

## **The Current Account Trade Deficit Mystery**

*“The current account trade deficit and the resultant net foreign debt are not major concerns because our foreign trading partners are “investing” in America. It is a better return on the investment than would be in their own country or elsewhere.”*

Wrong...! Any individual country must maintain an even trade balance with all of its trading partners in aggregate to avoid a gradual net loss (or gain) of business-asset ownership and control. If each country is not in aggregate balance with all other trading partners, the currency exchange rate must adjust. There should be no intervention or political cheerleading to inhibit the adjustment. On the other hand if significant business-asset ownership is conceded as a result of trade imbalances, then are there negative consequences that will occur to prevent further concessions or restore balance? Would a gold-based monetary system aid in visibility and avoidance of these “negative consequences”?

### **The “Enginomic” Perspective**

From an “enginomic” perspective the logic appears quite simple. If Country “A” sends Country “B” G&S (Goods and Services) in return for an IOU (expectation for future G&S redemption plus extra G&S for interest payment), then at some point in time the stream of G&S shipments must rightfully reverse to repay any outstanding balance, plus interest. Alternately, if Country “A” retains IOU’s and passes them on from generation to generation, there is a practical ceiling to this “one-way” benevolence, the most obvious of which is the attainment of total ownership of all business enterprises in Country “B”. At that point in time it would not be logical to send any more G&S to Country “B”.

Fiat money can distort this picture. The common perception is that underdeveloped countries need capital to empower advancement. Again, from an “enginomic” perspective, money (ill-defined capital) itself does nothing physically. The underdeveloped countries really need capital (properly defined) equipment, infrastructure, and training, all of which fall within the G&S spectrum. To avoid the negative consequences from mostly one-way company ownership concessions (addressed below), we must simply keep an even aggregate balance of trade at all times.

### **Let’s Model an Example**

To help us understand, let’s model an extreme example: The United States will have a productivity increase at a steady 2% per year for the next 50 years. Japan will have a productivity increase of 1% per year for the next 50 years. Why wouldn’t every spare Yen (or dollar resulting from trade) in Japan be “invested” in the US for the next 50 years? Acting on that premise, let’s further assume the trade deficit with Japan will be a steady 5% of US GDP effectively investing that amount in the robust US productive economic engine. In 20 years Japan could own all business assets in the US. That would represent complete ownership of all US resources that are capable of producing and enhancing wealth (via productivity increases) in contrast to buying US land or gold, which will only sustain wealth. There would be no logic to further “invest” beyond the 100% ownership of US companies. If the ownership includes US treasury securities, the

effect would be as though they owned US companies indirectly. Since the US government produces nothing, the only means of Treasury bill redemption is indirectly via US companies and their employees. e.g. If Japan owned \$6 trillion in treasuries and \$6 trillion in US company equities (50% of the US total equities), it would represent approximately the same US obligation to pay (and Japanese expectation to receive) as a 0% treasury and 100% US company ownership. The US Payment capability all comes from the same place, the US business enterprises.

Let's explore Micro vs Macro trading conditions assuming for a moment the US enjoyed a gold-backed currency. On a Micro scale the prospect of investing some hard earned real money (e.g. gold) in exchange for ownership in a foreign company is both straightforward and logical. There will be an expected real return through dividends and/or an increase in the company valuation. In either event the exchange of a wealth storage vehicle (gold) for ownership in a business enterprise vehicle (Company "X") is conceding earned wealth for a potential wealth enhancing entity. This is fine for a single investment. It would not be "fine" on a Macro scale if all investments were one-way from Country A to Country B. If the one-way investments continued, Country A's gold supply would deplete and Country B's company ownership remaining available would deplete yielding an unsustainable imbalance.

