

Is the U.S. Trade Deficit a Symptom of Destructive Monetary Policy?

Given our plethora of macroeconomic imbalances certainly the Trade Deficit is one of the most distorted of all. In U.S. history we enjoyed nearly a century of surplus Trading conditions. That changed after 1981. In 1985 the annual trade deficit rose to an extraordinary 2.8% of GDP⁽¹⁾ prompting an international G-7 conference at the Plaza Hotel in NYC. The outcome (The Plaza Accord) was a coordinated effort by the U.S. and its key trading partners to bring down the relative valuation of the dollar along with other initiatives to correct the frightening imbalance. Between its peak in February 1985 and the end of 1988, the dollar fell by 50% against both the mark and the yen⁽¹⁾. The noted 2.8%⁽¹⁾ deficit surged to a peak of 3.4%⁽¹⁾ due to momentum before the interventionist policies took hold, then the deficit dropped to a **surplus** by 1991⁽¹⁾. A U.S. recession, which caused an import demand slow-down, was a significant factor. Today our Current Account Trade Deficit is murderous 6.5% of U.S. GDP; more than twice the level that prompted the Plaza Accord agreements, and we see mostly yawns of complacency from mainstream economists and government officials. Why such comfort??

The “enginomics” perspective is very simple in these trade discussions. Healthy “Real Wealth” trade activity must remain balanced. The notion of trading “paper” financial assets for Real Wealth over an extended period of time can only end badly. Further, the notion of trading title of our capital goods (U.S. company equity) for imported consumable Goods and Services can lead to identity, productivity, political, and standard of living issues in the long-term⁽²⁾. From a macro context there are very few conditions that may justify an extended trade imbalance. Some are:

- A developed nation(s) trade surplus (predominantly Capital Goods) with an *underdeveloped* nation(s) in deficit, where the *underdeveloped* nation anticipates repaying in Goods and Services following the Capital Goods investment surge received resulting in manufacturing capacity increases enabling the subsequent repayment.
- Major War. A nation in need of supplies and equipment to defend itself will likely depend heavily upon sympathetic nations. In this case partial repayment, dismissal of the debt obligations, or repayment in debased currency is common.
- An extraordinary population age profile mismatch⁽³⁾ between trading partners such that country “A” may have a relatively high young generation populous compared to country “B” with a relative high older (e.g. Boomers) generation populous.

No Justification for U.S. Over Consumption

There is simply no justification for the U.S. over consumption behavior since 1990. How can anyone logically rationalize a developed nation consuming more than it produces in times of prosperity? Let’s imagine a developed nation growing used to (spoiled upon) a level of consumption greater than its production output regardless of its growth in productivity. How can that happen?

Start with a Compelling Reason to “Invest” in the U.S.

If we are experiencing an extraordinary long-run series of productivity increases at a level of say 4% per year, then logic from “Austrian Enginomics”⁽⁴⁾ suggests that the expected “real” return per capita should be a very respectable 4% equity valuation increase plus an historic 4.0% dividend totaling a real return of 8%. This would be less than some Asian countries today (e.g. China, India, etc.), but likely less volatile, thus less risk. Operating under this condition one can easily imagine the U.S. consumer could get used to enjoying a consumption increase per capita of 4% each year as long as the ongoing investment into the U.S. businesses enabled this extraordinary run of productivity improvements to continue. Now, WHAT IF an interested foreign investor (saver) wanted to get in on this 4% (plus dividends) action because he could not find that in his own country or elsewhere?

Let's Model a Foreign Investor Interested in the U.S.

Under this condition why wouldn't it make sense for a saver in a relatively lethargic Spain, for example, to invest their savings in the strong low-risk U.S. economic engine, thus creating a *possible* trade deficit assuming the corresponding saver in the U.S. had no interest in a Spanish investment? In a "real economy" context the Spanish investor would ship widgets ("real wealth") to the U.S. and receive "paper" assets (e.g. U.S. corporate bonds) in return. In a logical "enginomic" balanced result, the Spanish widgets would indirectly enable the U.S. economic engine to increase its *capacity* such that the wonderful 4% annual improvement from the U.S. labor/Capital Goods economic engine (U.S. businesses) would expand and return the same robust returns to the Spanish investor as the ongoing U.S. investors might enjoy. U.S. consumers consuming the Spanish widgets in place of U.S. produced widgets would enable this by shifting U.S. labor over from producing widgets here to the task of increasing the relatively more productive U.S. Capital Goods noted *capacity*. In that case the U.S. consumer would still enjoy the ongoing annual 4% increase in consumption just as the Spaniard would enjoy the 4% annual investment valuation increase. This noted one-time investment act would create a trade deficit by itself, but would very likely net out with "real wealth shipments of Goods and Services to Spain resulting from prior "one-time" investments. **That's OK!!** Spaniard investors are effectively paying to expand the superior U.S. economic engine. Note: Dividends are considered a *transfer* of wealth in contrast to an *increase* in real wealth. i.e. All transfers net to "0".

