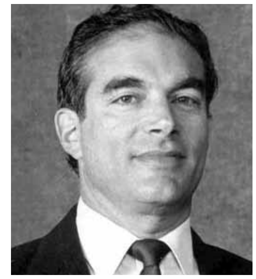
FOCUS ON THE ECONOMY



Budget Deficit, Trade Deficit, Savings Deficit and Monetary Policy Deficit: "Are We OK?"

BY DR. MARK LEE LEVINE, CRE

INTRODUCTION

IF IT IS TIME FOR THE UNITED STATES to have its annual "physical," it may be worthwhile to focus on the "Fiscal" issues, including any potential maladies.

I. U.S. TRADE DEFICIT

The U.S. budget deficit has been the focus of discussion, particularly in the last few years, as a result of huge U.S. trade deficits with other nations.

The U.S. trade deficit and the weaker dollar are of great concern. The report in *The Economist*, p. 96 (January 2005), stated: "The falling dollar has so far failed to reduce America's trade gap." It was thought by many commentators and political pundits that with the weaker dollar there was a "silver lining in the cloud;" it was the possible good news that there would be more exports; other countries would find that purchasing U.S. goods was less expensive. However, notwithstanding this logic, the weaker dollar has not produced the level contemplated; the U.S. trade deficit has grown!

The article in the Report, *The Economist* (January 2005), indicated that the U.S. trade deficit on goods and services widened to $60.3 billion in November 2004. The oil imports increased in price. (Crude oil was over $56.00 a barrel in March 2005. Of course, now the price per barrel has been in the high 60s, with projections for much higher prices coming for the winter of 2006.) U.S. exports of U.S. goods sold to other nations declined in that same month. As a result of these events, the U.S. trade deficit on goods, without considering other categories, as reported by *The Economist*, rose to $654 billion for the 12-month period ending November 2004. (This was an increase from the $547 billion for the prior year of comparative measurement.)

Lest one assume that this deficit position is common throughout the western world, the German trade surplus rose to close to $200 billion for the same time frame noted, November 2004!

Given the weakened dollar and market considerations, a comment in *Business Week*, page 30 (January 24, 2005) noted that many pundents and economic analysts were shocked by such increased U.S. trade deficit and trade gap.

About our Featured Columnist

Mark Lee Levine, CRE, PhD, is a professor and the director of the Burns School of Real Estate and Construction Management at the University of Denver. (E-mail: mlevine@du.edu)

Because U.S. imports purchased from other countries are about 50% greater than U.S. exports sold to consumers in other countries, based on the *Business Week* numbers, there is additional concern that the U.S. will have a very difficult time avoiding an increased trade gap, with huge deficits.

As pointed out in the *Business Week* article, the U.S. dollar has fallen against the Euro and Japanese yen, but it has not fallen to the same extent with many other countries that trade with the United States. It is clear that a lower dollar value position will not cure, by itself, the trade gap in the U.S. Rather, the U.S. needs to lessen U.S. imports and increase U.S. exports, by, in part, creating demand by other nations for U.S. goods.

With over a $600 billion trade deficit—and growing—U.S. trade deficit problem will not be an easy item to correct. An interesting statistic noted in an article in *Business Week* (February 28, 2005) was that for each $1 dollar spent on consumer goods, disregarding the automobile, 45 cents (45%) of that dollar will go to imports (U.S. purchasing goods from other countries). That figure increased from 25% in 1997!

Notwithstanding that the U.S. dollar has fallen approximately 15.4% in the past three (3) years, as noted by Chairman Greenspan in the *Business Week* article (February 28, 2005), the falling dollar does not cure the U.S. trade deficit. Citing Ms. Catherine Mann, a Senior Fellow with the Institute of International Economics, it was asserted that as the U.S. dollar falls, those foreign interests that have invested in U.S. assets will also lose value in the U.S. assets. As such, there is concern that foreign investors may not desire to continue to invest in U.S. assets.

A multiplicity of factors will impact the U.S. economy and the export-import trade gap issue.

II. BUDGET DEFICIT

In addition to the U.S. trade deficit, there is constant concern with the fiscal/budget deficit in the United States. As I have indicated in many articles, the U.S. fiscal deficit continues to grow on a monthly basis. The size of the overall budget deficit continues to break records.

The excess of payments or expenditures by the U.S. government, as opposed to revenues received, makes it clear that this imbalance situation cannot go on indefinitely. If it continues much longer, it will have major, negative, impacts on numerous financial markets and the U.S. economy in general. Such position was noted in an article by Cynthia Saltzman, "Federal Budget Deficits: It's Not If, But When They Matter," *Journal of Financial Service Professionals* 22 (March 2005). Dr. Saltzman noted concern with the Federal budget deficit. She was careful to cite the leading commentator on this issue, Federal Reserve Chairman, Alan Greenspan. Mr. Greenspan has warned, noted Dr. Saltzman, in November 2004, at the European Banking Conference, that there will be economic problems for the U.S., if the U.S. does not take steps to address the issue of current budget deficits and the total U.S. fiscal budget deficit, overall. Increased spending by the Federal government, with less monies coming into the FISC, make it clear that the U.S. is not in a favorable international financial position.

