Financial Powder Keg: The Global Economy, Geopolitics and the World Situation

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The 2013 summer sun, far from having brought the lull for which some hoped, has continued to heat finance, the economy, and especially global geopolitics white hot.

The Syrian apple of discord has shown the extent to which the international community was no longer one; the economic news, despite all the tricks possible, stubbornly refuses to announce a long awaited recovery; currency wars have flared up again, hitting the emerging countries head-on; sovereign bond interest rates are now out of control…

Unfortunately, the coming autumn will not calm things down. The end of the political summer break is, in fact, under pressure in Washington between discussions on Syria, the budget vote, the debt ceiling, etc. The extreme divisions between Democrats and Republicans makes this period full of danger.

The end of the financial summer break is no less so with the famous tapering on the agenda, that's to say the progressive reduction of the Fed's programme of Quantitative Easing which deals with the economy single-handedly; with the aftermath of Detroit's bankruptcy; and with the major Western banks withdrawing their support of the US government of necessity.

Finally, the end of the geopolitical summer break also promises to be eventful itself: the emerging countries, scalded by speculation in their currencies, certainly aren't going to sit idly by, which promises a real firework display in the foreign exchange markets and, in addition, they will wish to take advantage of their victory on Syria to increase their powers.

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The political soap opera begins again in Washington

We had almost forgotten the differences between Democrats and Republicans whilst there has been so much international news. But those interested in the twists and turns of the series “alert in Washington” will be kept in suspense for many more weeks (1).

Between the discussions on Syria (now without any stakes but reflecting the Western summer gamble as we will see), the 2014 budget and the debt ceiling, the Republicans will use all their blocking power to extract maximum concessions from Obama. And it goes without saying that they are ready to fight to the finish, either by sacrificing reform of the US healthcare system or slashing other social spending (or, better, both) (2).

Clearly, with the dangers posed by the absence of an agreement on these issues (3), no doubt a last-minute compromise will be found or, more likely, a few hours or days after the deadline. This compromise will increase the pressure further on the millions of Americans who depend on government benefits (4).

Nevertheless, the spectacle of a United States torn apart which we will be offered is a new body blow to the country’s credibility, an additional useless nervousness on the markets, an unwelcome game played on foreign creditors’ nerves and China first of all. This will be the cacophony too far which will put an end to the shaky confidence in what remains of the world’s leading power. And without confidence, the country loses everything that keeps it alive.

Unfortunately, the GEAB readers know that this is the home straight of the United States’ inevitable deterioration in influence, which we will discuss later since it is essential reading to understand world developments which are underway.

In short, in the coming months US politics is the first of the three sparks capable of lighting the fuse connected to the powder keg of the global economy which hasn’t yet completely cut the umbilical cord with Uncle Sam.

The Fed loses control

Worse, as we have repeatedly announced, US Treasury bond interest rates are now out of control. In spite of the $45 billion dollars’ worth of US public debt purchased by the Fed every month, in spite of a reduced Treasury bond issuance thanks to a reduction in the federal administration’s budget deficit, interest rates continue to rise.

If it were just a question of rumours of a reduction in QE3 then, first, they would have begun their rise after that, which isn’t the case; secondly, that a rumour of a 10% reduction in QE3 will cause more than a 1 percentage point rise in the 10 year bond interest rate does not bode well for what will happen when the Fed stops its support completely.

10 year US Treasury bond interest rate: at left, September 2012 – September 2013, at right, from 20 April to 31 May 2013 (source : MarketWatch/LEAP). The first tapering rumours appeared on the 13 May and were confirmed by Bernanke on the 19 June.

Thus it is understood that the Fed no longer controls anything and that the effects of its subsequent announcement only serve to make believe that it still controls the situation. Anyway, QE3 is of no help at all to the real economy because it only supports the formation of a bubble in the financial and real estate markets (5), which is why it doesn't balk too much at reducing it by disguising it as a consequence of a so-called consolidation of the economy. Everything is only a matter of image, the only thing that the Fed still succeeds in keeping at the moment.

In reality it doesn't really have a choice: in addition to its balance sheet which is growing dangerously, the general opinion now is that the cure is worse than the disease by constantly deferring the confrontation with reality and the bursting of the above- mentioned bubbles. Not to mention, of course, the political pressure undoubtedly exercised by China and other countries. In addition, the Fed must, above all, preserve the Dollar's international role, which is vital to the American economy which wouldn't emerge unscathed from a change in the international reserve currency: in particular, that requires maintaining its value and, for that, increasing US bonds' attractiveness. Thus, it's remarkable to note that despite the rumours of a tapering from September (6) which would reduce the amount of dollars printed every month, despite the rumours of a war in Syria which would have usually caused a "flight to the dollar", the dollar hasn't risen against the Euro, proof that it really needs a boost to avoid an extremely damaging sharp depreciation. We will return to the absence of a "flight to safety" caused by the risk of an attack on Syria, a tell-tale sign of a worrying change of mind for the United States.

This loss of control over interest rates is the second spark close to the powder keg, a huge spark which looks more like a blow torch.

The next Cyprus will be American

But it's not only government bonds that are in freefall. Following Detroit's bankruptcy, the Munibond market (US municipal bonds) is itself also extremely tense (7) as the following chart shows.

This is an alarming situation for many American cities which will inevitably lead to other significant bankruptcies in the coming months. In separating municipal and national debts, better numbers are shown certainly, but the risks are doubled.

20 year municipal bond interest rates. Source : Saint-Louis Fed.

Puerto Rico seems to be amongst the next market victims which seems to be already struggling with unsustainable interest rates (8).

This is reminiscent of the Cyprus incident, except that Puerto Rico's population is three times bigger; and that isn't happening in Europe but in the US sphere. Let's bet this time that the island will be considered insignificant, unlike Cyprus…

Notes:

(1) Source: ABC 7 News, 07/09/2013.

(2) Sources: Fox News (27/07/2013), CNN Money (06/09/2013), Huffington Post (10/09/2013).

(3) Read for example Fiscal Times (10/09/2013) on the consequences of blocking on the debt ceiling.

(4) Read for example New York Times (05/09/2013) on the reduction of benefits paid to an ever increasing number of people dependent on food stamps.

(5) Speaking of domestic consequences for the US are the only ones which count in the country's eyes despite the Dollar's still prominent global role, which should make American leaders aware of their responsibilities on the international stage. That has never been the case in the last 40 years, and it's not during a major crisis involving the country's survival that that will change.

(6) Source: CNBC, 28/09/2013.

(7) Read for example The Future Tense, 29/07/2013.

(8) Source: Wall Street Journal, (09/09/2013).

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