McVEAN
TRADING & INVESTMENTS, LLC

The US Economy: How We Got Here, How We Get Out

Chapter I

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Past Performance is Not Necessarily Indicative of Future Results.

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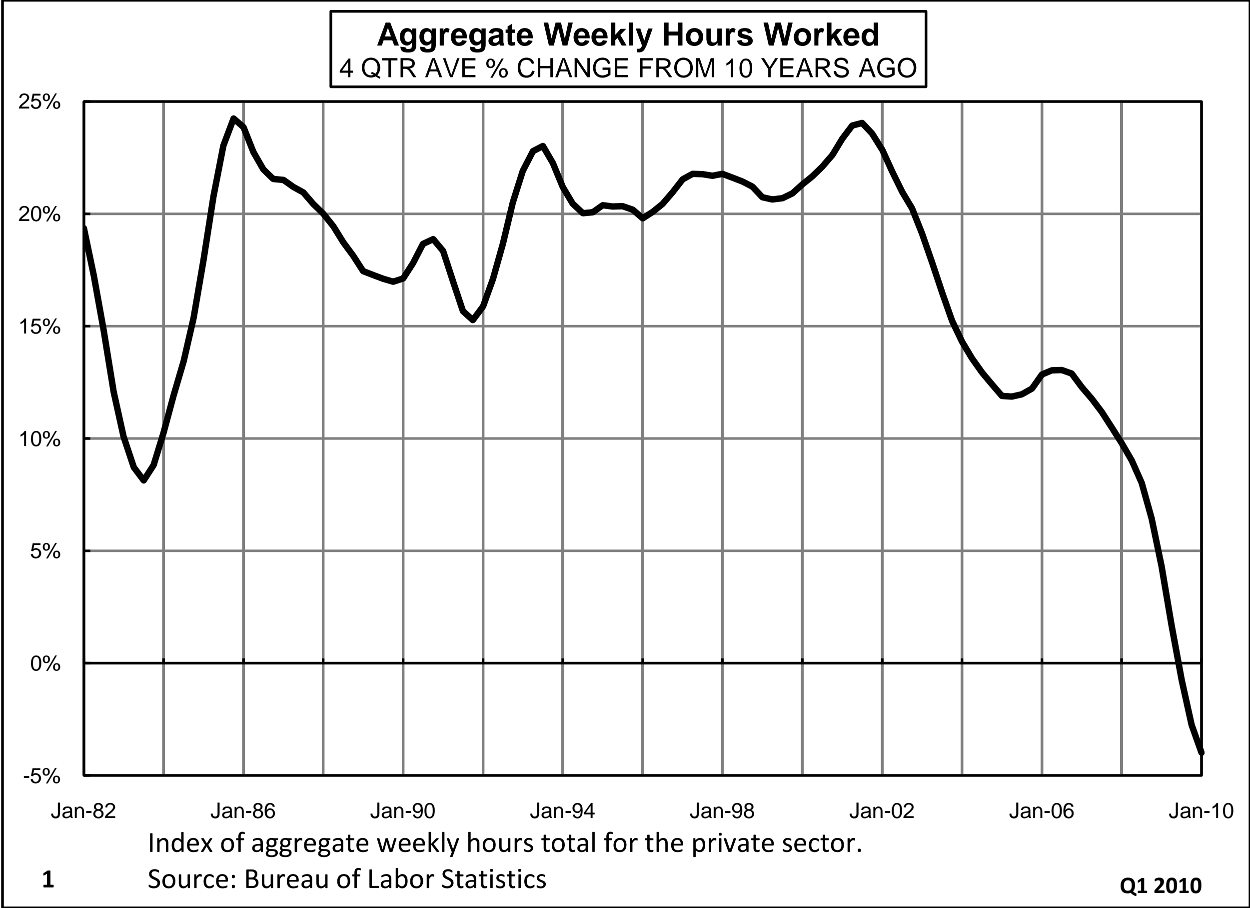
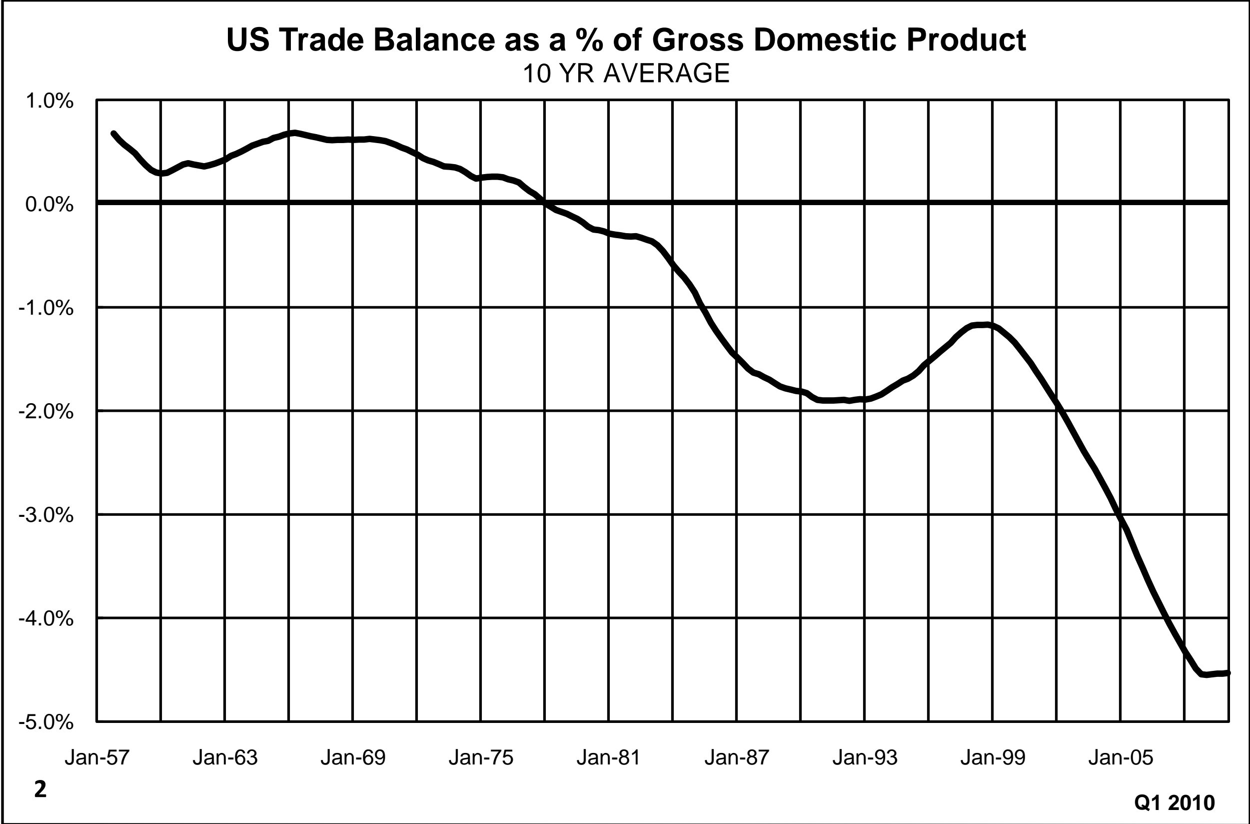
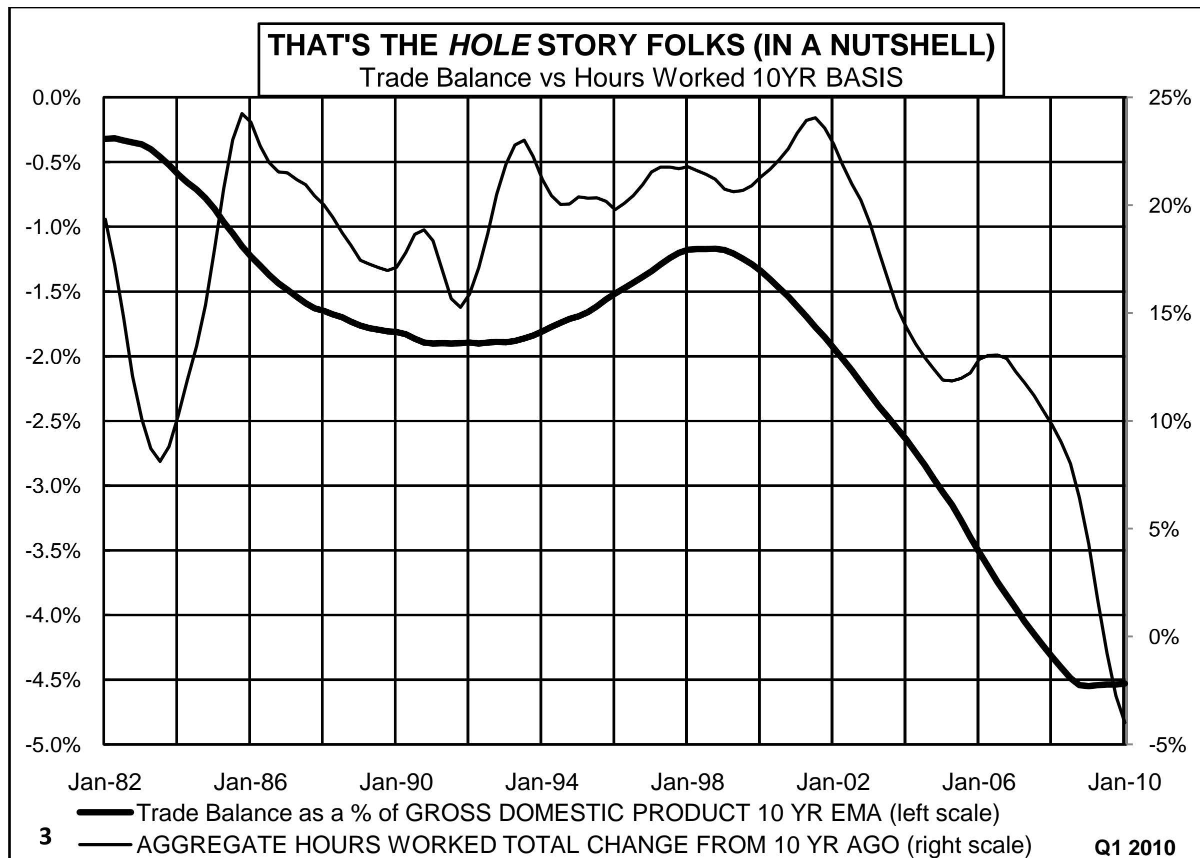
Chart 1 examines the catastrophic failure of the US economy to generate private sector employment over the past decade. On the available data, the previous worst episode, culminating in the double dip recession of the early 1980's, still saw total private hours worked 8% above 10 years prior. In the past year, private sector hours worked have fallen a shocking 4% below 1999. The severity of this decadal decline indicates critical systemic flaw(s) in the current US macroeconomic model.