Related economic issues will also create financial burdens on the government and will continue to place pressure on the U.S. government relative to the fiscal deficit. These issues include, among others, decreasing tax rates and, thus, decreasing tax revenues, advocacy to further decrease and make permanent the tax changes of the past few years (which further reduce U.S. tax revenues), potential Social Security funding problems, a negative trade balance position, Homeland Security issues that have financially drained local and national economies, recent losses from Hurricane Katrina and Rita, etc.

III. TAX CONSIDERATIONS

The overall economic tax consideration for the U.S. economy is the simple fact that the revenue stream for the U.S. Federal government has been reduced (as is true in many states), yet the demand for services from the U.S. government has remained strong.

Included in the U.S. deficit under its fiscal policy is the consideration by President Bush to make permanent many "temporary" tax changes that were made over the last few years. This concern with "permanency," and how to fund the same, will cause billions of dollars in additional deficits, unless offsetting positions can counterbalance the drain on the government and tax revenues when these "temporary" tax changes become "permanent," if such events occur.

Congress also recently mandated that Reports be given to Congress on a regular basis to analyze activities of the Internal Revenue Service, highlight major problems involved with the tax system, and make recommendations and propose other legislation to reduce or eliminate those problems. Consistent with these mandates by Congress, the Internal Revenue Code of 1986 (The "Code"), as amended, under Code Section 7803(c)(2)(B)(ii), requires the Reports indicated. Following the mandates, National Taxpayer Advocate, Nina Olson, released the *National 2004 Annual Report to Congress and Executive Summary* (January 11, 2005), consisting of 2 volumes of over 700 pages. This Report, which was given to Congress under I.R.-2005-7 (January 11, 2005), stated the need to also reduce the complexity in the tax system. Therefore, there is the desire to provide for "permanency" of prior "temporary" tax changes, as well as to provide a strong voice for simplification of Federal income tax laws.

Federal Reserve Board Chairman Alan Greenspan has warned for many years that making cuts in the income tax stream, without allowing offsetting support for those cuts, would create problems within the Federal government. Chairman Greenspan recently advocated that he favors extending some expiring tax cut positions, for a "permanency" position, but he is concerned with any changes that are not "pay as you go." (Chairman Greenspan's successsor will likely have the same concerns.)

This issue was raised in an article by Dustin Stamper, "No Tax Cut Extensions Without Offset, says Greenspan," *Tax Notes* 887 (February 21, 2005). In this article, Mr. Greenspan said: "I argued a year ago that my support for the tax cut is in the context of a pay-go rule...."

The need to provide for revenue, the desire by some in Congress and the President to extend many tax cuts from "temporary" status to a "permanent" position, and the attempt to eliminate some complexity that now exists within the Internal Revenue Code, affect the U.S. economy. (However, as I have noted in many articles, when Congress attempts to "eliminate" complexity and to "simplify" the tax law, it seems that the Code and supporting materials usually become longer and more complex!)

The additional issue of Social Security overlaps with general economics issues. It has been addressed vociferously by the President and members of Congress. This subject will continue to be debated. It is far from being resolved. What is certain is that any "solution" requires "funding."

IV. MONETARY POLICY

As to monetary policy, the big concern has been, and will continue to be, the issue of interest rates. Although the short-term interest rate has increased slightly in the past months, with many indications that the rates will continue to be increased, the concern focuses on how "substantial" these increases in the interest rate will be in the short term. For example, a sudden increase in the interest rate, such as 2% (200 percentage basis points), would substantially impact most areas of our economy; it will impact the ability to make other positive changes in U.S. tax law, trade deficits, budget deficits, the housing market, and much more.

A related issue is to examine how actions by leaders from other countries might impact U.S. and international monetary policies. Major foreign investors may determine that the sliding value of the U.S. dollar lessens real property values in the United States; terrorism remains an important concern in all areas, including its impact on economics; rising oil prices have damaged the hope for a trade balance; and other issues could potentially cause major upward changes in the interest rate. In such instances, one could reasonably expect strong, negative impact in many areas, such as in the housing industry.

This slowing of the economy, because of increasing interest rates, would have additional adverse effects that would substantially, and negatively, impact the U.S. economy, along with possibly the economies of many other countries.

For an overview of the issue as to interest rates and the impact of the same on home sales, and much more, see the note, "Real Balance," *REALTOR* magazine 26 (January 2005). This article noted issues as to interest rates and the equilibrium in the marketplace, along with questions on the rate of inflation, gross domestic product (GDP), unemployment rates, interest rates in general, and housing prices, among other issues. These topics were examined by David Lereah, chief economist for the National Association of Realtors (NAR); Paul Merski, chief economist for Independent Community Bankers of America; Mark Dotzour, chief economist for Texas A&M University; Frank Nothaft, chief economist for Freddie Mac; Doug Duncan, chief economist for Mortgage Bankers Assn (MBA); and Steve Bunn, the chief economist for C.B. Richard Ellis, Information Management. All of these economists and prognosticators clearly emphasized the concern with interest rates and the impact of major changes in the rate of interest charged.

