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It’s business models, stupid!

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In contrast to a massive current account deficit against China, the US runs a current account surplus with respect to the European Union. The US-EU surplus is largely driven by a positive service balance and primary incomes originating from US investments abroad. Services and primary incomes overcompensate the US goods trade deficit with the EU. Rather than representing a “rip–off”, the different balances reflect the economies’ different business models.

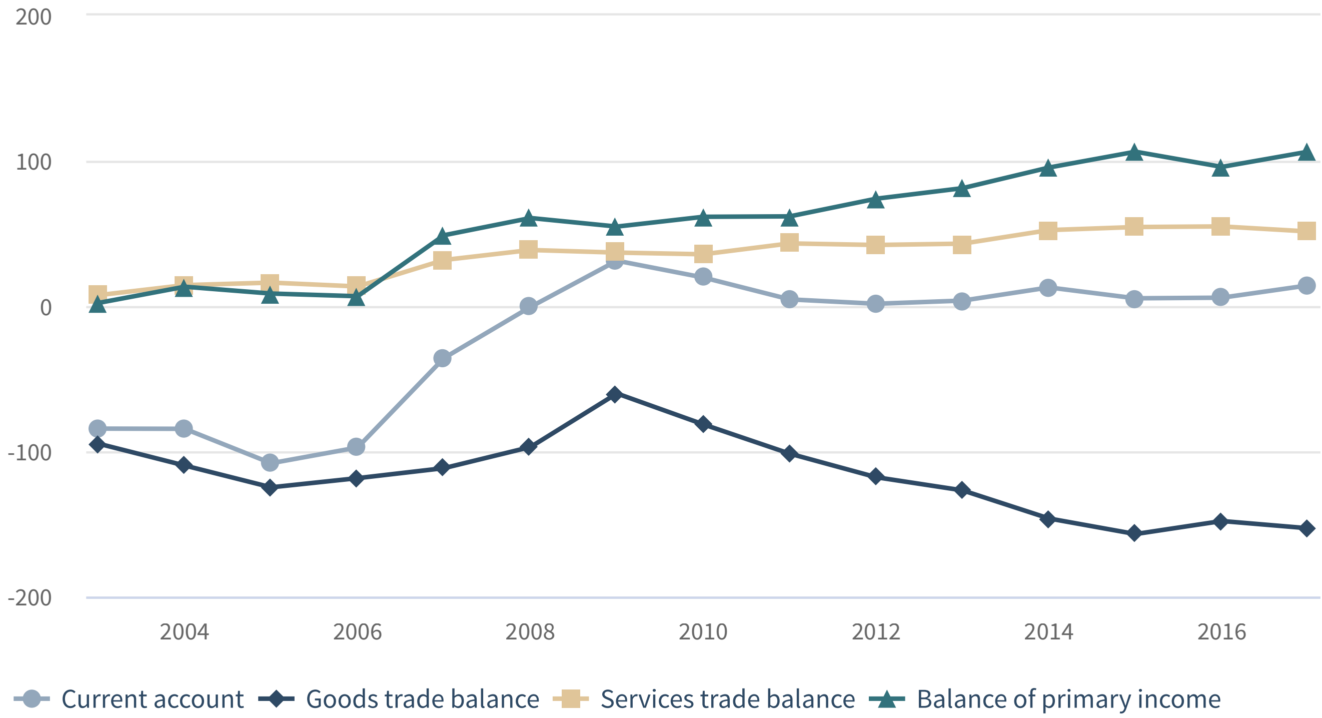
Donald Trump is a long-established critic of US-allies’ trade practices. In a Playboy interview in 1990 he revealed: “I think our country needs more ego, because it is being ripped off so badly by our so-called allies: i.e. Japan, West Germany, Saudi Arabia, South Korea.[…] Their products are better because they have so much subsidy”. Having become US president, Trump renewed his criticism of his trade partners’ unfair practices allegedly triggering the US goods trade deficit. With regard to steel and aluminium he also made clear that the cure he had in mind still applies: tariffs to fight the US deficits.

Finding and cure, however, face different caveats: **First of all**, with regards to the European Union the US did not face a current account deficit during the last 10 years. A former 100 billion US-Dollar current account deficit (in 2006) faded away and turned into a small surplus in favour of the US – amounting to 14 billion US-Dollar in 2017. In contrast, the US faces a significant and increasing current account deficit with China. After the financial crisis this US-China deficit spiked to over 300 billion US-Dollars and amounts to 358 billion US-Dollars in 2017. The US-China deficit makes up for more than 75 percent of the total US current account deficit.

