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US trade gap highlights rising debt burden

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The jump in the US trade deficit to a record high of \$43.1 billion for January has once again thrown the spotlight on the rising external indebtedness of the American economy.

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The widening of the trade gap, which occurred despite the fall in the value of the US dollar against major currencies, represented a 0.9 percent increase on the \$42.7 billion deficit registered in December. It came in the wake of figures showing that the current account deficit, which measures the rate at which the US is going into debt, continues to grow. According to the Commerce Department, the payments gap was \$542 billion last year, easily eclipsing the previous high of \$481 billion recorded in 2002.

Following his usual practice of trying to put the best face on the situation, Federal Reserve Board chairman Alan Greenspan remarked earlier this month that the weaker US dollar should eventually help narrow the trade deficit. But he also repeated a warning that “creeping protectionism” could endanger the “flexibility” of the global economy. In Greenspan’s view, global financial markets will be able to finance the US payments gap—now requiring a daily capital inflow of between \$1.5 and \$2 billion—provided trade and other restrictions are not imposed. But if, for any reason, money starts to move out of the US, a major crisis could erupt.

There are plenty of statistics that give rise to concern. In a report published earlier this month, the Financial Markets Center, which provides independent analysis of financial markets flows, noted that Flow of Funds data released by the Federal Reserve showed that US financial markets are becoming ever more dependent on inflows of foreign capital.

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“During the fourth quarter of 2003, foreign creditors loaned US borrowers an unprecedented \$848 billion (annualised)—an amount equal to one-third of all credit market lending,” it noted.

For 2003 as a whole, foreign investors accounted for 22.6 percent of net new lending in US markets and raised their share of outstanding credit market debt by a percentage point to 10.9 percent. The report noted that between 2000 and 2003 the volume of credit market instruments (including items such as US government securities, corporate bonds and loans to US businesses) owned by foreign investors expanded by more than half. Mainly as a result of purchases of corporate and US Treasury debt, foreign acquisitions of US credit market instruments “soared to a record \$611.2 billion in 2003—more than acquisitions in the previous two years combined.” Between October and December of last year, foreign investors bought 89 percent of net new securities issues issued by the US Treasury and 40 percent of bonds issued by US corporations.

In a bid to stable their own currencies against the US dollar, Asian central banks have been purchasing US dollars, which have then been used to buy government debt. Largely as a result of this process, central banks and other public agencies accounted for two thirds of the acquisitions of US Treasury securities during the fourth quarter of 2003.

The rising US external debt, coupled with the record federal budget deficit of more than \$500 billion, has prompted concerns that, at some point, investors are going to lose confidence and begin withdrawing funds.

Echoing these views in a television interview on the Australian Broadcasting Corporation’s program *Lateline* last week, *New York Times* economics columnist and Princeton University professor Paul Krugman described the US budget deficit as “comparable to the worst” ever seen.

According to Krugman, the tax cuts to the wealthy, which form such a central component of the Bush administration’s policies, are creating the conditions for a crisis. “The only thing that sustains the US right now is the fact that people say, ‘Well America’s a mature, advanced country and mature, advanced countries always, you know, get their financial house in order.’ But there’s not a hint that that’s on the political horizon, so I think we’re looking [at] a collapse of confidence some time in the not-too-distant future.”

In an article published on February 29, entitled “The dollar’s delicate balancing act”, *Financial Times* economics columnist Martin Wolf pointed to

“noteworthy risks” to the scenario that the present global imbalances would adjust smoothly. There would have to be a further fall in the dollar with the risk that “an abrupt fall could trigger sharp rises in US long-term interest rates and declines in US asset prices” leading to reduced household spending and “thereby generating a renewed economic slowdown.”

Other risks were that neither Japan nor Europe would be able to generate sufficient economic growth and that the failure of the countries of non-Japan Asia, in particular China, to adjust their currencies against the US dollar would lead to inflation and accumulation of bad debts in their banking systems. There was also the risk that internal and external adjustments would not take place in the US, leading to ever growing current account deficits, an explosion of US protectionism and a questioning of the role of the dollar as a reserve currency.

The problem confronting central bankers and policymakers in the leading capitalist countries is that, while on the one hand world economic growth as a whole is more dependent than ever on the expansion of the US economy; on the other this expansion itself generates ever-increasing levels of debt.

As Wolf noted at the conclusion of his article: “A world in which macroeconomic health can be achieved only at the expense of ever greater private and public debt accumulation in its biggest and richest economy is unstable. It is also perverse. If the world has surplus capital, more of it should go not to the world’s richest country, but to far poorer ones. That this is not happening is a grievous failure. For this reason, if no other, we need to find a way to sustain global economic activity that does not depend on a growing mountain of US debt.”

However, he was unable to suggest one.

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