U.S. Trade Deficit: Good, Bad, or Irrelevant?

It is not all bad, not all good, and certainly not irrelevant...

In recent months, the U.S. dollar has seen increasing signs of weakening or as it is technically called, depreciating against other currencies. It has caused nations like Japan to massively intervene to keep the Dollar expensive in terms of the Yen in order to continue their large trade surplus with the U.S. New estimates show that the U.S. trade deficit with the world will be close to one half of a trillion dollars for 2003, clearly this in not sustainable.

This recent turn of events should be understood within the context of the last thirty years or so. To clear up the myriad of confusing arguments both as to the cause and size of the problems, this newsletter begins a three part series on our economic/financial interface with the rest of the world in general and our growing trade deficits with Asian nations in particular. The hope of this effort is not to excite the readers into a new era of isolationism, but rather see the costs and benefits of an increasingly integrated world.

After many years of a trade surplus, in the early 1980s, the United States began to experience deficits in its trade balance with the rest of the world. The formal names for the trade balance are Net Exports of Goods and Services Accounts or the Balance on Goods and Services Accounts. Often the word Merchandise is used instead of the word Goods. As many readers are unfamiliar with the concept of the balance of payments, a technical presentation of this topic can be read on a hyperlink by clicking here.
By convention, a nation’s imports of goods and services are subtracted from its exports of goods and services. If exports exceed imports, it is called a surplus and if imports of goods and services exceed exports of goods and services, it is called a deficit. Since the early 1980s the U.S. has had very large deficits in this balance. Are deficits in the trade balance good or bad? The truth is that there are both benefits and costs to a deficit in this balance just as there is when a trade surplus occurs.

**Exports and Imports**

Exports add to a nation’s aggregate demand. If inflation is occurring, exports add to those inflationary pressures. The rest of the world, by buying our goods, increases the scarcity of those goods. Imports represent Americans buying foreign goods. This is disflationary or if deflation is occurring, it adds to deflationary pressures. If prices are rigid downward (as they were more so in the past), imports tend to depress the level of real economic activity and have a negative impact on employment.
Why do imports depress either real output or prices? When Americans earn income by supplying resources such as labor or capital to the production process, they receive a reward called income. The income received enables them to buy back goods and services they helped to produce. If they choose to buy foreign produced goods and services, or import them, they have less remaining income to buy domestically produced goods and services. Thus, those unconsumed goods and services will become unwanted unless other spending of the non-consumption type demands them. Non-consumption spending is termed injections and includes demand for capital goods, government purchases of goods and services and exports or the demand for our production by the rest of the world.

Exports on the other hand, add a stimulus to our economy by adding to total demand for the goods and services produced in this country. If our nation’s resources are fully employed, exports will be inflationary. If we have unemployed resources (as is currently the case), exports could move the economy toward full employment.

Imports enable a nation to consume beyond its production capabilities while exports reduce a nation’s ability to consume all they produce.
economic relationships with other nations is the Current Account. In addition to the Trade Balance, it adds in what are technically called Unilateral Transfers. These are official and private remittances to the U.S. from abroad and U.S. official and private remittances to the rest of the world. If foreign official and private remittances to the U.S. exceed U.S. official and private remittances to the rest of the world, it is termed a surplus in the Unilateral Transfer Balance. When we give more than we get, it is called a deficit in our Unilateral Transfer Balance.

Since the rebuilding of Europe after the Second World War, the Unilateral Balance has usually been in deficit, but of small magnitude with occasional exceptions. The Current account Balance, which includes both the Trade Balance and the Unilateral Transfer Balance, has since the early 1980s, reflected a large deficit just as the Trade Balance has shown. The Trade Balance is often over 95 percent of the Current Account Balance. For those unfamiliar with the Balance of Payments, If the Current Account Balance has a $300 billion deficit for the year, the Combined Capital Account Balance (includes both long and short-term capital movements between U.S. and the world) must have a surplus balance of $300 billion. This is so because once all accounts in the balance of payments are included, the sum must equal zero, or be in balance. Again, click here to see the more technical discussion of these relationships.

The Capital Account balances indicate whether the U.S. invested net in the rest of the world or vice versa. A surplus in our Combined Capital Accounts indicates that for the period under consideration, the rest of the world invested net in the U.S. In other words, they invested more in the U.S. than the U.S. invested in them.
The U.S. has had surpluses in its Combined Capital Accounts since the early 1980s, mirroring the deficits in the Current Account for the same time period. By about 1982, the U.S. was the world’s largest net creditor nation. Within several years, that position had switched to a net debtor status and has continued to grow, so that now the U.S. is one of the world’s largest net debtor nations.

This is evidenced by businesses being owned and such as Chrysler by Daimler, Columbia as transplanted foreign Honda and Toyota and many as well. They currently increasing portion of financial securities 20 percent of the U.S. debt. While that has accumulation in this nonetheless requires investments to be interest and profits are foreign interests.

Foreign Exchange Markets and the Price of the Dollar

As the U.S. position of having been the World’s largest net creditor nation was changing to that of a large net debtor nation, foreign demand for the dollar persistently exceeded the supply of the dollar in foreign exchange markets, resulting in a strong dollar. Many would say that the dollar was appreciably overvalued given our large and persistent trade deficits.

Why the strong dollar despite the large and persistent trade deficits? Recall that most of the current account deficit is due overwhelmingly to the trade deficit (more formally called the Deficit in the Merchandise and Services Account). By definition, when added together, the Current Account Balance and the Combined Capital Account Balance must sum to zero.
Which caused which?

This gives rise to two opposing arguments as to the cause of the growing indebtedness of the U.S. to the rest of the world. Is the villain, so to speak, the large and sustained deficit in the Current Account Balance that causes the Capital Account Surplus, or is it the Capital Account Surplus that causes the Current Account Deficit?

Since this condition began to occur over twenty years ago, the popular argument was to blame the Current Account Deficit on our inability to compete in world markets due to lack of labor productivity, excessive consumption due to the easy availability to credit, the desire of Americans for instant gratification, and so on. It became a part of American bashing, even from within.