### **Are There Natural Barriers to an Extreme Ownership Shift?**

What are the natural free-enterprise lassie faire barriers to prevent extreme international ownership shifts? Following are some significant potential consequences:

1. Political unease. If your county's "crown jewels", which are your only means of wealth creation, are gradually being sold, then our political leadership becomes vulnerable to whims of or decisions made by foreign governments outside our control.
2. Loss of productivity. In time, presuming the superior productivity gave reason for the foreign investment in the first place, one could assume that total ownership by a lesser productive society would have a productivity drag-down effect.
3. US entrepreneur despondency. If all avenues to start up or grow businesses are owned by a foreign country, then all "fruits of the entrepreneur labor" would go to foreign ownership. A freedom principle of working hard, growing a business, and becoming wealthy would be stifled.
4. US loss of identity. Values and principles, which were integrated into law and culture that shaped our identity, formed our nation. As ownership of key assets transfer, the ability to maintain control of our identity would be at risk.
5. Loss of Profits retained in the US. As ownership shifts, the US would become an employee-based economy where any wealth gains of a company will benefit the foreign owner, and the wage enhancements distributed would be only what is necessary to retain talent and remain competitive. As the US employees come to realize the fruits of productivity increases go to the Japanese, they will become motivated to control our own destiny by saving (gaining company ownership) rather than consuming (conceding company ownership).

Once 100% foreign business ownership is achieved, the only things remaining to concede would be assets that do not enhance wealth, but only retain it (e.g. gold, land, etc.). Therefore, further foreign investment interest would likely dry up. At that point in time would...

1. the Japanese citizenry be content to hold the US asset base and live off of the ongoing proceeds from ownership (dividends), ...
2. or reinvest the dividends back into the US, or ...

Note: In the two cases above the Japanese would pass asset wealth on from generation to generation without “cashing it in”.

3. would they want to “cash in” the assets at some point in time?

### **Repayment; The Magnitude**

A critical assumption we make is that the ongoing ownership concession would stop at some point for any of the reasons noted above. The stoppage and probable reversal of ownership concession would concurrently mean the stoppage and probable reversal of the current account trade deficit.

The current account trade deficit is approx. 6% of US GDP today.

- If we stopped the trade deficit abruptly, the US consumption (standard of living) would drop 6% immediately with no change in work conditions.
- If we stopped the trade deficit abruptly and paid “dividends only” on the net-deficit owed today, the US consumption (standard of living) would drop approx. 7% immediately with no change in work conditions.
- If we stopped the trade deficit abruptly and paid “dividends or yields” on the net deficit owed today, and began a redemption program to bring the deficit in balance over the next 25 years the US consumption (standard of living) would drop approx. 9% immediately with no change in work conditions.

The likelihood of the “X” and “Y” Gens maintaining interest in paying this debt in real terms is nil. In fact, the likelihood of all US citizens to voluntarily abruptly drop consumption 6% just to neutralize our trade deficit would be highly unlikely. We have effectively conditioned the younger and medium age generation to “front load” their consumption pattern in life. I.e. buy extra large houses, newer cars, and consumables today with the hope of paying it off later. The borrowing/spending pattern of a person’s life was historically governed by the natural interest rate level where creditors, understanding real risk, would demand premium down payments to protect their investment and market interest rates to attain the best return on their capital. By governments intervening and artificially suppressing interest rates, which encourages extraordinary borrowing habits, we are conditioning the spending pattern to satisfy an exaggerated short term desire for goods and services “today”, which effectively exacerbates the long term repayment “hill” to climb. Simply returning to a normal, natural interest rate regulated life-spending pattern for the later working years in life would be a significant consumption blow, let alone the challenge of enduring a lifelong effort to dig out of a debt hole resulting from the extraordinary early-life consumption.

However, the greatest surprise of all is that the “X” and “Y” Gens will not pay the bill the Boomers are expecting to receive in retirement...! The Boomers will be the losers assuming extraordinary government intervention via inflation continues. The Boomers will have to live on the radically devalued or bankrupted assets as a result of inflationary monetary policy.

If interest rates rise and housing values fall in concert with long term bond valuations, and many highly debt-leveraged houses go “underwater” where the debt obligation is greater than the newly depreciated value, there will be a strong tendency for owners to walk away from the debt, especially if the payments become an increasing burden of their income via deflation, or variable-mortgage interest rate increases.

