• WHO PAYS FOR THE US DEFICIT

The United States Congress is searching for ways to cut the spiralling US budget deficit. Assuming tax and spending policies remain unchanged the deficit is projected to rise to $270 billion by the end of the decade, 5% of gross national product.

But there will be far more at stake than the size of the defence budget or the possibility of a tax increase.

The deficit has attracted a lot of comment from Labour politicians in Britain, most of it favourable. According to Neil Kinnock's economic adviser Henry Neuburger, the advantages of the deficit are clear: 'In terms of economic growth and job creation the US is now more successful than it has been for three decades. What we must point out is that this recovery is the result of successful job creation by the state.'

Such a view generously overstates Reagan's achievements, and sadly ignores the international implications of this US spending spree. Under the Reagan administration employment in the US has risen by 6%. In the period between 1976-80, under the maligned Carter administration 10.5 million jobs were created - a rise of 12%.

The chairman of Nixon's Council of Economic Advisers, Herbert Stein has concluded that there is nothing miraculous about the Reagan recovery: 'The current recovery is distinctly stronger than only one previous postwar recovery, that of 1975-76.'

Not only have many on the Left accept the myth of 'Reagan's Recovery', in doing so they ignore the costs and risks of its achievement. It has only been possible because of a massive inflow of capital into the United States.

Taken together, the deficit and private investment are far outrunning the rate of private savings in the US. If the deficit had been financed by borrowings from domestic savings alone, interest rates would have risen to such a level that private investment would have been squeezed out. This has been prevented by the inflow of savings from abroad.

Almost half the growth in investment that led to the US recovery has been financed by foreigners. The foreign capital has been attracted by, amongst other things, the high interest rates and the growth produced by the deficit and the borrowing required to finance it. The high US interest rates have threatened to bankrupt the dollar debtor nations in Latin America and Africa. The very source of the debtor difficulties, the US, has been the chief beneficiary of the crisis.

The transfer of assets and savings into dollars to invest them in the United States has in turn led to the strength of the dollar. Since the fourth quarter of 1980 the dollar has appreciated by 40-50% against the currencies of other major industrialised nations.

The rise in the value of the dollar has led to

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falling import prices into the US, which has tended to reduce US inflation. It has at the same time lowered world commodity prices for many of the debtor nations thereby exacerbating their balance of payments difficulties. But it has also had significant effects in Europe.

The US recovery has contributed to a much more limited recovery in Europe. But the depreciation of the pound against the dollar has exerted upward pressure on UK inflation, and interest rates, to protect sterling.

Just as European governments have been cutting their budget deficits in the hope that interest rates will fall and thereby allow a blossoming of Thatcherite private investment, the US has been running up a massive deficit soaking up the funds European governments have made available by their policies.

This is not a mere accounting exercise: the deficit and the flow of foreign funds to the United States may have allowed an American recovery, but the cost has been a massive disequilibrium in the international economy. This year the United States will become a net debtor for the first time since the building of the railroads. For every three dollars the US is earning abroad it is spending four dollars on foreign goods.

The flow of foreign funds into the US can only be compared with the transfer of money to the oil producing countries after the second OPEC price rise in 1979. That international imbalance helped to produce inflation and recession in Western Europe. The disturbance created by the US deficit threatens similar consequences.

So the US has enjoyed its recovery courtesy of savings from Osaka, Bonn and Glasgow. What would happen if that flow were to dry up? If savings institutions decided they did not want to hold so much of their portfolios in dollar denominated assets, there would be a flight from the dollar. If this were a large and sudden flight US interest rates would have to be pushed up to try to protect the currency. But the dollar is overvalued by 20-30%. With the prospect that peoples' savings might depreciate by that much, an interest rate incentive of 1-2% is unlikely to tempt them back. Inflation would also rise.

But on top of the effects on the economy of a depreciating currency there would be additional problems in financing the deficit. With foreign funding unavailable in the amounts required, the administration would only have three ways to go.

One would be to draw more from domestic savings; but that would push interest rates up even further. If this proved too unpalatable the US central bank, the Federal Reserve, could buy government securities, thus providing money to finance government spending. But the sums involved are so large money would have to be printed on a large scale, pushing inflation even higher.

The third option would be to try to reduce the need for foreign funding by cutting government spending, or increasing taxes. But to do so under these conditions would almost certainly bring about a recession.

Whichever way you look at it a dramatic fall in the dollar would almost certainly bring about a recession in the United States, with largely unpredictable international consequences.

The prospects for an ordered decline in the budget deficit, and thereby an ordered decline in the value of the dollar depend on the US Congress. Specifically the prospects depend on the ability of moderate Senate Republicans to come up with a package that will be saleable to all sides.

But as one Carter administration economist said recently: 'The American political system only really responds to a crisis. And by the time this crisis comes it will be too late.'

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