Intelligence MEMOS

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To: Trump Administration Observers

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Re: **Arithmetic Upends the Trump Mercantilist Fallacy**

This summer, the Trump administration announced trade deals with Japan and the European Union. Each involved lower barriers to US exports, more foreign direct investment into the United States, and higher US tariffs on EU and Japanese goods. The United States looked like it was winning on all fronts.

According to the White House, Japan pledged US$550 billion in new investments in US projects and also agreed to increase its purchases of specific products. The EU deal included US$750 billion in energy purchases and US$600 billion in planned investments in the United States by EU companies. Meanwhile, US tariffs on both partners jumped from around 1.5 per cent to 15 per cent.

It's textbook mercantilism – a revival of the 18th-century belief that wealth comes from exporting more than you import. But there's a problem: It fails the test of basic arithmetic.

The Trump administration wants the United States to run a trade surplus and at the same time attract foreign investment. But both economic theory and accounting rules say that if you run a trade surplus, you're going to be a foreign investor yourself, not a recipient of foreign direct investment. You have to be: All that foreign money flowing in via your trade surplus has to go somewhere.

The balance of payments, the ledger that tracks a country's transactions with the rest of the world, is governed by an unbreakable accounting identity: The "current account" and the "capital account" must balance. The current account consists mostly of the trade balance and the net returns to existing investments, i.e., interest and other payments flowing into or out of your country. The capital account consists of net new investment flows. If you're lending, i.e., acquiring assets, your capital account is positive. If you're borrowing, it's negative.

As economists put it, the balance of payments always balances. If you've got a negative balance (a "deficit") on the current account, your capital account is going to be positive. And vice versa. So if the United States runs a trade surplus, it must be acquiring claims on foreigners, i.e., exporting capital. Conversely, if the United States imports more than it sells, then that means foreigners are acquiring claims on it, that is, investing more in the United States than the other way around. All the dollars flowing out via the trade deficit need come back in somehow, and that's generally through foreigners investing in the United States.

The Trump administration wants to improve both balances at once. But it can't do that. That's not ideology – it's accounting. If the United States runs a trade surplus, its total net claims on foreigners, including foreign direct investment and financial assets, must be increasing. Yes, strictly speaking, foreign investment into the United States could increase while it acquires an even larger pile of foreign financial assets, but that's unlikely. The new "big, beautiful" budget bill will add more than $3.4 trillion to the federal deficit over the next decade. The US government is going to be borrowing huge amounts of money for a long time to come, including from foreigners. The US private sector isn't likely to generate surpluses large enough to lend so much to foreigners that it offsets a trade surplus, plus foreign direct investment into the United States, plus all the extra borrowing the federal government will be doing.

Like the White Queen in *Alice Through the Looking Glass*, one can wish for six impossible things before breakfast, but that doesn't make any of them come true.

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