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Debtor Nation

by WILLIAM GREIDER

[from the May 10, 2004 issue]

The backstory for this election year lacks the urgency of war or of defeating George W. Bush but focuses on a most fateful question: When will this hemorrhaging debtor nation be compelled to pull back from profligate consumption and resign its role as "buyer of last resort" for the global economy? The smart money assumes such a momentous reckoning probably won't occur in time to disrupt Bush's re-election campaign, but it may well become the dominating crisis in the next presidential term, whoever is elected. At that point, the United States will lose its aura of unilateral superiority, and globalization will be forced to undergo wrenching change. The American economy, in other words, is in much deeper trouble than most people realize.

The facts are not secret. Despite ebbs and surges, the gap between US exports and imports has been steadily widening across three decades. The trade deficits of the early 1970s (due mainly to soaring oil prices) were trivial in size, but Americans were shocked in 1978 when the deficit hit \$30 billion (TV sets and some cars were now made in Japan). During the 1980s, the trade deficit expanded enormously, as Washington's strong-dollar policy crippled US manufacturers and companies moved jobs and production offshore in swelling volume. After a recession and dollar devaluation, the gap shrank briefly, but soon began expanding again.

For several decades, in fact, the federal government has tolerated and even encouraged the dispersal of American production overseas--first to secure allies during the cold war, later to advance the fortunes of US multinationals. No other major economy in the world accepts perennial trade deficits; some maintain huge surpluses. But American leaders and policy-makers are uniquely dedicated to a faith in "free market" globalization, and they have regularly promised Americans that despite the disruptions, this policy guarantees their long-term prosperity. Present facts make these long-held convictions look like gross illusion. By 1998, the trade deficit was back to a new high and expanding ferociously, despite supposed improvements in US competitiveness. Last year it set another new record: \$489 billion.

Yet no one running for President has found the nerve to discuss these facts in a straightforward manner. Nor do the candidates have anything to say about how the country might avoid a potential calamity. A few wise heads in finance, like billionaire investor Warren Buffett, have sounded the alarm--Buffett refers to the United States as "Squanderville" and is shifting billions offshore into foreign currencies for safety. Meanwhile, political leaders remain silent.

The US economy, in essence, is being kept afloat by enormous foreign lending so that consumers can keep buying more imports, thus increasing the bloated trade deficits. This lopsided arrangement will end when those foreign creditors--major trading partners like Japan, China and Europe--decide to stop the lending or simply reduce it substantially.

That reckoning could arrive as a sudden thunderclap of financial crisis--spiking interest rates, swooning stock market and crashing home prices. More likely it will be less dramatic but equally painful. As foreign capital moves elsewhere and easy credit disappears for consumers, many Americans will experience a major decline in their living standards--a gradual grinding-down process that could continue for years. If the US government reacts passively and allows "market forces" to make these adjustments, the consequences will be especially severe for the less affluent--families already stretched by stagnating wages and too much borrowing.

Normally, I wouldn't use an economic chart to make my point, but the one you see on page 11 tells the story of America's predicament more effectively than words. Prepared by University of Wisconsin economist Menzie Chinn (and illustrated by Stephen Kling/Avenging Angels), with dollar values adjusted to remove the distortions of price inflation, it's a visual display of the US economy's performance in the global trading system during the past three decades. Year by year, it traces the line of US imports versus the line of US exports. The red ink in between represents America's trade deficits.

The red ink, as you can see, is exploding. The thick red blob in the upper right-hand corner represents our present condition--the record trade deficits of recent years. Starting six or seven years ago, these two lines diverged dramatically: The volume of imports soared, while export growth leveled off. Historically, when a mature economy suffers perennial trade deficits, it is usually understood as a sign of weakness, especially if the deficits keep getting larger.

The red ink can also be read as a rough approximation of America's indebtedness to the rest of the world. Last year the US economy (business and households as well as the federal government) was compelled to borrow \$540 billion from overseas creditors. Since the United States first became a debtor nation fifteen years ago, it has accumulated nearly \$3 trillion in debt obligations abroad. At the current pace, the foreign debt load will double again in the next six or seven years. You can see why we have depicted the debt as a serpent, rising to strike. The serpent, I suggest, is biting the debtor nation that has fed it. Actually, it ate our lunch.

