Confluence INVESTMENT MANAGEMENT

Weekly Geopolitical Report

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Plunging U.S. Service Exports

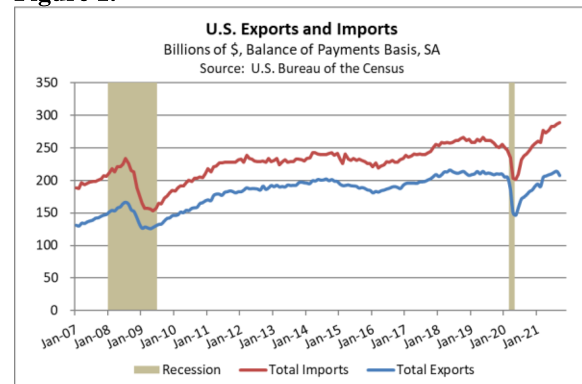
When people think about a country's exports, imports, and trade balance, they often focus only on physical goods (sometimes referred to as "commodities" or "merchandise"). That makes some sense, given that physical goods account for the majority of international trade for most countries. Trade in physical goods can also be volatile, and it can have big implications for a country's domestic politics. All the same, services are also a big part of international trade. In this report, we take a close look at the role of services in U.S. trade. We highlight how U.S. trade in services plummeted as a result of the global COVID-19 pandemic, and how it's now starting to bounce back. We end with a discussion of how that plunge and budding rebound may affect investors.

Services in U.S. International Trade

To illustrate the typical contours of U.S. trade and look past the unusual dynamics related to the coronavirus pandemic, our approach in this section is to focus first on the average level of U.S. exports, imports, and trade balances in the three years from 2017 to 2019.

The Big Picture. According to the Census Bureau, the nominal value of U.S. goods and services ***exports*** averaged approximately $2.486 trillion per year from 2017 to 2019, equal to about 12.2% of U.S. gross domestic product (GDP) during the period. That equates to some $207.2 billion worth of goods and services being sold abroad each month, or $6.8 billion each day of the year! That number is impressive, but goods and services ***imports*** were even higher. On average, total U.S. imports were valued at about $3.043 trillion per year from 2017 to 2019, equal to 14.9% of GDP. That's the equivalent of $253.6 billion per month and $8.3 billion per day. The average annual trade deficit of $556.7 billion was equivalent to 2.7% of GDP. Figure 1 shows total monthly exports and imports since just before the prior recession.

Figure 1.



- **Trade in Goods.** The average trade deficit of $556.7 billion per year in 2017 to 2019 stemmed entirely from U.S. trade in physical goods. However, since this report focuses on U.S. trade in services, we provide only a cursory overview of the country's goods trade here:
  - ***Goods Exports.*** In the three years prior to the pandemic, goods exports averaged $1.629 trillion per year, or 65.5% of total U.S. exports. Capital goods accounted for more than one-third of that, while industrial supplies (including petroleum and petroleum

products) accounted for almost one-third. The remainder of U.S. goods exports consisted mostly of consumer goods, autos and auto parts, and foods, feeds, and beverages.

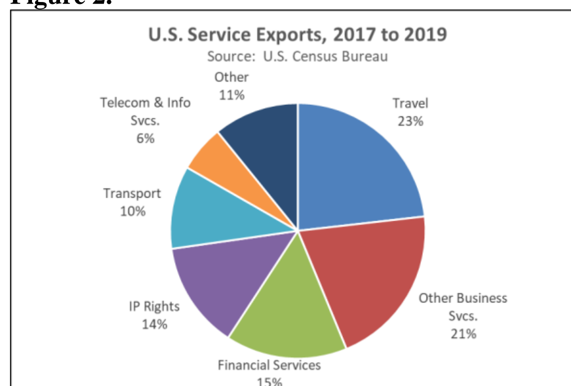
- *Goods Imports.* From 2017 to 2019, U.S. imports were much more lopsided in favor of physical goods. During the period, merchandise imports averaged $2.475 trillion per year, or 81.4% of total U.S. imports. Capital goods and consumer goods each accounted for slightly more than one-quarter of the total, while industrial supplies accounted for more than one-fifth. The remainder was made up mostly of autos and auto parts and foods, feeds, and beverages.

- *Goods Balance.* With average goods exports of $1.629 trillion per year and average goods imports of $2.475 trillion per year, the average U.S. shortfall in goods came to a whopping $846.5 billion per year in the three years ended in 2019!