This argument has become untenable in recent years for more than one reason. American productivity has been soaring for the past several years. Data on consumer debt does not support the fear of household debt reaching crisis proportions.
Researchers such as Courtenay C. Stone, in a 1989 article published by the St. Louis Fed, have shown that the personal or household savings rate is much higher than shown in the National Income and Product Accounts. The measure of personal savings in the NIPA is inadequate for the generally understood meaning of savings. As Stone pointed out in the late 1980s, when broadly defined to make it comparable to other nations, the U.S. Personal Savings Rate is favorably comparable to most other nations including Japan.

There is an alternative argument that the editors of this Newsletter support. The Dollar is overvalued for at least two reasons. As a result of the Fed’s decision in early 1980 to shift its policies from fighting unemployment (by more or less ignoring escalating inflation) to fighting inflation, while nominal or market interest fell dramatically during the early 1980s, real interest rates (inflation adjusted) rose significantly and stayed there until very recently.
In the early 1980s, while the American economy had been moving gradually but inexorably toward the New Paradigm, the remnants of monopoly power and the Old Paradigm still lingered on in a number of markets. The Fed’s actions to eliminate accelerating inflation were delayed out of fear that unemployment would rise as the anti-inflationary policy was implemented. This fear rested on the significant downward price rigidity still pervasive in the economy.

Recall that most of the high nominal or market rates of interest toward the end of this period were due to what is called inflation premium (Fisher Effect, see excerpt from Financial Economics, D. Byrne revised 2003.). Inflation had to be crushed to avoid its continued upward spiral. The resulting recession achieved this purpose; though the costs were high. Three quarters of the inflation was eliminated with the Fed stating the rest of the job would be achieved with a soft landing or no recession, and price stability would be achieved.

That goal was pretty much achieved several years ago but the lesson learned was to dominate the Fed’s thinking in the late 1990s and early 2000s. As pointed out in the very first issue of this newsletter, they provoked a recession that should never have occurred. Speculative bubbles? They were present, but were mere bubbles in a very solid economy sorely in need of policies to support the transformation to an increasingly competitive economy: enter the New Economic Paradigm.
Undoubtedly, the high real interest rates even though nominally low by 1980 standards, worked wonders on the elimination of the inflationary scourge. What many do not understand is that the relatively high real interest rates helped cause disinflation and now the growing probability of deflation.

The U.S. financial markets are where the world finds a safe haven from a host of financial and political problems. Flights to safety or quality mean flights to the financial markets of the U.S. For this reason, relatively low risk adjusted and inflation adjusted yields assure a healthy inflow of capital into the U.S. As the graph shows, the real or inflation adjusted interest rate has been higher beginning about the time of the switch from Current Account Surpluses (mirror image of the emergence of capital account deficits, to a period of continuing and large Current Account Deficits (mirror image of the continuing and large Capital Account surpluses).

The effects of the relatively high, real-risk adjusted interest rates, and the resulting appreciation of the dollar has been exacerbated by ongoing intervention in exchange markets by Japan, China and the like, in order to keep the dollar overvalued.

**United States: The 900 pound Gorilla? Or the 409 Kilogram Primate?**
THE DEVIL IS IN THE FOLLOWING DETAIL...

### 2002 World Exports by Country
**OECD Data**

- Canada: 4%
- France: 5%
- Germany: 10%
- Italy: 4%
- Japan: 7%
- United Kingdom: 4%
- United States: 11%
- Other OECD countries: 25%
- Non-OECD Asia: 18%
- Other non-OECD countries: 9%
- Latin America: 3%

### 2002 World Imports by Country
**OECD Data**

- Canada: 3%
- France: 5%
- Germany: 8%
- Italy: 3%
- Japan: 5%
- United Kingdom: 5%
- United States: 19%
- Other OECD countries: 24%
- Non-OECD Asia: 17%
- Other non-OECD countries: 8%
- Latin America: 3%
SHANGHAIED BY CHINA and/or TSUNAMIED BY JAPAN???

United States Exports
Data from U.S. Department of Commerce: Bureau of Economic Analysis
Annual for 2002; Export Balance: $1,230 Bil
United States Imports
Data from U.S. Department of Commerce: Bureau of Economic Analysis
Annual for 2002; Import Balance: ($1,652) Bil

Balance of Goods and Services
Data from Department of Commerce: Bureau of Economic Analysis
Annual for 2002; Balance: ($422) bil
Here are two examples of countries intervening in the foreign exchange markets to achieve and continue a significant trade surplus with the U.S. There is more to this story and we will discuss it in greater detail in upcoming newsletters.
US Annual Imports/Exports China
US Department of Commerce: Census
Bureau and Bureau of Economic Analysis
Exchange Rates: Board of Governors of the Federal Reserve System

...TO BE CONTINUED IN THE NEXT ISSUE
Exchange Rates and the Balance of Payments

Just as the basic determinants behind the supply of and demand for wheat are critical in fully understanding the behavior of wheat prices, so it is important to understand the factors behind the supply of and demand for foreign exchange to determine the price of a foreign currency. Again, it should be stressed that the factors determining the demand for Euros are also the factors determining the supply of dollars, and the factors determining the supply of Euros also determine the demand for dollars. The balance of payments is a systematic array of all the factors that determine the foreign exchange rate. That array follows long established conventions and is all-inclusive and mutually exclusive among the individual factors.

Assuming the supply of Euros constant (demand for $$ is constant) the effect of an increase in any of the factors determining the demand for Euros (supply of $$) would
cause the $ price of the Euro to rise (the Euro price of the dollar to fall). Hence, if there
is an increase in U.S. imports of goods from Germany, imports of services from
Germany, more U.S. gifts to Germany, more U.S. long-term investment in Germany, or
more U.S. short-term investment in Germany, the demand for Euros increases (the supply
of $$ increases) and causes the $ price of the Euro to rise (the Euro price of the $ to fall).
This would be termed a depreciation of the dollar in respect to the Euro (appreciation of
the Euro in respect to the U.S. Dollar).

