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Special Commentary

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U.S. Trade Deficit Widening: Trouble Brewing?

Executive Summary

The U.S. trade deficit widened in November to its highest level in nearly six years. Because a current account deficit is caused by a shortfall of national savings relative to national investment, the red ink in the current account likely will widen further going forward due, at least in part, to recent tax legislation.

In our view, the modest current account deficit that the United States is incurring is not a "problem," at least not from a purely economic standpoint. The country is having few troubles attracting the capital inflows that are needed to finance the deficit, and the dollar's depreciation to date has been orderly. However, the bilateral trade deficits that the United States incurs with China and Mexico have not gone unnoticed in Washington, and wider deficits going forward could provoke a policy response from the United States. A trade war, should one develop, likely would have negative financial and economic consequences.

Trade Deficit Reaching Multi-Year Highs

Recently released data show that the U.S. deficit in international trade in goods and services widened to $50.5 billion in November from $48.9 billion in October 2017, which was the largest deficit in nearly six years (Figure 1). Indeed, the overall trade deficit generally widened in 2017 after remaining roughly unchanged through most of 2015 and 2016.

The trade deficit is at its highest level in nearly six years.

Figure 1

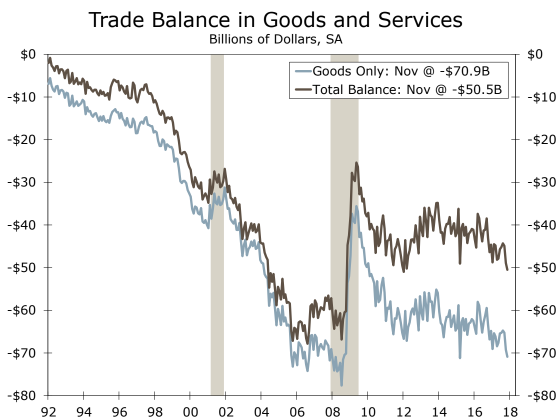
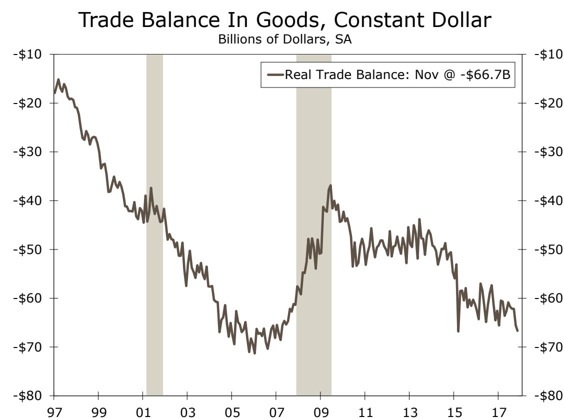


Figure 2



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

Although the United States continues to rack up large surpluses in international trade in services, massive deficits in goods trade have led to chronic amounts of red ink in the overall trade accounts. In that regard, the deficit in international trade in goods is on pace to exceed $800 billion in 2017, which would be the largest deficit since 2008. Not only has the nominal trade deficit widened over the past year, but the real (i.e., price adjusted) trade deficit, which

feeds directly into real GDP calculations, has also deteriorated in recent months (Figure 2). Before turning to the prognosis for the trade deficit going forward, we first drill down into its composition to glean some additional insights about the current state of U.S. international trade.

Decomposing the U.S. Trade Deficit

The vast majority of the U.S. trade deficit consists of goods that households typically purchase.

Let's start by decomposing the deficit into trade by major types of product. Outside of trade in food, feeds and beverages, where exports essentially equal imports, the United States incurs trade shortfalls in varying amounts in other types of major product groups (Figure 3). In 2008, when prices of industrial commodities were reaching record levels, the value of American imports of industrial supplies and materials exceeded the export value of those goods by about $400 billion. However, trade in those products is nearly balanced today. Not only have most commodity prices retreated significantly, but volumes of petroleum imports have dropped about 25 percent over the past decade as American oil production has surged. The United States also runs a modest deficit—about $100 billion over the past 12 months—in trade in capital goods. However, the vast majority of the overall U.S. trade deficit consists of goods that households typically purchase, namely automobiles and parts and general consumer goods.

