U.S. current account deficit could rupture economy

by Richard Freeman

The U.S. current account deficit, fuelled by a growing trade deficit, reached $99.8 billion for the fourth quarter of 1999, the highest level in history, the U.S. Commerce Department announced on March 15. It followed a deficit of $89.1 billion during the third quarter, putting the current account deficit for 1999 as a whole at an unprecedented $338.9 billion. Were the trend to continue, the deficit would grow to between $380 and $420 billion for the year 2000. The deficit shows that America's trade flows, and other key elements that make up the current account, are having serious problems. Indeed, it constitutes a strategic danger.

Thirty years ago, America imported a range of goods, but also exported goods of equal or greater value. As a result, the U.S. trade account was either in balance—the revenues from exports paid for the imports—or the United States ran a slight trade surplus or deficit. When the trade balance, which makes up the largest part of the current account balance, was in relatively decent shape, the current account was, too; when the trade deficit became very large, the current account deficit also became very large.

The 'post-industrial society' and 'globalization'

In about the mid-1960s, the Wall Street-City of London financier oligarchy imposed upon the United States a "post-industrial society" policy, which withered production in manufacturing, agriculture, and infrastructure, and sought to replace it with the "information age" and services, especially financial services, which sucked the physical economy dry, and built up the cancerous speculative bubble that plagues us today. Tens of thousands of American factories, producing capital goods (ranging from machine tools to tractors) and consumer goods, were shut down, and with them, America's ability to produce the goods needed for its existence. America became addictively dependent on imports to substitute for its production shortfall. This wrecked the trade balance. For example, whereas in the late 1960s, America imported 10% of its machine-tool purchases, by 1999, that figure was above 45%; whereas in the late 1960s, America imported 20% of the clothing and household appliances it bought each year, by 1999, that figure ranged between 30 and 65%, depending on the product.

The geopolitical gamemasters intensified this process through "globalization," one of whose key features is "outsourcing" to the poorest countries. Goods are produced by workers, frequently children, who are paid 5¢ to $1 per hour. The goods produced in these countries under slave-labor conditions wind up on the shelves of K-Mart and J.C. Penney in the United States. The 1993 North American Free Trade Agreement (NAFTA), with its slave-labor *maquiladora* system, accelerated the process. Now, there is talk of a NAFTA for the Western Hemisphere.

Financing the deficit

The larger the current account deficit grew each year, the more funds the United States needed to pay for it.

For the goods it imports, the United States issues dollar-denominated bills of trade, or comparable paper. Ultimately, however, the United States must cover its current account deficit, by making its assets attractive enough for foreigners to invest their money—purchasing U.S. stocks, U.S. government or corporate bonds, etc. Over the last five years, the United States has attracted hundreds of billions of dollars of foreign investment each year into the United States.

But, a drop in the level of foreign fund flows into the United States, or worse, a disinvestment by foreigners, in which they sell off a portion of their U.S. assets, so that funds begin flowing out of the United States, and the rigged game by which the current account deficit has been covered over, would break apart. That moment is imminently at hand. Foreigner dissatisfaction with the rate of return on U.S. bonds or stocks, or fear of holding vastly overinflated U.S. stocks vulnerable to a market crash, could trigger a sell-off of hundreds of billions of dollars. This would have two effects. First, U.S. ability to offer dollar-denominated trade paper to import goods would plunge. As a result, the level of imports would fall, intensifying the crisis in the already-damaged U.S. physical economy. Second, this would trigger a crisis of confidence in the U.S. dollar. That could be the last straw, causing a "reverse-leveraging" of the highly leveraged, bankrupt U.S. financial system.

We look at the operation of the U.S. current account deficit, and the process by which it grew over the recent period. We then examine the threatened outcome for the U.S. economy, when the capital flows into the United States no longer continue at the current rate.

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TABLE 1
Balances and current account balance, 1999
(billions $)

	Second Q	Third Q	Fourth Q	1999
Goods and services	–65.1	–72.6	–75.5	–267.5
Investment income	–4.6	–5.3	–10.4	–24.7
Net unilateral transfers	–11.2	–11.2	–13.9	–46.6
Balance on current account	–80.9	–89.1	–99.8	–338.9

Source: U.S. Department of Commerce.

