Record US trade deficit a symptom of deeper economic problems

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Earlier this month the Commerce Department reported that the US trade deficit had hit yet another monthly record, reaching $30.62 billion for June.

The announcement attracted little or no comment in the mass media. It was swamped by claims of unprecedented economic growth during the period of the Clinton presidency and optimistic assertions that, after a series of interest rate rises, the US Federal Reserve under the chairmanship of Alan Greenspan is successfully engineering a “soft landing” for the US economy.

But the record trade deficit is not merely a dark cloud on an otherwise sunny economic horizon. It is symptomatic of longer-term processes that could, quite rapidly, have severe implications for the US and the world economy as a whole. These tendencies, which include the increasing dependence of the US economy on international capital inflows, inflated stock market values and rising indebtedness, both personal and corporate, point to the fact that the US economic boom may be resting on shaky foundations.

While the latest trade figure attracted little public comment, there are indications that it is causing concern behind the scenes. An article entitled “Will the Trade Gap Lower the Boom?” in the August 14 edition of the *Wall Street Journal*, for example, posed the question as to what point investors would decide that the trade deficit had grown too wide, lose confidence in the US dollar, withdraw money and bring the boom to an end.

It pointed out that in the first three months of this year “the current account deficit—the broadest measure of trade imbalance—surpassed 4 percent of gross domestic product for the first time” and that according to projections by Merrill Lynch “the gap will measure $411 billion for the year, 24 percent wider than 1999's deficit and an unprecedented 4.2 percent of the overall economy.”

In most other countries such a trade gap would cause an economic crisis. But the US is in a unique position. Because of the role of the dollar as a world currency, it can finance its trade gap through the inflow of foreign investment. This means that even as the trade gap widens, money may still flow into the US, pushing up the dollar against other currencies, and attracting a still greater inflow of foreign funds. But such a process cannot continue indefinitely and at a certain point foreign investors may decide to withdraw their money.

The *WSJ* cited recent comments by Deutsche Bank Research chief economist Norbert Walter. “Confidence in the USA,” he warned the bank's clients, “could abruptly collapse before the world is firmly back on its feet. It is, at any rate, not out of the question that capital flows into the USA will dry up, and that the dollar will take a dive—triggering a rise in US yields [interest rates] and a stock market crisis.”

The scenario for such a crisis could take the following form: a sudden change in market perceptions, perhaps caused by an unexpected interest rate rise, convinces big investors that they need to shift out of dollars into euros or some other currency, leading to a fall in the value of the dollar, triggering a rapid exit from US markets by investors who do not want to hold dollar assets when its value is dropping. This in turn could see a move by the Federal Reserve Board to lift interest rates, resulting in a sharp decline in equity and property markets, thereby provoking a crisis for those individuals and corporations who have gone into debt to finance purchases on the basis that the market will keep rising.

While the *WSJ* maintained that such a “disaster scenario” was a distant possibility, it did acknowledge that it was becoming more likely with every increase in the trade deficit and cited testimony given by Alan Greenspan last month.

“At some point,” Greenspan told the US House of Representatives, “something has got to give, and we don't know what it's going to be. We don't know whether it will be protracted over a very long period of time, in which case the adjustments will occur in the normal manner without any significance, or whether they will occur more abruptly.”

While Greenspan is holding out the hope that the US trade imbalance will be resolved gradually, other analysts have warned that there could be a sharp reversal. A study by economist Wynn Godley, issued by the James Levy Institute in June, poured cold water on the idea that the so-called “new economy” could continue to expand indefinitely. Entitled “Drowning in Debt” the basis of Godley's analysis was that unprecedented levels of debt, at both a personal and corporate level, have sustained the growth of expenditure in the US economy.

He pointed out that over a great many years income consistently exceeded expenditure, with net saving averaging around 3 percent of national income. However the situation began to change after 1992 when expenditure began to rise relative to income and has taken a sharp turn in the recent period.

“Net saving,” Godley wrote, “fell through the zero line in 1997 and has been falling more and more deeply into negative territory ever since. In the first quarter of this year net saving reached minus 7.0 percent of income and was 9 to 10 percent below what used to be normal. Whatever this private deficit may portend for the future, it is certainly entirely different from anything that has ever happened before—at least in the United States.”

Godley pointed out that while the general view appeared to be that private spending was able to rise because of capital gains, figures published by the Federal Reserve showed that the main source of funds to finance the additional spending was additional borrowing.

Such borrowing made it possible to enjoy capital gains without selling assets and thereby incurring a capital gains tax.

While the net flow of credit to the nonfinancial private sector was a negligible amount in 1991, it had risen to more than $1 trillion in 1999, by which time borrowing was augmenting disposable income to the tune of 15 percent.

