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U.S. and Trade Partners Maintain Unhealthy Long-Term Relationship

By LOUIS UCHITELLE – September 18, 2004

No organization has been more alarmed about America's constantly rising deficit in global transactions than the Institute for International Economics, a center of expertise in this field. A disaster in the making, declares the institute's director, C. Fred Bergsten - and one coming soon.

But month after month, indeed year after year, the disaster has failed to occur and now one of the institute's own trade experts, Catherine L. Mann, has stopped, as she puts it, crying wolf.

"Because nothing happened, I did a lot more analysis," Ms. Mann said, "and I have come to the conclusion that a co-dependent relationship exists between the United States and its trading partners.'' That situation "may not be healthy for either side,'' she added, but it "can last for quite some time."

For Americans, the positive side of this equation - known as the balance on current account - is that they get to consume much more in goods and services than they produce. As for America's trading partners, particularly China, Japan and the Asian tigers, they gain from an overseas marketplace that allows them to expand production and job creation beyond what their own population can consume.

The downside for the United States is that most of its imports are purchased on credit extended by its trading partners. The overall indebtedness is now about $4.4 trillion, nearly twice what it was in 2000 - an increasingly costly arrangement for Americans and a potentially risky one for the nation's foreign creditors.

While Mr. Bergsten, one of the better-known commentators on the global economy, remains alarmed that the arrangement could unravel abruptly, with the dollar plummeting in value and inflation rising, Ms. Mann represents an alternative view held by a growing number of economists. This group argues that rather than crisis, the United States is caught in a gradual, almost imperceptible deterioration brought on by the yawning deficit in trade and other international transactions, and the deterioration could continue for a long time.

"If there has been no crisis, there has to be a counterweight that keeps the crisis from happening," Ms. Mann said. "The counterweight is that the United States and its main trading partners have a vested interest in the status quo.''

No one knows how this situation will unwind. The willingness of the United States to accumulate more and more debt could indeed end painfully or it could play out gradually and mildly as the nation's trading partners pull back on their lending and Americans slow their consumption of imported goods and services.

"I think in the long term what is happening is unsustainable but it is very hard to predict a turning point in an unsustainable situation," said Robert Blecker, an economist at American University who, like Ms. Mann, describes himself as a former Chicken Little. "You can see why something cannot keep going,'' he said, "but you can also see why it keeps going."

The scorecard in this process is the current account, which encompasses the imbalance in the trading of goods and services as well as the shortfall in all other cross-border payments, from interest income and rents to dividends and profits on direct investments. The current account deficit was equal to 5.7 percent of all domestic economic activity in the second quarter, the Commerce Department announced this week.

That was a record and an unusually rapid rise from 4.5 percent of G.D.P. in last year's fourth quarter and 5.1 percent in the first quarter. The trade deficit, the biggest single component, has risen to $447 billion over the last year, a 10 percent increase.

What could turn things around? Interest payments on the debt could finally get too burdensome for American borrowers, for example, or the Chinese, the centerpiece among the nation's trading partners, could discover that they finally have enough customers at home and do not need to sell so much to the United States on credit.

The dollar, in response, would fall sharply in value, forcing prices to rise in the United States for a vast array of imported goods and services, leaving Americans, in response, much more dependent on their own inadequate production.

"At some point the music stops, or slows down, as the two sides become too unhinged,'' said Lee Price, director of research at the Economic Policy Institute.

The focus on whether or not the rapidly growing current account deficit will produce an abrupt crisis draws attention away from the continuing deterioration in America's global economic status.

Interest income that once went to lenders within the United States now seeps overseas to foreign lenders. Foreigners own more than 40 percent of all Treasury securities, up from less than 15 percent a decade ago. They purchase these securities with the dollars American consumers pay for imports, in effect lending the dollars back to Americans for more purchases. The money collected through the Treasury sales finds its way back to the public through the Bush administration's deficit spending, and the cycle of purchasing on credit continues.

"The budget deficit is essentially consumption supported by foreign lending," said Stephen S. Roach, chief economist at Morgan Stanley, the investment bank.

China and Japan held $1.3 trillion in Treasuries through June, according to the International Monetary Fund. That continuing willingness to invest surplus dollars in Treasuries helps to explain why the dollar has fallen in value by only about 10 percent over the last year against a market basket of currencies representing the nation's trading partners. So far the dollar's preeminence as a reserve currency and America's importance as a consumer market outweigh the dangers of one or two lenders holding so much American debt.

"My hope prior to the Iraq war was that the ministers of the major nations would sit down and address the United States problem," said Christian Weller, a senior economist at the Center for American Progress, a research institute. "But the war overshadowed the discussions and the trade deficit became a sideshow."

The last time something similar happened, in the mid-1980's, America's trade problems focused more on Germany, France, Britain, and Japan. Recognizing the crisis, these countries reached an agreement with the Reagan administration to manage the fall of the dollar against their currencies. As imports became more expensive, American production revived, particularly in manufacturing.

This time, China, Japan and other Asian countries are the focus of trade, and lacking enough demand at home for all their production, they are eager to keep their goods and services as inexpensive as possible for American consumers. So they resist letting the dollar fall in value, defying market forces and ignoring mild prods from the Bush administration.

While Senator John Kerry, the Democratic presidential candidate, has said he will "take America in the right direction on trade," Tim Adams, policy director for the Bush campaign, has said, "We will continue to work with the Chinese toward a flexible exchange rate."

For the United States, however, the gradual deterioration is bringing the country to a turning point. Until now, despite the growing imbalance, income earned by Americans on all of their investments abroad as well as their exports has exceeded the earnings of foreigners on their holdings in the United States and their exports to this country.

Only occasionally have the roles reversed, and then only briefly. But now a heavy swing in the net income flow appears to be developing, Mr. Roach says, as interest payments rise on the hoard of Treasuries held by foreigners.

The net income flow favored the United States by $64 billion in last year's fourth quarter, but that net dwindled to less than $10 billion in the second quarter "and it will keep falling sharply," Mr. Roach said.

Production and job creation also suffer as imports substitute for goods and services made in America. These imports now account for nearly 15 percent of total consumption in the United States, up from 12 percent in the mid-1990's and 9 percent in the mid-1980's, according to government data. Manufacturing within the United States has simultaneously fallen to less than 13 percent of the gross domestic product from 15.4 percent in 1998.

With less and less production at home, stimulating the economy in periods of sluggish growth is becoming gradually more difficult, some economists argue. The Federal Reserve, for example, was forced to cut interest rates to rock-bottom levels before the economy started to recover, in part because a growing portion of the goods and services Americans buy are imported, diluting the stimulative effect on domestic production.

How long can this imbalance between the United States and the rest of the world continue? Indefinitely, says Albert Wojnilower, a Wall Street economist who argues that no other country has a currency as reliable and attractive as the dollar.

The downside is that a strong dollar forces the least competitive American companies to give up or shift operations abroad.

"If this went on forever, ultimately we would import everything," Mr. Wojnilower said. "But that is not going to happen."

Questions:

1. What is trade deficit?
2. Is trade deficit considered healthy or unhealthy for the economy? Explain.
3. How does the US dollar decline affect the deficit?
4. In your opinion, what should be done to solve a country's current account deficit problem?
5. Relate to Vietnam current account balance and give your opinion on the current situation.