US trade gap hits another record

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14 February 2006

For the fourth year in a row the United States trade deficit has reached a new record. Coming in at $726 billion for 2005, the trade gap is now almost twice the level of 2001 and represents around 5.8 percent of the gross domestic product, up from 5.3 percent in 2004 and 4.5 percent in 2003.

This upward trend was also reflected in the monthly figures which showed that the trade gap for December alone increased to $65.7 billion, up from $64.7 billion in November and the third highest monthly deficit on record.

The deficit with China formed the biggest portion of the overall result—$216 billion, up 24.5 percent on 2004. This result is likely to bring moves in the Congress over demands that China revalue its currency, the yuan, in order to make US exports to China less expensive and imports to the US more expensive.

Democrat Senator Charles Schumer of New York and Republican Lindsey Graham of South Carolina have already proposed a 27.5 percent tariff on Chinese imports if the yuan is not allowed to rise further against the dollar, following a 2 percent increase last July. Schumer said that there was a "very strong likelihood that we will move our bill in March should the Chinese not show further movements."

While the finger is being pointed at Chinese authorities for pegging the yuan against the dollar, the US trade deficit with the Asian region as a whole has changed little over the past few years. The increased prominence of China in the US trade gap is to a considerable extent the result of the transfer of manufacturing operations in Taiwan, Thailand, Korea and other East Asian countries to China.

Most Chinese exports are not from Chinese-owned companies but are designated as 'made in China" because that country is the last stage in what is increasingly a global supply chain organised by major transnational corporations.

Besides the deficit with China, the other major component of the deficit was the rising cost of oil and other energy supplies. Petroleum products accounted for 29 percent of the trade gap, compared to 25 percent in 2004.

One of the most significant figures was the $44 billion deficit in "advanced technology products", an increase of 20 percent over the previous year. The US has had a deficit in these goods since 2002. Prior to that it enjoyed a surplus, which was some $33 billion as recently as 1997. The manufactured goods sector had a deficit of $655 billion compared to $604 billion in 2004.

The widening trade gap means that the US will become even more dependent on the inflow of foreign capital, currently running at more than $2 billion a day, sourced mainly from East Asian banks and financial institutions.

This process is causing increasing concern for financial authorities who fear that at some point global financial imbalances will undergo a violent "correction". These increasing risks were the subject of remarks by Malcolm Knight, the general manager of the Bank for International Settlements—sometimes known as the central bankers' bank—to a meeting in Zurich last week.

Knight pointed out that the US external deficit had almost doubled in the past five years and was likely to grow even further in 2006. Even more unsettling was the extent to which net savings from capital scarce "emerging market economies" were flowing to capital rich industrial countries.

"It is hard to believe," he said, "that such an unprecedented flow of net savings from 'poor' to 'rich' countries can represent a sustainable global equilibrium. At some point, this highly unusual pattern will have to change."

However, as Knight went on to point out, even as these imbalances are increasing they are not being reflected in financial markets. Volatility levels in foreign exchange markets remained low, suggesting that financial markets attached a low probability to sharp movements in the exchange rate of the dollar in the future.

Another “key puzzle” is that even as short-term interest rates have increased in the US—up by 3.5 percentage points since May 2004—long-term rates have not risen at all “in sharp contrast to earlier periods of tightening monetary policy.”

According to Knight’s presentation, while macroeconomic risks were rising, and global imbalances would have to adjust at some point, the very stability of financial markets meant that increased risks were not being properly recognised and managed by financial markets. The present rules used by financial institutions were “not giving very meaningful signals,” he said.

Another sign of possible turbulence in the world economy came with the issuing of $14 billion worth of 30-year US Treasury bonds last week. The 30-year bond was discontinued in 2001 in the wake of federal government budget surpluses, but the swing into deficits under the Bush administration has increased the need for long-term funds.

The most significant aspect of the bond issue was that it completed the inversion of the so-called yield curve. Under normal circumstances interest rates on short-term bonds are lower than those on longer-term debt, reflecting the greater risk and uncertainty of investing over the longer term.

But one of the peculiar features of the bond market in the recent period is that long-term interest rates have fallen even as short-term rates have been rising. When the 30-year bond went on sale, its yield was about 4.5 percent. However, the yield on the 10-year bond was 4.54 percent, while the yield on the 2-year bond was 4.65 percent.

While it is by no means a certainty, inversion of the yield curve of the type now being seen in the US often points to the onset of recession. Whether it does so in this case remains to be seen. But whatever the immediate outcome, it is another sign of the imbalances in financial markets and the global economy as a whole.