real-world economics review, issue no. 105
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America's Trade Deficits: Blame U.S. Policies – Starting with Tax Laws

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Abstract:
American external imbalances of the past quarter-century result from structural changes in the global balance-of-payments system that evolved from the older Bretton-Woods system. American imbalances originate on the financial account side and flow from the confluence of two major forces: 1) the Global Savings Glut, 2) policy choices by U.S. authorities to passively allow other countries to vent those surplus savings in U.S. financial markets.

Financial account surpluses *directly cause* American current account deficits by inflating the dollar's value, in turn, creating a drag on aggregate demand. The inflows destabilize the U.S. financial system by adding debt and liquidity that is compounded by countercyclical fiscal and monetary policy. This process is politically and economically unsustainable.

Practical policy remedies, including removing perverse tax incentives for financial inflows, are available. However, there is doctrinal opposition to any restrictions on international financial flows and national pride in the "strong dollar." In fairness, some of the most harmful and counterproductive policies may have served legitimate objectives in a different era or different international financial system. Today, however, they require stringent, *de novo* review.

Keywords: Trade Deficits, Global Imbalances, Financial Account, Tax Law, Exchange Rate Determination, Reserve Currency

JEL Classification: F10, F31, F32, F41, F42, F62

Introduction

For over 20 years, the United States has struggled with large and unwanted trade deficits[1] and the consequent decline of its industrial base. Although the effects of the "China Shock" peaked over a

[1]The terms "trade deficits" and "current account deficits" are used interchangeably throughout. The more inclusive term "current account," includes other transactions and services, but is less intuitive for non-economists. We also ignore the relatively tiny "capital account" currently lumped into the new "Capital and Financial Accounts."

decade ago, its effects linger (Autor, et al., 2021). The deficits were the result of a combination of two factors: a global glut of savings, and policy choices by U.S. authorities to passively allow other countries to vent those surplus savings in U.S. financial markets. Either one, without the other, would not have caused the deficits. The first of these factors is external and relatively novel in the U.S. case. But it is largely unappreciated because many economists still fail to fully accept that all external balances are determined simultaneously (Austin 2019). The second factor is domestic: the result of prior policy choices and is therefore reversible.

But only policies that reverse the macroeconomic conditions and incentives that cause offshoring and overpricing of American manufactures will reduce its trade deficits in the longer term. This paper will explain that to accomplish these goals, policies must reduce the net financial inflows that finance the deficits.

This article's analytical framework begins with four insights of the proto-Keynesian economist John A. Hobson (Mummery & Hobson, 1889) and (Hobson, 1902): the true father of the idea of insufficient aggregate demand. These insights are:

1. Oversaving, more savings than are needed to fund productive investment, can be structural and persistent, as well as cyclical (the standard Keynesian case).
2. Income concentration is a primary cause of oversaving.
3. Oversaving can cause recession or stagnation. It funds bad investment, waste and household debt.
4. Surplus savings can be exported.

Many standard macroeconomic models assume capital and savings are scarce. However, in the case of persistent oversaving, whether from domestic or foreign sources, such models and their resulting policy prescriptions do not work. Keynesian counter-cyclical solutions cannot indefinitely offset persistent structural surplus saving without unsustainable debt increases.

Shrinking the U.S. trade deficit requires reducing the corresponding foreign savings inflows. This analysis identifies five mechanisms that drive the inflows and which ones are caused by and/or susceptible to U.S. policy control. Ironically, the easiest remedy is the elimination of the perverse and outdated tax incentives originally created to encourage financial inflows.

1. Financial Flows and Trade Imbalances

Non-economists, if they think about it at all, might believe that international financial and trade balances are unrelated to one another. Nothing could be further from the truth. Without financing (including transfers), the only way to pay for imports is with exports and the only way to accept payment for exports is by accepting imports: trade must be balanced to the penny.

We intuitively know that to spend more than we earn, we must borrow the difference or draw on savings. What is surprising and counterintuitive is that trade surpluses *must* be financed by lending the balance. If a trade-surplus country spends all its export revenues on imports, its trade surplus vanishes. That is why surpluses *must* be financed. If the exporter keeps any export revenue, even as dollars saved under mattresses, that is a form of lending. If, and when, the exporter spends the cash, it calls in the loan. Conversely, if the government or private residents of a foreign country wish to save dollars (or repay dollar debt), that country must run a trade surplus to obtain the dollars.

When foreigners lend to America, they typically exchange their own currency for dollars or use their dollar export earnings to acquire U.S. assets, including stocks, bonds, or U.S. bank deposits. This finances the U.S. trade deficit and, by one mechanism or another, the trade deficit adjusts to match its financing. Most commonly, the financing raises the relative value of the dollar and American goods and makes American manufacturing less price competitive.

Subsidies, trade deals, import quotas and tariffs can change the commodity composition of trade, protect key industrial sectors, and alter bilateral balances, but cannot reduce trade deficits unless they reduce financial inflows. Similarly, one cannot have net financial inflows without incurring trade deficits. The balance of payments is a basic double-entry bookkeeping system. If the system is properly designed, credits must equal debits and the current account must equal its financing. Assertions or implications to the contrary are fantasy and logical impossibilities.

2. Savings and Investment

Capitalism is distinguished from other economic systems by its ability to mobilize savings into productive capital (goods and services that produce more goods and services); hence the name "capitalism." Capital investment, and the technologies embodied in it, have been major drivers of economic growth for *at least* the last 300 years. Not only does capital contribute to the income of its owners, but according to standard economic growth theory, it increases the productivity and income of workers, as well as labor's *share* of total income. Thus, in theory, the more capital that is accumulated, the greater the general prosperity.

Economists have traditionally regarded capital and savings as perpetually scarce. "Tradition" is used literally here, "the transmission of customs or beliefs from generation to generation, or the fact of being passed on in this way." Historically, capital scarcity was the normal condition of society as observed by the classical economists, such as Adam Smith . Over the generations, capital scarcity has become folk wisdom among many economists and policymakers. Today however, there is concern about a contrary problem: "a savings glut."

To understand a "savings glut" properly, "saving" and "investment" must be carefully defined.

"Saving" is that portion of current disposable income not spent on consumption. The income that is not used to demand goods is the flow demand for assets. Assets can be a way of earning additional income or simply storing income. Assets can take many different forms with vastly different economic effects. Assets can involve storing the income in the form it was received as cash or kind or cash equivalents, such as stocks of goods, as bank accounts; as financial instruments, such as equities, bonds, or loans which are another person's, or entity's liabilities; or the purchases of new or existing productive capital, the means of production. In a globalized world, these assets can be both domestic and foreign.

Saving has important implications. If saving rates are low relative to available productive capital investment opportunities, then policies that boost savings promote growth. Such policies match the self-interest of those who need to save or can save a large proportion of their income and those who derive a large portion of their income from previous savings (including inheritances).

