US budget deficit to hit half a trillion dollars

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4 February 2004

The announcement by the Bush administration that it plans a budget deficit of $521 billion for the 2004 fiscal year—a record in dollar terms—is certain to bring further warnings of the dangers to the world financial system posed by the escalating US debt.

Last month the International Monetary Fund published a report stating that there were “significant risks” for the American economy and the rest of the world from growing US budget deficits. Significantly its warnings were echoed in a paper co-authored by former US Treasury Secretary Robert Rubin which was presented to a meeting of the American Economic Association in early January.

The paper, written by Rubin and well-known economists Peter Orszag of the Brookings Institute and Allan Sinai of Decision Economics, warned that the US federal budget was on “an unsustainable path” and that in the absence of significant policy changes deficits would total around $5 trillion over the next decade.

“The scale of the nation’s projected budgetary imbalances is now so large that the risk of severe adverse consequences must be taken very seriously, although it is impossible to predict when such consequences may occur.”

The Bush administration has sought to quell such concerns by offering assurances that it will halve the deficit by 2009. But these assurances do not cut much ice given that the administration only two years ago projected a deficit of just $14 billion for the fiscal year 2004.

One of the main arguments of the Rubin-Orszag-Sinai paper is the “conventional view” that the costs of budget deficits tend to build up gradually over time rather than occurring suddenly may not be correct.

“Substantial deficits projected far into the future,” they write, “can cause a fundamental shift in market expectations and a related loss of confidence both at home and abroad. The unfavourable dynamic effects that could ensue are largely if not entirely excluded from the conventional analysis of budget deficits. This omission is understandable and appropriate in the context of deficits that are small and temporary; it is increasingly untenable, however, in an environment with deficits that are large and permanent. Substantial ongoing deficits may severely and adversely affect expectations and confidence, which in turn can generate a self-reinforcing negative cycle among the underlying fiscal deficit, financial markets, and the real economy.”

The negative cycle could involve loss of investor confidence and a decision by international investors to shift out of dollar-based assets. That would spark a fall in the dollar and a rise in interest rates, leading to a decline in stock prices and reductions in household wealth. The result would be in a further loss of confidence.

They warned that failing to act sooner rather than later only made the problem more difficult to resolve and “raises the probability of fiscal and financial disarray at some point in the future.”

Other analysis of fiscal projections shows that the problem is bigger than has so far been officially acknowledged.

On January 6, the Congressional Budget Office (CBO) issued new projections showing that the cumulative deficit between 2004 and 2013 would reach $2.3 trillion. But this is generally acknowledged to be an understatement.

A study by the Center on Budget and Policy Priorities issued on February 1 noted that if likely or virtually certain costs, left out of the CBO projection, were added back in then the deficit projection for the next 10 years rose to $5.2 trillion.

The Center’s analysis made it clear that the budget blowout is not due to increases in domestic spending but is the result of the Bush tax cuts—aimed primarily at the wealthy—and increased spending on the military and “homeland security.” As a result of the tax cuts, revenues in 2004 will total only 15.8 percent of GDP—the lowest level since 1950—and will only average 17.1 percent of GDP over the coming decade, lower than average levels for every decade in the second half of the twentieth century.

In January 2001 estimates from the CBO showed surpluses for the 10-year period to 2011 totalling $5 trillion. Now it is estimated that there will be a deficit over the same period of $4.3 trillion. According to the Center’s report, approximately 35 percent of this $9.3 trillion turnaround is due to the tax cuts made by the Bush administration. Another 28 percent is due to increased spending, more than two thirds of which arises from increased costs for the military, homeland security and the “war on terrorism”. Only one-twenty-fifth of the new spending represented the increased costs of domestic programs outside of homeland security. The remainder of the turnaround was accounted for by over-optimistic estimates by the CBO in 2001.

Besides the financial dangers there are also concerns that the growing budget and balance of payments deficits may have adverse implications for the conduct of US foreign policy. An article by Sherle R. Schwenninger, entitled “America’s ‘Suez Moment’”, published in the latest issue of the *Atlantic Monthly* points out that while its military might is unchallenged, the US economy is dependent on the inflow of foreign capital with China and Japan holding so much US debt that they could “exert enormous leverage on American foreign policy.” If China were to disagree with a particular policy initiative, such as a decision to invade North Korea, it could move to dump US Treasury bills and other dollar-denominated assets, causing the value of the dollar to plunge and leading to a “major crisis” for the US economy.

“China and Japan,” the article pointed out, “wouldn’t have to be consciously hostile to wreak havoc; they could create a currency crisis by accident, through either bad policy decisions or instability in their own economies. Both countries have weak banking systems that are burdened by bad loans that will never be repaid. Economists have long warned that the collapse of Japan’s banking system could devastate the United States. A Chinese banking crisis could cause equally severe problems.”

Schwenninger recalled that at the height of its imperial domination, in contrast to the present position of the US, Britain was a net exporter of capital. However the empire declined and in 1956 its demise from great-power status was made clear in the clash with the US over Suez. “US policymakers should take note: Britain was brought to its knees not by a military defeat but by an economic one—specifically, America’s refusal to support the British pound, which created a monetary crisis for the British government, forcing it to call off its ill-advised campaign with France and Israel to recapture the Suez Canal after nationalisation by Egypt. As international debt grows, the United States becomes ever more vulnerable to its own Suez moment.”

Schwenninger, who wants a return to a more multilateral approach to foreign policy, clearly hopes that the growing economic difficulties will force a change from the bellicose agenda of the Bush administration. Such hopes are misplaced. Rather than resulting in a less aggressive foreign policy, the economic difficulties of the US will see ever more strenuous attempts to counter its economic decline with the use of military force, whatever administration rules in Washington. This dialectic was pointed out by Leon Trotsky more that 70 years ago as he analysed the rise of American imperialism in the 1920s.

Any belief that economic problems would restrict American imperialism, he wrote, could only result in the grossest errors. “In the period of crisis the hegemony of the United States will operate more completely, more openly, and more ruthlessly than in the period of boom.” The US would seek to extricate itself from its difficulties at the expense of its rivals “whether this takes place peacefully or through war.”