Similarly, assuming the demand for Euros constant (supply of dollars constant),
the effect of an increase in any of the factors determining the supply of Euros (demand
for $s) would cause the dollar price of the Euro to fall (Euro price of the dollar to rise).
Thus, if Germany increases imports of American goods, imports of U.S. services, gives
more gifts to the U.S., Germany increases its long-term investment in the U.S., or
increases its short-term investment in the U.S., the supply of German Euros increases
(demand of $$ increases) and causes the $ price of the Euro to fall (the Euro price of the
$ to rise). This would be termed an appreciation of the dollar in respect to the Euro or a
depreciation of the Euro in respect to the U.S. Dollar.

It should be obvious that a U.S. import from Germany is identical to a German
export to the U.S., and that a German import from the U.S. is identical to a U.S. export to
Germany. If you have trouble understanding why U.S. investment in Germany and U.S.
gifts to Germans are listed with U.S. imports of goods and services from Germany, think
of U.S. investment in Germany as the import of financial claims and U.S. gifts to
Germany as the U.S. importation of thank you notes or goodwill. All of these result in a
demand for Euros as well as a supply of dollars.

There are even more basic factors that lie behind the determinants of the demand
for and supply of foreign exchange. For example, what can cause the U.S. to import
more German goods? The rate of wage increases in the U.S. could exceed that in
Germany, which if occurring while rates of labor productivity increase are the same in
both nations, results in unit labor costs rising more rapidly in the U.S. In turn, this would
tend to cause a higher inflation rate (lower deflation rate) in the U.S. than in Germany.
Of course equivalent increases in wage rates while the Germans are experiencing high
rates of productivity increases would cause similar consequences. More rapid rates in
growth in money and credit in the U.S. than in Germany would also tend to result in
higher inflation rates in the U.S. than in Germany. Serious and prolonged strikes in the
U.S. could lead to more imports of some goods. If the U.S. were at capacity while the
Germans had idle capacity, it would tend to result in an increase in U.S. imports.

Similarly, a number of factors lie behind the amount of U.S. investment in
Germany as well as their investment in the U.S. If real interest rates rise more in the U.S.
than in Germany, it will tend to cause less U.S. investment in Germany and more German
investment in the U.S. Shifts in the political climate that increase the riskiness of
investment will likewise affect investment flows. For example, if a radical socialist party
assumes control of the German government and threatens nationalization of business, the
U.S. investment in Germany will drop precipitously and a flood of German investment in the U.S. will occur.

Shifts in foreign policy or changing ethnic concerns can cause substantial shifts in gifts from one nation to another (called unilateral transfers). U.S. Marshall Plan aid after World War II caused a sharp rise in U.S. gifts to other nations. An outflow of funds from Jews and those sympathetic to the Arab cause always rise when Middle East tensions reach the flash point. These can cause shifts in the demand and supply of foreign exchange thus causing changes in the exchange rates.

The determinants of the demand for and supply of foreign exchange, and thus the exchange rate, are also determinants of the various balances within the overall balance of payments. The factors that would tend to cause an increase in the supply of foreign exchange would also tend to cause a surplus (or reductions in a deficit) in the balance of payments. Factors causing an increase in the demand for foreign exchange would tend to cause balance of payments deficits (or reductions in surpluses).

The factors that were numbered one in the list of factors determining the demand for and supply of foreign exchange, when netted out, give what is called the Merchandise Balance. If the dollar value of goods (merchandise) exported to Germany exceeds the dollar value of goods (merchandise) imported from Germany, it is termed a surplus on U.S. merchandise balance. Thus, when we draw the line under the factors numbered one in our list above, the net or balance is called the merchandise or goods balance. A surplus in this means that more Euros are being supplied by German importers of U.S. goods than are being demanded by American importers of German goods (this could also be called a surplus on merchandise or goods account). In the absence of any other factors, it means that the dollar price of the Euro would fall (dollar is said to appreciate) and the Euro price of the $ would rise (Euro said to depreciate). But other factors play their part in the overall picture.

If we also consider the import and export of services along with the imports and exports of goods (that is we draw the line below one and two above), we get the balance on merchandise (goods) and service account. This balance is more inclusive of the factors affecting exchange rates but still leaves out unilateral transfers and capital flows. Before we include these items it would be helpful to give some examples of the goods and service balances. Assume that U.S. import of German goods or merchandise is 20 and an U.S. export of merchandise to Germany is 15. Also assume that U.S. imports of services from Germany are 4 and the U.S. exports of services are 7. The U.S. merchandise balance with Germany would be in deficit by 5, the services balance would be in surplus by 3. However, the goods and service balance would have a deficit of 2. In our examples, we would consider only such items between the U.S. and Germany.

While the merchandise account is pretty easily understood the services account is much more complicated. American tourist expenditures abroad (Germany in our limited balance of payments examples), U.S. expenditures on foreign shipping and related services, foreign income on their past investment in the U.S. (on German investment in
the U.S. in our limited balance of payments with Germany are all included in the services as they constitute a supply of dollars and a demand for Euros. Note that only the income on past investments is included in the Services Account. The investment expenditures themselves are included in the capital account. The income on foreign investments constitutes a supply of foreign exchange while a nation’s investment in the rest of the world constitutes a demand for foreign exchange. Similarly, German tourists in the U.S., German use of American transportation and U.S. firms’ repatriation of income from past capital investments in Germany are the other side of the Services Account.

Capital flows should be considered in determining the balance of payments. By drawing the line under the first four items listed above and netting them out, we arrive at what is termed the basic balance. In this balance only long-term capital flows are included above the line. Short-term flows are considered accommodative and determined by items in the basic balance. The treatment of short-term capital flows will be considered later. The factors leading to a surplus in the balance of payments are factors that supply foreign exchange. The factors leading to a deficit in the basic balance are factors that demand foreign exchange in the foreign exchange markets.

The items supplying Euros (demanding dollars) would be:

1. U.S. exports of goods (in our case to Germany)
2. U.S. exports of services (to Germany)
3. Foreign gifts to U.S. (German gifts to U.S.)
4. Long-term foreign (German) investment in the U.S. of either the brick and mortar type or the portfolio-type.

On the other hand, factors contributing to a deficit in the U.S. basic balance and to a demand for foreign exchange (in our case demand for Euros) are:

1. U.S. imports of goods and services (from Germany)
2. U.S. gifts to the rest of the world (to Germany in our limited case)
3. Long-term investment by U.S. in Germany.