1 Index of aggregate weekly hours total for the private sector.
Source: Bureau of Labor Statistics

Here we look at the US trade deficit as a percent of GDP on a 10 year average basis. Not a pretty picture to say the least.





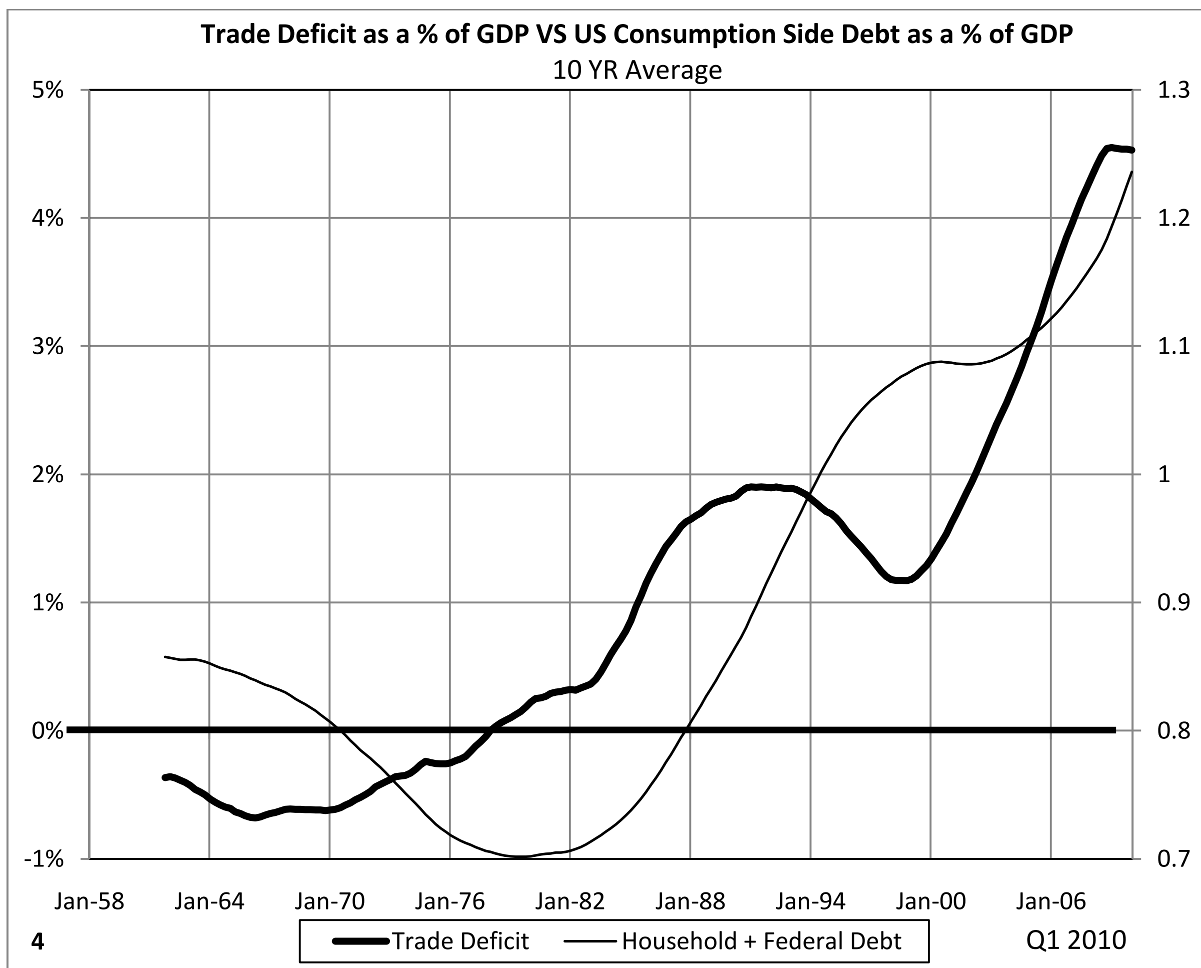
In **"The *Hole* Story in a Nutshell,"** we plot the 10 year average trade deficit versus the 10 year change in employment. We believe that the conclusion is fairly straight forward; the trade deficit has impaired our ability to generate private sector jobs in the US. Now, of course, there are those who will argue that productivity improvement has held down employment growth and, all else equal, this is certainly true. However, all else is never equal and accordingly, the productivity discussion does not alter the conclusion that given the level of productivity growth experienced, employment would have grown substantially faster without the trade deficit. Fortunately, the policy perspective, which arises from this somewhat complex discussion, is itself quite simple and obvious: **Teamed together, productivity enhancement and trade deficits are a lethal threat to employment growth in the United States. Secondly, as we shall see, the trade deficit has become a primary cause of the federal deficit. For these reasons, the trade deficit must now be recognized as a grave threat not only to our economy, but to our political stability and national security. A goal of eliminating the US trade deficit, hopefully in a pro-growth fashion, must rise to the very top of our national political agenda.**

