Tea Leaf

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Your guide to understanding today's economy and financial markets

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Twins No More

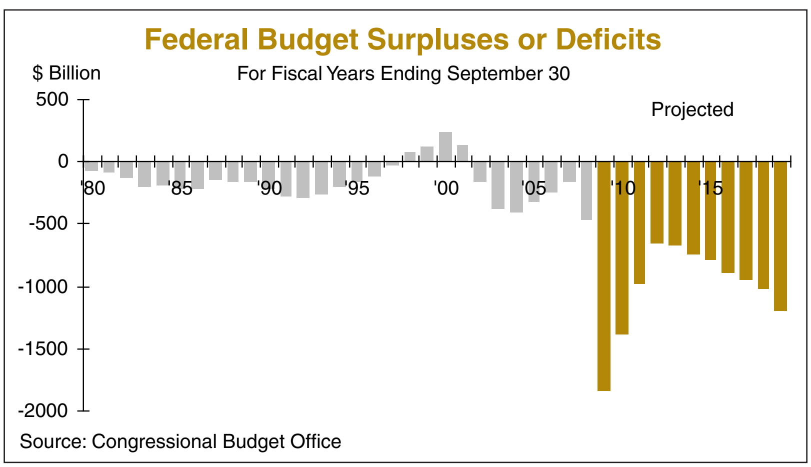
Written by Jeff Thredgold, CSP, President, Thredgold Economic Associates

During the past 30 years or so, American economists talked about the "twin deficits," i.e. those of the budget and of global trade. The budget deficit was viewed as the more critical by many, while others wrung their collective hands about the deficit in trade with other nations.

At times, both deficits grew. At other times, both deficits declined. Earlier in this decade, the budget deficit was in decline, while the trade imbalance with the world was rising rapidly. These deficits are now moving in opposite directions.

Budget Deficit Rises

In my view, the most critical challenge facing this country over the next 10-20 years will be our ability to control federal spending. Such a challenge will be made more difficult by a President and a Congress determined to see the government assume a greater and greater and greater role in our lives.



The largest annual budget deficit this nation ever ran was during fiscal year (FY) 2008, which ended last September 30, a deficit of $459,000,000,000. We shattered that record in the first nine months of FY 2009, with a 9-month deficit of $1.1 trillion.

The full-year budget deficit for FY 2009, which ends on September 30, 2009, will be near $1.84 trillion…FOUR TIMES the prior record. For every dollar Washington DC takes in this year, it will spend nearly two.

Picking Up the Pieces

We have noted before that the current Administration inherited an economic and financial disaster from its predecessor. If the calendar were such that George W. Bush was still President, the deficit this year would be similar.

The consensus view of economists has been that extraordinary levels of government action (spending) this year and next was the lesser of two evils…versus doing nothing and letting the greatest economic and financial threat to economic well-being since the Great Depression continue to spiral downward.

Later On

The problem is identified in the chart below. The problem is that future budget deficits averaging $1 trillion ($1,000,000,000,000) annually will greatly damage this nation.

The long-desired Democratic wish list of more and more government; more control and greater spending for health care; more money for education; greater power for labor unions; more funding for alternative energy, while ignoring nuclear power and offshore drilling; costly penalties for carbon emission; and "punishing" those successful Americans who happen to make more than $200,000 annually ($250,000 for joint incomes) with higher taxes on income, capital gains, and dividends is on the drawing board. A surtax for higher-income Americans to help pay for health care is also in vogue.

Much of the above plan is largely based upon the desirability of income redistribution, rather than incentives to create new income. The wish list, combined with the enormous costs of bailouts and financial market stabilization, has pushed

jeff thredgold, CSP
ECONOMIC FUTURIST

THREDGOLD ECONOMIC ASSOCIATES

The TEA Company
A Professional Speaking and Economic Consulting Company
1366 S Legend Hills Drive, Suite 150
Clearfield, Utah 84015
801-614-0403
www.thredgold.com

projected budget deficits to dizzying levels. They are simply too much in outer years.