It is crucial to see that the same forces determine exchange rates and balances in the balance of payments. The balances in the balance of payments are just a systematic arrangement of these factors, which were listed above. A deterioration of the U.S. balance of payments will cause in a system of floating exchange rates, a depreciation of the value of the dollar in the foreign exchange markets. In the absence of other factors, the dollar would depreciate ($$/Euro would rise and the Euro appreciate).

Assume U.S. exports of goods to Germany are 15; U.S. imports of goods from Germany are 12. Thus, the U.S. merchandise balance is in surplus by 4. Further assume that U.S. exports of services to Germany are 9 and imports from Germany of services are 15. The U.S. services balance is in deficit by 6, but the balance on goods and services account is in deficit by 2. There are many other possible combinations of goods and services balances.
The line could be drawn farther down on our list of factors affecting the exchange rates. If in addition to goods and services we include unilateral transfers, we arrive at what is called the **Current Account Balance**. That balance consists of: U.S. exports of goods and services to Germany plus German unilateral transfers to U.S. less the sum of U.S. imports of goods and services and U.S. gifts to Germany. Again there are a number of combinations of deficits and surpluses in the goods, services, and deficits and surpluses in the goods, services, and unilateral transfer accounts that would lead to a surplus, deficit or balance in the current account.

The history of the U.S. is rich in different variations of such combinations. The early 1800s often showed deficits in the current account balance because of deficits in the accounts for goods, services, and unilateral transfers. The early 1900s showed a surplus in the goods account, deficits in the services account and unilateral transfers, but a surplus in the overall current account balance. Recently, the U.S. has had deficits in the goods and unilateral transfers accounts partially offset by a surplus in the services account leading to a deficit in the more inclusive current account balance.

Before considering capital flows, it would do well to consider what is included in the term services (sometimes called intangibles or invisibles). The most important items are tourist expenditures, shipping or related expenditures and income on foreign investment made in previous periods. U.S. exports of services would include: foreign tourist expenditures in U.S., foreign expenditures on U.S. transportation services and related activities such as foreign payment of premiums to U.S. insurance companies, and repatriated profits, dividends, and interest on U.S. investments overseas. The short-term capital flows assure that the balance of payments will balance if there is no government intervention. Should the demand for foreign exchange not equal the supply of foreign exchange at the prevailing exchange rate, the exchange rate will change until demand and supply equal each other. An important policy question is how to treat these short-term capital flows. If the U.S. were not a key currency country, one could argue that short-term capital flows are merely accommodative of the items making up the basic balance.

It should be noted that basic balance items as well as short-term capital flows are influenced by speculative motives. In the case of the U.S., since its currency is an international medium of exchange and a primary store of value in foreign portfolio holdings of non-Americans, short-term capital can change independent of the changes in the factors determining the basic balance; that is, short-term capital flows are not simply accommodative. To the extent that the rest of the world desires larger or smaller amounts of short-term dollar assets, short-term capital flows will not be simply a balancing item. They can be exogenous factors influencing the exchange rate.

Assuming that the rest of the world wants more dollars as either a store of value or as a medium of exchange, foreign investment in short-term dollar assets in this nation (such as U.S. Treasury Bills) will increase, thus increasing the demand for the dollar and the supply of foreign exchange, with the result of an appreciation of a dollar and a
depreciation of the market value of foreign exchange. In fact, there is some justification for treating short-term capital flows that occur as a result of the demand for dollars as the international medium of exchange and store of value, as exports of dollars. This would show these flows above the basic balance line and in fact could put them in the merchandise balance much as South Africa would show gold exports in the trade balance.
### Current Account

<table>
<thead>
<tr>
<th>Item</th>
<th>2002</th>
<th>2003</th>
<th>Change</th>
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</thead>
<tbody>
<tr>
<td>Exports of goods and services and income receipts</td>
<td>1,229,649</td>
<td>341,022,000</td>
<td>-309,977,351</td>
</tr>
<tr>
<td>1 Exports of goods and services</td>
<td>974,107</td>
<td>247,815,000</td>
<td>-726,292,000</td>
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<tr>
<td>2 Goods, balance of payments basis</td>
<td>681,879</td>
<td>174,034</td>
<td>-507,845</td>
</tr>
<tr>
<td>3 Services</td>
<td>292,239</td>
<td>73,002</td>
<td>-219,237</td>
</tr>
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<td>4 Transfers under U.S. military agency sales contracts</td>
<td>11,943</td>
<td>2,865</td>
<td>9,078</td>
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<tr>
<td>5 Travel</td>
<td>66,547</td>
<td>16,030</td>
<td>-50,517</td>
</tr>
<tr>
<td>6 Passenger fares</td>
<td>17,046</td>
<td>4,297</td>
<td>-12,749</td>
</tr>
<tr>
<td>7 Other transportation</td>
<td>29,166</td>
<td>7,075</td>
<td>-22,091</td>
</tr>
<tr>
<td>8 Royalties and license fees</td>
<td>44,142</td>
<td>11,157</td>
<td>-32,985</td>
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<tr>
<td>9 Other private services</td>
<td>122,994</td>
<td>31,032</td>
<td>-91,962</td>
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<tr>
<td>10 U.S. Government miscellaneous services</td>
<td>755</td>
<td>195</td>
<td>560</td>
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<tr>
<td>11 Income receipts</td>
<td>255,542</td>
<td>63,828</td>
<td>-191,714</td>
</tr>
<tr>
<td>12 Income receipts on U.S.-owned assets abroad</td>
<td>222,375</td>
<td>59,074</td>
<td>-163,301</td>
</tr>
<tr>
<td>13 Direct investment receipts</td>
<td>142,933</td>
<td>34,874</td>
<td>-108,059</td>
</tr>
<tr>
<td>14 Other private receipts</td>
<td>105,143</td>
<td>25,960</td>
<td>-79,183</td>
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<tr>
<td>15 U.S. Government receipts</td>
<td>3,000</td>
<td>810</td>
<td>-2190</td>
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<tr>
<td>16 Compensation of employees</td>
<td>3,163</td>
<td>811</td>
<td>-2322</td>
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<tr>
<td>17 Imports of goods and services and income payments</td>
<td>-1,651,657</td>
<td>-361,716</td>
<td>1,289,941</td>
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<tr>
<td>18 Goods, balance of payments basis</td>
<td>-1,164,746</td>
<td>-271,301</td>
<td>893,445</td>
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<td>19 Direct investment payments</td>
<td>-277,399</td>
<td>-55,168</td>
<td>222,231</td>
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<td>20 Other private payments</td>
<td>-19,044</td>
<td>-4,297</td>
<td>14,747</td>
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<tr>
<td>21 U.S. Government miscellaneous services</td>
<td>2,900</td>
<td>741</td>
<td>-2,159</td>
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<tr>
<td>22 Income payments</td>
<td>-259,512</td>
<td>-61,365</td>
<td>198,147</td>
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<tr>
<td>23 Direct investment payments</td>
<td>-251,108</td>
<td>-66,246</td>
<td>184,862</td>
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<tr>
<td>24 Other private payments</td>
<td>-49,458</td>
<td>-13,464</td>
<td>36,028</td>
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<td>25 U.S. Government payments</td>
<td>-127,735</td>
<td>-33,773</td>
<td>93,962</td>
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<tr>
<td>26 Compensation of employees</td>
<td>-73,915</td>
<td>-16,868</td>
<td>57,047</td>
</tr>
<tr>
<td>27 Private remittances and other transfers</td>
<td>-8,004</td>
<td>-2,283</td>
<td>5,721</td>
</tr>
<tr>
<td>28 Unilateral current transfers, net</td>
<td>-58,833</td>
<td>-13,461</td>
<td>45,372</td>
</tr>
<tr>
<td>29 U.S. Government grants</td>
<td>-17,057</td>
<td>-6,081</td>
<td>10,976</td>
</tr>
<tr>
<td>30 U.S. Government pensions and other transfers</td>
<td>-5,125</td>
<td>-1,279</td>
<td>3,846</td>
</tr>
<tr>
<td>31 Private remittances and other transfers</td>
<td>-36,301</td>
<td>-9,458</td>
<td>26,843</td>
</tr>
</tbody>
</table>