A critical component of our trade deficit is what we call the Transportation Deficit. The Transportation Deficit combines the energy trade deficit and the auto trade deficit. Energy accounts for about 45% of our trade deficit and autos about 15%, together they add up to a Transportation Deficit of 60% of the total. **In Chapter 2, to follow, we will suggest public policy specifically targeted at the elimination of the Transportation Deficit ("The Wholesale Electrification of Intra-City Personal Transportation in the United States of America**").

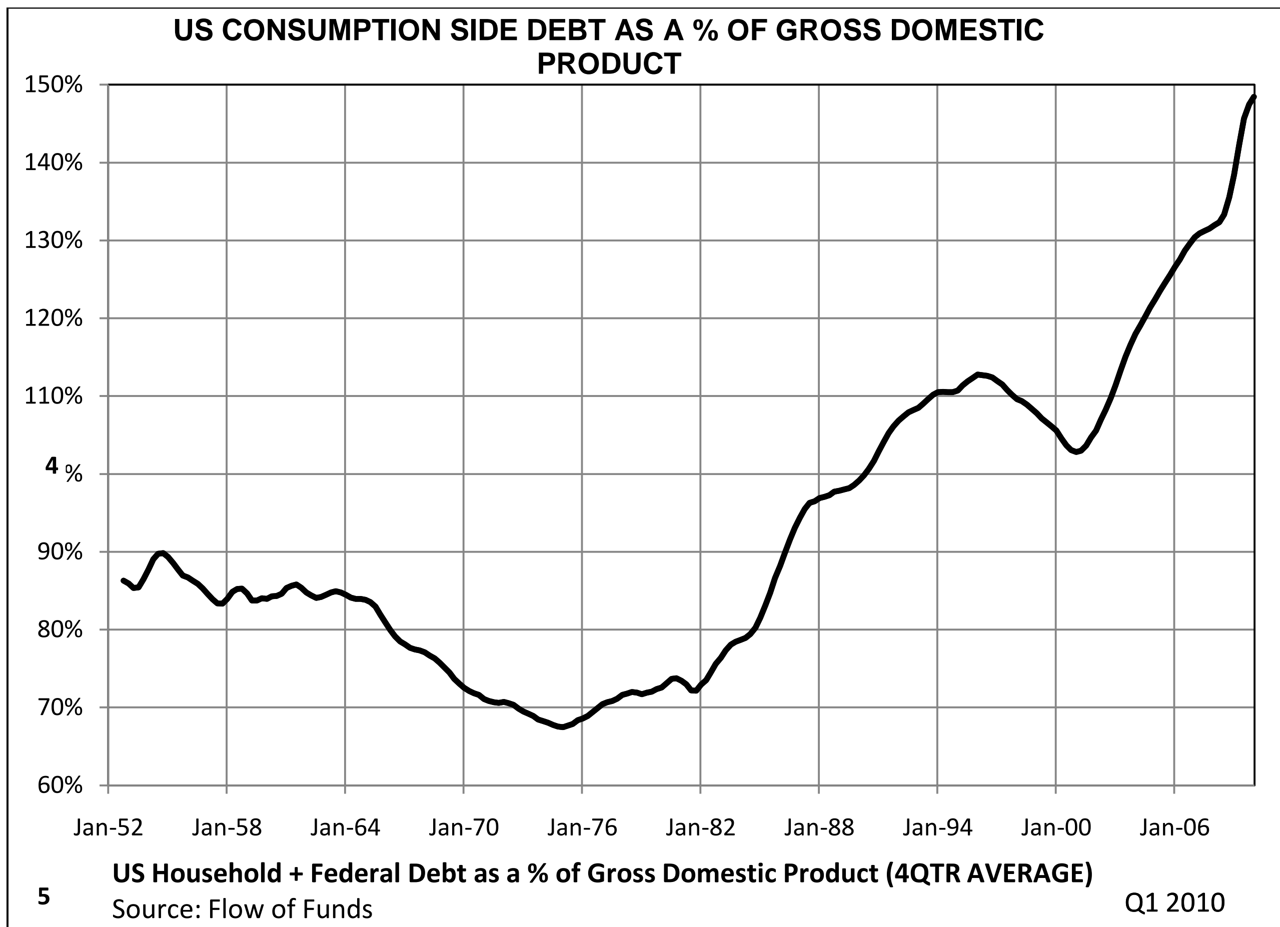
Now to refocus attention on Chapter 1, **let us make ourselves absolutely clear, our overriding intention in today's work is to seek an indictment, in the court of public opinion, of the number one enemy of economic progress in the United States, the foreign trade deficit**. Indeed, while well-meaning, the Tea Party movement may be dangerously misled in its singular fixation on the federal debt. There are two primary reasons: A) current cyclical growth may be fragile at best, meaning premature policy tightening could be very damaging to the economy, and B) in many ways the trade deficit is the underlying cause of the federal deficit, and therefore it would be preferable to attack the cause of the disease, rather than its symptoms.