If at your house this year, you collectively earn $80,000 but spend $160,000, life is good. If next year you earn $90,000, but spend $140,000, you can live well. You can do this only so long as 1) lenders are willing to lend you more money, and 2) you can handle the financing costs.

What is true at your house is also inevitably true with America, or any other nation. At some point, lenders stop lending. Bond buyers stop buying your bonds.

The interest cost alone—already exceeding $1,000,000,000 DAILY—begins to overwhelm you. The Chinese and the Saudis and the Dutch and the Japanese begin to question your ability to repay.

Role of Government

I continue to wish President Obama well. He has an enormous challenge. Those on the other side who hope to see him fail should be taken to task.

However, government is not the solution to many of the challenges we face. It creates as many problems as it solves. The role of government is to help sustain some level of economic and financial “normalcy” to allow private sector businesses and private sector individuals to prosper.

At times like these, government must fill the void to replace consumer and corporate spending as their respective confidence levels are whipsawed. As confidence returns…and it will…the best role of government is to simply get out of the way.

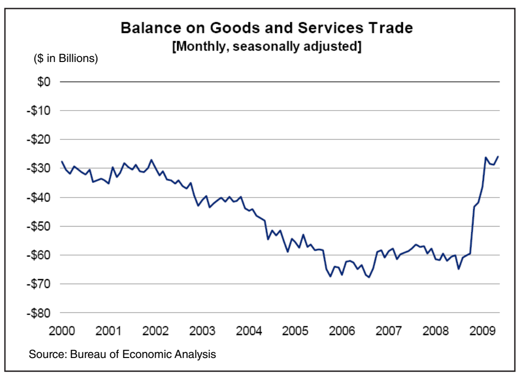
Trade Deficit Falls

This nation’s monthly trade imbalance with the world shrank to it lowest level in nine years in May, falling to $26 billion dollars. The monthly trade deficit was running at more than twice that level just a year ago, raising concerns about American competitiveness and the long-term stability of the U.S. dollar.

A declining trade deficit is largely good news for the American economy. U.S. exports to the world rose 1.6% in May to $123 billion, while U.S. imports fell 0.6% to $149 billion. Rising U.S. exports provide more ammunition that a renewal of global economic growth is expected in 2010, led by the U.S., China, and India. Imports fell for the 10th consecutive month, falling to their lowest level since 2004.

America’s largest export markets year-to-date through May were Canada ($79 billion), Mexico ($48 billion), China ($25 billion), Japan ($21 billion), and the U.K. ($19 billion). U.S. exports account for roughly $1 in every $8 of U.S. economic output.

Measures of U.S. economic growth are impacted by the changing nature of exports and imports. Rising exports result in stronger U.S. economic output, while rising imports, when they occur, subtract from measures of U.S. economic output. For example, if we buy larger quantities of imported shoes and electronic goods, we don’t need to produce as many of such items at home.



Source: Bureau of Economic Analysis

Return to Growth

We have noted frequently that the consensus of forecasting economists is for a return to slightly positive U.S. economic growth in the *current* quarter. This would follow a much lesser rate of contraction during the second quarter than occurred during the prior six months.

The latest trade data has led numerous forecasters to reduce their estimates of decline in second quarter GDP, while leading a few to suggest that U.S. economic growth might actually have been slightly positive during the second quarter. For example, Macroeconomic Advisors increased its second quarter GDP forecast from -1.6% (annual rate, after inflation) to +0.2% *(The Wall Street Journal)*…

…stay tuned

Jeff

“TEA”ser

I am a marvelous housekeeper. Every time I leave a man I keep his house.

—Zsa Zsa Gabor

jeff thredgold, CSP
ECONOMIC FUTURIST

THREDGOLD ECONOMIC ASSOCIATES

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Thredgold Economic Associates
1366 S Legend Hills Drive, Suite 150
Clearfield, Utah 84015
www.thredgold.com

Graphics and layout by Kendall Oliphant
Research assistance by Shawn Thredgold