ECONOMIC VIEWPOINT

The US Trade Deficit: Who's Really "Subsidizing" Whom?

Another Way to Look at the US Trade Deficit and How It Could Be Resolved

By Hendrix Vachon, Principal Economist

Donald Trump is fond of repeating that the United States "subsidizes" Canada and other countries, alluding to the country's trade deficits. Let's be clear: The United States isn't handing money out to Canada or to any other nation. A trade deficit isn't a subsidy. The United States is simply buying foreign products at market price. But let's say we decided to take a page from Trump's rhetorical playbook. We could argue, theoretically, that the rest of the world is actually "subsidizing" the United States. How so? Because trade deficits require foreign capital inflows. Foreign investment isn't technically a subsidy either, but it's true that the United States relies heavily on money from other countries.

In this Economic Viewpoint, we'll be examining the macroeconomic factors underlying trade deficits, using the balance of payments framework—a summary of how trade and capital flow between countries. Trade deficits are inextricably linked to consumer spending, investments, and government deficits. In reality, the United States won't really be able to reduce its trade deficit unless it also chooses to reduce one of these three components. That's a hard decision under any circumstances, and certain countries could choose to add to the pressure by restricting US access to capital. At that point, we'd no longer be talking about a trade war, but rather a capital war.

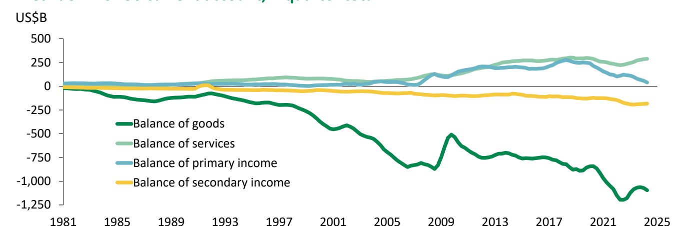
The United States Has a Persistent Current Account Deficit

The current account is one of the two components that make up the balance of payments. It records a country's transactions with the rest of the world. This includes both imports and exports of goods and services, as well as primary and secondary income flows. Primary income is income earned from the factors of production, such as wages and profits, whether received from or transferred abroad. Secondary income includes international assistance, donations and other transfers between countries.

In the United States, most of the current account deficit is the result of its goods trade deficit (graph 1). The country has a positive trade balance, or surplus, for its services trade. It also receives more primary income from abroad than it pays. However, like many advanced countries, the US secondary income balance is negative, as international aid and other transfers tend to flow to less developed countries.

The United States has had a current account deficit since the early 1990s (graph 2 on page 2). When calculated as a percentage of GDP, it peaked at around 6% in 2006, before the global financial crisis. Right now, the deficit is closer to 4%

Graph 1
Most of the US Current Account Deficit Stems from the Goods Trade Deficit
Breakdown of US current account, 4-quarter total



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of GDP, which is still considered fairly sizable. Expressed in dollars, according to the most recent data, the deficit should exceed $1,000B for 2024. This stands in marked contrast with the surpluses recorded by China, the eurozone, Japan and several other advanced economies (graph 3 on page 2). While these figures may trigger jealousy or outrage in some Americans... they may only have themselves to blame.

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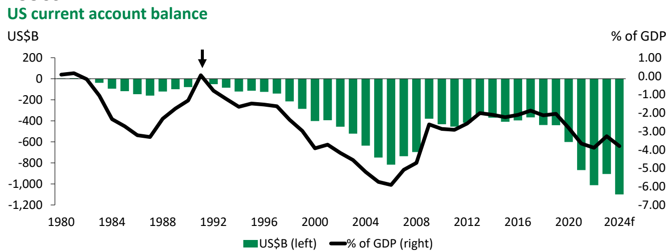
Graph 2
The United States Has Had a Current Account Deficit Since the Early 1990s
US current account balance



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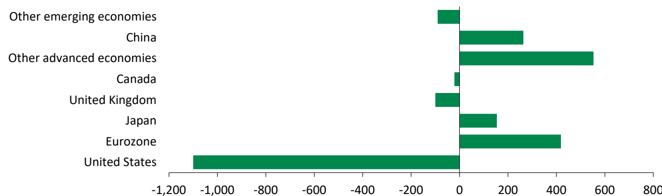
Graph 3
The United States Current Account Deficit Contrasts Sharply with the Surpluses in China and Many Advanced Economies
Estimated current account balances for 2024 in US$B



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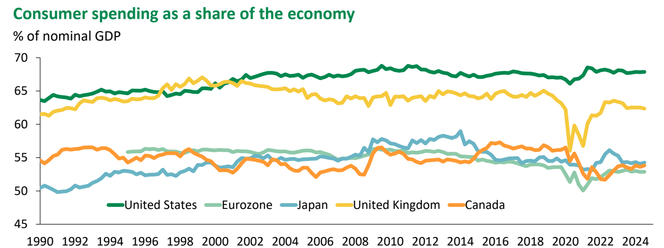
Excessive Spending

If a country has a current account deficit, that means it's spending more than it's earning. The current account is calculated by subtracting consumer spending, investment and government spending from the country's incomes. When incomes aren't high enough, the country must be financed from abroad to maintain its level of expenditure. And conversely, countries that spend less than their incomes have excess savings they can use to invest in other countries. Countries with excess savings could also choose to boost consumer spending, investment or government spending.