- **Trade in Services.** When it comes to services, U.S. trade has historically been much healthier, with an average annual surplus of $289.9 billion from 2017 to 2019:

  - *Service Exports.* In the three years immediately prior to 2020, the value of U.S. service exports averaged $857.3 billion per year, equal to 34.5% of all U.S. exports in the period. Almost one-quarter of that amount consisted of travel services sold to foreigners, while more than one-fifth consisted of miscellaneous business services. Financial services (excluding insurance) made up almost one-fifth of the total, followed by charges for the use of intellectual property (see Figure 2).

Figure 2.



- *Service Imports.* From 2017 to 2019, U.S. residents bought few services from foreigners. During the period, U.S. service imports had an average value of only $567.4 billion per year, or about 18.7% of total U.S. imports. As with service exports, purchases of foreign travel services made up almost one-quarter of U.S. service imports in the period, followed by purchases of foreign transportation services and other business services. Insurance, other financial services, telecom and information services, charges for intellectual property, and the like all made up only a small part of U.S. service imports.

- *Service Balance.* For all the angst that U.S. policymakers and voters express regarding the country's overall trade deficit, the figures above suggest they should feel much more positive about U.S. trade in services. With service exports valued at $857.3 billion per year, and service imports just $567.4 billion per year, the annual surplus in services was enough to offset almost one-third of the U.S. trade deficit in goods before the pandemic (see

Figure 3, which shows the U.S. monthly goods and services trade balances since just before the prior recession). Moreover, prior to the pandemic, U.S. service exports were growing not only steadily, but also much more rapidly than service imports, producing an increasing service surplus (see Figure 4).

Figure 3.

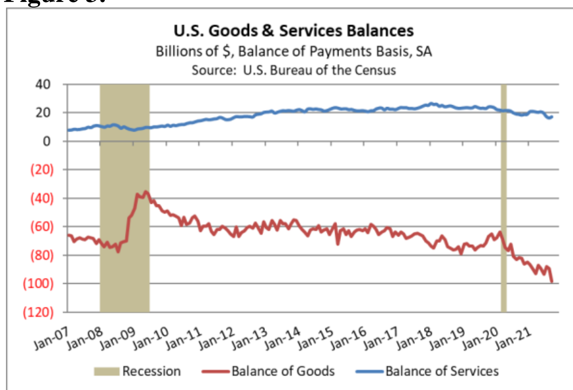
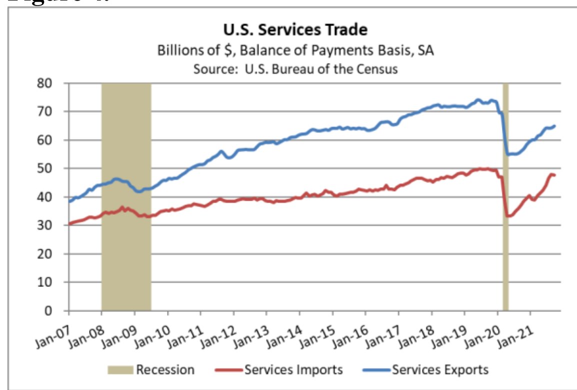


Figure 4.



Impact of the Pandemic

As shown in Figures 3 and 4 above, the pandemic recession and its aftermath have had huge impacts on the U.S. trade balance. The overall trade deficit from the beginning of 2020 through the third quarter of 2021 averaged $62.6 billion per month compared with an average of $46.4 billion from 2017 to 2019. Most of the expansion in the deficit reflected a wider shortfall in U.S. goods trade as income support policies, a shift in demand to goods from services, and a stronger dollar prompted a huge increase in merchandise imports. However, the shift in services trade was even more dramatic. In 2020 and the first nine months of 2021, the average U.S. services surplus declined to $20.0 billion per month compared with $24.2 billion in the prior three years. Service exports and imports both declined after the pandemic compared with their steady growth in the three years ended 2019, but the drop in service exports was greater.

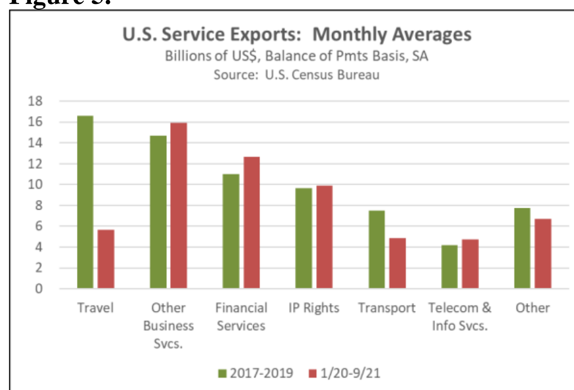
The Problem with Travel. Why has the drop in U.S. service exports been so dramatic? Our analysis indicates that almost all the decline in service exports since the onset of the pandemic can be traced to reduced sales of travel services to foreigners. From the start of 2020 through the first nine months of 2021, total U.S. service exports averaged just $60.4 billion per month, down $11.0 billion from the average of $71.4 billion per month from 2017 to 2019. Travel service exports alone fell to just $5.6 billion per month, down $10.9 billion from the $16.6 billion average in the prior three years. In contrast, some service categories actually saw increased foreign sales between the two periods (see Figure 5, next page).