**Change:**
-2002 Quarter: 2002.000
-2003 Quarter: 2003.000

**Notes:**
- All figures are in billions of dollars.
- Figures are rounded to the nearest million.
- The table includes both credits (positive values) and debits (negative values).

**References:**
- Economic Newsletter for the New Millennium
- Bureau of Economic Analysis (NIPA Accounts)
- September 15, 2003
Table 1—U.S. International Transactions (Continued)

[Millions of dollars, quarters seasonally adjusted]

<table>
<thead>
<tr>
<th>(Credits +, debits -)</th>
<th>2002</th>
<th>2002 Quarterly</th>
<th>2003 Quarterly</th>
<th>Change</th>
<th>2003</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>I</td>
<td>II</td>
<td>III</td>
<td>IV</td>
<td>I</td>
</tr>
<tr>
<td>Capital and financial account</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>Capital account</td>
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</tr>
<tr>
<td>Financial account</td>
<td></td>
<td></td>
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<td></td>
<td></td>
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<tr>
<td>Foreign-owned assets in the United States, net (increase/financial inflow (+))</td>
<td>-321,333</td>
<td>-42</td>
<td>-364</td>
<td>-358</td>
<td>-388</td>
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<td>Balance on current account (lines 1, 18, and 35 or lines 73, 74, and 75)</td>
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<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>U.S. Government assets, other than official reserve assets, net</td>
<td>-45,852</td>
<td>-4,581</td>
<td>30,438</td>
<td>-48,102</td>
<td>-23,602</td>
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<td>2003 Quarterly</td>
<td>706,983</td>
<td>146,813</td>
<td>221,242</td>
<td>141,478</td>
<td>197,448</td>
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<tr>
<td>Statistical discrepancy (sum of above items with sign reversed)</td>
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<td></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>

Memoranda:

71 Balance on goods (lines 3 and 20) | -482,872 | -106,033 | -121,286 | -123,312 | -132,341 | -136,018 | -137,979 | -1,961 |
| Balance on services (lines 4 and 21) | 64,834 | 15,976 | 16,396 | 16,332 | 16,125 | 14,389 | 14,571 | 182 |
| Balance on goods and services (lines 2 and 19) | -448,038 | -121,057 | -137,692 | -139,648 | -139,224 | -139,633 | -140,454 | -1,082 |
| Balance on income (lines 12 and 29) | -3,970 | -4,651 | 30,408 | -48,102 | -23,602 | -1,578 | -9,612 | -8,034 |
| Unilateral current transfers, net (line 35) | -58,833 | -15,938 | -13,461 | -13,997 | -15,436 | -17,269 | -16,942 | 327 |
| Balance on current account (lines 1, 18, and 35 or lines 73, 74, and 75) | -480,861 | -106,728 | -122,287 | -122,724 | -128,569 | -138,707 | -138,671 | 36 |

Revised p Preliminary.

NOTE: Details may not add to totals because of rounding. Source: U.S. Bureau of Economic Analysis
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**Fisher Effect**

In the chapters on interest rates, it was seen that inflation affects interest rates by driving a wedge between nominal and real interest rates. In the model of rational expectations, the nominal interest rate did all of the adjusting with inflation having no effect on the real interest rate. If two nations, alike in all other respects but have different inflation rates, according to the Fisher Effect, in a model of rational expectations, the nation with the higher inflation should have the higher nominal interest rates. If we continue to assume that the U.S. inflation rate expected over the coming year is 4% and in Germany is 12% nominal interest rates on similar securities should be 8% higher in Germany than in the U.S.