But policies intended to encourage capital accumulation and growth are often ineffective or even counterproductive. One reason is that the term "investment" has multiple definitions that often cause confusion and sloppy reasoning, even among well-respected economists. These definitions are important, not only for economists' formal models, but, for the "mental models" that people use to

visualize the economy. To understand the financial flows that cause trade imbalances, several precise definitions must be laid out.

> Definition #1 ($I_{\#1}$): The type of "*investment"* politicians and policymakers want to make the economy grow faster is *"expenditure on new productive capacity."* This is *"real investment."* In the National Income and Product Accounts (NIPA) statistics produced by the U.S. Department of Commerce's Bureau of Economic Analysis (BEA), this falls into the category "private fixed investment." It excludes the purchase of existing capital assets or natural resources.

Gross private investment expenditures is a slightly broader category in the NIPA that also includes business inventories. This definition is essentially a residual category.

> Definition #2 ($I_{\#2}$): *"Investment"* is all final production that is not classified as something else, including unsold goods. Definition #2 can be divided into two subcategories:
> - #2a ($I_{\#2a}$): "Profitable investment" or "Desired investment."
> - #2b ($I_{\#2b}$): *"Unprofitable investment"* or *"Undesired Investment."*

$I_{\#2b}$ could also be called "Unsustainable Investment" because firms will reduce their output or investment to eliminate it.

The Keynesian tradition is to consider #2b to be excess inventories of goods. A more Hobsonian approach includes investment in excess capacity that is misallocated or unneeded because effective demand is insufficient to justify increased productive capacity. This broader definition corresponds better to recent experiences, for example the dot-com bubble of the late 1990s or the excess capacity of China's state-owned enterprises.

> Definition #3: "Financial investment" is the transfer or allocation of savings among financial instruments and individuals.

"Financial investment" can be very misleading if it falsely implies a direct increase in the capital stock. Investing in corporate stock is an exchange of bank deposits for equities. Bank deposits are a loan to the bank. It is up to the bank how the money is used. The bank may use it, *inter alia*, to finance productive business investment, consumer lending, or excess reserves. Consumer borrowing and spending is an act of dissaving that cancels out the original act of saving. Because of the potential dissaving, it cannot be assumed that a new act of saving or inward transfer of savings will finance new capital investment; it could alternatively finance dissaving.

Similarly, the term "financial capital" is deceptive or ambiguous if it falsely implies real capital.[2] The financial inflows that cause trade deficits are incoming transfers of savings, not expenditures on productive investment as included in the definition $I_{\#2a}$ or BEA's term "fixed investment." This is not nitpicking or pedantry. In the U.S. case, very little incoming "*foreign investment"* directly contributes to the America's stock of real capital.

[2] Because of their historical usage, the misuse of the terms "capital" and "investment" is sometimes unavoidable. Terms like "capital controls," "capital account," or "foreign investment" can be misnomers.

Even what the United States classifies as "Foreign Direct Investment" (FDI) is largely something other than new additions to the productive capital stock.[3] This distinction is very clear if one compares BEA's definitions of Fixed Investment and FDI (U.S. Bureau of Economic Analysis (BEA), n.d.):

> **Fixed Investment:** Consists of purchases of residential and nonresidential structures, equipment and intellectual property products by private businesses, by nonprofit institutions, and by governments in the United States. (Owner-occupied housing is treated like a business in the NIPAs.)
>
> **Foreign direct investment in the United States (FDIUS)**: Ownership or control, directly or indirectly, by one foreign person, or entity, of 10 percent or more of the voting securities of an incorporated U.S. business enterprise or an equivalent interest in an unincorporated U.S. business enterprise.

Typically, only three to four percent of FDI involves the establishment or expansion of U.S. businesses: in pre-pandemic 2019, only 2 percent (U.S. Bureau of Economic Analysis, 2021). The rest is financial investment, largely bank deposits used to acquire control of existing U.S. businesses and their existing real capital. Reclassifying the latter as Foreign Direct Acquisition (FDA) would reduce misunderstanding. In many countries, the meaning of FDI may be even more dubious and less connected to real economic activity (Blanchard & Acalien, 2016).

This conflation of external financial flows and real capital in the minds of the public and policy makers, and even eminent economists impedes reform of American economic policy making.

3. Savings Gluts and International Financial Flows

If the idea of surplus savings seems counterintuitive, desiring a persistent trade surplus should be even more counterintuitive.

- A trade-surplus country consumes *less* than it produces; it has a lower standard of living.
- If savings are scarce, then exporting precious savings is a burden.

The true benefit of the trade surplus is the economic stimulus that comes from exchanging the surplus savings and getting the foreign customers. In short, if a country cannot productively invest its savings, they are toxic industrial waste.

Historical conditions may not be eternal. Until the Great Depression and Keynes, anyone (notably Hobson) who doubted the "more saving is better" doctrine was considered a crackpot or heretic. But in Keynesian theory, high savings rates are risky. Invest them *all*, and the economy thrives and grows quickly. Fail to invest them *all* and the economy may stall. An increase in collective saving (consuming less) can reduce the need for additional productive capital.

If real capital and savings are scarce, these problems and ensuing recessions are usually temporary and mild. The standard Keynesian remedy for recession is fiscal policy: the government borrows and spends the surplus savings. Borrowing and spending is the opposite of saving – dissaving. So, the government's dissaving cancels out the private sector's surplus saving. But governments fear high debt

[3] Capital refers here to BEA's definition of fixed assets: "Produced assets that are used repeatedly, or continuously, in processes of production for an extended period of time." (U.S. Bureau of Economic Analysis (BEA), n.d.).

levels are unsustainable, so fiscal policy may not be politically sustainable in the long term even if it is economically sustainable.

Keynes' cyclical focus was, in some ways, a step back from Hobson. Mummery and Hobson raised the issue of inadequate investment opportunities long before (Keynes, 1937) and (Hansen, 1939) raised the specter of secular stagnation. Unlike Hansen or Keynes who saw the problem as one of declining or stable populations and technology limiting new investment opportunities, Hobson focused on the flip side; income concentration causing high saving. Similarly, today's frequent asset bubbles reflect Hobsonian Point #3 about investment misallocation.

Analyzing oversaving and its consequences requires using correct definitions of "investment." Take the simple closed-economy case. People often simply write "Saving = Investment."

$S = I_{\#2}$ (Savings = All Investment): This is the "Savings-Investment Identity." 1.

Equation 1 is always true. But "Saving = Investment" can also be an equilibrium condition.

$S = I_{\#2a}$ (Savings = Profitable Investment): the economy is in equilibrium. 2.

$S > I_{\#2a}$ (Savings > Profitable Investment): the economy contracts.
This is a *savings glut*. 3.

The difference between Equations 1 and 2 is definition $I_{\#2}$ or $I_{\#2a}$. Conflating the two is a serious logical error that even good economists can make (see for example (Taylor, 2009), location 88). Equation 1, $S = I_{\#2}$, *always* holds, but Equality 2, $S = I_{\#2a}$, may not. In the savings glut case, economic output may shrink.