To oversimplify, when a nation consumes more than it produces, by definition, it spends more than it earns, and therefore must borrow from foreigners to pay for the difference, which is the trade deficit. This process has been an important contributor to the overall buildup of debt in our society.

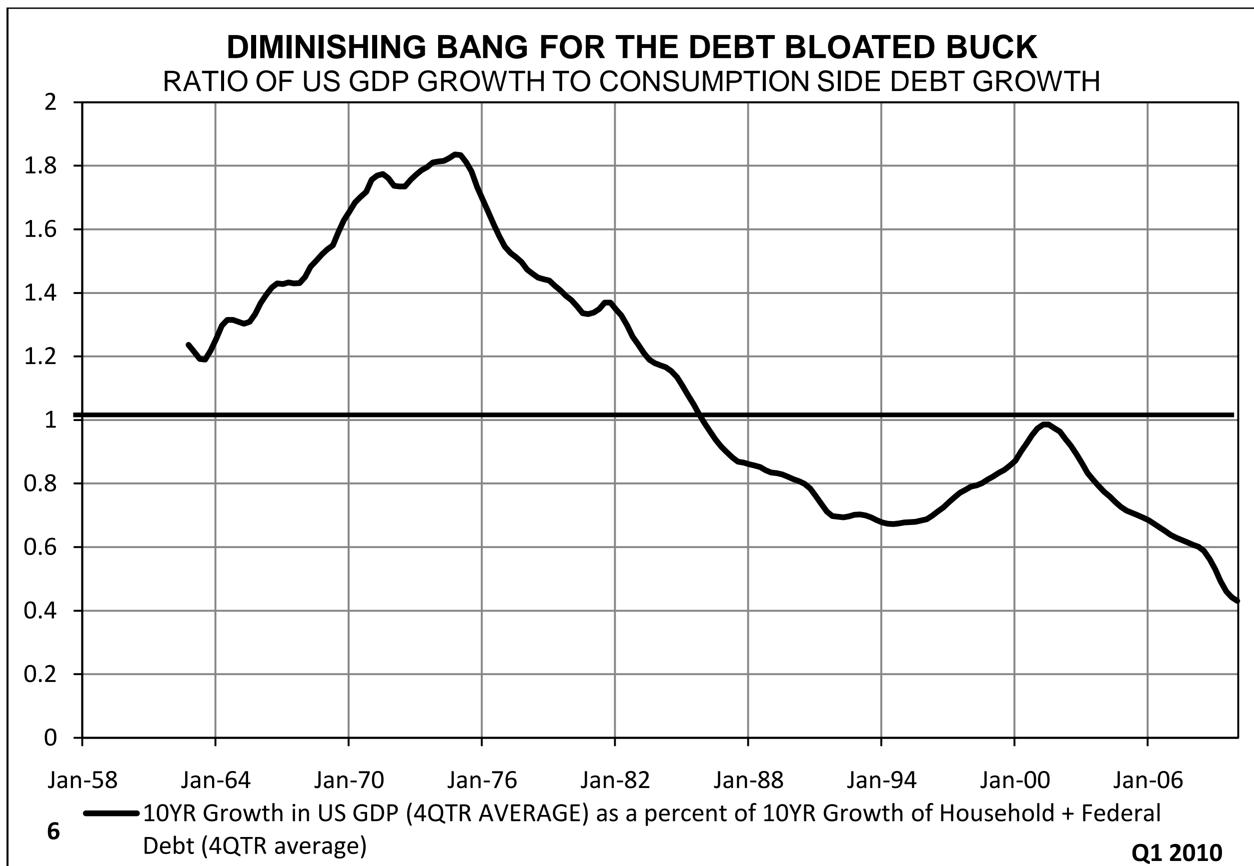
On our next chart, we examine the relationship between the trade deficit and consumption side debt. Please note that since our trade position went negative, we have been forced to pile on consumption side debt, more or less in lockstep with the trade deficit. **The trade deficit is the primary underlying cause of the over-indebted position of the United States of America.**



