Downside UP

A Voice of Contemporary Political Economy, Volume VII, Issue 1: January/February, 2007
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U.S. Trade and Budget Deficits: You Really Can Understand – and Really Should Care

DON'T PANIC! I can see (most of) your eyes glazing over already. The title of this article looks like it is going to be about economics, economics uses lots of numbers, and you are already saying to yourself, "There is no way I am going to understand any of this; I might as well quit now." Don't.

Lots of people talk about United States trade and budget deficits as if they understand what these deficits mean. The Democrats shake their heads as if knowing. The Republicans pretend to soberly consider the consequences of massive tax cuts and off-the-books $100 billion a year Iraq war spending. The media reports on both deficits, typically quoting economists extensively without the reporters having a clue as to what the economists are saying.

I, however, have the arrogance to propose that, in 3,000 words, using plain English, I can get you to understand both kinds of deficits, realize why they are important, and assess the risks which derive from them for you and the United States. Most unexpectedly, I am going to show you how the two are related, how they feed on each other in an apparently beneficial way today, but could, another day, reverse their effects and put the U.S. economy in a tailspin.[1]

The Budget Deficit

A government, like a family, runs a deficit when it spends more money than it receives. The U.S. budget deficit has never been larger. In fact, it looks better than it is because Social Security is still taking in a lot more money from current workers than it has to spend on payments to current retirees. In theory, these surpluses should be building up – in the famous "lock box" -- for the time when there is more money going out to pay retirees than there is coming in from current workers. If the money were building up, Social Security wouldn't run out of money for another four decades or so.

Apologists for the deficit claim that Social Security is <u>investing</u> its surplus in government bonds, but it is all too convenient that the rest of the government is running a deficit and Social Security <u>has</u> to, by law, put its surplus in government bonds. Bonds are I.O.U.'s. People loan money to the U.S. government by buying its bonds. The bond seller agrees after some length of time – five years, 10 years, 30 years -- to pay back the lender the full price of the bond plus interest. Except in this

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[1] But I'm not going to use elaborative footnotes for the economist types. I think I can anticipate almost every "oversimplification" they might object to, but have chosen not to try to respond to them. I only ask that they consider whether, <u>overall</u>, my description of the situation is basically sound.

case, the government is borrowing from itself and will eventually, like a family, have to pay Social Security back from the regular budget which you and I fund with our taxes. When Society Security starts generating deficits, it will be making the overall budget deficit look worse rather than better.

The deficit is so huge today because the government has drastically increased spending at the same time that it has drastically reduced tax rates for both individuals (especially wealthy ones) and corporations. The Iraq war represents, overwhelmingly the major share of increased spending. There is an economic theory, called "supply side economics," which holds that reductions in taxes can so stimulate economic initiative and growth that even though tax rates are lowered, total tax revenue will increase. Taxes of 10% on a $100 economy generate $10 in revenue, but lowering the tax rate to 7% leads to a $150 economy generating $10.50.

This idea, like increased government spending, can lead to a stimulated economy and more jobs. There is nothing morally wrong with governments, any more than families, running deficits if total debt does not become too large relative to the total economy and the government's, or a family's, ability to pay. But there can be problems with execution. Under Ronald Reagan and George W. Bush, the real goal of proponents has been to strangle government programs, especially government social programs, and "reward" people who invest money to earn dividends and capital gains rather than earn money by working at jobs. According to supply side theory, investors – "our most productive citizens" – invest their money in producing goods and services which employ regular people and everyone benefits by the cascading effect of investment, profits from investment, and more investment.

Unfortunately, investors don't invest in making goods and services if they don't think ordinary workers will have enough money to buy those goods and services. Instead, investors put their money in real estate and art. If tax cuts too heavily benefit the rich and not the poor and middle class, too many people are buying real estate and art and too few can buy computers and eat out at restaurants. Building up consumer debt is one response but the "supply side" effect is inadequate.

