US balance of payments deficit hits another record

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The extent of the imbalances in the global economy and the fact that normal growth patterns will not correct them has been underlined by the latest US balance of payments deficit. The current account deficit reached $225 billion in the fourth quarter of 2005, up from $185.4 billion in the third. For the year 2005 the deficit was $805 billion, equivalent to 6.4 percent of gross domestic product.

The latest figures show that rather than being closed, the payments gap is widening. This was the seventh year out of the last eight in which the deficit hit a new record.

"The bottom line is that a current account deficit of this unparalleled magnitude is unsustainable and there is no hope of it being painlessly resolved through higher exports alone," Paul Ashworth, an analyst at Capital Economic told the *Financial Times*.

Total US exports would need to increase by 70 percent to eliminate the payments gap. "This is clearly not going to happen," Ashworth continued. "Instead it will require a big dollar depreciation alongside much weaker domestic demand for imports."

In other words, the only way the deficit would start to fall is through a major recession in the US. On the one hand, "a big dollar depreciation" would almost certainly lead to a sharp interest rate rise, as international banks and financial institutions demanded bigger compensation for placing their funds in dollar assets. And a significant interest rate rise would bring a downturn in the economy.

On the other hand, "weaker domestic demand for imports" could be achieved only by a severe contraction of the US economy.

This is because the very structure of the US economy, in which imports of goods and services are some 59 percent higher than exports, means that normal economic growth automatically increases the deficit.

As Morgan Stanley chief economist Stephen Roach noted in a recent report: "Given the high import content of domestic demand, a given increment of consumption growth ... produces a much larger surge in imports than would have been the case in days past when import content was considerably lower. Moreover, the extreme imbalance that now exists between goods imports and exports makes it next to impossible for the US to export its way out of this problem. Exports would have to expand at twice the growth rate of imports just to hold America's outsized trade deficit on goods constant!"

The only way the US could export its way out of the crisis would be if economic growth in the rest of the world proceeded at a significantly higher rate than the American economy. But here a vicious circle is in operation because economic growth in the rest of the world is itself highly dependent on an expanding US market. This is especially the case in Asia where economic growth is increasingly being fuelled by exports to China where goods are manufactured for the American market.

Apart from the ever-widening gap on traded goods, the balance of payments data contained other reasons for concern. The US has long benefited from a situation where the income received from investments overseas is higher than the income received by foreigners investing in America. But this positive balance has started to turn around.

Foreign earnings on US assets rose to $132.3 billion in the fourth quarter, up from $115.9 billion in the previous three months. Income on overseas assets held by US investors rose to $129.8 billion, up from $120.8 billion. This left a deficit of $2.4 billion on investment income, compared to the $4.9 billion surplus in the third quarter.

This result undermines a recent argument that the US balance of payments deficit is not a cause for concern because it is sustained by the financial equivalent of "dark matter"—the invisible substance which theoretically holds the universe together. According to its proponents, financial "dark matter" means that despite its increasing indebtedness, the US is in a much stronger position than the figures would indicate because of the surplus on investment income.

In fact, the US is becoming increasingly dependent on foreign sources to support its current account and budget deficits. Foreign lenders have been financing 80 percent of the increase in the federal budget deficit, and foreign holdings of treasury securities increased by $108 billion in the last quarter of 2005.

As Stephen Roach noted, with a foreign capital inflow of $3 billion every business day—up from $2 billion in 2003—the external dependency of the US "is simply without precedent in the annals of globalization and international finance".

Last month, former US Treasury Secretary Robert Rubin said the federal budget and current account deficits were "unsound underpinnings" in an otherwise "good" economic landscape. However, he continued, these deficits were "not viable". "The probabilities are extremely high that if we don't address these imbalances, then at some point, and it could be years down the road, we'll pay a very big price."

In his testimony to Congress last month, the incoming Federal Reserve Board chairman Ben Bernanke also pointed to the widening balance of payments gap. "I don't think that we can continue to finance the current account deficit at 6 percent or 7 percent of GDP indefinitely, and it's desirable for us to bring down that ratio over a period of time," he said.

But neither Bernanke, Rubin, nor any other leading figure in the US financial establishment has any plan for halting, let alone contracting, the ever-widening payments gap.

This policy vacuum is being filled by ever more strident calls for action against China, whose undervalued currency is held to be the cause of America's worsening trade position.

Last Tuesday, ahead of next month's visit to Washington by Chinese President Hu Jintao, the Bush administration indicated it was preparing to step up pressure in support of demands for the opening of Chinese markets and concrete action by the Chinese government to reduce its growing $200 billion trade surplus with the US.

In language not dissimilar to that being used against Iran, Commerce Secretary Carlos Gutierrez, said: "China's failure to address economic frictions will have consequences. Without concrete results, the administration, and the American people, may be forced to reassess our bilateral economic relationship." He said there were growing demands for trade action against China and that without results, "Congress may go down a path that none of us wants."

The advocates of China-bashing, both within the Bush administration and the US Congress, are well aware of the growing dependence of American financial markets on the flow of funds from the Chinese central bank. But they believe that the Chinese authorities have nowhere else to place their money and that the recessionary consequences of any significant withdrawal of funds would rebound on the Chinese economy. In other words, they consider that what former Treasury Secretary Lawrence Summers once called the "balance of financial terror" will operate in favour of the US.

That may be the case at present. How long it remains so is another question.