Funding the Future

Are government debt and trade deficits linked – and d...

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I was asked this question on the blog yesterday by Anja Cradden:

I have a slightly related, slightly tangential question… is there a relationship between the size of government debt and the trade deficit?

If we want to pay down government debt and stop transferring interest payments to wealthy 'depositors' with the UK government in the form of gilts, would becoming a net exporter help us do that?

Am I wrong in having a hunch that low post-WWII asset prices were a contributing factor to high post-war productivity growth?

Is there something wrong in my feeling that a pretty high, properly anti inflationary wealth tax designed to drastically lower asset prices could contribute to productivity growth in the UK economy, allowing us to export more and allowing us to pay down our government debt without employing austerity against our population?

The way this relates to my thoughts on Trump in Venezuela is that I wonder if the rich in the USA do not want to address their asset price bubble with asset price drops and are looking to resolve their trade deficit issues and prop up asset values by incorporating exports of Venezuelan oil wealth into the U.S.A. 'export ledger' instead of addressing their internal economic problems, my feeling here being that if the trade deficit and government debt are linked in this way, is a long term government debt a sign that a country is living 'beyond its means'? That is, importing more value than it exports? And that in the end that will have to be accounted for by a period of rebalancing by exporting more value than we import if we want to avoid a trajectory towards wars of imperialism to shore up our excess consumption?

That was a bit of a mega question, requiring a substantial response. This is it:

There is a persistent belief that long-term government debt signals that a country is "living beyond its means". That intuition usually rests on an analogy with household borrowing. It is also wrong. But it does touch on something real, which needs to be explained.

The accounting reality

In any economy, three financial balances must sum to zero:

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The government balance

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The private sector balance

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The external (trade) balance

This is not a theory. It is accounting. There is an explanation in this blog's glossary under the technical description of sectoral balances, which explains what these balances, together, create.

What this means is that if a country runs a trade deficit, importing more than it exports, then someone domestically must run a deficit to pay for that. In turn, that means that if households and firms want to save overall, as they usually do and as governments encourage, at least with regard to the household sector, then the government will have to run a deficit instead, if income is not assumed to decline. That is not profligacy. It is the mechanism that the sectoral balances require. It also stops the economy from contracting.

So, a persistent trade deficit will often coincide with persistent government deficits and a rising stock of government debt. The debt is not the cause. It is the accommodation for what is happening elsewhere in the economy. This is the government acting as the borrower of last resort.

Would becoming a net exporter change this?

A country becoming a net exporter might change this, but not in the way many imagine.

A trade surplus allows the private sector to save without requiring the government to run deficits of the same scale. That can make it easier to stabilise or reduce the stock of government debt over time. But exporting more does not automatically "pay down" debt, and it does not eliminate the need for fiscal policy. It simply changes the space in which fiscal policy operates.

More importantly, the fastest way to reduce the burden of government debt is usually not to repay it, but to control the interest paid on it. Debt interest is a policy choice to be preferred to the alternative of running government surpluses, which usually impose a real cost on society by voluntarily reducing economic activity, often through the imposition of austerity. Being a net exporter is not, then, a panacea.

Asset prices, productivity, and rent extraction

Turning to the next part of the question, there is a strong case to be made that high asset prices are a drag on productivity, especially in economies like the UK.

High land and property prices raise business costs, divert capital into speculation, and reward rent extraction over innovation. Meanwhile, financial capital is saved to match asset inflation because that is seen as safer and more profitable than funding productive risk. The result is weak investment, poor productivity growth, and rising inequality.

The post-war period is instructive. Asset prices were low, capital was controlled, finance was constrained, and investment in productive capacity was high. Productivity growth followed. This was not an accident. It was by design.

Increased taxes on wealth and the income and gains derived from it could help reverse this, but only if they were part of a broader strategy that included labour reforms, public investment, industrial policy, competition policy, credit regulation, and a proper approach to climate change. Asset price deflation alone is not enough.

Is long-term government debt a sign of excess consumption?

This is not the case in a monetary sense. A currency-issuing government does not “run out of money”. It is impossible for it to do so, meaning that the question does, in itself, not make complete sense.

However, a trade deficit is a real resource issue. It reflects import dependence. That creates vulnerability to inflation, to supply shocks, and to geopolitical pressure. If elites refuse to rebalance internally, whether by taxing wealth, curbing rent extraction, and investing productively, the temptation is to rebalance externally instead. History shows that this can lead to economic problems, which were traditionally addressed through overseas exploitation, a route that should no longer be available to any country.

The real choice

What all this means is that the real choice is not between debt and virtue. It is between:

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building domestic productive capacity and reducing import dependence, or

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sustaining living standards through asset inflation, financialisation, and external leverage

The former requires confronting wealth and power at home. The latter risks drift into coercive geopolitics abroad, as is now being seen in the case of the USA.

Government debt is not the warning light. Trade dependence combined with asset-led inequality is.

I hope that helps answer the questions.

See also this morning's post on sectoral balances, also written in response to this question.

Tickets are now on sale for the **Funding the Future live event in Cambridge** on 28 February. **Tickets and details are available here.**

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