In the current Bush regime, no one seriously imagined that tax cuts would "pay for themselves" with increased revenue. Massive deficits are intended to put pressure on funding for consumer protection and environmental regulation, health care and education. Then, when these programs have been thoroughly de-boned and de-muscled, their failures can be used to justify yet further cuts. Thus, the deficits mount up. Fixing Social Security will be harder and harder to do, and, by Republican design, the Democrats won't have the money to restore social programs without raising taxes.

The Trade Deficit

Trade deficits occur because countries buy more goods from foreigners than they sell to foreigners. The U.S. trade deficit, like the budget deficit, is also at record levels. Although the United States sells more to various countries, like some in Latin America, than it buys from those places, it buys much, much more from other countries, especially in Asia and especially China and Japan. We all know this.

International trade works by every country exchanging its money for another country's money to buy goods (e.g. televisions) and services (e.g. banking). In foreign exchange markets, China trades so many *yuan* for so many dollars. It uses the dollars to buy computer software. The United States does the same thing in reverse. It trades dollars for *yuan* to buy DVD players. If they both sold each other the same value of goods at the current value of each other's currency, the system would be pretty simple. Alas, that is often not the case and between the United States and China, among many other countries, it is very much not the case.

In theory (again), when one country buys much more goods than it sells, and another country sells more goods than it buys, the values of the seller's and the buyer's two currencies change so as to reestablish a trade equilibrium. A country trying to buy a higher value of goods puts more of its currency (dollars) into the foreign exchange market. If other countries don't want so much of that country's goods and therefore don't want so much of its currency, the value of that currency goes down.

In effect, other countries say that they are only interested in the first country's goods if its currency (the dollar) is cheaper and they can therefore buy the country's goods more cheaply. A German might not think she can afford a trip to the Grand Canyon (tourism is a service you get when you go to a foreign country) if she only gets one dollar for one Euro, as she did several years ago. Now, however, she can get $1.30 for each Euro so, for her, the trip is now cheaper even though the price in dollars may not have changed at all. It is the same system which causes lots of my friends going to Europe not to buy much to bring home: since the dollar now buys fewer Euros, everything costs more in dollars.

From here on, to maintain the simplicity of my explanation of trade and budget deficits, I am going to talk about currencies as if countries exchanged their currencies directly and China were piling up dollars in a warehouse. My economist consultant on this article couldn't live without my at least recognizing that there actually is a market constantly exchanging all currencies among all countries.

The point is that while the value of the dollar relative to the *yuan* and the Euro is going down, it should be going down much more. The dollar should be getting cheaper to buy and the Chinese people buying more U.S. goods and services. At the same time, the *yuan* should be getting more expensive for Americans so they buy fewer Chinese goods and services. The Chinese buy more and sell less; Americans buy less and sell more. Trade balance is reestablished.

Trade Deficit Meets Budget Deficit: a Solution and an Irony

For better or for worse, practice does not match theory (again!). The reason is first of all that other countries rather like dollars. Historically, the United States has been a very stable country with a very stable economy and currency. Strength begets strength when it comes to economies and currencies. Most countries are content to be paid, even owed, in dollars because dollars have tended to hold their value over time. Indeed, the dollar has on the whole been quite stable in value relative to the rest of the world for most of the 20th century.

So what do China, Japan, and the oil cartel countries do with their dollars? They buy U.S. government bonds – the same bonds used to cover U.S. budget deficits! Instead of using their dollars to buy goods and services, they use their dollars (through the currency exchange market) to buy and hold what has been, historically, a safe and secure asset. When the bond pays off, they expect it to do so in dollars which have largely retained their original value for buying goods and services, or more bonds, in the future.

There is much talk in the media about how the Chinese are supposedly manipulating their currency so it won't go up too much in value (and the dollar go down proportionately). The Japanese have been accused of the same and it is in a sense true. But if they are doing so, it is mainly by buying bonds the U.S. government is desperately trying to sell! And the primary result is that the Chinese and the Japanese end up being offered even more dollars for more of their goods and because of that have an even bigger stake in the <u>dollar not losing value</u>!