Americans have a current account deficit—so where is their money going? Compared to the other major advanced economies, the United States has a dramatically higher rate of consumer spending (graph 4), which accounts for nearly 70% of its GDP. In Canada, the eurozone and Japan, that figure lies closer to 55%, and the United Kingdom falls somewhere between. Some of the additional consumer spending in the United States can be explained by health care costs. As there is no public health care system that covers the entire population, Americans must pay for a larger share of their own expenses. Taxes are also lower, which helps encourage consumer spending.

Graph 4
Americans Spend More than Their Peers in Other Advanced Economies

Consumer spending as a share of the economy



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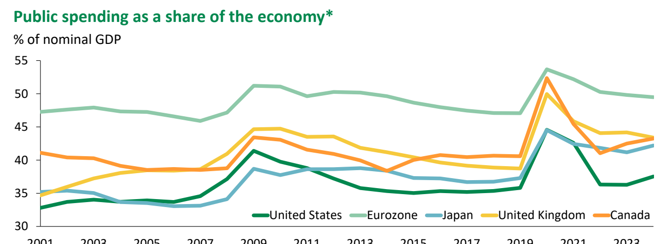
This lack of public health care system also means that total government spending is lower than it is in other major advanced economies (graph 5). But fiscal revenue is still not enough to offset the country's expenses, which has led to a sizable deficit (graph 6). This deficit from public administration, combined with high consumer spending, has caused the current account deficit to swell. Cutting government spending could help reduce the current account deficit. Another option would be to raise taxes, which would reduce household disposable income and curb spending.

Graph 5
Government Spending Is Lower in the United States

Public spending as a share of the economy*



* 2024 data is a forecast.
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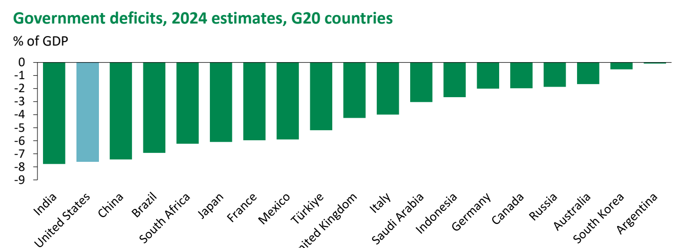
Graph 6
The United States Has a Public Deficit Problem

Government deficits, 2024 estimates, G20 countries



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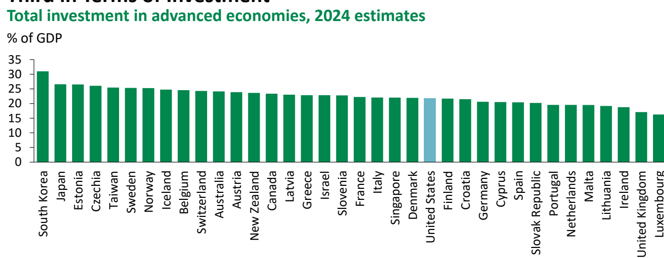
Investments Should Be Maintained

The United States could also improve the current account deficit by reducing its investments, but that could do more harm than good in the long run. Investment helps build up productive capital, which supports long-term economic growth.

If we look at how much other advanced economies invest, we can see the United States appears to invest a bit less than the average (graph 7). That said, it's important to exercise caution when interpreting this data: not all investments are created equal. The figures for some countries may be inflated by residential investments or by higher public investment to replace aging infrastructure. These types of investment have less impact on long-term economic growth than investments in new equipment and technology, which are more likely to generate productivity gains. The United States is currently recognized as a leader in terms of productivity growth. Tweaking this winning formula would be a bad idea.

Graph 7
Among Advanced Economies, the United States Is Near the Bottom Third in Terms of Investment
Total investment in advanced economies, 2024 estimates



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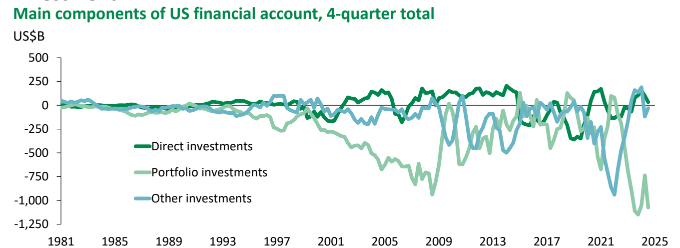
US Reliance on Foreign Capital Is a Weak Point

The truth is that the US economy depends on massive inflows of foreign capital. Additional information can be found in the financial account of the balance of payments, which groups international monetary flows into three main categories. These are direct investments, portfolio investments (including stocks and bonds) and other types of investments, such as derivatives and reserve assets. Currently, net foreign capital inflows for the United States are mainly concentrated in portfolio investments (graph 8).