Leading authorities typically explain what is happening by observing correctly that Americans are collectively "overconsuming"--that is, living beyond their means--but experts assume that "market forces" will eventually correct the situation. Once the global economy regains robust growth, it is said, other nations will buy more US exports. Or, once the dollar has depreciated in value sufficiently, Americans will buy fewer imports. Some even claim the indebtedness is America's good fortune--a sign of strength that other nations are so eager to finance US consumption.

I think the authorities are wrong. When I look at the chart, I see the United States sinking into financial dependency--dangerously indebted to rival nations that are holding our debt paper, collecting the interest on Treasury bonds and private bank loans, or repatriating the profits from companies that used to be American- owned. A very wealthy nation can tolerate this negative toll for many years, but not forever. Unless the historic meaning of debt has been repealed, no nation can borrow endlessly from others without sooner or later forfeiting control of its destiny, and also losing the economic foundations of its general prosperity.

The world at large will be better off, in my view, when Washington is compelled to accept a less

dominating role and global political power is dispersed more multilaterally. But the transition itself could be an unsettling, even dangerous time, since the declining economic power also happens to be the pre-eminent military power. In any case, an American reckoning would also have economic consequences for the rest of the world. If the United States were to tap out, the global system would lose its best customer. American consumers have propped up global trade with their open-ended purchases. Now the rest of the world is propping up American consumers, lending them the money to buy still more.

The endgame might be triggered by any number of events--including the financial exhaustion of America's overextended consumers--but the most likely venue is the global trade in capital, not the trade in goods and services. In theory, wealthy countries are expected to ship investment capital to poorer countries to build factories and infrastructure. But at present, most of the world's capital is flowing in reverse: The net inflow of foreign capital to the United States represents a staggering 75 percent of the net outflows from the rest of the world, according to economist Jane D'Arista of the Financial Markets Center. Even more abnormal is that nearly one-fourth of this lending comes from emerging-market nations, led by China, whose trade surplus with America has surpassed Japan's.

Both China and Japan are prodigious financiers of US consumption--the two largest foreign holders of US Treasury bonds--despite the weak returns they get from low US interest rates. China and Japan are willing to do this because they calculate that sustaining their own industrial output and employment is worth more than seeking stronger financial returns elsewhere.

All sides recognize a self-interest in keeping the game going--avoiding a global meltdown that might ruin everyone. But the anticipated benefits from this cooperation are very different: The US consumes in the present, through indebtedness that it must repay from future production; the others accumulate financial wealth now and expand their industrial capabilities to produce in the future.

The Bush Administration must convince its major trading partners, especially China and Japan, to stay at the table and keep lending huge sums even as it encourages the dollar's decline in the hope of boosting US exports, discouraging imports from Asia and Europe and thus shrinking America's trade gap (with little success so far).

The poker game ends when one major player or another decides it has gotten the last dollar off the table and it's time to go home. Creditor nations naturally have the upper hand, like any banker who can call the loan when he sees the borrower is hopelessly mired. But the decision to exit might be dictated by necessity more than bad faith. China, for instance, is booming, with a banking system riddled with bad loans to its domestic enterprises. If a banking crisis developed, Beijing might have no choice but to sell off its US bonds and use the capital at home to stabilize its financial system or to assuage political unrest among its unemployed masses. Tokyo has for some years anticipated an eventual American reckoning but hoped to keep the United States from doing anything rash until the Asian sphere was strong enough to prosper on its own, without depending so heavily on American consumers.

What might be done to avoid the worst? The necessary first step is for American politicians to cast aside the propagandistic claims advanced by multinational business and finance and endorsed by policy elites and orthodox economists. For decades, globalization advocates insisted, for example, that the solution to America's trade deficits was more "free trade." Each new trade agreement has been heralded as a market-opening breakthrough that would boost US exports and thus move toward balanced trade. That is not what happened--not after NAFTA (1993) and the WTO (1994), nor after China normalization (2000). In each case, the trade deficits grew dramatically. (Yes, it's true that since the early 1970s US export volume has grown by more than five times, but import volume has grown by eight times.) Economists have also claimed that ending deficit spending by the federal government would eliminate

the trade gap. Yet when the federal government's budget did finally come into balance in 1999, the trade deficits were exploding. This discredited explanation is nonetheless being recycled, now that huge federal deficits have been spectacularly revived by the Bush Administration.