If the real interest rate in both nations is 2% on one year T-bills, the nominal one year T-bill rate in the U.S. will tend to be 6% and in Germany will tend to be 14%. Note that differing inflation rates have two impacts. Through purchasing power parity, the forward premium on the dollar in respect to the Euro is 8% (difference in expected annual inflation rates). Through the Fisher Effect, the difference in nominal interest rates on similar securities is 8% (difference in expected annual inflation rates), being higher in Germany than in the U.S.
Current Statistics (10-03-2003)

Unemployment Rate (6.2% Jul)…(6.1% Aug)…(6.1% Sep)

The September Unemployment Rate came in at 6.1%. The previous from the Bureau of Labor Statistics showed the unemployment dropping from 6.2% in July to 6.1% of the labor force in August – the July through August time frame constituted the first consecutive monthly drop in the unemployment rate in nearly three years (September – October 2000). Despite analysts’ predictions, who expect that the rate would edge back up to the 6.2% level for the month of September, the rate instead remained steady at 6.1.

The following side-by-side comparison of the current recovery to the last is interesting in that it is clear that this latest recession was really not as severe as the last. This is a clear example of the New Paradigm in Economics: an economy marked by stiff competition, increased productivity, marked by unemployment that is structural in nature and can only reduced by raising economic activity and creating new jobs.
The second quarter of 2003 showed continued positive growth in real GDP… The Commerce Dept. reported a 3.3% growth rate for the 2nd Quarter 2003 (on an annualized basis), revised upward from last month’s estimate of 3.1% (which was revised upward from an initial estimate of 2.4% in July). It marked the 7th consecutive quarter of economic expansion, allaying fears of a double dip recession. At this rate, indicators argue that the 3rd Quarter of 2003 will confirm continued economic expansion. Interestingly, many analysts are forecasting a fall-off in GDP for the remainder of the year. Their rationale is based on their belief that the effect of tax cuts and resultant durable goods purchases have already been registered and will not play a role in third – fourth quarter GDP.

### GDP (2nd Quarter 2003 Real GDP: 3.3% - Revised from 3.1%)

Like the unemployment comparison above, the GDP growth statistics clearly point out the fact that this most recent recession and recovery, 1st Quarter 2001 – 2nd Quarter 2002, are much less severe than in the recession/recovery in 3rd Quarter 1990 – 2nd Quarter 1992. Note: the overall total average GDP for seven quarters 1990 – 1992 was 1.6%, while the GDP for 2001 – 2003 was 1.7%.

### What Recession?

**Seven (7) quarters of economic growth and counting!**

(2nd Qtr 2003 revised upward from 2.4 to 3.1, 3.3)

<table>
<thead>
<tr>
<th>Bureau of Economic Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Table 8.1. Percent Change From Preceding Period in Selected Series</td>
</tr>
<tr>
<td>[Percent] Seasonally adjusted at annual rates</td>
</tr>
<tr>
<td>Today is: 9/26/03 Last Revised on September 26, 2003</td>
</tr>
</tbody>
</table>

#### Gross Domestic Product:

<table>
<thead>
<tr>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
</tr>
</thead>
</table>
| I | II | III | IV | I | II | III | IV | I | II | III | IV | I | II |%
| Current dollars | 5.7 | 7.3 | 2.2 | 3.2 | 3.0 | 0.9 | 1.9 | 2.2 | 6.5 | 2.5 | 5.1 | 3.2 | 3.8 | 4.3 |
| Chain-typequantityindex | 2.6 | 6.8 | 0.6 | 1.1 | (0.6) | (1.6) | (0.3) | 2.7 | 5.0 | 1.3 | 4.0 | 1.4 | 1.4 | 3.3 |
| Chain-typepriceindex | 3.1 | 2.3 | 1.6 | 2.1 | 3.7 | 2.5 | 2.2 | (0.5) | 1.3 | 1.2 | 1.0 | 1.8 | 2.4 | 1.0 |
| Implicit price deflator | 2.1 | 2.3 | 1.6 | 2.1 | 3.7 | 2.5 | 2.2 | (0.5) | 1.3 | 1.2 | 1.0 | 1.8 | 2.4 | 1.0 |

Like the unemployment comparison above, the GDP growth statistics clearly point out the fact that this most recent recession and recovery, 1st Quarter 2001 – 2nd Quarter 2002, are much less severe than in the recession/recovery in 3rd Quarter 1990 – 2nd Quarter 1992. Note: the overall total average GDP for seven quarters 1990 – 1992 was 1.6%, while the GDP for 2001 – 2003 was 1.7%.
Jobless Claims (4-wk rolling avg: 411,000 Sep-13, to 407,000 Sep-20, 403,500 Sep-27)

The new Jobless Claims data came in at 399,000 for the week ending September 27, 2003. Department of Labor data indicate that the new jobless claims are trending slightly downward, however there have now been five consecutive weeks of claims above the 400,000 mark, generally viewed as the level required for economic expansion.

On a brighter note, in the Unemployment Insurance Weekly Claim Report, published by the Department of Labor, highlights the fact that first time jobless claims have gone from 428,000 for week ending Sep. 6, to 400,000 for week ending Sep. 13 to 381,000 for week ending Sep. 20. The four-week rolling average edged downward to 403,500 from the 407,000 reported the previous week.

The following graph provides yet another comparison of this latest recovery to the last one in the early 1990s. Note: initial jobless claims in this recovery period are considerably lower than before. Also, again in keeping with the New Paradigm in Economics, the jobless claims are back loaded this time around pointing to higher levels of structural unemployment.

Note: there were 173,000 more Initial Jobless Claims in the 3rd Quarter 1990 – 4th Quarter 1992 time frame; averaging 17,300 per quarter more than in the 1st Quarter 2001 – 2nd Quarter 2003 time frame.
**Leading Indicators**  (6.0%+ annual rate September 18, 2003)

According to figures released by the Conference Board on September 18, “The leading index increased again in August, and is now up by 2.5 percent from its low in March (more than a 6.0 percent annual rate). In addition, the strength in the leading index has been widespread over this period.”

**New Housing Starts**

The most recent data shows continued near record levels of new housing starts. While the August figures dropped 3.8% since July, it represents an 11.7% over August 2002 numbers. This amounts to an annualized rate of 1.8 million units seasonally adjusted. This sector continues to perform strongly through the current expansion.

**New Residential Sales**

According to the Census Bureau, sales of new homes grew at a 3.4% clip in August, representing 1.15 million units seasonally adjusted. Again, this rate exceeds the August 2002 figures by 12.2%.