Balance can be restored by either reducing savings or increasing investment. If capital is scarce, and credit markets are functional, the problem can work itself out though interest rate adjustments. But if capital and savings are overabundant, the problem can persist.

In an open economy, if $S > I_{\#2a}$, there is another alternative to recessions and stagnation: vent the surplus savings abroad. For capital scarce countries, this can work out well. As the stream of surplus savings flows (is lent) from one country to the next, two things happen. The savings can be channeled into new, productive investment in the (willing) recipient country. Simultaneously, the lending will finance (cause) trade imbalances. The lending country runs a trade surplus, and the borrower runs a trade deficit. The trade surplus transforms the lender's surplus goods and savings into exports. The trade deficit will allow the borrowing country to temporarily consume and invest more than its own production. This can benefit both countries.

We represent the outflow of financing (saving) that finances a trade surplus by adding the term F to equilibrium condition #1. A negative F is an inflow and finances a trade deficit.

$S - F = I_{\#2a}$
(Domestic Savings – Financial Outflows = Profitable Domestic Investment) 4.

Or we could write the equivalent expression:

$S = I_{\#2a} + BOT$
(Domestic Savings = Profitable Domestic Investment + Balance of Trade) 4'.

Note that F is an outflow of savings and finances the trade balance. Exporting surplus savings and running trade surpluses can stimulate and stabilize an economy.

But what if, globally, there are not enough qualified and willing borrowers to absorb the surplus savings? This brings us to Hobsonian Point #4: The export of surplus savings, the Economic Taproot of Imperialism (Hobson, 1902)(Chapter VI). In Hobson's day, that meant that the relatively advanced countries of the time acquired colonies. Today, countries at almost all levels of development take advantage of open financial markets to push out their extra savings. Their favorite destination is the United States.

In 2005, Ben Bernanke coined the term "Global Savings Glut" to explain America's record current account deficits (Bernanke, 2005). He stated that the root cause of U.S. current account deficits was remarkably high savings levels in some developing countries, primarily Asian, that pursued export-led growth strategies. He described his analysis as "somewhat unconventional," although it was just a consistent application of textbook theory. In fact, Bernanke's "savings glut" is just a rewording of Hobson's "oversaving." Bernanke argued that because the origins of the problem were external to the United States, there were few effective U.S. policy responses available. America, and other trade deficit economies, needed to endure and wait for poorer countries to resume their theoretically expected role of international borrowers.

Most mainstream economists tacitly accepted Bernanke's analysis. A cynic can argue that this was because Bernanke had not disrupted the intellectual status quo nor advocated any difficult policy decisions. However, with a few exceptions such as (Aliber, 2020), many economists failed to recognize or accept that the inflows causing U.S. trade deficits resulted from external conditions and conflicted with U.S. economic needs.

The consequence of these savings inflows was the Great Recession/Global Financial Crisis. The crisis happened with a speed and scale that none would have guessed two years earlier in 2005. The trade surplus countries not only transferred surplus savings to the United States; they transferred the consequences: financial imbalances and powerful recessionary impulses. The savings inflows overvalued the dollar, switched expenditure from American goods to foreign goods, and created an excess of total saving (domestic and foreign) relative to domestic investment. Although it created more financing for domestic investment, less domestic investment was needed since the aggregate expenditure on American goods has been reduced.

The current account deficit is an external imbalance that corresponds to the financial inflows (foreign savings). The problem for U.S. policy is maintaining internal balance (full employment) or $S - F = I_{\#2a}$ (Domestic Savings – Financial Outflows = Profitable Domestic Investment).

Fiscal expansion is the most immediate way of compensating for the loss of expenditures due to the increased trade deficit. Fiscal stimulus is a deliberate act of government dissaving that restores macroeconomic balance by reducing aggregate saving (S – F). The 2001 and 2009 recessions both followed large surges in foreign financial inflows that caused rapid increases in the trade deficit. In turn, they led to major U.S. fiscal stimulus packages intended to restore aggregate demand. Thus, trade deficits caused fiscal deficits.

Both trade and fiscal deficits *ceteris paribus* increase aggregate debt without increasing debt service capacity; sustaining aggregate output comes at the cost of increasing financial fragility. In theory, the

sequence can work in reverse if the trade deficit can be reduced and fiscal stimulus withdrawn, maintaining output while reducing debt accumulation.

Monetary policy puts the Fed in a double bind. If it tries to compensate for the loss of aggregate demand created by the trade deficit, it must add even more liquidity to the liquidity flowing in from abroad via the financial account. The Great Financial Crisis of 2007/8 demonstrates the destabilizing consequences of such a double-barreled liquidity expansion. Part of the problem is that the U.S. financial system, monetary policy, and interest rates may not conform to the simplifying assumptions of textbooks.

Economists still neglect the role of household borrowing in the macroeconomic adjustment process. Generations of economists have been taught that lower interest rates increase demand by increasing investment expenditure. As (Keynes, 1964) put it:

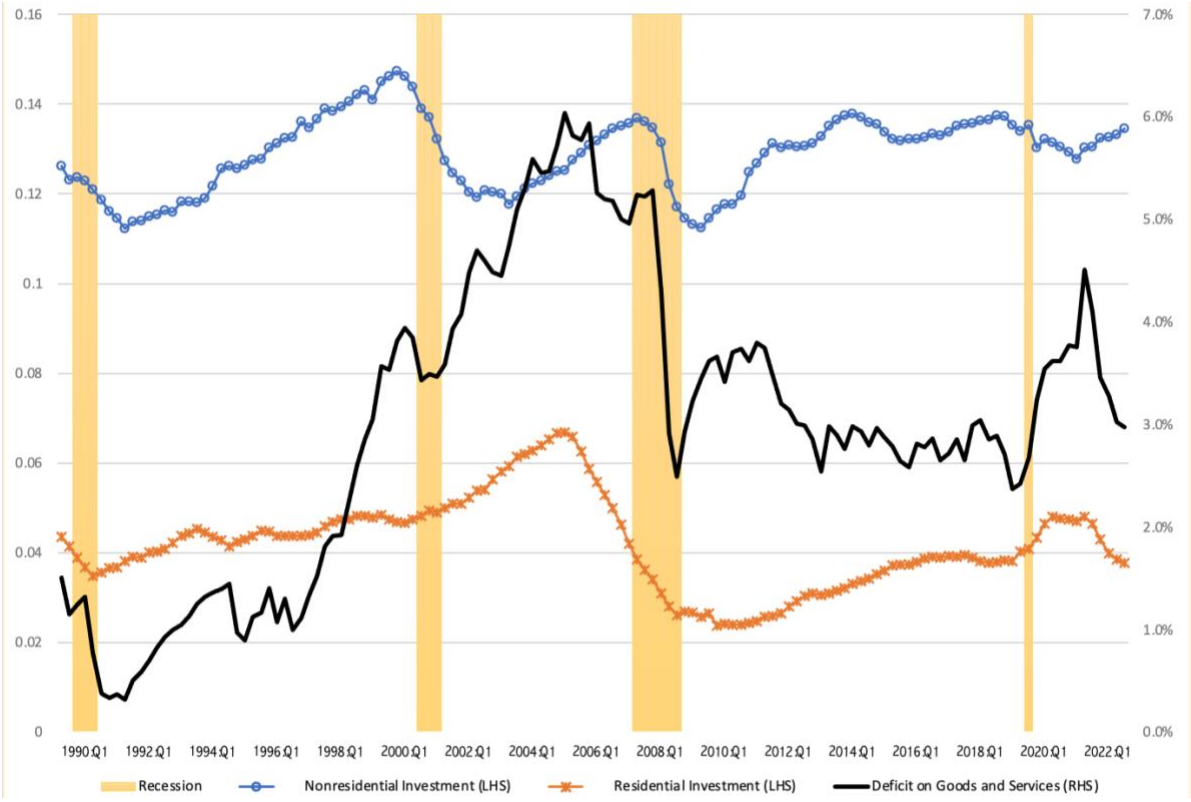
> a relatively weak propensity to consume (high saving) helps to cause unemployment by requiring and not receiving the accompaniment of a compensating volume of new investment.