The humbling reality is this: Across three decades, only one economic event has been guaranteed to produce balanced US trade: a recession. When the economy is contracting, people naturally buy less of everything, including imports. Look at the chart: On the four occasions when the line of exports briefly converged with the line of imports, the country was in recession. Each time economic growth was restored, the trade deficits resumed. A more ominous contradiction occurred during the 2001 recession: The trade gap was so enormous it persisted throughout. This suggests that American dependency on foreign producers has advanced to a dangerous new level.

The failure of conventional explanations for trade deficits leads, logically, to an unorthodox conclusion: The source of the deficits (and growing indebtedness) must be embedded in the trading system itself, independent of shifts in macroeconomic conditions, and so it is there we must also look for solutions. The national ambitions and competitive energies of globalization, at least as currently practiced, persist in developing new productive capacity--more factories--faster than they generate rising incomes and adequate demand to absorb the surplus of goods. This leads inevitably to falling prices and stiffer pressures for cost reductions. The convenient remedy--somebody, somewhere has to shut down factories--has typically begun by closing America's and moving its high-wage production offshore for cheaper labor.

American production usually goes first because the US government does not resist and US multinationals gain from the transaction, even if the US labor force does not. Indeed, the multinationals are major actors in generating America's trade deficits, since they "export" and "import" within the firms themselves--shipping components and materials back and forth between their overseas subsidiaries and US-based plants. Trade is commonly described as between nations, but fully half of US foreign trade, excluding oil, is composed of these intra-firm transactions. This reality explains the interconnection between trade deficits and job losses: When an American company moves production to Mexico or China, it still counts the output as its own, but its labor costs are reduced drastically while its foreign-manufactured products becomes imports, adding to the trade deficit and accumulating foreign debt. For years, advocates have dismissed worries about deficits in manufactured goods by pointing to the smaller but growing surplus in services. As more service jobs are offshored, however, that surplus is shrinking rapidly too, declining from \$90 billion to \$60 billion over the past seven years.

Of course, other advanced economies face the same global pressures and engage in the same sort of dispersal when required, but their governments (and societies) do not yield so willingly. Through industrial policy and numerous informal barriers, America's European rivals have managed to avoid both trade deficits and the thirty-year stagnation of wages that US industrial workers have suffered. Only in America do the experts believe these consequences have no meaning for overall prosperity. Only in America has the government put the interests of multinationals ahead of citizens.

A decisive President, one who grasped the gravity of the situation, would start by bringing up a taboo subject--tariffs--and inform the world that the United States is prepared to impose a temporary general tariff of 10 or 15 percent on all US imports. Every multinational would have to rethink its industrial strategy, because some of its production might be stranded in the wrong country. Import-dependent retailers like Wal-Mart would be seriously disrupted, too.

The idea of tariffs is so alien to conventional wisdom it probably sounds illegal. Actually, a nondiscriminatory general tariff is permitted under the original GATT agreement for a nation to correct grave financial imbalances--exactly the problem America is facing. Richard Nixon stunned the world in

1971 when he abruptly announced a 10 percent import surcharge, devalued the dollar and unilaterally discarded the Bretton Woods monetary system. America needs a bit of Nixonian nerve.

With a general tariff, the practice of wage arbitrage--shifting high-wage jobs to low-wage nations, then selling the goods to the US market--would no longer be a free ride. If the US market were less wide-open, globalization could continue, but countries and companies would need to disperse production on different assumptions. They might finally confront the central dilemma of inadequate global demand versus the permanent overabundance of supply.

The fundamental solution is to raise wages everywhere in the world, with perhaps fewer millionaires but a more generalized prosperity, especially in developing nations. In short, the global system needs more workers with the incomes to buy what they make. Globalization would have to proceed at a more moderate pace, with less rip-and-run disruption, financial crisis and social disorder. It is most unlikely, I have to add, that America's governing elites will come around to such drastic measures in time to avert an end-of-era reckoning.

If a full-blown crisis does occur, the macroeconomic challenge would be unlike anything the United States has faced in more than half a century. While this would be a time of wrenching, painful change, the new adverse circumstances might also inspire a great shift toward a new, more progressive politics. Given our rapidly deteriorating condition, it is not too soon to begin considering how the nation might dig out, lest popular confusion and bitterness generate reactionary politics instead.

The first imperative--an unavoidable necessity--would be to suppress consumption through credit-restraining measures, fiscal caution or tax reform, and to stimulate greater domestic savings, yet somehow to keep the economy growing. If this great adjustment is left to market forces alone, the predictable consequences will be to punish the innocent--struggling households and small businesses--first.

