Record U.S. current account deficit signals disaster ahead

by Richard Freeman

The U.S. current account deficit reached $80.7 billion for the second quarter of 1999, the highest level in history, the Commerce Department announced on Sept. 14. This followed a current account deficit of $68.7 billion for the first quarter, putting the current account deficit for the first half of this year at $149.4 billion, also a record. Were this trend to continue, the United States would register a current account deficit of $300-320 billion for 1999. This deficit indicates that America's trade flows, and other elements that make up the current account, are seriously misperforming. The high level of the current account deficit represents a strategic danger.

First, the U.S. trade deficit—trade is a major included element of the current account deficit—is large, and growing. In order to survive, America must import a growing amount of goods; its physical economy is no longer capable of producing the physical goods upon which the population's existence depends. A growing share of its imports are produced in countries dominated by free trade conditions, in which, exacerbated by the North American Free Trade Agreement (NAFTA), workers toil under virtual slave-labor conditions. Second, a traditional way that the United States has offset its current account deficit, is by having large flows of money come into America from abroad. Were foreigners—realizing the risk of having money invested in the bubble-ized U.S. financial system—to cut back or even reverse those flows, the United States would be unable to cover its current account deficit. The succeeding chain of events would be a large fall in the U.S. dollar, and a sharp de-leveraging of the U.S. financial system.

We look at what the current account balance is, and the process by which, during the 1990s, America's current account has grown increasingly negative.

Current account

The current account balance is the sum of three balances: trade in goods and services, investment income, and net unilateral transfers. The balance on trade in goods and services is clear: Nations that run a surplus on trade in goods and services are exporting more goods and services than they import. The investment income balance is the income which American individuals, firms, and governments earn on their investments abroad, minus the income which foreign individuals, firms, and governments earn on their investments in the United States. The net unilateral transfers balance is the funds that U.S. government agencies (such as the Agency for International Development) and private charities (such as the Red Cross) send abroad in food and humanitarian and other aid, plus the remittances that foreign workers living in the United States send to their home countries, minus the level of funds that foreign government agencies and private charities send to America in food and humanitarian and other aid, plus the remittances that American workers living abroad send to the United States.

Table 1 shows that America ran a trade deficit on goods and services of $54 billion in the first quarter and $65 billion in the second quarter; for the first half of 1999, America's trade deficit on goods and services stood at $119 billion. That constitutes 79%, nearly four-fifths, of America's first half of 1999 current account deficit of $149.4 billion. The trade deficit is the leading component of the U.S. current account deficit.

Figure 1 shows that the U.S. trade balance in goods and services has sharply deteriorated since 1970, the result of implementation of the British financier-steered post-industrial policy in the United States. Two policy decisions were key in this. The first was President Richard Nixon's delinking of the U.S. dollar from the gold reserve standard in 1971, which ushered in the floating exchange rate system. The effect was not seen immediately; in 1975, the United States ran a trade surplus on goods and services of $12.5 billion. But, starting in 1976, the balance on trade in goods and services became negative, and has grown worse ever since. Second, in October 1979, Federal Reserve Board Chairman Paul Volcker began instituting a decisive phase of the policy he called "con-

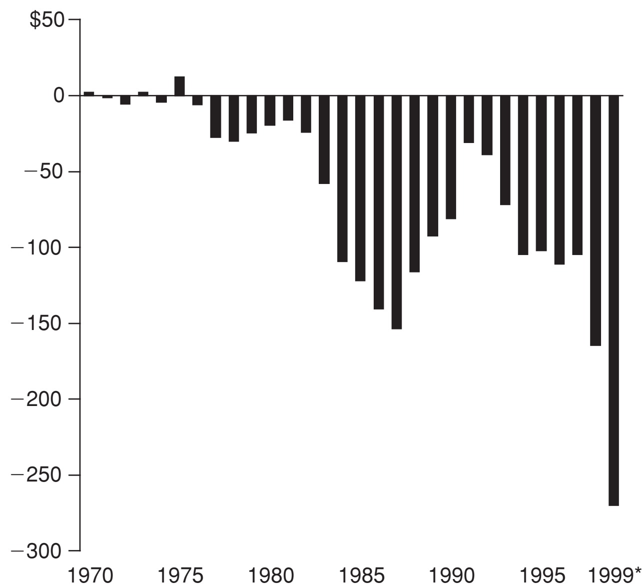
TABLE 1
Balances and current account balance
(billions $)

	1st Quarter	2nd Quarter	First two quarters combined
Balance on goods and services	–54.0	–65.0	–119.0
Balance on investment income	–4.3	–4.4	–8.7
Balance on net unilateral transfers	–10.3	–11.3	–21.6
Balance on current account	–68.7	–80.7	–149.7

Source: U.S. Dpeartment of Commerce.

