We're Number One!

Were traders pumping their fists in the air shouting this on Wall St. last week as the US economy set a couple of more new records? Ok, maybe not. The new records this time were for Current Account and Trade deficits. As expected, the US outdid itself again in 2005, racking up a Current Account deficit of $804.9 billion, the biggest annual total ever. Lest anyone hope this occurred in the face of an improving trend, the Q4 2005 quarterly deficit was also a record at $224.9 billion. This bodes well (if that's the phrase) for another record in 2006.

Not to be outdone, the trade deficit also went for the gold in 2005, with its own record of $780 billion. Again, there is little prospect of improvement in sight. The trade deficit (which accounts for most of the broader Current Account deficit) widened to a monthly record of $68.5 billion in January. It's likely that 2006 will be another record year for both deficits. The actual total for this year is still anyone's guess but if oil prices hold their current levels $900 billion is probably not a bad estimate

It's not news that these twin deficits are bad and getting worse but the position that these deficits are a problem that will create real havoc down the road is by no means unanimous. Many economists would argue that the deficits are a sign that people want to invest in the US and that the mighty US consumer is again keeping the rest of the world afloat. We don't disagree with the consumer part, though it's foolish to think we're dealing with some sort of virtuous circle of consumption when most of the money buying those consumer goods is borrowed. Likewise, a lot of the "investment" flowing into the US is strategic purchases of Treasuries by exporting countries that are piling up US Dollars and need someplace to put them. Those purchases, at the margin, have been largely responsible for keeping interest rates down and the US Dollar (relatively) strong.

One can argue that this is a cycle that can continue forever. The US does have a major advantage. The Dollar continues to be the world's trade currency and therefore in demand. All that is true, but it's also true that no matter how bullish economists want to paint things, the US economy has to import $3 billion a day. Not because the world loves them or because it's the wisest policy option but because the economy cannot sustain itself at current expenditure and savings levels without someone lending the US that much money each and every day.

This is not news to most of you and the consequences are equally clear; higher interest rates or a lower Dollar or both. The real question is when. This imbalance *could* continue for the foreseeable future but we don't expect it. One other statistic that doesn't get much press deserves a mention. It's the monthly International Capital Data, released by the US Treasury Dept. Basically, it's a summary of inflows and outflows in terms of investment. The data shows that in the last two months, purchases of US financial assets (which creates demand for Dollars) were not sufficient to cover the trade deficits for those months. Net foreign purchases have dropped significantly. Two months does not make a trend but if this continues it will start to weigh on the Dollar.

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