The problem with a trade surplus for other countries is that if they hold a lot of dollar-denominated bonds and the dollar loses value, they are out a lot of value when paid back in interest and principal. The more dollars there are floating around, the greater their risk. So, instead of letting the dollar fall in value so their people will buy more U.S. goods and services, they use their excess of dollars to buy "dollar-denominated" bonds – that is, U.S. government bonds. And they keep on buying those bonds. In fact, the United States has had such a big trade deficit for so long a time and there are so many dollars out in the market that the dollar has become the <u>de facto</u> world currency. Now the whole world depends on a stable dollar. Oil prices are denominated in dollars. Iran and Venezuela would like to switch to the Euro but that would risk undermining the value of the dollar to which their economies are already tied. The system may not make sense and no one planned it. But it happened.

And there's more! As the Chinese economy grows, U.S. corporations want to get in on the action. They want to invest – and China often, but not always, wants the United States to invest. The higher the value of the dollar, the less expensive it is for U.S. corporations to buy production capacity in China -- or anywhere else. And – get this -- the more American corporations invest in China, the more interest they have in themselves selling cheap goods back to the United States. A cheap *yuan*/high value dollar facilitates more investment, more sales, and more jobs -- in China.

To some extent, investment out of the United States and into China is another drain on the dollar. While the dollar is not buying consumer goods, it is buying and building Chinese factories and business. These businesses in turn contribute to the sale of more goods out of China to the United States. Yet, since the stockholders of U.S. corporations are mostly Americans, the profits from investment in China come back to the United States as dollars exchanged from *yuan*. Often, over time, profits can surpass the value of an original investment. The system is all inter-connected – perhaps too interconnected.

While Saudi Arabia has notably if gradually, increased its investments in U.S. real estate and businesses, most of the "excess" dollars held abroad come back to the United States to buy government bonds sold to meet U.S. government deficits. Just as a family buys a mortgage, gets a home equity loan, or runs up credit on its credit cards, the U.S. government covers its deficits by borrowing money through the sale of bonds. China, Japan, the United Kingdom, Saudi Arabia, and other countries own billions of dollars worth of U.S. bonds.

What is wildly ironic is that the more bonds they hold, the more interest they have in maintaining the value of the dollar and the more risky it becomes to refuse to buy or hold U.S. bonds. A dollar that falls in value already threatens their trade. Now, if the dollar "crashes," their ever-growing investment in U.S. government bonds crashes. They have dug themselves a hole and they are digging it deeper and deeper every day.

It would not be wrong to say that the U.S. trade deficit finances the U.S. budget deficit. Together they hold up a dollar which would otherwise be tanking. Together, they hold up the U.S. economy which, if it were Nicaragua or Somalia, or even South Africa or Canada, or perhaps any other country, would have gone into a tailspin long ago under the weight of so much total debt – accumulated deficits – relative to the size of the economy.

Today, total U.S. budgetary debt is pushing $9 trillion and rising at the rate of $1.8 billion a day. Some 40% of the debt is owned by the Federal Reserve Bank and other government agencies, including Social Security – that is, owed by one part of the government to another – a whole other issue in itself! Of the remaining 60% owned by the public, more than 38% is held by foreigners (23% of the total debt). Adjusted for inflation, the debt was virtually constant from just after World War II to the early 1980's, under Ronald Reagan rose precipitously from then to the mid-1990's, under Bill Clinton slowed its rise and then fell in fiscal years 2000 and 2001, and under Bush II has again risen dramatically and continuously since 2002.[2]

<u>A Bubble About to Pop?: Risks All Around</u>

There are even more ironies in this Rube Goldberg system. In theory, both a large budget deficit and a large trade deficit should cause interest rates to rise. A large budget deficit forces a government to sell a lot of bonds to get money to pay its bills. In the past, when the United States government and its agencies had to sell a lot of bonds, it had to offer higher and higher interest rates in order to attract investors.