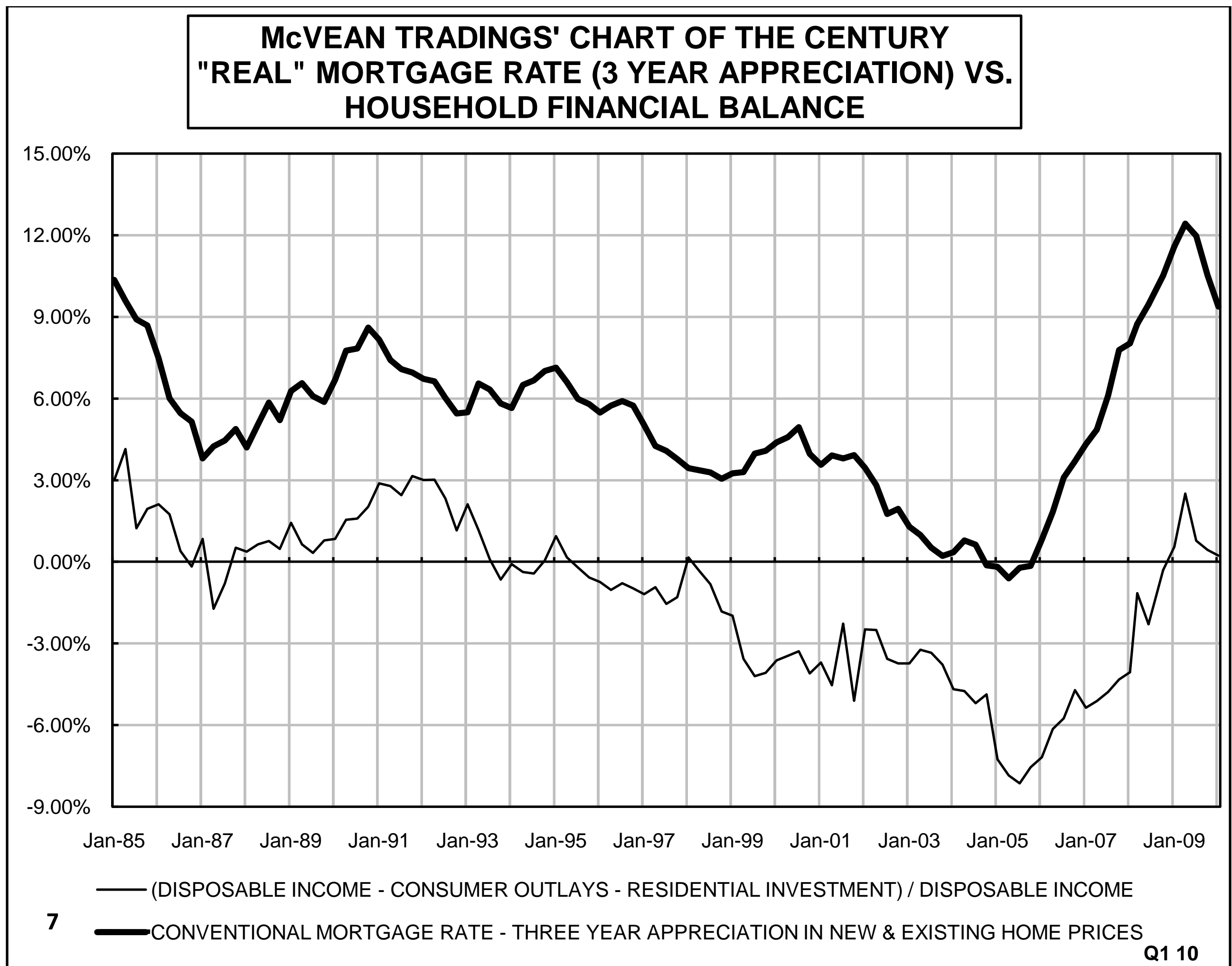
Many economists prefer to begin an analysis of aggregate debt with a chart which shows total non-financial debt as a percent of GDP. In our opinion, it is far better to strip out supply side debt, i.e. business debt, and focus on consumption side debt, for which we use total federal plus household debt. Here we see the obviously unsustainable explosion in consumption side debt.



