

Debtor Nation, another view

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Debtor Nation, Without Rhetoric
By Thomas Nugent
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In the world of economic analysis, fundamental truths are sometimes lost to rhetoric. For example, it is fact ? not theory ? that government budget deficits add exactly that amount to the savings of financial assets that the rest of us hold. Yet politicians and economists have attacked the federal budget deficit on the premise that it reduces savings. Few media moguls pick up on the fact that expansive fiscal policy (the budget deficit) has been directly responsible for the recent increases in non–government savings, just as they overlooked the fact that the Clinton surpluses reduced our savings.

Along with errantly berating budget deficits as draining our savings, the media make an equally illogical error regarding the trade deficit. Within the Beltway, a trade deficit means that U.S. consumption is at the mercy of foreign lenders, and the U.S. Treasury is beholden to foreign owners of its securities. The image is that of the U.S. government and American consumer going hat–in–hand around the world begging for credit to fund expenditures, with the United States also at risk of meeting its foreign "obligations." We are presumed to be suffering the consequences of being a debtor nation.

Fortunately, the truth is far from the mythology. To expose these myths, all that's needed is a closer look at what's really happening. First it's the U.S. consumer who is funding foreign savings, and not foreign savings that is funding the consumer. Second, U.S. Treasury issuance has to do with alternative accounts at the Federal Reserve, and is not the precursor of financial stress.

What occurs when a U.S. consumer purchases a German–made car? If the consumer pays cash, the consumer's checking account in a U.S. bank is debited and the German car maker's account is credited, thereby increasing foreign savings of U.S. dollars. Total deposits in the U.S. banking system remain the same. (By the way, there is no cargo ship in New York harbor taking dollars back to Germany. All that occurs is a change in holders of U.S. dollar deposits in the banking system.)

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When the consumer borrows to buy the car rather than using cash in his bank account (a more likely option), the bank makes a loan to the consumer, creating a loan on the asset side of the bank's balance sheet and a new deposit on the liability side. (Loans create deposits.) After the car is paid for, the German car company has the new bank deposit. Note that consumer borrowing increased total bank deposits and funded foreign deposits (savings) of U.S. dollars. The widely held causal myth is that foreigners are funding U.S. consumers.

That's what the trade gap is all about — the desire of foreigners to net save U.S. dollars and to sell goods and services to the U.S. to obtain those assets. If foreigners did not desire to save U.S. dollars, they would instead [use their dollars to] buy goods and services from the U.S. and there would be no trade deficit.

Following the above transaction, the foreign holder of U.S. dollar bank deposits may decide to invest in U.S. Treasury securities rather than hold a bank deposit. At the time of the German car company's purchase of these securities, the seller of the Treasury securities becomes the new holder of the bank deposit, and the foreigner the new holder of the Treasury security. (If the foreigner buys securities directly from the Treasury the result is the same.)

When foreigners hold Treasury securities, the U.S. government is said to have foreign creditors, and the U.S. is said to be a debtor nation. While this is true by definition, a look past the rhetoric at what the U.S. government actually owes the holder of Treasury securities is revealing. The government promises that, at maturity, the foreigner's security account at the Fed will be debited, and his bank's reserve account at the Fed will be credited for the balance due. In other words, the U.S. government's promise is only that, at maturity of the Treasury security, a non-interest bearing reserve balance will be substituted for an interest bearing Treasury security. This transaction is not a potential source of financial stress for the government. Remember, the U.S. is no longer on a gold standard meaning that the dollar is not redeemable at the government for gold or any other good or service. Holders of deposits or Treasury securities can't demand the surrender of our national parks, or any other U.S. asset.

Understanding that government deficits add to savings and that U.S. consumers fund the desires of foreigners to save is a good way to start seeing through the media's economic mythology.

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