**Durable Goods**

The most recent report from the Commerce Department shows that New Orders for Manufactured durable goods dropped of 0.9% in August, the first such drop since April of this year. Shipments also dropped 2.9%.

New orders for Capital, or long-lasting durable goods grew at a 2.2% rate, while shipments dropped 3.5%. Within that data, defense related orders increased $2.6 billion, while non-defense actually fell by $1.2 billion.

While first impressions might lead one to have grave doubts concerning the argument for a continued recovery based on the latest lackluster numbers, it’s interesting to note that the July numbers were revised upward considerably from last month, skewing further the month over month change. Mark Vitner, Economist at Wachovia Securities, noted in an interview on CNBC that adjustments are common in this extremely volatile segment and the stand-alone news for August was actually very respectable.

**Current Account Balance**

The Current Account Balance consists of the Trade Balance (Net Exports (Exports less Imports) of Goods and Services), the Income Balance (Income Receipts and Income Payments), and net Unilateral Current Transfers.

Despite continued productivity and unit labor cost gains, the Current Account, buoyed by an overvalued Dollar, continues to worsen. So long as the major trading partners (Pacific Rim, Europe and North America) continue to intervene to undervalue their currencies, then Current Account deficit levels will hold or continue to deteriorate.
CPI

On a seasonally adjusted basis, the CPI rose 0.3 percent in August, according to the Bureau of Labor Statistics. The core rate (absent food and energy) rose at a 0.1 percent rate, down from the 0.2 percent rate in July. The unadjusted 12-month figure for inflation weighed in at a whopping 2.2 percent and at 1.3 percent excluding food and energy.

The following graph again compares current CPI data to that from the previous recession/recovery (3rd Quarter 1990 – 4th Quarter 1992):
From another perspective: for the inflation experienced in the same number of time periods (30-months), the CPI for 3rd Quarter 1990 – 4th Quarter 1992 totaled 9.1%, while that for 1st Quarter 2001 – 2nd Quarter 2003 totaled 5.0%…

10-year U.S. Government Bond Rate

The 10-year Maturity U.S. Government Security continues to remain trading at a relatively low rate. At close of business, October 3, 2003 the yield stood at 4.20 percent. In the absence of inflation, and the quality of U.S. Government debt, there is no reason for it to rise to a higher rate in the near future.

Click here for a more thorough treatment on the inverse relationship between interest rates and security prices.
<table>
<thead>
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<th>Date</th>
<th>Yield (%)</th>
</tr>
</thead>
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<td>3.00</td>
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<tr>
<td>02/02/2003</td>
<td>3.20</td>
</tr>
<tr>
<td>03/04/2003</td>
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</tr>
<tr>
<td>04/03/2003</td>
<td>3.60</td>
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<tr>
<td>08/31/2003</td>
<td>4.60</td>
</tr>
</tbody>
</table>
The Inverse Relationship between Interest Rates and Security Prices

The Importance of the Inverse Relationship

Much of the validity of the liquidity preference theory of interest rates depends upon an inverse relationship between the quantity demanded of money and interest rates. While the validity of modern finance depends upon the inverse relationship between interest rates and the value of security prices (especially debt securities such as bills and bonds).

Valuation of a Debt Security

A financial claim entitles the owner to a future cash flow. That cash flow can be very clearly articulated or it can be very vague. A bond is an example of the former, and a share of stock is an example of the latter. These cash flows are usually defined in terms of medium of exchange money (M-1), the ultimate of liquidity. The more certain the cash flow, the lower the risk to the owner of the financial claim. The less certain is that cash flow, the greater the risk to the owner of the claim. Usually, the more uncertain the cash flow, the higher the yield or the greater the cash flow the market expects from a security.

It is not the absolute value of the cash flow alone that determines the value or market price of the security. The closer the cash flow is to the present time, the more valuable is the market price of the claim. This is accounted for by the time value of money. If $100 is invested now at 10% compounded annually, it will grow or be worth $110 in one year. Thus, $110 to be received in one year if the going rate of interest is 10% would have a present value of $100. If the treasury is issuing a T-Bill with one year to maturity, what will determine the market price? Since it is a pure discount instrument, its market price depends upon what the market demands as its required rate of return. Assume that the required rate of return is 8%. Discounting the maturity value of $10,000 at an 8% rate of discount for one year would give a present value of $9,259.26.

\[
\frac{10,000}{1.10^1} = 9,259.26
\]

Had the T-bill been discounted by a higher rate of interest, for instance 10%, its present value would be only $9,090.91.

\[
\frac{10,000}{1.10^1} = 9,090.91
\]

If that present value were compounded annually at 10% for 1 year, the T-bill would grow to $10,000, or $9,259.26 compounded at 10% it would grow to $10,000.
The present and future values can be determined without a calculator by using a set of present and future values tables found at the end of this narrative. In this case if we find the one-year row and the 8% column of the present value of a sum table we find the present value discount factor 0.92595. The maturity value of the Treasury bill is $10,000. The present value of the maturity value is 0.92595 multiplied by $10,000; the product is $9,259.26. This is called the present value. Similarly, if the required rate of return is 10% the one-year row and the 10% column together list the discount factor of 0.90909. Again, the maturity of $10,000 is multiplied by the discount factor of 0.90909 and the present value is $9,090.91.

A $1,000 maturity value, 5-year pure discount (zero-coupon) bond that has a required rate of return of 10% would have a market value of $620.90. In this case, we would find in the tables, the discount factor on the 5-year row and the 10% column of the present value of 0.6209. If the maturity value of the bond were $1,000 then the price of the bond would be 0.6209($1,000) or $620.90. To better understand this, think of investing $620.90 for 5 years at a 10% rate of return compounded annually. Using the future value tables for a lump sum we can see that the future value factor is 1.67051 times $620.90 which equals $1,000. $620.90(1.1)^5 = $620.90(1.67051) = $1,000.