There were five (5) interest rate increases in 2004 by the Federal Reserve, moving the Federal Funds (interest rate) to 2.25%. At the time of the writing of this article, this rate has moved to 3.75%. There is additional concern with continuing, rising interest rates and the effects on U.S. and world economies.

V. OVERALL ECONOMY FACTORS

As mentioned, the U.S. economy is influenced and impacted by many factors, such as the U.S. trade deficit, tax laws, monetary policy, etc. Many additional important areas must be considered within the economy, as noted below:

SOCIAL SECURITY

Many debates have developed on the issue as to how the U.S. government should address the apparent shortfall in funds necessary to pay for Social Security benefits, currently and in years to come. With rising medical costs, people living longer, and more people retiring (especially those among the "baby boomers"), there is great concern that the "insufficient funds" with Social Security will not be able to meet the rising demand. The "best means" to address the Social Security issue is not the intended focus of this article. But, the timeliness of properly addressing this issue will impact the economy.

An article by Howard Gleckman, "The Real Retirement Time Bomb," *Business Week* 72 (January 31, 2005), summarized concerns with amounts of Social Security paid out today, and what could be paid out in coming years if changes are not made in the Social Security system. See also the article by Pete Engardio, et al, "Now, the Geezer Glut," *Business Week* 44 (January 31, 2005). This article focused on the baby boomers throughout the world affecting U.S. and world economies in general. The attempt to fund retirement for aging workers shifts the financial burden onto existing workers to fund some of the monies required for Social Security needs.

HOUSING

It is clear that the housing market has supported the U.S. economy for many years. Whether the housing market can sustain its position, which most economists agree cannot be the case, and when such markets will change, are additional, important economic issues. An article by Jeff Opdyke, "Hot Housing Markets Face New Risks," *Wall Street Journal* D2 (Wednesday, March 2, 2005), focused on the risks in the housing market. One risk is the inability for the housing market to continue to produce sales at the same sales rate as existed in years 2002-2005. Of course, part of the demand was a function of the lower interest rates. Lower interest rates will probably continue in the short term, but the long-term forecast is for increasing interest rates. Thus, housing will be impacted. With higher rates, many potential buyers will be placed outside the area of affordability for the purchase of a home. Refinancing will also slow.

There is also concern that many housing markets are overpriced, because of growth in the housing market over the past few years. The "B" word is coming up again—the "Bubble." A housing bubble may break. The Opdyke article noted that the riskiest U.S. housing markets were in ten metropolitan areas, which have greater risk of a housing bubble bursting. Six out of the ten areas are in California. Several markets of concern included: Boston, New York, New Jersey, Michigan, and Rhode Island. The article commented that there was a 16.1% chance of decline, overall, of the national housing market in the top 50 metropolitan markets in the United States.

For more on the issue of the housing market and areas of concern, such as mortgage rates, housing starts, inflation, affordability, and so forth, see the monthly report produced by Meyers Housing Market: Key Indicator Alert, which can be found on the web at: http://www.meyersgroup.com.

OIL

The price of oil recently rose to over $65.00 per barrel. Consistent, rising demand for oil has a negative impact on the U.S. trade deficit position. As oil prices continue to increase, and demand does not lessen, a negative impact on the U.S. economy results. The rise in heating oil prices, gasoline for travel, and other uses of fuel affect both private and commercial activities.

STOCK MARKET

The U.S. stock market has been fairly strong over the last year. However, the general consensus of economists seems to express concern for this market, especially as to segments involving the housing market, oil and gas prices, monetary and fiscal policies within the United States, budget issues, interest rates, and a myriad of other factors.

POPULATION

The baby boomer issue relative to Social Security, as well as changing population demographics in many countries, affect all economies. The rise of the hispanic population affects the U.S. markets. There are more immigrants into the U.S. Also, the overall increase in U.S. population, approaching almost 300 million, educational levels of the population, and aging considerations influence overall world economies, too. For an examination of many of these issues, see the broad look at the industry addressed in a major article in *Business Week*, p. 88 (January 10, 2005).

VI. OTHER ISSUES

Other issues need to be addressed for positive development of the U.S. economy. Transportation, aerospace, general construction, auto production, pharmaceuticals, and environmental issues are only a few examples of those areas which impact on the U.S. economy. Continuing conflicts in the Mideast and other locations substantially impair the ability of the U.S. and other countries to perform positively, on an economic level.

VII. CONCLUSION

Many factors must be considered when looking to the overall posturing of the U.S. economy. This includes trade surpluses and deficits, tax (fiscal) policy, monetary policy, housing, Social Security, the stock market, petroleum, population mix and much more.

Changing world markets, particularly the growing markets in China and India, are shaping the direction of economies throughout the world. Major conflicts or major settlements between countries, such as conflict issues in Middle Eastern countries, certainly impact world economies. A lack of consumer confidence and a concern for the direction of the country (U.S.) are additional intangibles that raise the level of concern for our economy—and our country.

With all of these variables, it appears that a "wait-and-see" position for 2006 will be important for many markets. Maybe we need another good physical? ■