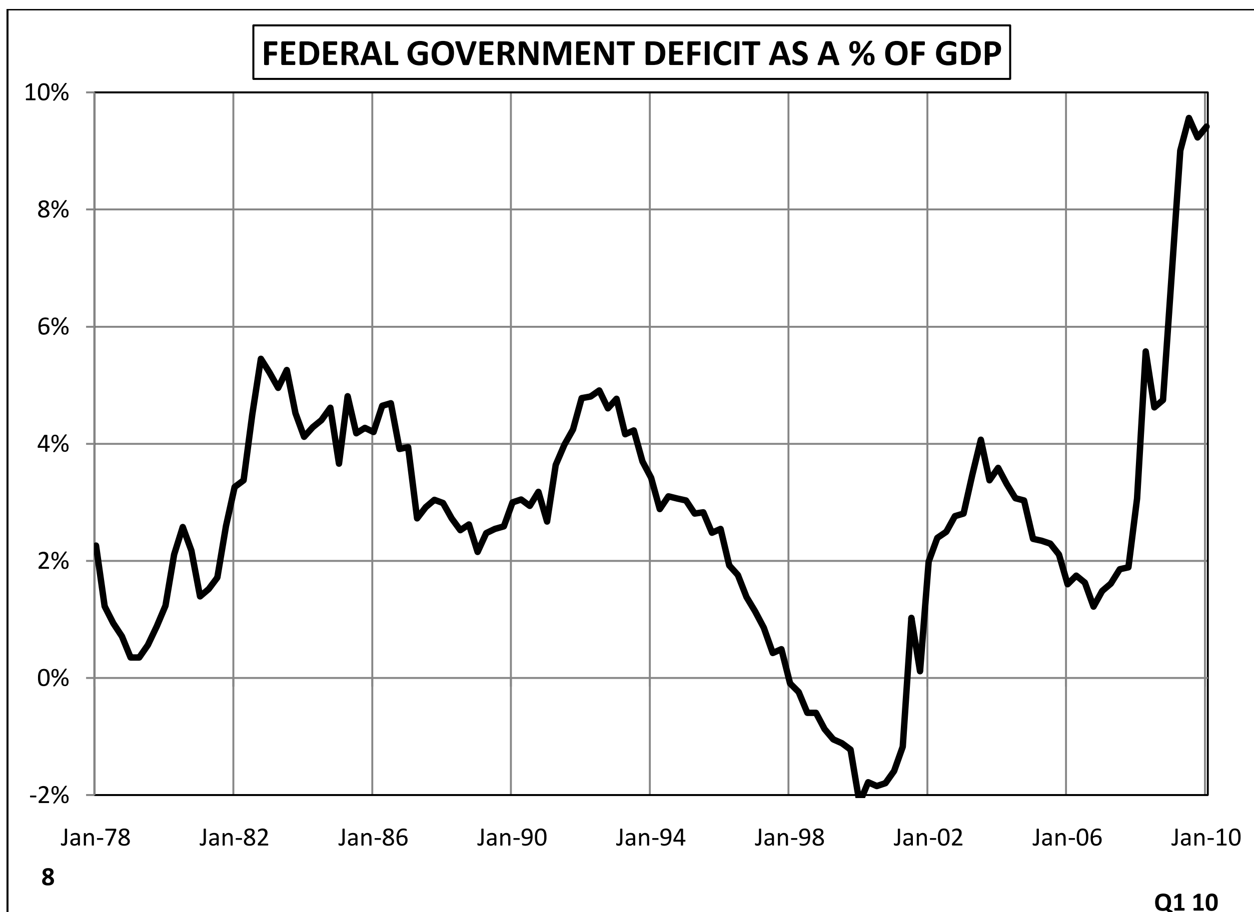
Ominously, on Chart 6 we observe the diminishing increase in nominal dollar GDP growth relative to consumption side debt accumulation. Credit can only go so far to offset the negative impact on demand of anemic labor income growth. Going forward, policy must be directed toward restarting labor income growth. Ultimately, organic income growth is the only way to reduce the mounting welfare obligations of the government. **Unless "the land of opportunity" gets its act back together and learns to put its people back to work, it will inevitably experience economic, political, and societal failure.**



When a country runs a trade deficit, we know that one or more of its three internal sectors (household, business, or government) is spending more than its income, and going deeper into debt in the process. From 1993 to 2007, it was the household sector which relentlessly overspent its income. As we see on our **Chart of the Century**, this spending binge was a result, more than anything else, of rapid house price increases relative to prevailing mortgage rates. But now the household sector can obviously no longer spend more than its income and must begin to save (both to repair overleveraged balance sheets and to brace for the coming retirement of the baby boomers).