"It seems fair to conclude," Godley wrote, "... that the high level of debt now poses a risk; if there were a big fall in asset prices or a significant further rise in interest rates, weak positions might be exposed, which could generate a downward spiral of forced selling."

He noted that the fiscal projections of government spokesmen, based on continued economic growth and a rising budget surplus, depend on higher levels of spending, which in turn assumes that "private net saving continues to fall into increasingly negative territory"—a situation which is inherently unsustainable.

On the other hand, the US economic growth has become so dependent on rising expenditure that if net saving were to recover to levels that were once considered normal "the results would be horrendous."

"With private expenditure falling by 5 to 10 percent relative to income, there could be hardly any growth at all for some years," he wrote. And if the reversal took place quickly "there could be a severe recession, with grave consequences for the rest of the world." The budget surplus would disappear, and with a recession or prolonged stagnation, there could be "a large fall in the stock market, which would make matters infinitely worse."

Not only has the US economy become increasingly dependent on debt, it has relied to an ever greater extent on international sources of funds to finance growth.

Attracted by rising stock market values and a strong dollar investment, capital has poured into the US even as the balance of payments gap has widened. The inflow of capital has in turn boosted the stock market, lifted expenditure and growth and strengthened the dollar, leading to a further foreign capital inflow. But such a virtuous circle can rapidly transform into a vicious one—setting in motion the kind of disaster scenario set out in the *WSJ* analysis.

The dependence of the US on international sources of capital was graphically detailed in a report on "International Capital Flows and the US Capital Account" prepared by economist Jane D'Arista for the Financial Markets Centre in December last year. According to her analysis, the inflow of international funds has become " the main support for US prosperity."

"By virtually any standard, the inflow of capital is enormous. America's net financial debt to the rest of the world has grown so large that interest and other payments on foreign-held US financial assets have far surpassed income on US-held foreign assets (-$12 billion at year-end 1998)."

The report noted that at the time of the 1987 stock market crash the international financial position of the US was still as positive as it had been since World War 1 but that since that time there has been a rapid reversal.

"By 1989, the US had become a net debtor nation and its external (i.e. foreign) debt continued to mount throughout the 1990s. At year-end 1996, the debt reached a record $548 billion (with assets at market values). One year later, it crossed the $1 trillion threshold—equivalent to 13 percent of gross domestic product—and by year-end 1998 rose to $1.5 trillion. After tripling in size over the course of 24 months, external debt equaled 18 percent of GDP."

According to this analysis, the US economy is vulnerable to foreign and domestic shocks that could undermine confidence in the dollar.

"If confidence were lost, sales of US financial assets by foreign investors would put upward pressure on domestic interest rates and depress the dollar exchange rate to levels that could trigger a much deeper recession than occurred under similar circumstances in the 1980s."

The increasing instability of the US economy resulting from the increase in indebtedness and growing dependence on foreign capital inflows can also be seen from a comparison of the Clinton presidency with previous administrations.

An article by Robert Pollin in the May-June issue of the British journal *New Left Review* points out that "virtually all the economic achievements of the Clinton years have been tied to the extraordinary performance of the stock market, which has concurrently generated a highly fragile financial structure."

While GDP growth from 1993 to 1999 has averaged 3.7 percent per annum, comparing favourably with the 2.7 and 2.9 percent growth rates in the Nixon-Ford and Reagan-Bush years respectively, it is still only marginally higher than the 3.4 percent growth rate recorded during the period of the Carter administration and well below the 4.8 percent growth rate reached in the Kennedy-Johnson administrations.

The same tendency can be seen in productivity growth, which has averaged 1.8 percent from 1993 to 1999, well below the rate of 3.4 percent in the Kennedy-Johnson years and only marginally above the 1.7 percent rate achieved during the Reagan-Bush administration.

But in statistics on the stock market and the escalation of debt the Clinton administration outstrips all others. In the period 1993-99, the S&P 500 index has grown at an average annual rate of 17.6 per cent in real terms, more than two and a half times the rate of increase under Reagan and Bush. At the same time the ratio of total household liabilities to disposable income, which reached 77.8 percent under Reagan-Bush—itself an unprecedented level compared to any earlier period—has climbed still further under Clinton to 94.2 percent.

While Clinton points to his economic record, wage increases under his administration remain smaller than those achieved under any previous period of economic expansion. In this regard Pollin pointed to some telling statistics from a survey conducted by the magazine *Business Week* at the end of 1999. It found that 51 percent of American workers "felt cheated by their employer" and when asked their view of the so-called "productivity boom" some 63 percent said it had not raised their earnings, while 62 percent said it had not increased their job security.

If the almost total silence on the latest trade figures and their implications are any guide there will be almost no discussion or analysis of the real state of the American economy in the run-up to the presidential election over the next two months. This is because such an examination all too clearly reveals processes that point to a deep-going financial crisis, which may well erupt sooner rather than later.