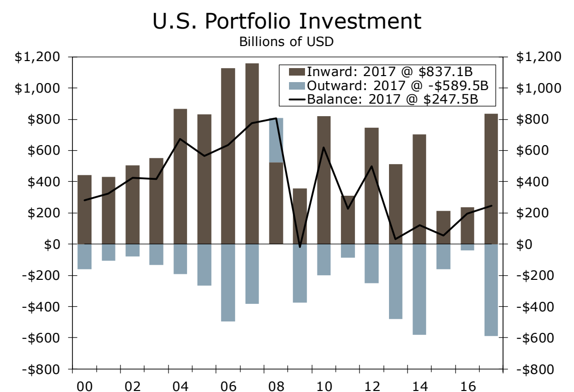


Figure 3



Source: U.S. Department of Commerce and Wells Fargo Securities

Inflows of portfolio capital rose to a 10-year high in 2017.

By their very nature, flows of portfolio capital tend to be larger and more volatile than FDI flows. After slowing markedly in 2015 and 2016, inflows of foreign portfolio capital into the United States rebounded sharply last year to $837 billion, the strongest year for inbound portfolio investment since the record year in 2007 (Figure 3). Although American purchases of foreign stocks and bonds also strengthened last year, portfolio inflows still exceeded portfolio outflows by nearly $250 billion in 2017.

Figure 4

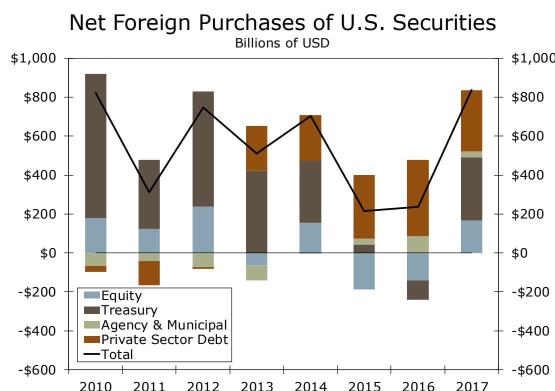
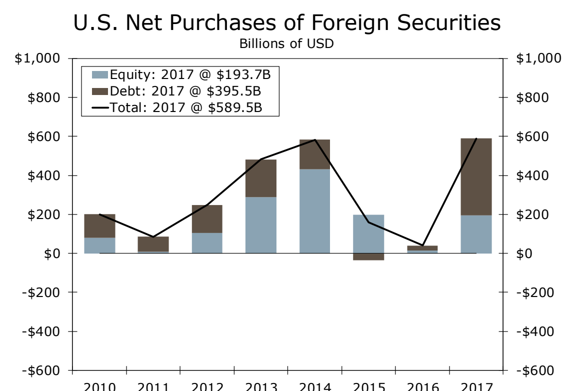


Figure 5



Source: U.S. Department of Commerce and Wells Fargo Securities

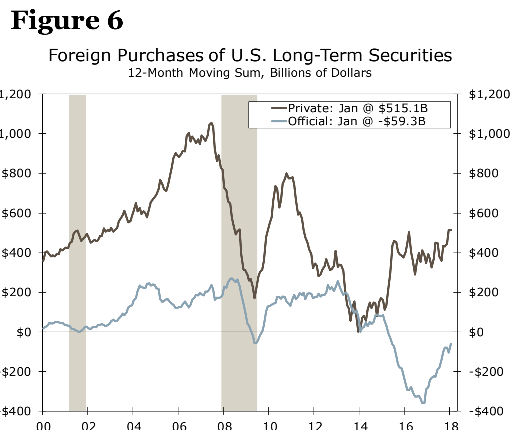
Drilling down further shows that inflows of portfolio capital weakened in 2015 as foreign purchases of American equities turned negative, and this weakness was compounded in 2016 as foreign purchases of U.S. Treasury securities also turned negative (Figure 4). However, there was broad-based foreign buying of American assets across asset categories last year. Not only did foreign net purchases of American equities total $167 billion in 2017, but foreigners also bought $324 billion worth of Treasury securities, $30 billion of agency securities and $317 of private sector debt securities. On the other side of the ledger, American purchases of foreign stocks and bonds rebounded in 2017 (Figure 5), but total inflows of portfolio capital (Figure 4) still exceeded outflows (Figure 5) by roughly $250 billion last year.

No Sign of Panic Among Foreign Investors

The foreign official sector is no longer a major source of financing for the current account deficit.

This broad-based foreign buying of American assets last year indicates that foreigners seem to be quite willing to finance the U.S. current account deficit, at least for now. There is one caveat to this statement, however. Specifically, the foreign "official" sector (largely foreign central banks) is no longer a major source of financing for the U.S. current account deficit. For years, foreign central banks were buying $200 billion or so per annum of U.S. long-term securities (Figure 6). Much of this official buying originated in China where authorities were using their swelling foreign exchange (FX) reserves to purchase U.S. Treasury securities. But the Chinese renminbi came under downward pressure in 2015 and 2016. To stabilize the exchange rate, Chinese authorities bought Chinese yuan and sold U.S. dollars, which they raised through sales of U.S. Treasury securities.[2] Although the pace of selling slowed last year, net sales of U.S. long-term securities by the foreign official sector totaled more than $100 billion in 2017. Unless the Chinese current account surplus balloons again, which does not seem very likely, purchases of U.S. Treasury securities by the foreign official sector is not likely to go back to it pace of 2004-07 and 2010-13.[3]

Figure 6



Source: U.S. Department of the Treasury and Wells Fargo Securities

Therefore, it would be more accurate to say that the foreign private sector remains quite willing to finance the U.S. current account deficit, at least for the time being. Could that willingness change? Sure, but it probably would take a significant reassessment of American economic prospects for foreign investors to sharply reduce their net purchases of U.S. assets, let alone to turn into net sellers. In that regard, an all-out trade war with some important trading partners, should one develop, could dampen the enthusiasm by foreign investors for U.S. assets. But as long as net foreign purchases of American assets do not collapse, any depreciation that the dollar will undergo going forward likely will remain orderly.[4]

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[2] **The terms "renminbi" and "yuan" are often used interchangeably when referencing the Chinese currency.**

[3] **See "Who Will Buy All the New Treasury Securities?" (November 27, 2017).**

[4] **The Wells Fargo currency strategy team looks for the dollar to depreciate modestly versus most foreign currencies in coming quarters.**

Conclusion

The U.S. current account deficit widened to a nine-year high of $466 billion in 2017. The gaping deficit in international trade in goods was partially offset by meaningful surpluses in trade in services and in the primary income balance. The current account deficit-to-GDP ratio remained unchanged at 2.4 percent last year. Looking forward, we expect that the current account deficit will widen further, albeit modestly. On the one hand, solid growth in the rest of the world and lagged effects of dollar depreciation should help to support export growth. On the other hand, strong growth in U.S. domestic demand, which will be boosted, at least in part, by recent tax cuts will help to underpin import growth.

Fortunately, foreigners remain willing financiers of the red ink in the American current account. FDI inflows exceeded $300 billion for the third consecutive year, and foreign net purchases of American securities jumped to their highest level since the record year of 2007. We look for modest dollar depreciation in coming quarters. But a full-blown rout of the greenback does not seem likely, unless something happens that leads foreigners to significantly reassess American economic prospects in coming years.

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