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COMMENTARY
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Getting Sucked Into the Trade Gap

Aside from causing the U.S. to pile up an unsustainable debt, the yawning deficit saps the country's economic growth

The size of America's foreign debt just keeps mounting, as U.S. imports run way ahead of exports. True, the trade deficit has been growing for years, but let's be real: This can't go on indefinitely. The U.S. can't continually buy more than it sells. Eventually, foreign trading partners will tire of collecting IOUs and want to get back something tangible. And when investors lose their appetite for IOUs, the value of the dollar will begin to slide.

And yet, the numbers keep getting more dire. On Sept. 14, the Commerce Dept. announced a record deficit of $166 billion for the second quarter on the broadest measure of trade: the current account, which covers goods, services, and investment income.

A deficit that big amounts to more than 5% of the nation's entire output of goods and services. When smaller countries' deficits reach that level, it's considered a warning sign -- an indicator that nervous investors could panic and pull out, causing the national currency to collapse.

HURTING GDP. The second-quarter deficit in the current account exceeded the average forecast of around $158 billion. But it was exactly in line with the prediction of Michael Englund, chief economist of forecaster Action Economics.

Aside from causing the U.S. to pile up an unsustainable debt, the trade deficit saps economic growth at home. Why? Because Americans are buying goods and services from abroad instead of using domestic labor and materials to make them. The worsening of the trade deficit in the second quarter subtracted a full percentage point from the GDP growth rate, estimates Nariman Behravesh, chief economist of forecaster Global Insight. He also predicted a $166 billion number from the Commerce Dept.

A glimmer of good news appeared on Sept. 10, when the government announced that the trade deficit had shrunk 9% from June to July. But the July imbalance, at $50.1 billion, was still the second-largest ever. And the biggest factor in the drop was a 9% drop in the bill for imported oil. Since crude prices went on to hit record highs in August, the trade deficit almost certainly returned to its June level -- a record $55 billion.

BUYING SPREE. A little math explains why the deficit is so hard to shrink. Since imports are one-third larger than exports, exports have to increase 50% faster than imports month-to-month just to keep the deficit from getting bigger. And that hasn't been happening.

Is the U.S. in danger of a panicky run on the dollar? Not likely for now. The country is too stable. But the dollar could still substantially decline over the next year. All it would take, notes Action Economics' Englund, would be a pullback by foreign governments, which have been propping up the dollar to keep their goods and services competitive with those of the U.S. Says Global Insight's Behravesh: "It's just a matter of time before the dollar comes under pressure again."

The extent to which foreign governments have propped up the dollar is evident in the Commerce Dept. data on foreign official purchases of dollar assets. Throughout history, the biggest increase ever in foreign official assets was $127 billion in 1996. Last year, that record was shattered, when the total reached $249 billion. Then, in the first quarter of this year, the net increase was a stunning $125 billion, for an annual rate of $500 billion. In the second quarter, the spree slowed a bit, with assets rising by $74 billion. But that was still a record annual pace.

"PAYBACK TIME." If foreign governments become so stuffed with dollars that they can't maintain their currency-buying spree, the law of supply and demand says the price of the dollar will fall in the foreign-exchange market. One thing that could lessen foreign governments' appetite would be an increase in their domestic inflation rates caused by over-rapid growth in their money supply, says a new report by State Street Global Markets, a unit of State Street Bank & Trust.

A decline in the dollar would hurt American consumers by raising the price of imported products and services. It could also harm some of America's weaker trading partners by making their currencies uncompetitive. On the other hand, world economic growth is fairly robust, so it's a good time for American trading partners to absorb a hit. Best of all, a weaker dollar would help revive the U.S. manufacturing sector by improving the competitiveness of domestic goods. Englund says a weaker dollar would be "payback time" for U.S. producers whose export markets have shrunk of late.

But when it comes to the trade deficit and the dollar, one sentence pretty much sums things up: Sooner or later, the piper must be paid.

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