Graph 8
Most of the Current Account Deficit Is Offset by Foreign Portfolio Investment
Main components of US financial account, 4-quarter total



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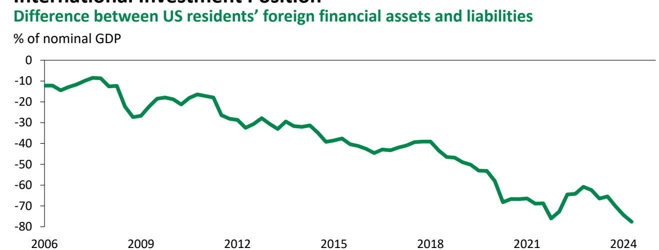
The ongoing string of current account deficits has caused the United States to build up sizable foreign liabilities. The country's net international investment position is nearing −80% of GDP (graph 9). However, the United States has an advantage: its liabilities are largely denominated in US dollars, meaning it's sheltered from abrupt currency shifts. According to [data from the International Monetary Fund](), US external liabilities in 2023 totalled more than US$24,000, of which nearly $22,500 was denominated in US dollars. But this advantage wouldn't protect the United States if other countries chose to impose capital control measures.

Graph 9
Cumulative Current Account Deficits Have Deteriorated the US Net International Investment Position
Difference between US residents' foreign financial assets and liabilities



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Pivoting from a Trade War to a Capital War

First and foremost, very few economists are in favour of measures to restrict international capital flows—it's probably equal to the number of economists who are pro-tariff. The free flow of capital helps better allocate financial resources globally and lets individual and institutional investors optimize their returns.

But when a trade war begins, bringing greater political and economic instability, capital controls can be a tool for countries wishing to retaliate or simply protect themselves. And capital control measures are already used quite often. They're one of

the economic sanctions that a country or group of countries can impose during international conflicts. A recent example would be the sanctions against Russia in response to its invasion of Ukraine. It would be hard to justify applying those same extreme measures against the United States, though. A delicate balance would have to be struck. The United States also has an advantage in that it controls the main currency used in global trade. It could attempt to retaliate by limiting other countries' use of the US dollar.

Capital controls vary widely. They may target specific investment types, specific countries or specific companies. They could be used to limit investment allocation in foreign assets, or apply just to US assets, if more targeted action is desired. Ideally, several countries would agree upon and apply the same restrictions. There's strength in numbers, after all.

If this path was chosen, US bond yields might go up, as foreign demand for this asset type would fall. US equities could also underperform. Rising interest rates, combined with shrinking stock values, could damage the country's economy. Consumer spending and investment could both falter, which would, potentially, affect the current account deficit. So in theory, limiting US access to foreign capital would be another way to reduce the current account deficit.

But the countries applying these capital controls wouldn't necessarily emerge unscathed. They could lose returns on foreign assets, which would hurt their domestic economies. The global markets may also become more volatile, since these hypothetical measures target the United States. The international banking system could also be impacted, resulting in higher financing costs for many borrowers. And, of course, it would do little to improve diplomatic relations with US authorities.

At the same time, reducing investments in US assets would also free up capital for more domestic investments or investments in allied nations. When combined with policies intended to kickstart investments, this could help offset the economic damage done by any tariffs imposed by the United States. Capital controls can also be used to protect against a mass exodus of investors, who may flee if a country is deemed especially vulnerable to tariffs. For example, when Iceland was particularly affected by the 2008 global financial crisis, it decided to preserve its financial resources through significant capital control measures.

In Conclusion, the United States Isn't Invincible

Trade wars and capital wars are both dangerous. They would have significant negative repercussions for the economy and financial markets. But it's good to know that while the United States may be a giant, it still has chinks it its armour—and a lot to lose.

Debates over the US trade deficit can't be divorced from discussions about US spending or reliance on foreign capital. Sooner or later, President Trump will be forced to realize he can't have it both ways. If he decides to reduce the trade balance by making good on his tariff threats, he'll also have to accept a drop in consumer or government spending.

If a trade war begins, other countries may retaliate with measures of their own on certain imports. They may also work in concert to restrict the flow of capital to the United States, though this could come at a steep cost to the economy or global financial system. If we view this scenario through a positive lens, we could see more capital put to use supporting our allies or encouraging domestic investment. Whatever happens, if Americans decide to eliminate their trade deficit, countries with surpluses will have to find new markets elsewhere or boost domestic demand. In the long term, this would be an adverse scenario for the United States, but a beneficial one for any countries that successfully adapt.