TABLE 2
Balances and current account balance, 1995-99
(billions $)

	1995	1996	1997	1998	1999
Goods and services	–99.9	–108.6	–110.2	–164.3	–267.5
Investment income	+19.3	+14.2	–5.3	–12.2	–24.7
Net unilateral transfers	–34.6	–40.6	–39.7	–44.1	–46.6
Balance on current account	–115.3	–134.9	–155.2	–220.6	–338.9

Source: U.S. Department of Commerce.

How the current account functions

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 than they import. The investment income balance represents the income which 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 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 the current account balance, and each of its three components, for the second, third, and fourth quarters of 1999, and for 1999 as a whole. The table shows that America ran a trade deficit of $65.1 billion for the second quarter, $72.6 billion for the third quarter, and $75.5 billion for the fourth quarter; for the whole of 1999, the trade deficit on goods and services was $267.5 billion. That constituted fully 79% of America's 1999 current account deficit of $338.9 billion.

Table 2, which covers 1995-99, shows just how rapidly the current account deficit has grown in only five years, exploding the Big Lie that the United States is enjoying "unparalleled economic expansion." In 1995, the current account deficit was $115.3 billion; in 1999, it had tripled to $338.9 billion. The trade deficit on goods and services, which rose during this period from $99.9 billion to $267.5 billion, was the primary driving force behind the rise in the current account deficit. But, there is also the income from investment: In 1995, America earned, net, $19.3 billion more from its investments abroad than foreigners earned on their investments in the United States. But, because America keeps increasing foreign capital flows into the United States to cover its current account deficit, foreigners now have greatly enlarged their holdings of income-earning assets in the United States, and in 1999, the U.S. net balance on investment income was –$24.7 billion, i.e., America earned $24.7 billion less on its foreign investments than foreigners earned on their investments in the United States.

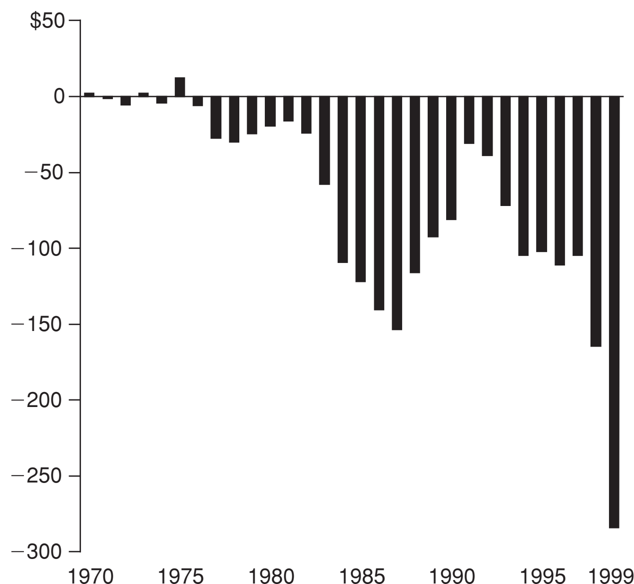
Effects on the physical economy

The crisis of the U.S. current account deficit, while manifesting itself sharply during the last five years, originates with the post-industrial-society policy of the past three decades. As this policy destroyed the U.S. physical economy, it ruined the trade balance. **Figure 1,** which shows the U.S. trade balance on goods and services, dramatically displays its longer-term effect.

Within the overall post-industrial-society policy, three subsumed policy decisions were key. The first was President Richard Nixon's delinking of the U.S. dollar from the gold reserve standard in 1971, which terminated the Bretton Woods system and ushered in the floating-exchange-rate monetary system. Suddenly, financial flows were severed from production. The effect was not seen immediately; in 1975, the United States still 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 that negative balance has grown ever since.