Economists tend to assume an upward-sloping savings curve with respect to real interest rates (although the justification for this in the standard intertemporal optimization models was always ambiguous). Thus, falling interest rates eliminate surplus saving (and avoid recession) by inducing both higher investment and lower savings.

An important paper (Mian, et al., 2021) quantitatively demonstrates that the dissaving of less affluent households may sometimes be the most dynamic and important factor in macroeconomic adjustment. Thus, dissaving, especially household borrowing, should not be simply aggregated into a single net private savings term "S." Figure 4 of their paper shows the links between the combined inflow of global savings and the increased saving of the richest one percent of Americans on the dissaving and debt accumulation by the non-rich, comparing the period 1983 –2015 relative to 1973 –1982. The combined savings increase did not raise real investment rates. Instead, net investment rates fell. The counterpart of the savings increase was dissaving of the bottom 99 percent of the U.S. income distribution and a smaller increase in government debt.

Figure 1 shows the relationship between the U.S. current account deficit and residential and non-residential fixed investment. It illustrates the Mian et al conclusions about investment. There is no obvious relationship between the current account and non-residential investment.

Figure 1: Trade Deficits and Investment (percent of GDP)

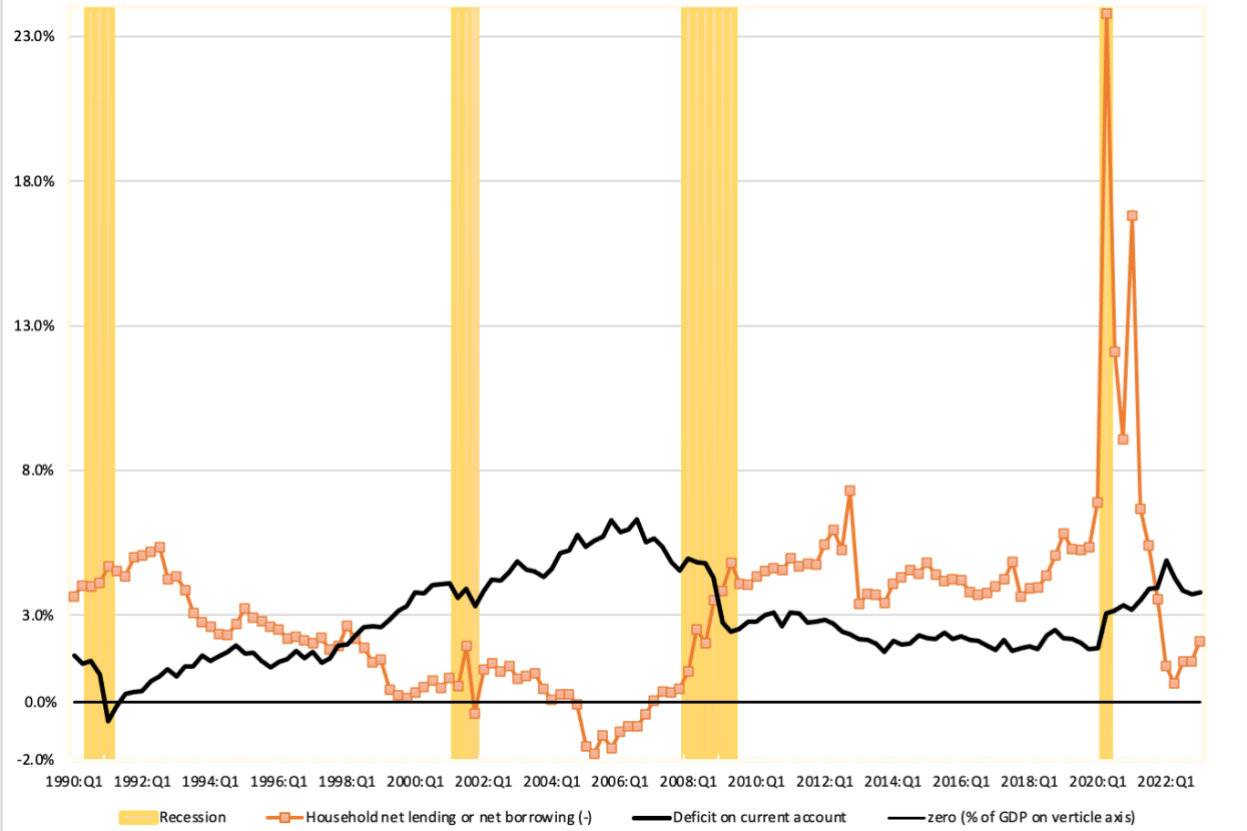


Source: BEA and author's calculations

Residential investment and the current account do show a similar pattern of growth and decline from the end of the 2001 "dot-com" recession until the end of the Great Recession in 2009, but no obvious relationship at other times.

Instead, it is dissaving among the less wealthy that has served as the major equilibrating mechanism as foreign savings flow into the U.S. economy. Figure 2 shows that Household Net Lending (negative values represent borrowing) mirrors changes in the current account deficit quite closely until the COVID crisis when household net lending mirrored the massive net government borrowing that financed the COVID-relief packages. Aggregate demand is restored by a fall in some combination of interest rates and/or prudential standards that induces (allows) more household borrowing. Increased household debt does not create growth in repayment capacity and may not be sustainable.

Figure 2:Current Account Deficit and Household Net Lending (Percent of GDP)



Source: BEA and author's calculations

A subsequent working paper (Bauluz, et al., 2022) found that the "Savings Glut of the Rich" is a common phenomenon in the G3 (China, Western Europe, and the United States) and has a common root: retained corporate earnings, most of which accrues to the wealthiest 10 percent of households. Corresponding to this a decline in the net saving of the middle classes, defined as households between the 50th and 90th percentile (the "Middle 40"). This was especially pronounced in the United States and to a lesser extent in Europe. The Middle 40 accumulated fewer financial assets and more debt.