### **Is There a Tolerable Magnitude?**

We know the Boomer’s offspring will be overburdened with producing a stream of goods and services for our own Boomers in retirement, let alone service any foreign obligation. However, considering a short-term trade rebalance, a tolerable rate of repayment might be ½ to 1% of GDP, which might be a manageable portion of our annual 1-2% annual productivity improvement. We would still enjoy a 0 to 1 ½ % standard of living improvement under that circumstance.

Needless to say the current rate of 5+% to GDP trade deficit is untenable and will likely require a dollar crisis to even slow it down.

### **Gold Backed Currency:**

Would a commodity backed currency help minimize the ownership shift?

Yes. The dollar reserves in foreign hands would not inflate to the level that exists today, because we would not have sufficient gold in our treasury to back the currency. As redemption demands for the commodity (e.g. gold) increase, and none was available, then the valuation of US assets or goods and services must drop to become more attractive in exchange for goods and services produced by the foreign trading partner. The “tight leash” of finite real money would prevent a significant trade deficit from even occurring.

Also, a commodity-backed currency with no fractional reserve would tend to keep published economic numbers more accurate. Due to the finite availability of gold, a self-controlling restraint would exist for asset valuations. Without inflation to disguise earnings and valuations, companies would be recognized and valued for their real earnings returned from the real stream of profitable goods and services they produce. Excess “liquidity” would not be available to enable a broad based Ponzi scheme blow-off in stock valuations. Hence, the justification for the foreign investment would be based upon non-distorted information rather than upon inflated, Ponzi-based data.

### **Fiat Currency**

In a fiat currency environment there is risk of incorporating systemic inflation into the currency as well as asset valuations. It is possible for the expanded currency to channel

into bond and stock market valuations rather than goods and service prices, if there is international willingness to absorb the expanded credit in asset form via unlimited bond and stock purchases.

This condition can become especially dangerous in trading. For example, trading between an economically advanced country and an underdeveloped country might mean shipping equipment and education services to one country in exchange for finished goods (or visa-versa), not simply exchanging “paper” (fiat currency) for goods. Fiat money may facilitate these exchanges, but its value is dynamic, thus opportunity for devaluation and abuse exist. By extending credit for payment of goods and services, the subsequent valuation of currency in repayment may drop, thus unjustly harming those holding dollars or dollar based assets.

### **A Plausible Justification for a Long Term Imbalance?**

There are two trade imbalance condition causes that are tolerable:

1. An extreme population profile imbalance between trading partners, where dependency ratios are projected to be so severe in a country “A” that a net ownership gain of companies in country “B” is necessary to eventually supply goods and services to country “A’s” retirees. For example, the magnitude of an ownership shift that could be justified for this purpose between Japan and the US is approx. \$15 Billion, which is justification for no more than a 0.1% GDP annual trade imbalance.
2. An underdeveloped country that is in need of and receptive to a massive influx of capital equipment, infrastructure, and skill-set training. In this case a short-term imbalance (less than 10 years) could be tolerable. The underdeveloped citizenry must universally understand they are receiving Goods and Services in one form (e.g. capital equipment) and must pay them back (e.g. tennis shoes) and effectively reverse the “tide” of the Goods and Service flow in short order until balance is reached.

Clearly, a one-way flow of predominantly consumer goods into a developed country (USA) does not fit one of the options noted above.

The day of reckoning for the US lies ahead when foreigners holding dollar-based “investment” assets realize that their real value is a small fraction of what they believe exists today.

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8-10-2004

**A referee writes:**

What prevents residents in one country from continually investing in businesses in another particular country is the equilibration of the (risk-adjusted) interest rate between the two countries, the same thing that stops New Jerseyans (who have the highest per capita income in the U.S.) from continuing to invest in and buy up all of Mississippi.....

**RESPONSE:** *I fully understand this point (I think...). I am attempting to "peel the onion back one more layer". i.e. What does prevent New Jerseyans from buying all of Mississippi, if the state and local government stability, productivity increases, and debt redemption history offer inherently better aggregate returns than NJ?*

Furthermore, the increase in U.S. productivity ("The U.S. has an increase of 2% per year for the next fifty years . . . ") the author assumes doesn't just occur miraculously but is the precisely the result of capital investment.

