

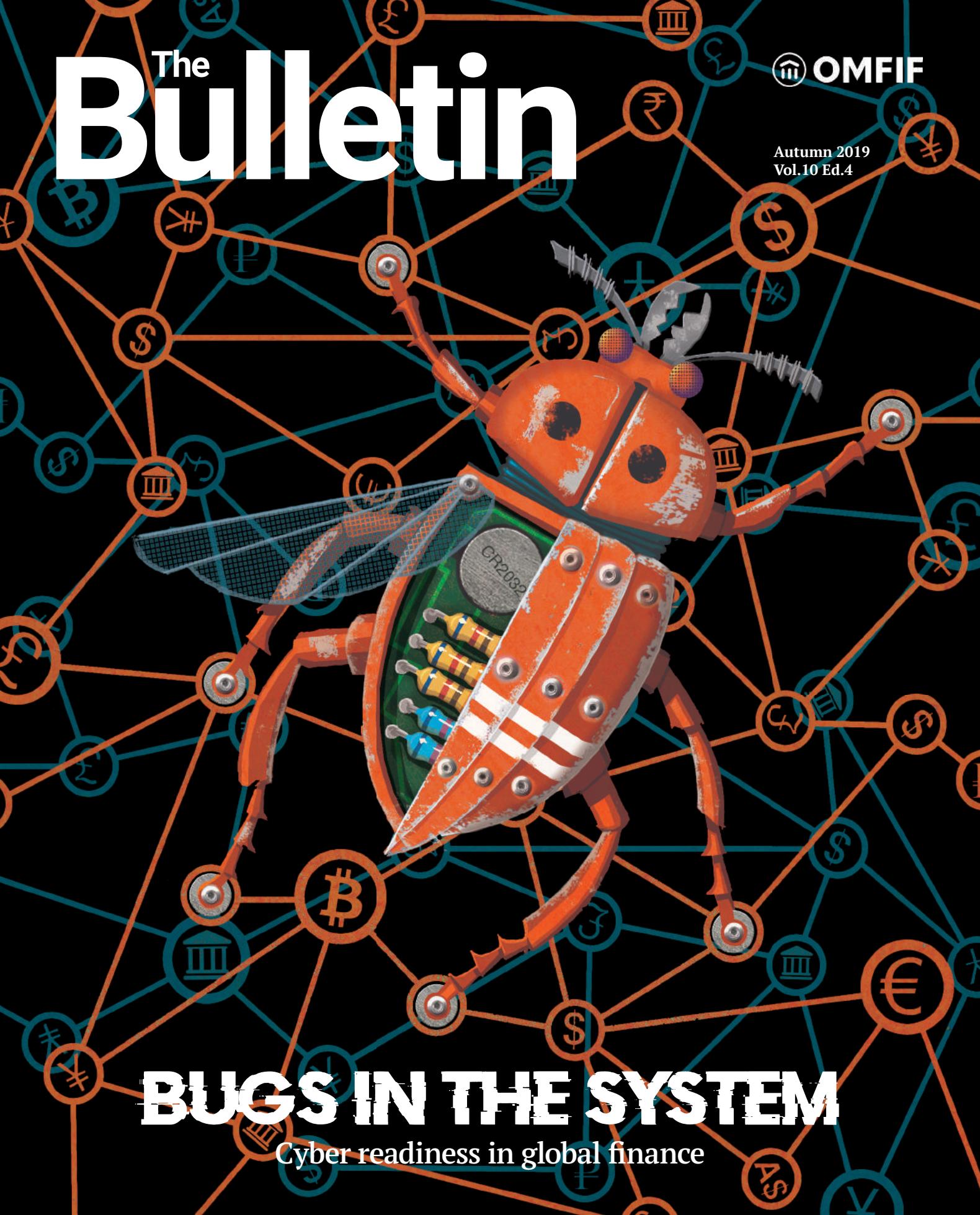
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BUGS IN THE SYSTEM

Cyber readiness in global finance



US trade deficit is homegrown

Trump commits a 'fallacy of composition'

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US President Donald Trump, alongside many business leaders, has a straightforward view on international trade, particularly the US external balance. He believes an external deficit is a malady caused by foreigners who manipulate exchange rates, impose tariff and non-tariff barriers, steal intellectual property and engage in unfair trade practices. The president and his followers feel the US is victimised by foreigners, as reflected in the country's negative external balance.

This wrongheaded mercantilist view of international trade and external accounts has its roots in how individual businesses operate. A healthy business generates positive free cash flows – revenues exceed outlays. If a business cannot generate positive free cash flows on a sustained basis, take on more debt or issue more equity to finance itself, then it will be forced to declare bankruptcy.

Business leaders employ this general free-cash-flow template when they think about the economy and its external balance. For them, a negative external balance for the nation is equivalent to a negative cash flow for a business. In both cases, more cash is going out than is coming in.

But this line of thinking represents a classic fallacy of composition. This is the belief that what is true of a part (a business) is true for the whole (the economy). Alas, economics is littered with fallacies. These cause businessmen to confuse their own arguments about international trade and external balances almost beyond reason.

Savings-investment identity
The negative external balance in the US is not a 'problem', nor is it caused by foreigners engaging in nefarious activities. The US's negative external balance, which the country has registered every year since 1975, is 'made in the USA', a result of its savings deficiency.

To view the external balance correctly, the focus should be on the domestic economy. The external balance is homegrown; it is produced by the relationship between domestic savings and domestic investment. Foreigners only come into the picture 'through the backdoor'. Countries running external balance deficits must finance them by borrowing from countries running external balance surpluses.

It is the gap between a country's savings and domestic investment that drives and determines its external balance. This is demonstrated by the 'savings-investment identity'. In economics, identities play an important role. By definition, they are always true. Identities

are derived generally by expressing an aggregate as a sum of parts, or by equating two different breakdowns of a single aggregate.

First, the national savings-investment gap determines the current account balance. Both the public and private sector contribute to the current account balance through their respective savings-investment gaps. The counterpart of the current account balance is the sum of the private savings-investment gap and public savings-investment gap or the public sector balance.

The US external deficit, therefore, mirrors what is happening in the US domestic economy. This holds true for any country, even those with significant external surpluses. The below figure, which comports with the savings-investment identity, makes this clear. The US displays a savings

deficiency and a negative current account balance that reflects its negative savings-investment gap. Japan and China display savings surpluses, and both run current account surpluses that mirror their positive savings-investment gaps.

Given the stunning level of economic illiteracy that surrounds the strange world of international trade policy, it is time to use the irrefutable arguments and evidence to explain finally why a country's external balance is determined domestically, not by foreigners. ●

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Savings and investment determine external balances

Current account balance and savings-investment gap, % of GDP



Sources: Economic and Social Research Institute of Japan, National Bureau of Statistics of China, and US Bureau of Economic Analysis. Calculations by Steve Hanke and Edward Li.

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