Three articles in the financial press, (Moise, 2021) in the Financial Times and (Andriotis, 2021) and (Eisen, 2022) in the Wall Street Journal, illustrate how aggressive marketing by lenders can be an important balancing mechanism for financial markets. Andriotis begins, "Americans paid down credit-card debt during the pandemic. Credit-card issuers are spending big to get them borrowing again." Such behavior by lenders explains how an inflow of foreign saving (demand for assets), can be matched by an increase in household liabilities (dissaving). Eisen explains that with automobiles in short supply, car dealers are marketing dealer financing so aggressively that they literally discourage buyers from paying cash. Dealer financing is no longer a tool for sales promotion but is now a major profit source for automobile retailers.

Aggregating gross saving and dissaving into a single term in textbook and macroeconomic analysis veils the role of debt and dissaving in the macroeconomic adjustment process. Changing the aggregation of our models is a means to a more important end: changing how we think of the U.S. macroeconomic adjustment and balance.

4. The Dollar's Reserve Role and Its Quasi-floating Exchange Rate

In the current mixed or "non-system" of exchange rates, the U.S. dollar plays a unique role that is poorly understood by mainstream economists. The dollar is nominally free floating. The U.S. government and monetary authorities do not intervene in foreign exchange markets. However, some countries fix their exchange rates at depreciated levels against the dollar, or baskets of currencies including the dollar. This is for the obvious, but unstated, purpose of running a trade surplus. In effect, the U.S. has a quasi-floating exchange rate; it floats against some currencies, but against others, the dollar is pegged under the control of other governments (the fixer).

The quasi-floating exchange rate differs from a true fixed exchange rate in two ways 1) the fixer alone controls the bilateral exchange rate and modifies it at will and 2) the United States allows the fixer to buy U.S. financial assets as reserves to unilaterally maintain the exchange rate.

The second point means that the United States treats foreign central-bank purchases of U.S. Treasury securities as ordinary private sales of domestic assets to foreigners (except that the income is tax exempt). The U.S. central bank is not involved and there is no direct tally of the foreign central bank dollar-reserve transactions. The transactions are treated in the U.S. balance-of-payments statistics almost the same as ordinary, private, financial inflows.

A simple description of three countries (calling them the U.S., UK, and China for our example) within the larger "non-system" illustrates the mechanics of the quasi-floating exchange rate system. Begin by defining the U.S. balance of trade as a function of exchange rates:

$$BOT^{us}(e, e^c) \equiv X^{us}(e, e^c) - M^{us}(e, e^c), \qquad 5.$$

where U.S. Exports $\equiv X^{us}$, Imports $\equiv M^{us}$, and e is a floating exchange rate defined as the dollar price of the British pound: \$/£.[4] China (the fixer) pegs its exchange rate e^c, (\$/¥), against the dollar. It is an exogenous policy instrument under the control of China's government. American balance-of-payments equilibrium requires that the BOT equals its financing: F^{us}:

$$BOT^{us}(e, e^c) = F^{us} \leftrightarrow BOT^{us}(e, e^c) - F^{us} = 0. \qquad 6.$$

F^{us} is the balance on the U.S. Financial Account. It includes financial-asset sales to both the foreign private and official sectors. Since F is a savings outflow, a negative value of F denotes a financial inflow. A trade deficit must be financed by a savings inflow (negative outflow): credits that correspond to the net debits of the trade balance. Neither the U.S. nor UK central bank buys or sells reserves, although the U.S. and UK private sectors buy and sell both foreign assets freely. Since the dollar and pound float against one another, e must adjust to keep $BOT^{us}(e, e^c) = F^{us}$. If $BOT^{us}(e, e^c) < F^{us}$ then the dollar must depreciate against the pound (e must increase). If $BOT^{us}(e, e^c) > F^{us}$ then the dollar must appreciate against the pound (e must decrease).

The Chinese balance of payments equilibrium is:

$$BOT^{c}(e, e^c) = F^{c} + R \leftrightarrow BOT^{c}(e, e^c) - F^{c} = R. \qquad 7.$$

[4] There are three bilateral exchange rates, but the third rate is a function of the other two. Thus ¥/£ = \$/£ ÷ \$/¥.

China's Central Bank buys U.S. financial assets to hold as official reserves (R). China's official (reserve) demand for U.S. financial assets is determined by it overall balance-of-payments surplus: $BOT^c(e, e^c) - F^c$. This directly leads to an important conclusion: China's dollar reserve purchases are unrelated to the U.S. economy's or financial markets' need for financing. Instead, China's reserve purchases depend on its overall balance-of-payments surplus.

The Fixer's central bank reserve purchases cause the dollar to appreciate against the pound. For example, assume increased Chinese exports to Saudi Arabia result in a larger Chinese trade surplus. Maintaining China's fixed bilateral exchange rate requires an increase in China's reserve purchases. The counterpart of a change in China's reserve purchases, ΔR, is a change in U.S. net asset sales ΔF^{us}. That causes an appreciation of the dollar and larger U.S. trade deficits against third countries with floating rates.

A disproportionate portion burden of the counterpart deficit to China's trade surplus falls on America because it is the reserve issuer, not because China fixes its exchange rate against the dollar. Normally a fixer fixes its exchange rate against either the reserve currency or a currency basket. However, even if the fixer sets its bilateral rate against a third currency, it is the reserve issuer's currency that will appreciate and the reserve issuer's trade balance which will deteriorate because of the reserve purchases. For a broader discussion of this phenomenon see (Austin, 2014). To the extent that trade surpluses are financed by private financial flows, the same qualities that make U.S. assets attractive to foreign central banks make them attractive to private money managers. In the case of China, the government's extensive financial controls, including directed lending and large state-banking system, blur the distinction between official and private flows. That reduces China's dependence on official reserve purchases to defend its chosen exchange rate.

U.S. policy actions, *inter alia,* tariffs, quotas, subsidies, domestic content requirements etc., can change the commodity composition of trade, the direction of trade, and the volume of trade. These outcomes may fulfill trade-policy objectives, such as protecting specific industries.

However, these actions cause the dollar to appreciate against other floating currencies, so they cannot directly improve the bilateral trade balances against countries such as the UK. Any benefits to favored industries come at the expense of other domestic industries. This is because only changes in the financial balance, F^{us}, can change the trade deficit. Floating-rate systems have no automatic mechanism to finance trade-balance changes, so the exchange rate adjusts the current account to changes in the financial account.

However, these policy actions can be effective in the case of a quasi-floating rate regime because changes in the fixing country's trade balance are financed by changes in reserve purchases. If a U.S. tariff on Chinese goods reduces China's trade surplus, Chinese reserve purchases will decline to maintain the chosen bilateral exchange rate ($/¥). This comes with the caveat that China can respond by depreciating against the dollar to maintain its trade surplus.