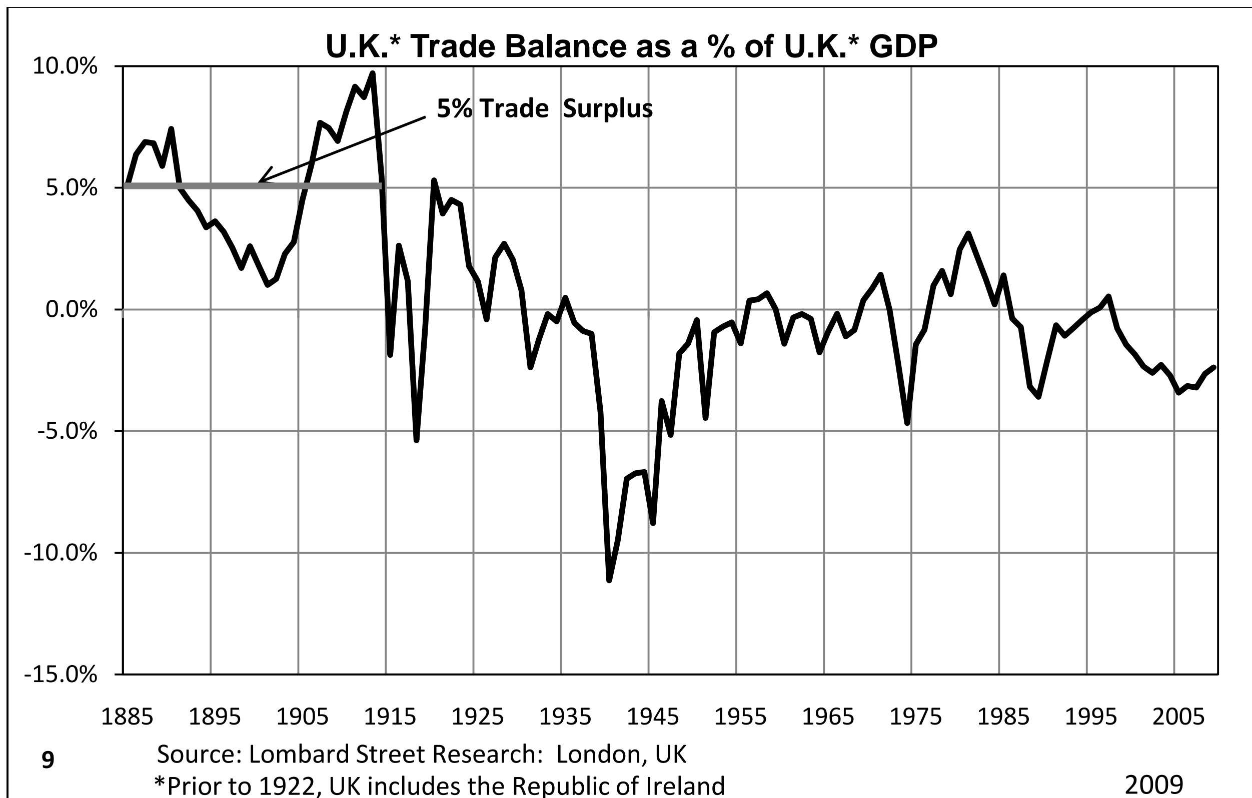


<u>From here forward, if 1.) we persist in running a trade deficit, and 2.) the household sector is in balance or surplus, then 3.) the domestic business sector has no apparent incentive to lever up, and therefore, 4.) the only available conduit for financing of the trade deficit is the federal deficit. Unfortunately, no other sector of our economy is willing or able to pay the bills for our excess spending.</u> Through this process, we see that indeed the trade deficit is causing at least a large part of the federal deficit. If the trade deficit is reducing employment and thereby reducing tax receipts on the one hand, and increasing unemployment benefits on the other, it is easy to see that it is increasing the federal deficit. This is not to mention the massive stimulus programs brought about by the weakened economy, which as we have demonstrated, was itself largely caused by the trade deficit. At any rate, superimposing trade deficit financing, on top of rising domestic obligations, will soon be too much for our already overly indebted government to bear.



<u>Years ago, Ross Perot was at least partially correct about his "giant sucking sound," it was just that so few others could hear it yet.</u> No wonder, it gets confusing when cause and effect reverse roles in important macroeconomic relationships. This is one critical reason why all econometric models are doomed to failure, often at the most inopportune moments. At any rate, we must now recognize that the chain of causality running between the US trade deficit and US aggregate domestic demand has reversed course, like a giant aircraft carrier turning 180 degrees. During the go-go years we call "The Age of Finance" (1993-2007), credit induced overspending by the US private sector, relative to domestic production, drove the US trade deficit wider. However, for years easy credit masked the problems, and created the illusion of economic vitality. But in the meantime, the ensuing import penetration has decimated our industrial infrastructure, and the credit frenzy has exhausted itself. Now finally the trade deficit has gotten the upper hand and everyone should hear Mr. Perot's sucking sound very clearly. The transmission mechanisms include: A) reductions in labor income growth, B) credit restrained workers no longer able to spend as much relative to their incomes, C) lack of domestically produced goods, and D) reduced investment demand for onshore plant and equipment. Investment demand is afflicted not only by the structural shift of capacity offshore, but also by reduced expectations for future growth in demand for domestic output.

Our final chart, within the limits of available data, addresses the relationship between structural trade balance and global geopolitical status. Here we note that Britain, in its final 30 years of international dominance, enjoyed an average 5% trade surplus in the prewar period. Our point– **the naïve notion of a super power, the United States of America, which incurs a sustained structural trade deficit is, at best, oxymoronic**.



Of course, we fully expect to hear from free market purists who contend that "Mr. Market" will somehow cure our worsening structural trade deficit, if only he is left to his own devices. Much of this group also felt that credit market excesses were self-correcting. Free marketeers are wrong again about the trade deficit, once more we are at the point where only government policy can offer solutions.

Fortunately, there are very positive ways to go about correcting our trade position. **Any successful strategy, however, must address two independent priorities: A) it must close the Transportation Trade Deficit, and B) it must create large numbers of decent paying US jobs**. A special challenge, associated with this dual mandate, is that many supply side responses to the energy deficit, for example, building nukes and windmills, will unfortunately not create many jobs. Perhaps then, we should focus harder on the demand side of the energy equation.

Accordingly, Chapter 2, to follow in the near future, will address our plan for moving forward: "**The Wholesale Electrification of Intra-City Personal Transportation in the United States of America**." Our strategy stands on four pillars, they are: A) the electric motor is vastly more efficient than the internal combustion engine, B) electric power plants, regardless of fuel source, enjoy enormous economies of scale, C) at night, there is excess capacity in our nation's generation systems, and D) the magic of lithium battery technology now offers the glue to bind it all together. We recommend to you the work of **"The Electrification Coalition"*** for a virtual gold mine of information on these subjects. **Going a step further, as mentioned earlier, our plan would target the elimination of the Transportation Deficit, to include the auto component, as well as the energy component. To do so, we would seek unequivocal US dominance in the technologies and processes involved in electric vehicle production and supportive infrastructure.**

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