The Problem Enters with U.S. Over Consumption

If the Spaniard ships widgets here and the U.S. consumer simply consumes them without a corresponding cut in consumption of U.S. consumable goods or services in concert with a labor shift into producing more Capital Goods and Services to increase U.S. capacity, then the problem begins! The U.S. consumers become spoiled on the higher level of consumption due to the incremental shipment of Spanish widgets. In the mean time the Spanish investor is holding "paper" assets thinking the now spoiled U.S. consumer is shifting labor into expanding the Capital Goods capacity to enable the Spaniard to enjoy the increased output of the superior U.S. economic engine.

Why Does this Happen?

Fiat currency and the power of the FED/banking/brokerage/Agency/Hedge/Private Equity cartel to expand liquidity (fiat money and credit) at a far greater rate than the real output expansion has enabled this extraordinary disconnect between the real economy and the financial economy. As long as the Spanish investor is told by the cartel not to worry because he will eventually receive his total investment plus interest and any capital gains in the base investment in real terms, why worry?? The financial cartel has effectively usurped power from the industrial base resulting in an illusion of "paper asset" wealth held by trusting foreign trading partners. Once this excessive credit and "paper asset" expansion "genie" is launched into high gear, it perpetually builds upon itself. Increase begets increase begets increase. The noted disconnect between the "real economy" and the "financial economy" rapidly expands until those buying our debt securities and "paper assets" realize they are predominantly an illusion of wealth. Then, they will slow net purchases or, more likely, divest themselves of dollars and dollar-based assets.

What Would Fix the Problem?

If major producing countries in the world returned to a commodity (gold, silver, etc.) backed currency, the ability of the noted cartel to egregiously expand liquidity greater than the rate of real economic output ("real wealth" creation) would be dramatically limited. The seemingly unlimited expansion of "paper" (liquidity) floating around the world leading holders to believe they represent a low-risk contract to receive a future stream of real goods and services would stop.

Conclusion

The horrific trade deficits the U.S. is experiencing today are a symptom of the underlying problem of irresponsible monetary policy including use of fiat currency enabling explosive credit expansion relative to real economic output. This policy gives holders of the overblown credit instruments the perception they will receive much more real wealth when the time comes to cash-in than is possible. The likely repayment to foreign creditors will be simply more debased currency along with our “hat in hand” begging for massive refinancing and further credit extension. At some point this one-way consumption binge will stop rather abruptly, and likely initiate or exacerbate a global depression. I anticipate that time will be 2008-2010⁽⁵⁾ when Boomers in most of the industrialized world begin to retire and attempt cashing in on the illusory inflated assets.

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Home Page: www.austrianenginomics.com

References:

- 1) Federal Reserve Economic Data: St. Louis Fed; GDP; Bureau of Economic Analysis
- 2) See article by Russ Randall, 8-10-2004 here:
<http://austrianenginomics.com/TheCurrentAccountTradeDeficitMystery.pdf>
- 3) See example #1; pg. 3 here:
<http://austrianenginomics.com/TheCurrentAccountTradeDeficitMystery.pdf>
- 4) Ref: “Is the FED Adjusting Dining Car Temperature in a Free-Falling Train?” by Russ Randall found here: <http://austrianenginomics.com/IsTheFedAdjustingDiningCarTemperatureinaFreeFallingTrainA.pdf> (page #2).
- 5) “Our Aggregate Debt Seals the Fate of Economic Depression Starting 2008-2010” by Russ Randall.
<http://austrianenginomics.com/OurAggregateDebtSealstheFateofEconomicDepression.pdf>