5. Why America Cannot Just Stop Borrowing

It is a foolish and circular argument to assert that the inflows of savings are mutually beneficial and market-driven transactions as evidenced by the fact that they occurred. In fact, America's continued international borrowing seems paradoxical given the widespread political opposition to its unintended and adverse effects. The short explanation is other countries want to lend and rid themselves of surplus

savings, even at expected negative real rates of return. A complete inventory of mechanisms behind America's ongoing borrowing would be long and complicated, but there are five important reasons.

Reason #1 is the glut of global savings. A savings glut is a dangerous, deflationary impulse. Both private and official financial flows transfer savings to U.S. financial markets and finance U.S. current account deficits. If capital were scarce worldwide, there is neither the reason, nor the available savings, to send funds to America. It would be needed and invested elsewhere.

Reason #2 is that aggregate international lending does not require mutual consent. The mechanics of international borrowing and lending, especially in the U.S. case, are very different from the individual and private credit transactions with which we are all personally familiar. A private credit transaction is a deliberate and consensual act by lender and borrower, but Uncle Sam does not fill out a loan application at the People's Bank of China.

Instead, anyone not under U.S. Government sanctions has unrestricted access to the American financial system. Foreigners can keep their savings in U.S. banks deposit or exchange their deposits for U.S. stocks or bonds. The transferred savings earn income and finance American trade deficits. Private foreign individuals may put their money in U.S. assets for a variety of reasons besides earning income: because it is the proceeds of criminal activity, because their home financial systems cannot intermediate savings adequately, for safe haven against political risks, or to evade taxes. For whatever reason foreigners choose U.S. assets, they determine how much America borrows abroad. But these reasons have little to do with America's needs or ability to absorb more savings.

Reason #3: The U.S. Government actively refuses to prevent or regulate these inflows. Doing so would require a full re-examination of conventional economic doctrine. Mainstream American economists, across the political spectrum, champion free movement of international "capital." Any policy intended to restrict or penalize inflows would come within the definition of "capital controls" or what the IMF calls "Capital Flow Management Measures" (CFMs).

At Bretton Woods, Keynes advocated strict controls on "capital" movements. The IMF Articles of Agreement include an explicitly enumerated right to control flows of international capital. But the United States, then the world's paramount exporter and industrial power favored eliminating controls. Over time, the U.S. position dominated. Just prior to the Asian Financial Crisis of 1997, the U.S. and other industrial countries nearly succeeded in restricting the formal right of IMF members to use "capital controls." But whatever the written rules, an unwritten rule prohibiting restrictions on international financial flows has been vigorously enforced with rare, grudging exceptions for developing countries.

Reason #4 is the dollar's reserve currency role. The reserve currency role, *strictly speaking,* means that foreign central banks buy and hold dollars. But the dollar serves other international purposes that are carelessly conflated with that role. Within the international financial system, the dollar performs three functions generally attributed money. It is a means of exchange, a measure of value, and a store of value. Because the dollar is commonly used in international transactions and denominating international contracts; Americans conveniently avoid changing money. This also allows the United States to impose economic sanctions. But these other functions do not directly depend on the dollar's role as a public or private store of value. In the early 1970s, the advanced economies agreed to float their currencies against one another and reduced the dollar's formal reserve currency role. However, the dollar continued, or even expanded, its transactions currency role.

But it is the dollar's store of value role that finances American external deficits. If other countries want trade surpluses, they are free to fix their currencies and depreciated exchange rates by buying safe

American financial assets, such as Treasury bonds and hold them as foreign exchange reserves. This finances their trade surpluses and keeps the U.S. dollar prices of their currency and exports cheap. This is called "exchange rate management," or less favorably, "exchange rate manipulation."

Reserve accumulation plays a smaller role in global imbalances that it did just a few years ago, but it remains a problem and could become more serious again. The IMF's Currency Composition of Official Foreign Exchange Reserves (COFER) data indicate that global foreign-exchange reserves have peaked in recent years after a nearly six-fold increase between 2001 and 2013. However, because of COFER's narrow reserve definition, this is misleading. (Setser, 2023 a) and (Setser, 2023 b) demonstrate how governments can conceal their foreign exchange reserve accumulation by keeping it off the central bank's books. Setser estimates that China's hidden reserves maybe nearly as large as the officially reported $3 trillion. If the intent is to maintain a depreciated currency and finance a current account surplus, these measures muddle the issue and maybe give plausible deniability to currency manipulation charges.

Reason #5: A surprising reason that foreign money pours into the United States and finances the trade deficit is that American tax law subsidizes it. Putting your money in America is artificially attractive because you don't have to pay U.S. taxes. As a bonus, the U.S. government often avoids reporting the income to your home country's tax collectors (and sometimes the criminal authorities). Two such important and perverse provisions of the U.S. tax code are:

26 CFR §1.895-1 (Legal Information Institute, 1975) exempts income of foreign central banks on obligations of the United States. Central banks (including China's and Japan's) buy and hold foreign financial assets as reserves to manipulate their exchange rates. It's one of the definitions of exchange rate manipulation under U.S. law and 26 CFR §1.895-1 tax subsidizes it.

26 U.S.C. §871(h)(1) (Legal Information Institute, 1984) exempts portfolio interest income received by nonresident aliens from U.S. sources. If an American owns a corporate bond, she gets an IRS Form 1099 and pays taxes on the interest. But if she sells it to a German, the interest income disappears from the U.S. tax base and is no longer reported to the IRS. In fact, to the dismay of many other governments, the United States does not generally reciprocate the type of information gathering and sharing it demands for its own tax authorities. That income is effectively tax-free. Think-tankers on the left have criticized this provision on fairness and tax evasion grounds (Tax Justice Network, 2020), but the deleterious economic effects are not fully appreciated. These exemptions are granted to foreigners who can't even vote in U.S. elections and chew up a large portion of the U.S. tax base and complicates tax administration. Thus the U.S. tax code *incentivizes* trade deficits and foreign lending into the U.S. financial system.

A closely related problem is that the United States is very ambivalent, at best, about international information sharing on tax matters which can encourage inflows for the purpose of tax evasion. It does not participate in the OECD's Automatic Exchange of Information (AEOI) and Common Reporting Standard (CRS), but instead relies on a system based on its own Foreign Account Tax Compliance Act (FATCA). This patchwork system does not meet the OECD's minimum standards. Beyond the direct tax issues, (Michel, 2021) shows how foreigners can use the U.S. legal system to keep money beyond the reach of foreign criminal authorities. Regardless of the ethical issues, these policies encourage the financial inflows which maintain America's external imbalances and their adverse impact on U.S. economic performance.

6. Effective Policy Options Open to the United States

This analysis makes no political forecasts regarding American political will to re-examine its international economic policies. But the economic and political costs have created a political impetus for change that atypically receives support across the American political spectrum. For U.S. policy makers and Congress to choose a more active approach, they must overcome the self-imposed ideological constraints of American policy. These include the "strong dollar" mantra, unequivocal opposition to "capital controls," and the dollar's grossly misunderstood, quasi-sacred reserve currency status and its conflation with the dollar's transactions currency role. If American policy makers can clear these hurdles, there are effective remedies available. Reducing U.S. trade deficits is straightforward; America must stop absorbing foreign savings that it doesn't need. All else fails.

