

US trade deficit a sign of growing problems

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The increase in the trade deficit to a record \$34.3 billion in September has increased concerns that the United States economy could be heading into financial troubles, which would bring about a sharp decline in growth and even a recession. At its present rate the trade deficit is on course to reach \$365 billion this year—that is a gap of \$1 billion a day—representing an increase of \$100 million over the record 1999 level.

Despite the growing trade gap, the US has so far been able to avert a financial crisis because of the inflow of foreign capital from the rest of the world. But this is starting to cause strains in the international economy as evidenced by tightening capital markets and rising interest rates. The extent of the imbalance can be gauged from the fact that the US current account deficit at present equals about 60 percent of the combined surpluses of the surplus countries.

Up until now the prevailing “conventional wisdom” has been that the widening trade gap presents no real problems so long as investment funds keep flowing into the US economy. And this will continue for the foreseeable future, it is argued, because the US market still delivers a higher rate of return.

But even if this argument is accepted, the process in which the US trade gap is financed by an inflow of foreign capital is inherently unsustainable. The greater the inflow of funds, the more this pushes up the value of the dollar. But an increase in the dollar makes US exports more expensive in world markets and cheapens imports, thereby widening the trade gap and creating the need for an even greater inflow of foreign funds. As a result of this process, the dollar has risen by more than 20 percent against a basket of the world's major currencies.

Now concerns are being voiced about where it will all end. Trade economist Greg Mastel, for instance, told the *New York Times* that the rising trade deficit and strengthening dollar were “the Damocles' sword

hanging over us—the largest long-term threat to our economy. The next administration is likely to have to adjust a trade policy, dollar policy and fiscal policy to find a solution.”

The US trade gap, however, is only one of a series of problems. Writing in the *Financial Times* of November 22, Stephen Roach, the chief economist at the financial firm Morgan Stanley Dean Witter, warned that a decelerating global economy combined with a financial shock could bring about a recession.

“There is a great danger lurking in the global economy,” he wrote. “The healing that followed the financial crisis of 1998 is turning out to be surprisingly short-lived. The risks of a hard landing, or outright recession, are high and rising—especially in the US. I would assign a 40 percent probability to such an outcome in the first half of next year. For me, that is tantamount to maximum alert.”

Roach said there were several factors pointing to a deceleration in the world economy, including the impact of US and European interest rate rises, increased oil prices, falls in business investment, especially in the technology intensive telecommunications sector, and the impact of stock market falls on spending in the US.

In addition to an overall slowdown, the world economy could be hit by a series of shocks. Among these was the possibility of a “earnings shock” in the US. “Profit margins could be squeezed by energy costs, corporate financing costs, labour costs and technology costs.” A fall in markets could drag the stock market down and see the emergence of the so-called “negative wealth effect” in which US consumers, suffering losses on the market, reduce spending, thereby setting in motion recessionary tendencies throughout the economy.

“Finally,” Roach warned, “there is the possibility of a dollar shock. The armour-plated greenback has been vital to America's virtuous circle. Yet the dollar is a

disaster waiting to happen. America's record external deficit is only part of the problem. A downturn in the global cycle of mergers and acquisitions threatens to crimp capital inflows into the US.

“A narrowing of the growth differential between the US and the rest of the world could challenge the notion that investors are willing to attach a permanent premium to dollar-denominated assets. ... If the dollar goes, America's virtuous circle could turn vicious very quickly. Europe and Japan could then be struggling with stronger currencies.”

A forecast published by the Levy Institute in October points to financial problems in the US economy as providing a trigger for a recession in the next 12 months, which it rates at a 70 percent probability.

The forecast took issue with the “accepted notion” that nothing more than a gentle economic slowdown was at hand. It said the negative wealth effects of a falling stock market were greater than generally appreciated, capital spending will slow as the economy weakens and the deteriorating credit system would also create problems.

It warned that “excessive debt” may be the biggest problem for the US economy. “The boom of the late 1990s was financed by rapid debt growth. Liquidity provided by the Federal Reserve plus many lenders' reckless disregard for risk pushed already record debt levels to even greater heights.”

In addition, the international economy was particularly vulnerable to problems in the US. “The rest of the world depends on the United States for profits to an unprecedented degree. Moreover, in much of the world the debt is more excessive than in the United States; in many countries leverage is greater than it was in 1997.”

The institute warned that even if the US escaped a recession in the next 12 months, “it cannot eliminate the massive debt overhang and its dependence on boom conditions to forestall a systemic financial crisis.”



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