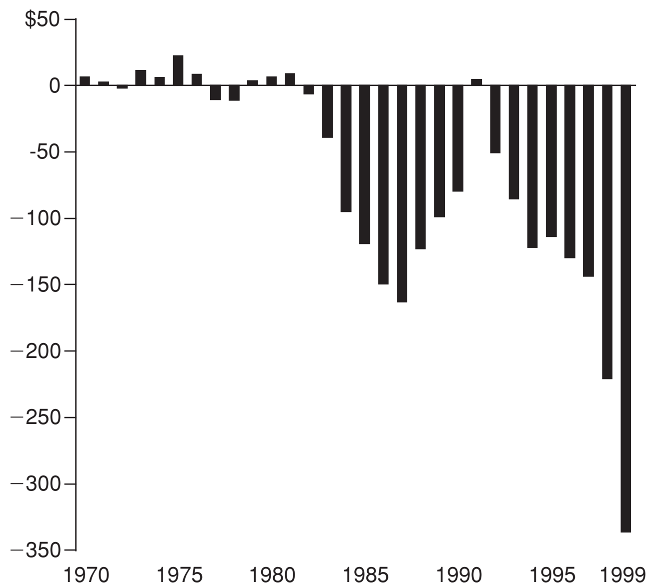
The second decision occurred in October 1979: Federal Reserve Board Chairman Paul Volcker began instituting the policy he called "controlled disintegration." Volcker sent interest rates into the stratosphere: By December 1980, the banks' prime lending rate in the United States was forced up to 21.5%, and Volcker held the prime lending rate at double-digit levels for several years. By design, this withered manufacturing and agriculture; tens of thousands of machine-tool plants, steel mills, and other productive factories were bankrupted and shut down.

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



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

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



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

One can see the process in the case of machine tools, which incorporate the most advanced scientific ideas into the economy as a whole. The Midwest and New England are America's two main regions for machine-tool production. Between 1977 and 1992, as a result of Volcker's policy, the number of operating machine-tool plants in the Midwest fell from 567 to 317, a reduction of 44.1%; the number of machine-tool plants in New England fell from 275 to 155, a reduction of 58.2%. America made up for the machine tools that it no longer produced, by importing. The percentage of machine tools bought by American industry that were imported, rose from 18% of the total in 1977, to 44% in 1992, to 48% today. What was true for machine tools was also true for hundreds of other products. And, in this environment, speculation flourished.

In 1993, NAFTA was passed, which was another powerful negative force. It established a system of slave-labor factories, or *maquiladoras* in northern Mexico, just over the U.S. border; 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, it in fact enforced a system of slave labor throughout the world, as other regions gouged wages in order to compete.

Steadily, over the past 30 years, disastrous policy decisions pushed the trade deficit on goods and services higher and higher. (*EIR* will show in a future issue, that as bad as the trade deficit on goods and services is, when services, which in many cases add nothing of value to the economy, are excluded, the picture is much worse.)

This same process has governed the current account. **Figure 2** shows that the U.S. current account deficit has also grown at an accelerating rate. *EIR* estimates that were the trajectory to continue, America's current account deficit in the year 2000 would be in the range of $380-420 billion.

Financial flows into the United States

The United States has required an increasingly large inflow of capital to cover the current account deficit.

America's current account deficit represents real obligations. Foreigners buy U.S. assets, such as Treasury bonds, stocks, corporate and municipal bonds, or outright take over U.S. companies. Were foreigners not to buy U.S. assets, the United States would be in deep trouble. Therefore, the United States has rigged the financial system so that foreigners continue to buy large quantities of U.S. assets: Yields and rates of return on U.S. bonds and financial investments are kept relatively high; U.S. stocks are pushed up in price (both for U.S. citizens and foreigners) so that money can be made on their artificial appreciation, and so forth.

In 1999, at least $338.9 billion had to flow into the United States to cover the current account deficit.