Figure 3

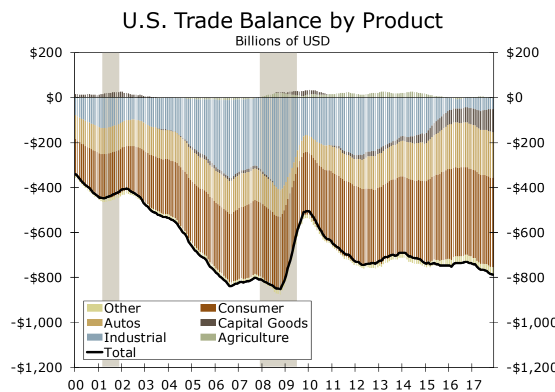
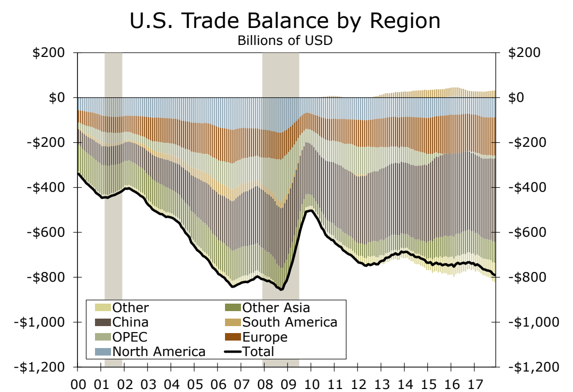


Figure 4



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

The United States has a large bilateral trade deficit with China.

Now let's turn to the decomposition of the trade deficit by major regions of the world. The United States runs a small trade surplus with the countries of South America and the Caribbean. American trade with OPEC countries is nearly balanced today, which is consistent with the sharp reduction in American petroleum imports that was noted previously. The United States has incurred a modest deficit ($88 billion) with its NAFTA trading partners over the past 12 months, while the deficit with European countries totaled $170 billion over that period. However, the trade imbalance that the United States incurs with China is America's largest bilateral deficit by far. As we discuss further below, this large bilateral deficit could potentially lead to frictions between Washington and Beijing going forward.

The Current Account and the Saving-Investment Imbalance

The U.S. current account deficit reflects the saving-investment imbalance.

So why does the United States have red ink in its trade accounts? Simply put, the United States runs a trade deficit because Americans spend more than they produce. That is, the excess spending by American consumers, businesses and government must be filled with goods and services that are produced somewhere, and that excess spending is fulfilled by imports. Said another way, a current account deficit is equivalently equal to the shortfall of a country's saving rate from its investment rate (see the appendix for a formal derivation).

As shown in Figure 5, the U.S. current account deficit has closely tracked the shortfall of American savings from American investment.[1] On the other hand, China racks up current account surpluses because its national saving rate exceeds its national investment rate. Therefore, the U.S. trade deficit has nothing to do with China, per se. China could disappear tomorrow, and the United States would continue to run the same current account deficit as it does today. It would simply incur larger bilateral trade deficits vis-à-vis other trading partners. In order to reduce its overall trade account deficit, the United States must raise its national saving rate and/or cut its investment rate.

Figure 5

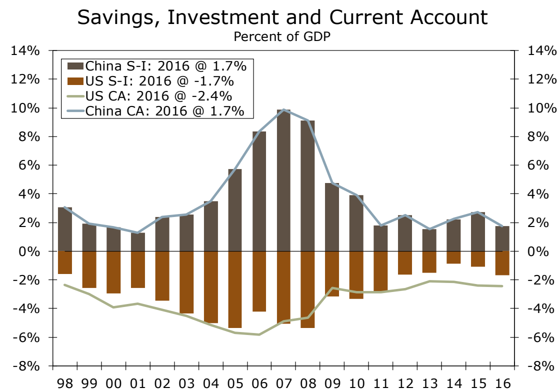
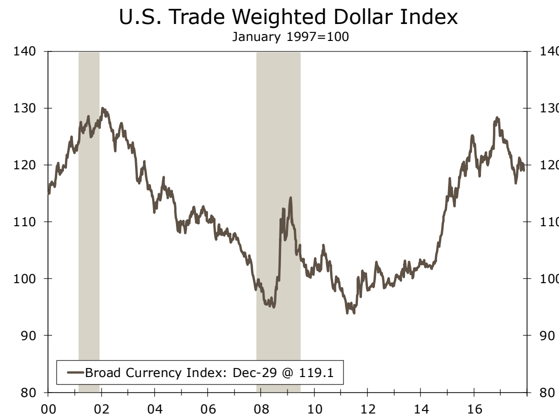


Figure 6



Source: International Monetary Fund, Federal Reserve Board and Wells Fargo Securities

The trade deficit is not an economic "problem" at present.

Is the current account deficit a "problem"? From a purely economic standpoint, the red ink in the current account does not seem to be much of a problem at present. In order to finance the deficit, the United States must import capital from abroad, and foreigners seem to be quite willing to finance the U.S. current account deficit at present. Through the first three quarters of 2017, foreigners bought $740 billion worth of American securities and their foreign direct investment purchases in the United States totaled $284 billion. The U.S. dollar fell 8 percent on a trade-weighted basis last year, but the greenback is hardly getting pounded at present due to a lack of capital inflows (Figure 6).