© 1999 EIR News Service Inc. All Rights Reserved. Reproduction in whole or in part without permission strictly prohibited.

FIGURE 1
U.S. trade balance on goods and services
(billions $)



*Estimated.
Sources: U.S. Department of Commerce; *EIR.*

trolled disintegration." Volcker sent interest rates into the stratosphere; by February 1980, the prime lending rate in the United States was 21.5%. By design, this withered manufacturing and agriculture; hundreds of machine-tool plants, steel factories, and other productive operations shut down. In this environment, speculation flourished. America began to make up for the goods that it no longer produced, by importing.

The passage of NAFTA in 1993 was an additional, powerful negative force. It established a system of slave-labor *maquiladoras* in Mexico; American industry began outsourcing production there, closing down operations and firing workers in the United States. But, while NAFTA is formally a treaty among the United States, Mexico, and Canada, in fact, it enforced a system of slave-labor throughout the world, as other regions gouged wages in order to compete.

The U.S. trade deficit in goods and services for the first seven months of 1999 was severe. In July, it was $25.2 billion. (The U.S. Commerce Department's accounting of the U.S. trade deficit is of goods and services, so that is what we use here. But, *EIR* has shown that concentrating on the deficit of physical goods alone—putting aside services, which in many cases add nothing of value to the economy—the picture is even worse. For example, in July, the U.S. deficit of physical goods was $31.7 billion.) It is estimated that the U.S. trade deficit of goods and services for 1999 will reach an unprecedented $250-270 billion.

Figure 2 shows that the U.S. current account deficit parallels the U.S. trade deficit of goods and services.

America's gigantic current account deficit shows that the U.S. physical economy and financial system have serious problems which require correction. However, many U.S. policymakers and financiers have become cavalier about the deficit, stating that it is a minor problem that "can be handled."

'Balancing' the current account deficit

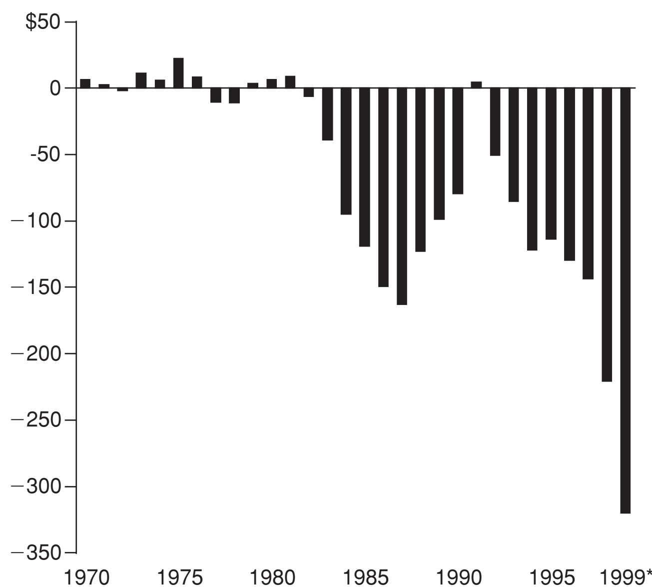
No country can continue to run huge current account deficits without incurring drastic consequences. For good reason, in traditional international trade and capital terms, it is required that a current account deficit be balanced, or covered by an offsetting flow of money. In 1998, the United States ran a record $220.6 billion current account deficit. If present trends continue, the United States will register a current account deficit of $300-320 billion for 1999. This means that during the course of the year, America will ship the equivalent of $300-320 billion in net funds out of the country to pay for goods and services, and for other purposes—an amount equivalent to more than half of America's entire physical cash money supply now in circulation. Two years of American current account deficits of $300 billion, and the United States would exhaust all its cash trying to pay for them. Since 1980, America has run a cumulative current account deficit of $1.58 trillion. While America does not pay for most of its imports in physical dollar bills, had it tried to do so, it would have long ago run out of money.

What foreigners receive from America are bills of trade, or comparable instruments, that is, dollar-denominated U.S. IOUs. These are real obligations. America has historically sought to have foreigners bring those dollar-denominated IOUs back into the United States, by investing them, or their equivalent, in U.S. assets in the United States. Thus, foreigners would buy U.S. assets, such as U.S. Treasury bonds, U.S. stocks, U.S. corporate and municipal bonds, or buy outright, that is, take over, U.S. companies. In each case, the foreigner would pay for the purchase with dollars, bringing the dollars back into the United States.