Similarly, as the value of the dollar threatened to decline in the face of large trade deficits, the likelihood of investors – bond and other -- being paid back in depreciated dollars grew. The government had to entice bond investors with higher interest rates. As the government upped interest rates to entice lenders, banks and corporations had to compete for loans with their own higher interest rates to get the money they wanted for their own loans and investment. Higher interest rates even made budget deficits worse because government interest costs took an increased share of the budget.

By all rights, in the United States today, interest rates should be in the stratosphere, corporations strapped for money to invest, consumers putting away their wallets and facing bankruptcy, and the economy in the tank. We should look like the 1970's and 80's in the aftermath of Lyndon Johnson's attempt to both expand social programs at home and fight a war abroad. (Similar to Bush II cutting taxes and fighting a war.)

But we aren't. And the question is, do we have a free pass or is payment to the piper yet to come.

The media keeps talking about the danger of all those foreigners refusing to accept any more dollars and letting the dollar come crashing down. But the foreigners have some serious dilemmas. The United States is the world's economic engine. Its policies may be somehow immoral, but that doesn't mean other countries can do much about them. They are as dependent upon a prosperous United States as we are dependent upon their production of electronics and oil. Indeed, just as profits

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[2] Ed Hall, "U.S. National Debt Clock FAQ," www.brillig.com/debt_clock/faq.html

from U.S. corporate investments in China come back to the United States, the principle and interest payments going back to China from U.S. bonds partially counteract the flow of dollars to the United States to buy the bonds! It is certainly nice for American consumers to go on buying what seems to be an endless supply of cheap foreign goods. Perhaps the system the world has created is a self-perpetuating economic utopia. Perhaps.

But not necessarily. Suppose two of our biggest buyers of U.S. government debt (bonds), China and Saudi Arabia, decide that national interest and religious sectarianism overweigh economics, and they are willing modify their ties to the U.S. economy. Suppose China is willing to risk its investment in the United States to gain sovereignty over Taiwan. Suppose Saudi Arabia decides that it is more important to prevent destruction of the minority Sunni population in Iraq. The Saudis have agreed to hold off arming the Sunnis as Iran has been arming the Shiites, but only so long as the United States doesn't bail out ("cut and run") from Iraq -- a reality that already makes Bush II's Iraq policy hostage to his debt policy.

Just a gradual reduction in foreigners' willingness to "underwrite" our debt -- buy bonds – could kick off a major downslide in the dollar and the American economy. The government could be forced to kick up interest rates to sell bonds at the very moment when it needs lower interest rates to stimulate the economy. What is now a virtuous circle could quickly become a vicious one.

I don't find either the Chinese or the Saudi scenario unimaginable.

In the end, the risk for the United States is huge. What has been just about money could morph into more about power, nationalism, and religious antagonisms. Our idiotic financial policies could get us into a military morass that would make the adventure in Iraq look like a walk in the park.

Web Site: __Downside Up__ has had a web site, and may have one again, but I haven't figured out to create one without tying myself down with blog management. If you need a back issue, email me at downsideup2@bellsouth.net.

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__Ronald Woodbury__ is the publisher, editor, and general flunkey for all of __Downside Up__. While publication benefits from the editorial advice of one of his daughters, a friend, and occasional other pre-publication readers, they will, for their own privacy and sanity, remain anonymous.

Woodbury has a B.A., M.A., and Ph.D. in history and economics from Amherst College and Columbia University. In addition to many professional articles, he has published a column, also called __Downside Up__, in the Lacey, WA, __Leader__. After a 36 year career as a teacher and administrator at six different colleges and universities, he retired with his wife to St. Augustine, FL, where he continues to be active in church and community. He has two daughters, one a physician and one an anthropologist, and six grandchildren.