**RESPONSE:** *Here I am attempting to establish a "Mississippi" condition for the US as a basis for trade logic to understand the "extreme ownership shift" barriers that would surface in a gold-based free market and trade condition. I want to assume the 2% per year precisely for the reason you state, which has been an established condition in "Mississippi" for years. I'm also attempting to differentiate "investment" logic from "acquisition" logic.*

In a global capital market scarce capital investment will be apportioned among different nations so that the rate of return on investment in spatially diverse businesses continually tend toward equality.

**RESPONSE:** *I presume you mean Capital will search globally for its best risk/return value and "tend toward" that combined risk/return reward being equal? My struggle is that given the noted "Mississippi" condition there would logically be a one-way ownership shift (everyone in the world would want to own "Mississippi" first) until one or more of the 5 barriers to extreme ownership shift noted in my article are reached.*

Of course, ex post, it may turn out that a particular country's residents overinvest in another country's business assets as the Japanese did in the U.S. in the 1980's, "buying up" America (Chrysler building, California golf courses, etc.). But when the financial bubble popped in the late 1980's, the Japanese suffered tremendous capital losses and were forced to divest themselves of many of these assets. In the meantime the American sellers had enjoyed capital gains by selling the Japanese these overpriced assets.

**RESPONSE:** *I understood the root cause of the Japanese "buying up" America was largely due to their monetary-induced economic boom resulting in an overvalued Yen looking for something to acquire. Had all of us been utilizing a gold-based currency, I believe the initial Japanese boom would have been constrained as well as the 90's US boom.*

Furthermore, the financing of U.S. government deficits aside, all other things equal, the influx of foreign investment into the private sector results in the creation of new capital goods which raises domestic labor productivity and real wages, and serves as the source of the principal and interest repayments to the foreign investors. Moreover, the foreign

investors have no claim on Americans beyond the value of these specific capital assets they bought shares in, claims on, or built, regardless of what happens to their value.

**RESPONSE:** *This is where my engineering instincts clash with classical economics...! If the "investments" are largely in the form of recycled US dollars, then rather than "creation of new capital goods" they are simply acquiring US company ownership, which again ties to the point of my paper. What is there to stop it? Certainly, a developed country private "investment" of capital **equipment** into an underdeveloped county would fit the logic you note.*

Finally, to the extent that the influx of foreign capital to the U.S. is driven by the Federal government budget deficit, which puts upward pressure on interest rates in the U.S., it is unhealthy because it imposes a burden on future American taxpayers by obligating them to make interest and principal payments to foreigners. So it is the budget deficit that is the root of the problem and not the current account deficit (the obverse of the capital inflow), which is merely one of its manifestations.

**RESPONSE:** *Again, my engineering instincts differ.. I'm suggesting the root of the problem was the "strong dollar" policies only possible with a fiat currency (i.e. difficult to construct a "strong gold" policy). Numerous causes of the strong dollar included government suppression of the gold price, expansion of our money supply (creating an unprecedented US equity Ponzi scheme attracting Billions in direct foreign investment), and, of course, foreign trading partners actively devaluing their currencies relative to the dollar. If we were magically on a gold standard and experienced a Federal government budget deficit, granted, interest rates would see pressure to increase and would pose a burden on future taxpayers. However, if a country did that to itself, wouldn't that logically create a less attractive investment climate? We recently experienced a budget surplus, and at the same time, a rocketing trade deficit. If government policy guided them independently, I believe it's possible we would not have the "twin deficit" problem we have today. Further, I view the trade deficit as a far more serious challenge than the budget deficit.*

**Bottom line...** *I believe the notion that Japan is recycling dollars and acquiring US securities and equities in the spirit of "investing in America" is not true. They are desperately working to keep their currency suppressed and have their own little carry trade motives in purchasing Treasuries, both of which feed momentum of the extreme "ownership shift" that carries tremendous risk. They are not shipping us significant capital equipment (yes, some auto plants, but not much else) from which they could expect better returns from superior productivity; it's mostly cars and plasma TV's. I believe we are steep into a "perfect storm" where initial misdirected investment momentum for the wrong reasons will be devastating to reverse.*

*Your thoughts? Got a good reference to help guide me?*

*Sincerely,  
Russ Randall*