The most obvious measures are the elimination or reversal of the tax incentives established to encourage the inflows, starting with 26 CFR §1.895-1(tax exemption of central banks' income on U.S. government obligation), 26 U.S.C. §871(h)(1) (tax exemption of non-residents U.S. portfolio income), including exemptions from tax withholding given to foreigners. If the beneficial owners have tax-exempt status under bilateral tax treaties, the income can be withheld and refunded to the home country's tax authorities, so that the income would still be taxed. In essence, foreigners buying U.S. financial assets will either get U.S. national treatment or be taxed by their home authorities.

This should be unobjectionable on both legal and equity grounds; the United States has the sovereign right to tax U.S.-source income except when it is exempt under tax treaties. Even then, tax treaties can be abrogated or renegotiated for chronic trade-surplus countries. Tax treaties are meant to protect cross-border financial income from double taxation, but without information sharing the money is often effectively shielded from *any* taxation. The United States has been criticized by others for its favorable tax treatment of U.S. income of foreign residents and failure to share information with other governments. Aggressive taxation of foreign residents and information sharing may even be popular with some other governments. But that cannot happen without a realization that current tax law and policy is destructive of broader U.S. economic interests. America can have it both ways: on one hand, the rule of law and tax administration without favor to special interests, and on the other growth, and balanced trade.

It is hard to evaluate how much revenue repealing a tax break can produce, but a quick back-of-the-envelope estimate is easy for repeal of 26 CFR §1.895-1. Foreign official holding of U.S. obligations are roughly $4 trillion (U.S. Department of the Treasury, 2022). A 2.5 percent average interest rate on U.S. Treasury obligations produces $100 billion in annual income. A 30 percent tax rate would generate $30 billion (about a quarter from China and Japan each). Of course, if dollar reserves are reduced, the tax revenue may be less, but the trade deficit will shrink, and domestic tax revenues will increase.

Taxation of foreign income earned from U.S. assets is not a novel idea. It has been proposed for over a decade including (Pettis, 2019), several economists at Peterson Institute for International Economics *inter alia* (Hufbauer, 2010), (Hufbauer & Gagnon, 2011), (Gagnon, 2011), and (Bergsten & Gagnon, 2017).

An advantage to eliminating perverse tax incentives is that it is politically and diplomatically more defensible than penalizing foreign residents. The difficulty is the novelty of these policy reforms. The sensitivity of the inflows to taxation and how quickly changes will occur is unpredictable. The objective is a medium-term adjustment, not a disruptive shock. While some capacity exists to increase the output of tradeable goods, the United States needs to rebuild much of its tradeable-goods sector if it wishes to eliminate its trade deficit. That capacity was built once, and it can be rebuilt. U.S. multinationals build

these capabilities abroad from scratch. The issue is time. However, market economies adjust; that's the purpose of markets. New policy measures need to be cautiously inaugurated and calibrated upwards. Just announcing that foreign-owned U.S. assets are part of the tax base may immediately reduce the inflows.

The United States can impose other restrictions on the use of U.S. assets as central bank reserves. But strict reporting requirements on foreign central banks' U.S. asset transactions and positions should come first. The United States Government routinely discloses such information, including weekly foreign exchange information (U.S. Department of the Treasury, n.d.). This is certainly not a capital control; it is a transparency requirement and a deterrent to abuse.

Other, economically effective measures are legally available, but face doctrinal and political hurdles. Some well-respected economists mischaracterize the dollar's reserve-currency role as an "exorbitant privilege" (Eichengreen, 2011) (Page 4). Yet no one else wants that "privilege." Calling it a "privilege" is the same scam that Tom Sawyer used to get the other kids to do his work, paint his fence, and pay for the honor. Is the dollar's reserve role really a privilege or just a vain man's status symbol? Is everybody else just happy to let America have the honor of sitting at the head of the table so that it can pick up the check? Is it really a privilege to borrow and spend the money instead of earning the money yourself by making the things you buy?

Some economists have actually asserted the former point. (Blinder, 2016) states:

> A trade deficit means that foreigners send us more goods and services than we send them. To balance the books, they get our IOUs, which means they wind up holding paper—U.S. Treasury bills, corporate bonds or other private debt instruments. That doesn't sound so terrible for us, does it?

The Great Financial Crisis should have conclusively answered that rhetorical question, unless Blinder is suggesting that repayment is optional.

If these measures are insufficient to eliminate the current account deficit, then another doctrinal taboo must be breached: capital controls. Ironically, although U.S. policy in recent decades has consistently opposed capital controls, a residency-based tax provision like 26 U.S.C. §871(h)(1) *is a capital control* (or more euphemistically, **capital flow management**). Nobody notices because the United States aims the gun backwards and defeats its own economic objectives. However, a positive, residency-based, surtax on foreign purchases of U.S. financial assets or income from those assets would also be an obvious capital control. An example is the Market Access Charge (MAC) proposed in Section 5 of the (Baldwin-Hawley, 2019) bill introduced in the U.S. Congress. The MAC is a tax on the initial foreign purchases of U.S. assets. It would be set and subsequently readjusted to a level intended to eliminate the U.S. current account balance within five years. It can be argued that the sale of U.S. financial liabilities by U.S. residents to eager foreign buyers at premium prices is a mutually beneficial market transaction. But those are private benefits. On a macroeconomic level, the transaction can result in increased domestic debt levels, financial instability, and loss of demand for U.S. output. These are social losses: a negative externality. The best policy remedy is a tax on the transaction producing the externality.

This illustrates a paradox. Market transactions can be refused by either party. That assures that they are mutually beneficial. At the "macro" or national level though, financial inflows cannot be refused without measures that are technically "capital controls." Disallowing capital controls means financial transactions are exempted from any restrictions on their negative externalities.

If the United States wishes to eliminate its trade (current account) deficits only policies that directly or indirectly reduce its financial account surplus to zero will work. Targeting the financial account itself is superior to using the exchange rate as an intermediate target. The reason is simple. The authorities cannot know the Current Account Balancing Exchange Rate (CABER) in advance. But they know that to reach and maintain the CABER, they must intervene until the financial account reaches zero. Thus, it logically follows that the authorities only need to know the directional effects of their policies to bring about a gradual reduction of the financial account surplus to zero.

Ironically, such policies might help conserve the dollar's "reserve currency" role and status. Over time, the dollar's international currency role will continue to evolve. However, the United States faces a problem similar to the Triffin Dilemma. If it continues to passively supply the rest of the world's demand for safe assets, its external liabilities (both official and private) will reach unsustainable levels and the dollar may face a sudden loss of value and even reserve-currency status. Alternatively, if the net deficit on the financial account were gradually reduced to zero and held at that level, the U.S. Net International Investment Position (NIIP) would stabilize in nominal terms. The NIIP would thereafter decline relative to GDP. This would reduce concerns about U.S. financial solvency. If foreign central banks or private sectors wished to hold the then stable stock of dollar assets or trade them beyond U.S. borders, they would still be able to do so. Such a system might resemble the gold standard in that there might be a fixed quantity of dollar central bank reserve assets, but further speculation is beyond the scope of this paper. But the Triffin-Dilemma-like problem would be gone.