The Current Account and the Saving-Investment Imbalance

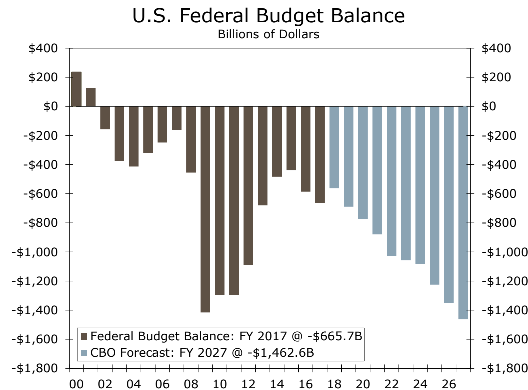
The U.S. trade deficit has been trending higher in recent months and it likely will widen further going forward due, at least in part, to the recently-enacted tax cuts. As discussed above, a country's current account deficit reflects its shortfall of savings (both private and public) from its investment. The tax cuts could have two effects on the country's saving-investment imbalance, which would both tend to increase the current account deficit.

The "dissaving" of the government will become even more acute.

According to projections made by the Congressional Budget Office (CBO), the federal government budget deficit will widen in coming years (Figure 7). That is, the "dissaving" of the government will become even more acute than it is currently. And these CBO projections were made prior to the passage of the tax cut legislation, which the CBO estimates will add an additional $1.5 trillion to the cumulative budget deficit over the next 10 years. Unless households and businesses increase their saving rates, which does not seem very likely, the national saving rate likely will recede as the federal budget deficit widens. The reduction in the saving rate would lead to higher current account deficits, everything else equal.

[1] **As shown in the appendix, a country's current account balance is, in theory, identically equal to the discrepancy between its national saving rate and its national investment rate. Statistical discrepancies often prevent this accounting identity from holding precisely in real world economic data.**

Figure 7



Source: Congressional Budget Office and Wells Fargo Securities

On the other side of the coin, investment could very well increase as after-tax cash flow among American businesses strengthens. The combination of lower national savings and higher investment would cause the current account deficit to widen.

As we have already noted, the current account deficit does not appear to be much of a “problem” at present from a purely economic standpoint. Foreigners seem quite willing to finance the red ink in America’s trade accounts. Because U.S. capital markets are the world’s gold standard in terms of deepness, transparency and liquidity, foreigners likely will remain willing to finance even larger current account deficits, at least for the foreseeable future. Our currency strategists look for the dollar to trend lower versus most currencies in coming quarters, but we would not characterize the modest depreciation that they envision as disorderly or disruptive.

Large bilateral trade deficits have not gone unnoticed in Washington.

However, the bilateral trade deficits that the United States incurs with China and its NAFTA trading partners, especially Mexico, have not gone unnoticed in Washington, D.C. If, as we expect, the overall trade deficit widens further going forward, then some of this increase will undoubtedly show up as higher bilateral deficits with China and Mexico. Consequently, American policymakers may feel compelled to “do something” about the “problem” and trade tensions between the United States and China and/or Mexico could ratchet up. Prospects of a potential trade war could lead to some volatility in financial markets. In our view, the outlook for the U.S. economy would deteriorate if the United States were to actually undertake a trade war with one or more of its major trading partners.

Conclusion

The U.S. trade deficit widened in November to its highest level in nearly six years. Because a current account deficit is caused by a shortfall of national savings relative to national investment, the red ink in the current account likely will widen further going forward due, at least in part, to recent tax legislation. The increase in federal budget deficits that is expected to occur, and which the tax cuts will probably compound, will cause the national saving rate to decline, everything else equal. On the other side of the saving-investment imbalance, the corporate tax cuts could lead to stronger investment spending, at least at the margin.

In our view, the modest current account deficit that the United States is incurring is not a “problem,” at least not from a purely economic standpoint. The country is having few troubles attracting the capital inflows that are needed to finance the deficit, and the dollar’s depreciation to date has been orderly. However, the bilateral trade deficits that the United States incurs with China and Mexico have not gone unnoticed in Washington, and wider deficits going forward could provoke a policy response from the United States. A trade war, should one develop, likely would have negative financial and economic consequences.

APPENDIX

The national income and product accounting identity can be written

$$Y \equiv C + I + G + X - IM$$

where Y = GDP (i.e., the value of all final goods and service produced in an economy)

C = personal consumption expenditures

I = private investment expenditures

G = government consumption and investment expenditure

X = exports

IM = imports

The act of producing goods and services (Y) generates an equivalent amount of income for somebody in the economy. This income can be consumed, saved, or used to pay taxes. Therefore,

$$Y \equiv C + S + T$$

where S = private savings

T = taxes

Equating the first algebraic expression to the second algebraic expression and rearranging terms yields

$$(X - IM) \equiv (S - I) + (T - G)$$

Thus, net exports (the term on the left-hand side of the equation) are equivalent to the discrepancy between private savings and private investment (the first term on the RHS) and the government's fiscal imbalance (the second term on the RHS). In other words, a country's current account position, which is more or less equal to net exports, is equivalent to the imbalance between private saving and investment and the net saving (or dissaving) of the government.

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