And the rise of China did affect the US economy: Current research pins down the effects on the US labour market due to import competition from China after its WTO entry in 2001. Of the 6 million jobs lost in the US manufacturing sector between 1999 and 2011, Acemoglu et al. (2016) attribute a job loss of one million to direct or indirect import competition from China – 2 to 2.4 million jobs in the entire economy. The US government currently tries to prevent a similar development in the future and introduced significant tariffs for imports from China for artificial intelligence related products and other goods that the Chinese government explicitly subsidises within their China 2025 strategy. The outcome of unilateral protectionist measures against state funded industrial politics is entirely unclear. Furthermore, the fact that China did comply to WTO ruling in the past questions the US measures without making use of the given multilateral institutions.

US trade balance with respect to the European Union

in billion US-Dollars



Source: Bureau of Economic Analysis

By and large, China did export cheap products into the US and crowded out employment. Nevertheless, this is not necessarily due to abusive and unfair practices from the Chinese side. The comparison with Germany reveals that economies in the past did have the chance to profit from access to new markets and value chains: Dauth et al. (2014) show that in Germany 400.000 new jobs were created on a net basis due to the rise of China and the opening of Eastern European markets. Also in Germany new import competition had geographically as well as sectoral heterogeneous effects on the labour market. However, a competitive and innovative economy in combination with extensive welfare state programs in place, in order to provide help and education to those negatively affected by globalization, has turned out to be a winning strategy.

Secondly, the current account balance is more complex than a simple trade tracker. Particularly with respect to services, country specific trade data can vary depending on the national statistical agency: A service provided by an US owned company based in Ireland for a customer in Germany for example is a service export from Ireland to Germany. If revenues are repatriated to the US headquarter, they additionally become a primary income from Ireland to the US. Depending on how the transactions are reported, country specific statistics might differ. The US reports a questionable 20 percent EU service export share to Ireland and only a 14 percent export share to Germany. Especially with respect to digital service trade, statistics are imprecise when trying to assign value added geographically (Jung, 2018).

Hence, analysing the EU as an aggregated trading block also reduces the evident biases and reflects the interconnected European wide value chains. By zooming in on the US-EU economic relations published by the US Bureau of Economic Analysis the picture becomes clear (see figure). The 14 billion US-Dollar US current account surplus with regard to the EU can be divided into a 153 billion US-Dollar goods trade deficit, a 52 billion US-Dollar services trade surplus and 106 billion US-Dollar primary income surplus.

These balances reflect the **different economies' business models**. The US is strongly focused on the service sector exporting financial, legal and digital services as well as tourism. The respective services surplus accounts for one third of the goods trade deficit. Additionally, US companies are much stronger in investing abroad and repatriating their high-yielding revenues. The total share of primary income in relation to the respective current account increased significantly from 21 percent in the 1990s to 27 percent in 2017 and decreased to 18 percent in the EU (and 11 percent in Germany).

On the contrary, value added in the US manufacturing sector declined to 12 percent of total gross value added (GVA) of the economy, but accounts for 16 percent of GVA in the EU – and for even 23 percent in Germany. What is more, European manufacturing companies are embedded into closely entangled value chains that allow for the integration of smart services into industry products. In contrast to American "stand alone" companies (Berger et al., 2013), the European industry acts frictionless over borders and as a hub for the entire economy. The joint production of the manufacturing sector together with the service sector accounts for another four percent of EU GVA (and even nine percent in Germany) whereas the respective share amounts to only one percent of GVA in the US (Fritsch et al., 2018).

The strong exposure of European manufacturing based exports gives the US a strong leverage on the tariff side. And the EU does not always meet its own demands as the world's free trade champion: On average the EU enforces slightly higher tariffs than the US (unweighted tariffs: in the EU 5.2 percent; in the US 3.5 percent). However, the total amount of tariffs the US charged for imports from the EU (7.1 billion US-Dollars in 2015) was significantly higher than the total amount of the tariffs the EU charged for imports from the US (5.7 billion US-Dollar in 2015) (Felbermayr, 2018). These numbers provide under no circumstances justification for a penalty tariff against allegedly unfair trade partners – disregarding the arbitrary justification over national security. However, given the unpredictable US trade politics, there can be no waiting for future WTO rulings in the matter: In the end, an instrument targeting the highly profitable American digital multinational might be the only answer the US government will bend to.

Finally, there is no need for an obsession with the current account deficit: a trade deficit is not in itself a weakness. US companies and households indeed consume more goods and service than they manage to sell and repatriate in primary incomes – relatively stable around 400 billion US-Dollars over the last 10 years. This means US consumption and investments are financed from abroad. The standard of living would be significantly lower without the foreign money inflow.

Anyway, the EU and the US need to pull themselves together and develop a strategy on how to deal with state funded ring-fenced competitors that China currently establishes and that will be launched on the global market sooner or later.

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