This was covered by what is called the capital/financial account. During 1999, foreigners increased their assets in the United States by $750.8 billion, while U.S.-owned assets abroad increased by $372.6 billion. Thus, on capital/financial

TABLE 3
Composition of foreign-owned investment in United States, 1999
(billion $)

Foreign direct investment	$282.5
U.S. liabilities (largely banks) to foreigners	67.7
Net foreign purchase of U.S. stocks	94.9
Net foreign purchase of U.S. corporate bonds	231.0
Net foreign purchase of U.S. Treasuries	–21.8
Other	94.5
Total	$750.8

Source: U.S. Department of Commerce.

account, the U.S. experienced a net surplus of $378.2 billion, representing the fact that $378.2 billion more in capital was invested in the United States than flowed out. During 1999, that capital/financial account surplus covered the U.S. current account deficit of $338.9 billion.

The composition of the $750.8 billion by which foreigners increased their assets in the United States gives a glimpse of the nature of the movement of financial flows between the United States and the rest of the world (**Table 3**).

Thus, foreigners sold $21.8 billion of U.S. Treasuries. Still, they increased by record amounts their purchases of U.S. stocks and corporate bonds, by $94.5 billion and $213.0 billion, respectively. Moreover, they made direct investment of $282.5 billion, which is largely foreigners buying out U.S. companies.

This represents a diminution of national sovereignty, and hence a strategic danger, which cannot be remedied by a quick fix, but would require the elimination of the underlying post-industrial-society policy which has destroyed the U.S. economy. The United States is able to survive only through a rigged game, which brings in large amounts of foreign capital to cover the current account deficit. With increasing instability caused by the deepening of worldwide financial disintegration, the possibility is that either foreigners decide that they no longer wish to hold so much of U.S. assets, and begin pulling out funds, or, several U.S. markets crash, prompting foreigners to get out as quickly as they can. It is possible that one event would quickly follow the other, either precipitated by, or also precipitating, a crisis in derivatives instruments.

This would produce two catastrophic consequences: First, U.S. ability to bring in imported goods would fall steeply. This would intensify the rate of contraction of the U.S. economy, with noticeable drops in the standard of living of the population. Second, as foreigners fled out of dollar instruments, and dollars in general, this would produce a dollar crisis that would de-leverage the highly leveraged U.S. financial system.

The rigged game which covers up for the fundamental inadequacies of the U.S. economy, cannot be sustained.

Debt crisis builds: What Japanese recovery?

by William Engdahl

The sudden political loss of Prime Minister Keizo Obuchi, who suffered a stroke and remains in a coma, coinciding with the March 31 end of the Japanese fiscal year, has put the spotlight on the fragility of the world's second largest industrial economy.

The Japanese stock market in recent months has been focus of great excitement from foreign fund managers looking for large gains, as their holdings in the inflated U.S. Nasdaq high-tech market threaten to disappear in a cloud of electronic smoke.

At the beginning of April, Tokyo's Nikkei Dow stock index soared well above 20,000 points, its highest level in more than three years. Only ten months ago it was flirting with lows of 12,000. The Japanese high-tech stock index, the Nikkei OTC index, had risen 213% in the past year, before a recent sell-off. Internet-linked stocks such as Softbank or Sony have been soaring until recently. Even hedge fund guru George Soros, whose Quantum Fund lost big when the Internet boom went bust, has decided to open a Tokyo office to profit from the revival of investment prospects there.

Yet a booming stock market does not a healthy economy make. The underlying catastrophic reality of Japan's $3 trillion economy, underscores how fragile the present state of the world economy is.

The world's worst public debtor

Several weeks ago, Moody's Investors Services announced that it was placing the rating of the government of Japan's yen debt under review for possible downgrade. The reason, they noted, was "structural problems in Japan's economy that have resulted in a level of public sector debt that will soon be the highest, relative to GDP, among the advanced industrial economies." Japan's gross public debt is already $5.5 trillion, 130% of GDP, well beyond the 60% levels in Germany and even more than that of Italy. By next year, even under the best assumptions of the Finance Ministry, debt will rise to 140% of GDP.

This may only be part of the full debt picture. According to Akio Ogawa of Tokyo Chuo University, the Ministry of Finance is hiding another $1 trillion of public debts in a special account used to make loans to state corporations.

Moody's debt warning stated that, given the scale of Ja-