The valuation of a coupon bond differs due to the periodic interest rate paid in addition to the return of the maturity value on the maturity date. For the sake of simplicity, we will assume that interest is paid annually. The maturity of the bond is 10 years, its coupon rate is 12% and the required rate of return is 10%. The maturity value is $1,000. Examining a present value of the annuity table, the discount factor for 10 periods at 10% is 6.1446. The periodic interest payment is 0.12 of the $1,000 maturity value or $120 per year. The present value of the flow of coupon interest is 6.1446($120) = $735.35. The current amount of the maturity value of $1,000 is the discount factor for 10% and 10 years or 0.3855 times $1,000 or $385.50. Adding the two together ($735.35 + $385.50) equals the market price of the coupon bond or $1,122.83.

There is a precise relationship between interest rates and bond prices. Note that the coupon bond had a required rate of return that was greater than the coupon rate, which explains why the bond had a market price greater than its maturity value; it was a premium. Again using the present value tables, the market price of the coupon bond as described above, would be $1,000 or par if the required rate of return were 12%.

The present value factor for the coupon interest flow is found by looking at the 10-year row and the 12% column of the present value of an annuity table, which is 5.6502. When multiplied by the annual coupon interest of $120, the present value of the
flow of coupon interest is $678.00. The present value of the maturity value of $1,000 to be received in 10 years is $1,000(0.3220) = $322. When this is added to the present value of the coupon interest, the sum of $1,000 is the market price of the bond.

If the required rate of return were 14% which is greater than the coupon of 12%, the market price of the coupon bond would be at a discount to the maturity value. In this case the market price would be $895.63:

$120 (5.2161) = $625.93
$1,000 (0.2697) = $269.70 = $625.93 + $269.70 = $895.63
### Present Value Table

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<tr>
<th>Yr</th>
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<th>8%</th>
<th>10%</th>
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<th>14%</th>
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### Present Value Table (Annuity)

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<td>0.67803</td>
<td>0.73026</td>
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Letters to the Editor

Laid-off in L.A....

I’ve been out of work from job in IT and looking for employment for the past several months. I drive past the LA/Long Beach Harbor area on a daily basis and from what I have seen of the traffic on the freeway and can see out in the blue Pacific, the shipping business is absolutely booming. My comment/question is…are we better or worse off from all of this trade? It would appear that there must be some jobs in all the hustle and bustle, but I, for one, have not been able to find one...

Bill in Lomita, California

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The Zero-Sum Game of Imports/Exports?

We’ve talked a great deal of the pros and cons of running a trade deficit, from enhancing our Consumption and Capital Goods Accumulation Curve to the depressing effects of net imports on the economy. Another aspect of the import/export relationship has to do with the entrepot or port of entry/staging point (warehousing) for off-loading/on-loading of imported and exported goods.

It’s clear that a state with ports of entry/exit has the distinct advantage of being insulated from the negative effects of a net increase in net imports, absent the state’s own loss of export potential. That is to say, that a state with major ports of entry, Washington for example, has much more to gain from increased net activity through its terminals than would a Wyoming, for example. Goods are transshipped in/or out, with the supply chain leading from or to the terminal. This same scenario would hold true for ports of entry across the United States. In the end, it really doesn’t matter whether or not imports exceed exports to an entrepot (go-between), so long as trade increases overall.

The irony here is that while imports tend to promote competition and limit inflation in such areas as manufacturing for example, West Coast ports of entry have experienced a boom in shipping. Ports like Tacoma, Washington (and LA/Long Beach) have experienced meteoric increases in shipping tonnage over the past several years. According to the Tacoma Port Authority, “Through the end of May, the Port's total container throughputs is 28 percent ahead of the same period in 2002 - more than double the average growth at other West Coast ports (roughly 13 percent).”

The limiting factor benefiting these states is the fact that much of the cargo is being shipped on foreign operated vessels. In essence, the real benefit to these ports is to the labor used in on/off-loading and further facilitating the supply chain. It is interesting to note that the vast majority of the incoming shipments from the Pacific Rim are shipped to the Midwest and further east.

…the long and short of it, Bill, is that while we are recovering as reflected in the traffic you’ve witnessed in the West Coast ports, whether the economy be in a
mild recession, or a strong recovery, restructuring is occurring and you may never get your IT job back…the good news that you are certainly not alone. Not to lose hope, the recovery is in full swing and “new” jobs are being created as we speak.

Linda in Michigan…

I was surprised to see in your last newsletter that the cost of education had grown so much over the past several years – more significantly, that autos and computers had dropped so much in that same time frame. It was just shocking to me is all…

To this point in time, a few sectors, including education, professional sports, big oil, etc., have not seen the intense competition experienced by auto and computers… The education industry would be called a bilateral monopoly in traditional economic literature. The reason is that roughly 80% of education is public, depending primarily on tax-revenue and not on tuition. Most of the educators in the public sector are unionized.

Please note: as the auto industry experienced there are signs of growing limitations to oil, sports and education that competitive factors are beginning to enter the picture.

From Paul in MI

You’re right on in pointing out that unemployment is a lagging indicator in our current situation!!!

In days of yore, cyclical unemployment would fall with recovery, moderated by an encouraged worker effect. That lag of falling unemployment in a recovery is greatly reinforced because so much of the unemployment is now structural. We can expect in future recoveries from recession that so-called jobless recoveries will be the rule rather than the exception.

Bob in Oakland

Looking into your crystal ball, how will state and local governments deal with ongoing problems relating to revenue shortfalls?

The Bad News

Our US GDP was approximately $10 Trillion with a growth rate in excess of 5% in 2000. In the second half of 2000 a precipitous drop in our growth rate occurred, leading to a recession three quarters long in 2001 (the recession bottomed at -1.5%).
Translating into tax revenue losses
6.5% of $10 Trillion is $650 Billion in lost GDP
Overall taxes constitute 30% of GDP
30% X $650 Bil = $195 Bil

and of that…

State and Local is about 45% of the total

45% X 195 = $88 Bil

By the way, California constitutes about 12% of our economy…and translates approximately into $10.5 Bil in lost revenues (annually).

Please note that much of the problem is due to budgeted spending linked to a forecast increase in revenues collected.

Having laid that groundwork, as the economy recovers (as it currently is), the increase in the tax base generating increased revenues will gradually alleviate the deficits currently experienced by state and local governments.

…the caveat is that spending must be curtailed.