- In IMF parlance, this type of export consists of "services acquired from an economy by travelers in that economy for their own use during visits of less than one year for business or personal purposes. Travel services include the goods and services consumed by travelers, such as lodging and meals and transport (within the economy visited)."

- In other words, virtually all the drop in U.S. service exports can be traced to the government's unanticipated, long-lasting ban on most foreign travelers to the U.S. from the beginning of the pandemic until late 2021. A small part

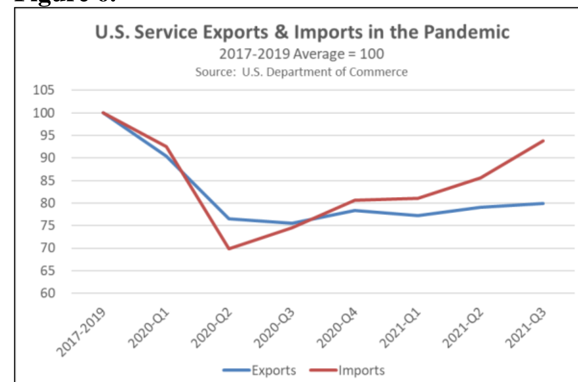
of the decline can also be traced to reduced sales of transportation services and repair and maintenance work for foreigners. All the same, the data highlight the huge impact of travel restrictions in the international balance of payments. Other countries' bans on U.S. visitors also helped drag down U.S. service imports.

Figure 5.



Impact on the Economy. The trade figures above are all in nominal terms, i.e., at current prices. However, measuring economic growth typically is done after stripping out price changes. How has the drop in services exports affected inflation-adjusted economic growth in the pandemic? Our analysis indicates that after stripping out price changes, overall U.S. service exports fell at an annualized rate of 12.3% from the end of 2019 through the third quarter of 2021, mostly reflecting a slow recovery from their mid-2020 trough. U.S. service imports declined at an annualized rate of 5.0%, reflecting a sharper drop early in the pandemic offset by a faster recovery (see Figure 6). As a result, services trade alone detracted about 0.50% from U.S. economic growth over the period. All else being equal, that means that without the drop in services exports during the pandemic, U.S. gross domestic product (GDP) would have grown at an average annual rate of about 1.3% during the pandemic period to date, instead of the actual rate of 0.8%.

Figure 6.



Ramifications

This analysis has important implications as the world faces the new Omicron mutation of the coronavirus. After all, one of the first government reactions to the new mutation was to immediately ban visitors from the countries in southern Africa where it was first identified. Japan and Israel went a step further, banning all foreign nationals from visiting for the time being. This analysis demonstrates that while banning foreign visitors is easy, and perhaps effective in delaying the spread of a new mutation, it can also have considerable negative implications for the economy. It can suddenly throw large numbers of travel and tourism workers out of their jobs. It can threaten airlines, travel and tour agencies, hotels, restaurants, and countless other businesses. And it can worsen a country's trade balance and slow its economic growth, potentially even undermining its currency.

On the flip side, when rich, developed countries discourage or ban their own citizens from traveling abroad, they can impose sizeable costs on other countries, especially in the emerging markets. They can throw many people out of work, push businesses into liquidation, impede economic growth, and destabilize those countries' currencies. That explains why such policies generate so much protest from tourism-dependent countries. Because of

this, such policies have significant geopolitical implications.

For investors, the lesson is clear: as long as the pandemic continues and new variants of the virus can spread, travel and tourism businesses will be at high risk of a sudden, long-lasting shutdown (although the same can be said of other service businesses that are considered to be venues for spreading the disease and not so essential that they need to keep operating). Economies that are especially dependent on foreign tourists (such as Italy, Greece, and emerging markets such as Mexico and Indonesia) are at heightened risk, especially if richer developed countries ban their citizens from traveling there. Overall economic growth and stock markets in such tourism-dependent countries could very well weaken if Omicron or other new mutations begin to spread rapidly. Those countries' currencies could also be at risk. Finally, given the high use of fuel for international airline travel, any renewed, widespread clampdown on tourism would likely be negative for crude oil in the coming months.

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