This gets to what is called the capital-financial account. America runs a *capital-financial account surplus,* where foreigners buy more U.S. assets (U.S. stocks, bonds, etc.) than Americans buy foreign assets (foreign stocks, bonds, etc.). America "benefitted" from this, in the (short-sighted) short term. During the second quarter, American individuals and institutions bought $124.2 billion worth of foreign assets, but foreigners bought $241 billion worth of U.S. assets. This led to a second quarter $116.8 billion *net* capital-financial account surplus for the United States: that is, $116.8 billion more foreign capital seeking investments flowed into the United States than flowed out of the United States abroad.

Since the net capital-financial account offsets the net current account deficit, then, during the second quarter, America's $116.8 billion net capital-financial account surplus was more than sufficient to offset America's $80.7 billion current account deficit. It is this gimmick that America has been play-

FIGURE 2
U.S. current account balance
(billions $)



*Estimated.
Sources: U.S. Department of Commerce; *EIR.*

TABLE 2
Composition of foreign-owned investment in United States, 2nd Quarter 1999
(billions $)

Foreign direct investment	$118.6
U.S. liabilities (largely banks) to foreigners	49.4
Net foreign purchase of U.S. stocks	28.8
Net foreign purchase of U.S. corporate bonds	48.5
Net foreign purchase of U.S. Treasuries	–5.5
Other	1.2
Total	$241.0

Source: U.S. Department of Commerce.

ing for much of the past decade and a half. It creates tremendous instabilities, with the potential for an explosion of the financial system.

First, consider **Table 2,** which shows the composition of the $241 billion which foreigners made in new investments in the United States during the second quarter. It offers a glimpse into the nature of the movement of the active financial flows between the United States and the rest of the world; it also pinpoints the great dangers.

Table 3 shows that during the second quarter, foreigners sold off net $5.5 billion of U.S. Treasuries (they sold $5.5 billion more U.S. Treasuries than they bought). Also during the second quarter, foreigners increased their purchases of U.S. stocks and corporate bonds by a sizable $28.8 billion and $48.5 billion net, respectively. Moreover, they made considerable foreign direct investment, at $118.6 billion; foreign direct investment means foreigners are gobbling up U.S. companies.

The United States has been desperately relying on the hope that the level of purchases by foreigners of U.S. assets will continue to go higher and higher, as the U.S. current account deficit rises higher and higher. In part, U.S. financial arrangements are rigged to keep this game going.

But, there are unresolvable problems. First, during the second quarter, foreigners made direct investments, that is, took over American companies, to the tune of $118.6 billion. This is an annualized rate of almost a half-trillion dollars of foreign take-overs of U.S. companies per year. That is far from a sound strategy for dealing with a growing current account deficit. Second, the more that foreigners purchase U.S. assets, the more that America will have to pay in *income* to foreigners on their U.S. holdings. It will be recalled that the income paid on investment is an element of the current account balance. Thus, this will increase the U.S. current account deficit further.

This strategy cannot be sustained—there is no way that such high volumes of foreign funds could continue to pour into the United States, at the rate of nearly one-quarter of a trillion dollars per quarter. No policymaker should think that that could happen. The U.S. financial system is a speculative casino, which exists because of high levels of leverage. It has attached to it $23 trillion worth of indebtedness, and $55 trillion in U.S.-held derivatives outstanding. As financial instabilities increase, the danger of financial disintegration increases. Foreign investors, many of whom are skittish about the U.S. financial bubble, will yank out funds, rather than put them in. Foreign new investment flows into the United States, which were $241 billion during the second quarter, will fall to less than $100 billion, or, as conditions become intense, may become negative, as foreigners disinvest. The whole rigged game then falls apart.

At that point, two pronounced consequences would follow. First, U.S. dollar-denominated instruments and, consequently, the U.S. dollar itself, will be seen as unstable, and not advisable to hold. This will create a severe dollar crisis. In turn, that would accelerate the flow out of the dollar and dollar-denominated instruments. This would implode the inflated U.S. financial system. It would abet the process of reverse-leverage of U.S. financial instruments.

Second, foreign nations and companies would be less willing to sell their products in exchange for U.S. dollar-denominated IOUs. This would expose the fundamental weakness—that America cannot produce its own existence. The contraction of imports would collapse the physical economy even further.