Thus, the second imperative would be to confront inequality aggressively, through progressive taxation and other measures. An interlude of mild austerity will seem more tolerable if people know the sacrifices are genuinely shared by all.

The principle of equity also matches the economics. With consumption suppressed, far greater investment spending will be needed to sustain the economy--an ambitious agenda of public and private investments. After decades of obsession with global competition, the country's wealth and ingenuity will be refocused inward--rebuilding and expanding the public infrastructure and common assets all citizens need and use (education, healthcare, transportation, energy, the environment). But the investment also would be aimed at long-term redevelopment of the economy, force-feeding new industrial sectors. Not coincidentally, this will generate millions of new jobs not subject to export.

The jump-shift strategy I am describing would be the economic equivalent of wartime, without the bombing and killing. Indeed, the closest precedent is World War II, an extraordinary era of economic development that virtually shut down many forms of domestic consumption (cars and housing) while the government's spending on war production launched major new industries (electronics, petrochemicals, modern aircraft and many others). Essentially, accelerated investment and forced savings replaced consumer spending as the leading fuel for economic growth. After the war, pent-up desires and needs became the economic demand that drove the long postwar era of prosperity.

War mobilizations encourage national cohesion, but the need for solidarity can also create a political consensus to enact greater social and economic guarantees to citizens. In that sense, World War II was a

seedbed for postwar reform and lasting social change: The GI Bill, which universalized access to higher education, broadened home ownership and the initial political agitations for what became the civil rights movement. In Britain, wartime solidarity produced bipartisan agreement to enact national health insurance. If the United States must accept a period of shared sacrifice, the experience can similarly create commitments to enact fundamental measures involving health, education and other social needs once the financial cloud has lifted.

An important difference from the World War II example, however, is that the reconstruction could not be financed primarily through deficit spending, given that the country is already burdened by growing indebtedness and the objective would be to reverse that trend. Financing would come, most obviously, from the revival of steeply progressive taxation. But private capital can also be pushed to invest in neglected domestic priorities. For example:

§ An "invest or else" wealth tax, quite modest in size, would give the largest wealth-holders and financial institutions this choice: Either pay the wealth tax or invest an equivalent amount in a priority list of long-term public improvements, from high-speed rail to renewable energy systems, these projects to be pursued as both private ventures and public programs. Alternatively, one's "wealth tax due" could be invested in ten-year, low-yield, inflation-proof government bonds that provide cheaper financing for softer projects like revitalizing education, from early infancy to midlife job-skills training.

§ Progressive taxation could be restored through a graduated consumption tax, replacing the deformed federal income tax. The tax rate on consumption would rise steeply by income class, but generous deductions for necessary household living expenses would effectively exempt most families on the bottom half of the income ladder. They might still be taxed on their consumption through value-added taxes collected at points of sale, much like Europe's. Either system could discreetly encourage more responsible choices by favoring less wasteful and damaging products, while lucrative tax-avoidance schemes and pointless subsidies would disappear for both corporations and wealthy individuals. Suggesting a consumption tax is risky, I concede, because unless political forces are realigned by crisis, the right wing would turn it into a regressive flat tax--injuring those who have already been injured.

§ A Fannie Mae for environmental progress, for small businesses, for inner-city rehabilitation and for other capital-starved realms of the economy would insure greater access to capital and credit, just as Fannie Mae's financing does for home ownership. Other quasi-governmental institutions might provide partial tax preferences for experimental ventures embracing equitable commitments to workers, like the living wage, or important new priorities, like ecological sustainability and worker ownership.

§ A less grandiose military posture toward the rest of the world would save scarce capital. Why exactly does the United States maintain its vast forward empire of military outposts? The \$500 billion military budget, citizens may observe, does not protect America from the \$500 billion trade deficit.

§ Trade deficits (or surpluses) could be held to moderate levels for all nations by a band of tolerances that, when violated, would authorize nations to take protective measures. Global leaders would need to focus on institutional reforms like labor rights and ecological accords and on inventing a new international financial institution that could end destructive currency wars and other instabilities.

All these ideas, I know, sound quite improbable at this moment. Certainly, the establishment would brush them aside. But do not dismiss the possibility that dramatic change and epic political reforms lie ahead. When self-important people and powerful institutions are governed by illusion, history has a way of biting back.