Eliminating the net financial inflows will reduce the amount of credit to be intermediated by the U.S. financial sector and may initially constrain that sector's growth. However, since the Great Financial Crisis, there has been a re-evaluation of the relationship between financial-sector growth and GDP growth. Studies such as (Cecchetti & Kharroubi, 2012) and (Cournède & Denk, 2015) have found that for many countries there appears to be a threshold level above which growth of the relative size of the financial sector is associated with lower overall economic growth. This implies there is no strong *a priori* reason to believe that the pain of adjustment will spread beyond the financial sector.

7. Consequences for the Rest of the World

Keynes advocated the adjustment burden be distributed on both surplus and deficit countries. He feared forcing trade-deficit countries to assume the entire burden imparts a deflationary bias on the global economy. If the burden is shared by trade-surplus countries adopting expansionary policies, then the overall impact on the global economy will be more neutral – and the surplus countries will enjoy a higher standard of living. But FDR's New Deal Treasury Department opposed Keynes' approach and the burden remained solely on deficit countries. Sixty years later, in the age of the Global Savings Glut, trade surplus countries discovered how to transfer their *ex ante* demand deficiencies to the United States.

For 25 years, America has been the global macroeconomic-balancing mechanism. The rest of the world has become collectively dependent on America. For America, this is neither politically nor economically sustainable. By Stein's Law, it must change. The sooner, the better, for everyone.

The other Anglophone trade deficit countries – the UK, Canada, Australia, and New Zealand, will need to follow suit or lose control of their trade deficits. The UK's Overseas Territories and Crown Dependencies are among the most secretive banking jurisdictions (Tax Justice Network, 2020), but presumably the deposits of those banks flow elsewhere. The Russian invasion of Ukraine has called

attention to the London's (nicknamed Londongrad) prominent role in hosting Russian oligarchs. The UK is, in fact, *by design,* a primary destination for foreign oligarchs and money of questionable origin as noted by the British magazine, The Economist: "The rise of Londongrad was planned. British governments of all stripes opened the country to Russian capital." (Economist, 2022). (For an even more trenchant of the UK's role in attracting money of questionable provenance see (Bullough, 2018) and (Bullough, 2022) Britain's economists and government seem oblivious to the role of these financial inflows in Britain's current account deficits and deindustrialization.

Developing countries will be either delighted, or rightfully terrified, that torrents of unwanted savings will be diverted to them depending on whether they want to increase or reduce their external deficit. If they follow the U.S. lead, they will have to use "capital flow management" to either deflect the flows or negotiate more advantageous terms.

Without the United States to absorb the surplus savings, eventually the burden of adjustment will return to its countries of origin: the trade-surplus countries. Klein & Pettis (2020) give an excellent description of the economic policies that helped concentrate wealth and create the Global Savings Glut, not only in trade surplus countries such as Germany and China, but in America. Their concluding chapter describes what other countries will have to do if the United States ends its role as the great global balancing mechanism. In short, their working and middle classes will have to accept a higher standard of living.

Klein and Pettis believe unilateral U.S. action to stop the inflow of unwanted funds would be too painful and disruptive for the rest of the world. Instead, they advocate dramatic changes in trade-surplus countries' domestic policies that would eliminate the savings glut.

There is a major weakness in their position. American presidents have asked nicely since the Clinton Administration for help reducing the trade deficits and have been ignored or scorned. In 2010, Chinese President Hu Jintao flatly told the Obama Administration that China would not yield to "external pressure" to appreciate its hard yuan peg of 6.83/$ (Chen & Delaney, 2010). Yet the peg was only possible because of U.S. acquiescence to massive Chinese intervention in its financial markets.

Baring U.S. action to stop the financial inflows, there is no reason to expect that will change. If the political decision is made to begin reducing the inflows, the two realistically possible choices are: (1) A medium-term, mutually advantageous adjustment, or (2) a sudden shock. The latter will eventually occur if the present situation continues until enough damage has been done to the American economy that the system collapses.

Unilateral U.S. measures to control the inflow of the Global Savings Glut would push the world closer to the first option. If properly designed, such measures will allow the surplus countries at least three to five years to adjust. Depending on how quickly they respond, that could be enough. But the result should be politically popular improvements in living standards. The problem is that for either political or ideological reasons, many surplus countries have refused these reforms thus far.

8. Summary and Conclusions

Today, surplus saving that the U.S. economy does not need flows in from economies that need it even less. This not only causes U.S. trade deficits but harms the financial and industrial sector. It drove U.S. interest rates towards historic lows while the Fed worried that ultra-low interest rates trigger financial instability. American savers suffer (especially retirees living on their savings), and consumers are

burdened with debt. Economists worry about the "zero lower bound" rendering monetary policy ineffective. Yet American tax policy subsidizes this!

America's position is constant from each presidential administration to the next, regardless of party. In this respect, America has shunned the routine hypocrisy that defends the self-interests of nations. Donald Trump obsessed about the trade deficit and resulting deindustrialization of America. He proclaimed an "America First" policy. And yet, the U.S. Treasury's institutional bias for a "strong" (i.e. overvalued) dollar endured. This allows other countries to do the opposite: undervalue their currencies to make their exports cheaper. Therefore, American wares are overpriced and uncompetitive on world markets and its factories are no longer viable. U.S. trade negotiators seem unaware that the financial inflows prevent any adjustment of the exchange rate or trade deficit. While the Trump Administration seemed to delight in violating many of the norms and conventions of American politics, including those of the old Republican Establishment, it never actually challenged the intellectual inertia of America's policy elites.

In fairness, under fixed exchange rate systems or when capital was scarce, measures to encourage financial inflows may have served American national interests, even if at other countries' expense. Today, these measures are obsolete and destructive government economic interventions. Eliminate them and America's external imbalances will shrink. For America, that is good news because it has the incentive and means to act unilaterally. The governments of trade-surplus economies have no compelling incentive to help, even if their populations would enjoy higher living standards if they adopted the appropriate reforms. But the American problem is that it doesn't even understand the consequences of its own tax code. [5]

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[5] The author would like to thank, among others, John Hansen, Jeff Ferry, Michael Joffe, John Mueller, Matthew Klein, Michael Pettis, Amir Sufi, Ludwig Straub, Atif Mian, Warren Coats, Rich Danker, Kurt Schuler and participants in the WEA's online conference Trade Wars After Coronavirus. Any remaining errors are strictly the fault of the author.

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SUGGESTED CITATION:
Kenneth E. Austin, "America's Trade Deficits: Blame U.S. Policies – Starting with Tax Laws", *real-world economics review*, issue no. 105, October 2023, pp. 25–45, http://www.paecon.net/PAEReview/issue105/Austin

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