US deficit hits a new record

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The US balance of payments deficit hit an all-time high for the first quarter of the year, rising to $195.1 billion, up 3.6 percent from the previous record of $188.4 billion for the final three months of 2004 and well above market predictions of $190 billion. The latest figure means that the US payments deficit is running at an annual rate of $780 billion, requiring $2 billion a day from the rest of the world—mainly provided by Japan, China and other Asian nations—to finance it.

The current account deficit for 2004 was a record $668.1 billion, up 28.6 percent from the previous record of $519.7 billion in 2003. But if present trends continue, this year's deficit will be even larger.

The record payments gap is certain to fuel demands for the Bush administration to take action against US trade rivals. The Congress has already passed a resolution calling for the revaluation of the Chinese currency within six months and protectionist sentiment is growing.

Democrat Senator Byron Dorgan said the latest figures showed the current account deficit had reached "dangerously high levels" and that the administration had to change course on trade.

The trade figures appeared to bring to an end the recent rally enjoyed by the dollar in international currency markets—following the No vote on the proposed European constitution in France and the Netherlands and the row over the European Union budget. After sliding by 6.7 percent since early May, the euro rose by 1.1 percent last week, with much of the gain coming after the announcement of the US deficit.

The relative movements of the euro and the dollar—reflecting the growing economic weaknesses of both the United States and the eurozone economies—point to underlying problems at the heart of the world financial system.

On the one hand, the general rise of the euro over the past three years has been caused in the main by the growing debts of the US—both the ever-widening balance of payments gap and the federal budget deficit. With US imports now around 50 percent higher than exports, no serious observer believes that there is a "quick fix"—such as a revaluation of the Chinese yuan or the introduction of protectionist measures—that can reduce the US payments deficit. Even with a decline in the value of the dollar of more than 25 percent against the euro since the start of 2002, the current account deficit has continued to rise, growing by 1.6 percentage points of gross domestic product since the start of 2003.

On the other hand, the recent fall in the euro and the rebound of the dollar has been caused by the rejection of the European constitution and the doubts this has raised about the future of the euro and even the European Union. In other words, the strength or weakness of each of the world's two major currencies is determined by the relative position of the other.

Last April, the *Financial Times* noted in an editorial comment that the euro did not have a great deal going for it except that it was not the US dollar. "In truth, there are good reasons for selling all three of the world's main currencies (the dollar, the euro and the yen). But could they all fall? Yes, against either gold or the Chinese renminbi (yuan)," it stated.

This conclusion points to deep problems in the global monetary system. For the past 34 years, since the decision by US president Nixon to remove its gold backing, the US dollar has functioned as a global fiat currency. Its position in international markets has depended on the relative strength of the US economy vis-à-vis the other major capitalist powers.

That position has steadily eroded over the past decade and a half. Up until the end of the 1980s, the position of the dollar was sustained by the fact that, even though its trade and balance of payments situation was worsening, the US was still a net international creditor—a status it

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first attained in the aftermath of World War I. From the mid-1990s, even as US international debts steadily grew, the "strong dollar" was sustained by an inflow of capital into the US, attracted by the higher returns on investment and in the stock market.

But since the collapse of the share market bubble in 2000, the US has come to increasingly depend on an inflow of capital from the central banks of Asia to cover its debts—so much so that more than 75 percent of all the balance of payments surpluses of the rest of the world are used to finance the US deficit. The danger to the stability of the global financial system lies in the fact that, at a certain point, this inflow may cease, sparking a rapid fall in the dollar's value, a rise in interest rates and the onset of a US and global recession.

Were such an economic scenario to develop, it would by no means necessarily follow that the euro would come to replace the dollar as the chief international currency. The present crisis of the European Union, and the doubt it casts on the long-term future of the euro, means that a major dollar crisis could bring a crisis of confidence in all major currencies, and a turn to gold as the only secure store of value. The steady rise of the price of gold over the past four weeks amid the political turmoil surrounding the European Union could well be a sign of things to come.

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