Trade deficit fuels fears of dollar crisis

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While the Dow Jones index continues to surge—hitting a new record high of 11,299 on Monday—warnings are being sounded that the ever-widening US trade deficit and growing indebtedness are setting the conditions for a financial crisis.

US Commerce Department figures released last week showed that the US trade deficit for June had expanded to a new record monthly high of $24.62 billion, well in excess of the predicted figure of $20.5 billion and easily eclipsing the previous record of $21.17 billion in May.

The total deficit for the first half of the year was $118.14 billion compared with $75.3 billion for the same period in 1998 and the trade gap is running at an annual rate of $236 billion, far in excess of last year's record of $164.28 billion.

The concern being voiced by a growing number of financial analysts and commentators is that the growing trade gap will set in motion a fall in the dollar and the withdrawal of foreign capital, leading to interest rate rises, a sharp fall on stock markets and a consequent recession.

Addressing the US Trade Deficit Review Commission at its hearing on Capitol Hill last Thursday, Catherine Mann, a senior fellow at the Institute for International Economic warned that the deficit could not be indefinitely financed by international borrowing.

“We are on a trajectory that is unsustainable, and at some point in time the rest of the world is going to decide they don't want to lend to us any more,” she said.

Massachusetts Institute of Technology economist Lester Thurow, a member of the commission, said the US could face massive capital flight such as that which took place in Asia in 1997 and 1998.

In her formal briefing for the Commission, Mann pointed out that the US current account, which measures the net flow of trade as well as investment income, has been in deficit for the past 20 years. From 1980 to 1987 both the trade deficit and the current account deficit widened and then returned to near balance by 1991. However, since then they have increasingly moved back into deficit.

“The cyclical behavior of the current account comes from a large and widening deficit of trade in goods, even as trade in services is increasingly in surplus. However, an increasingly important component of the current account dynamic is the net investment payments. Whatever measurement techniques are used, the value of foreign assets owned by the United States is less than the value of US assets held by foreigners; the negative net international investment position is some $1.5 trillion. Over a period of less than 10 years, the net investment earnings on this position turned from a positive $22 billion to a negative $22 billion.”

According to Mann's submission, the trade deficit is now so large that to narrow the gap between imports and exports would require a “dramatic change” in the growth differential. The gap could be narrowed if import growth “slowed markedly to about one quarter the average growth in the 1990s and export growth rose significantly to about four times the rate of growth in the 1990s.” While Mann did not spell out what could produce such a turn around, the implications of her analysis are nevertheless clear: it would require severe recession.

The imbalances in the international position of the US have also been highlighted by the International Monetary Fund, which has begun publishing Public Information Notices following criticism that it provided no warnings of the Asian financial crisis. The notice for the US, issued on August 5, pointed out that during 1998 the “international investment position of the United States deteriorated further, with the net foreign liability position rising to 18 percent of GDP.”

"Although the performance of the US economy had been remarkable," the notice declared, "Directors noted the contribution of possibly transitory factors and cautioned that there were significant risks. Principal among these is the danger of a substantial and abrupt decline in US equity prices."

One sign of growing turbulence is the divergent behaviour of the stock and bond markets. In a column published in the *Financial Times* of August 16, James Grant of *Grant's Interest Rate Observer* noted that while some sections of the financial markets appeared full of confidence "the senior portion of the nation's capital structure ... is suffering what looks like a nervous breakdown."

Grant was referring to the rise in interest rates on long-dated US Treasury bonds to more than 6 percent and the widening gap between the interest rate yields on Treasury bonds and corporate bonds—a sure sign of financial nervousness.

In some markets, the interest rate spread is back to the level it reached last October, in the midst of the financial crisis that followed the collapse of Long Term Capital Management hedge fund. According to Grant, the rising bond market interest rates reflect the efforts of investors to take precautions against risk. But "few such precautions are evident in the US stock market."

"Never before has a dollar or corporate earnings been so expensive as at the recent all-time peak. A return to median fair value would require a decline in the equity indices of more than 50 percent."

Another well-known commentator to warn of global turbulence is Kenneth Courtis, the chief economist and strategist for Deutsche Bank Asia Pacific. He predicts that currency instability and higher interest rates will cause severe market instability with a "major scare as the US market corrects", possibly by as much as 25 percent.

Courtis warned that "emerging markets" were still "slothed in debt" and had to dramatically cut back their debt levels otherwise "the global banking system gets into huge trouble."

But the growth of indebtedness is also a problem for the world's major capitalist power as well. According to Courtis, the US will borrow $332 billion from the rest of the world this year after borrowing $288 billion last year and $262 billion and $248 billion in the years 1997 and 1996 respectively.

"America's long-term net external debt at this rate will be almost 30 percent of GNP. At some point world markets are going to say: 'Hey wait a minute Uncle Sam, we will continue to finance your bubble dot.com, but we're only going to do it at much higher interest rates', and that's going to put the skids under Wall Street."