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Headwinds for the US Economy

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> "In the long run, we are all dead." John M. Keynes (1883-1946)

> Fourth sorrow: "There is bankruptcy, as the United States pours its economic resources into ever more grandiose military projects and shortchanges the education, health, and safety of its citizens."Chalmers Johnson, (Sorrows of Empire)

> "The moral and constitutional obligations of our representatives in Washington are to protect our liberty, not coddle the world, precipitating no-win wars, while bringing bankruptcy and economic turmoil to our people." Ron Paul, U.S. Representative (R – TX)

In 2004, it was revealed that Saudi Prince Bandar had promised President George W. Bush that Saudi Arabia would increase oil production and **lower oil prices** in the months before the 2004 presidential election—to ensure that the U.S. economy was strong on election day. This was exposed in Washington journalist Bob Woodward's 2004 book "**Plan of Attack.**". In the weeks leading up to the November 7 (2006) midterm elections, there is renewed optimism that falling oil and commodities prices, coupled with a soft housing market, will persuade the Federal Reserve to lower interest rates next year, and not raise them further. The bond market, while also sending messages that inflation is not an immediate threat, seems to forecast slower economic growth in the coming years, and possibly negative growth for one quarter, while the risk of a recession (two consecutive quarters with negative growth) is not negligible. The downturn in the housing market alone would account for a big chunk of this decline in economic growth, as capital spending slows down and as banks see their mortgage business contract.

Because of the aggressive low interest rate policy that the Fed pursued after 2001 and because of such financial innovations as **interest-only mortgages,** construction and its related industries are one of the three economic sectors which have created new employment since 2002, the other two being the health and military sectors. —However, as a consequence, many over-leveraged homeowners risk being caught in a 'negative equity' trap in the coming months, when the value of their mortgaged assets is not sufficient to cover the amounts borrowed. In the past, such squeezing has resulted in increased foreclosures and banking difficulties.

A downturn in construction would have the negative impact of removing one of the three pillars of employment growth in the U.S. —Therefore, we can understand why the Fed is weary of raising interest rates further. The Fed, in fact, is caught in a dilemma: it cannot raise interest rates much higher for fear of creating an unmanageable collapse in the housing market. However, the U.S. is running large **current account external deficits** ($-791,5 billion in 2005). And, because the American economy needs to draw a large amount of capital from abroad to finance its deficit spending, American interest rates must remain competitive.

Indeed, under the Bush administration, a combination of large tax cuts and large increases in military outlays to wage costly wars abroad have stimulated the economy, in a Keynesian way. However, this has also pushed the U.S. budget deficit to record current-dollar levels. In five years, from 2002 to 2006, the cumulative federal budget deficit has exceeded one and a half trillion (1.5 trillion) dollars. —Since the rest of the U.S. economy was also in deficit, the only exit was to borrow abroad the necessary cash. The United States is still borrowing abroad more than $2 billion a day just to keep this binge of expenses going. From whom? Mainly from China, Japan and some oil-rich Middle East countries which hold tons of U.S. dollars.

As a consequence, foreigners own an increasing share of the federal public debt, that share presently being estimated at $2.1 trillion or about 42 percent of all the public debt held outside the government (about $5.0 trillion in a total debt of $8.6 trillion). These foreign holdings represent an amount that is 17 percent of GDP ($12.3 trillion), a share that is increasing fast toward 20 percent of GDP. Keep in mind that this percentage was less than 1.5 percent in 1970 and less than 1 percent in 1946.

What does it all mean for the **U.S. dollar**? As a reserve currency, there is a built-in demand for the dollar from central banks and from worldwide operators, such as oil traders, who deal in dollars and who are big buyers of U.S. securities. These purchases have the double benefit of shoring up the dollar and of keeping U.S. interest rates low. That is why the foreign demand for U.S. dollars is not going to collapse overnight, even if relative American interest rates were to stay flat for a while. In this sense, it can be said that the U.S dollar has some resilience. This is one of the **"seigniorage" benefits** that accrue to the United States because its currency is held abroad as a reserve currency. —In the short run, measured in months, the U.S. dollar should continue its rebound against other major currencies, as long as oil and commodities prices are soft and as long as U.S. interest rates remain firm. However, in the longer run, measured in years, the dire external financial situation of the United States should begin to weigh more heavily on the dollar.

One currency against which the U.S. dollar is expected to decline is the **Chinese yuan.** Since July 2005, the yuan tracks a basket of currencies that includes the yen, the euro, the Hong Kong dollar and the South Korean won. Previously "pegged" to the dollar at the rate of about eight yuans for one dollar, the yuan has begun a slow appreciation toward the dollar and stands at a value of 7.9 yuans for one dollar, or at a price of about 12.6 US¢.

But, at this rate, the yuan is way undervalued and should be revalued substantially more to reflect China's huge external trade surpluses. Indeed, China has accumulated foreign **exchange reserves** in excess of $950 billion, which are invested roughly three-quarters in U.S. Treasury bills and other dollar-denominated assets, the rest being invested in other currencies. However, the Chinese government has expressed a wish to **diversify** somewhat its pool of foreign exchange reserves toward the euro or the yen and even increase its strategic stocks of oil.

In 2005, China attempted to spend some of its U.S. dollars to buy an American oil company, **Unocal**, for about $18.5 billion. However, the Chinese offer was unceremoniously rebuffed by the U.S. Congress.

A similar fate was met by Dubai-owned Dubai Ports World in early 2006, when it bought a British company (Peninsular and Oriental Steam Navigation Co or P&O for $6.8 billion) that happened to manage six U.S. ports. The company was forced to disinvest itself from its American interests by the **U.S. Congress**. —The message sent to foreign lenders was loud and clear: if you accumulate American dollars, deposit the money in our banks or buy U.S. government securities (Treasury bills), but do not attempt to invest them in income-generating real American industrial assets. How long will that scam last? Nobody knows. But, it most likely won't last forever.

The central question is how long will confidence in the U.S. dollar hold in the face of all these factors. If you add the widespread unpopularity that the Bush administration has bestowed upon the United States around the world, it is more likely than not that the value of the U.S. dollar, after the current show of strength, will continue eroding in the coming years. A lower currency translates into more imported inflation and makes it difficult to maintain low interest rates. The stage would then be set for a bout of stagflation, that is to say creeping higher inflation and slower economic growth..

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