Stagflation is Here

By Prof Rodrigue Tremblay
Global Research, January 31, 2008
31 January 2008

Region: USA
Theme: Global Economy

War—after all, what is it that the people get? Why—widows, taxes, wooden legs and debt.

Samuel B. Pettengill

"Armies, and debts, and taxes are the known instruments for bringing the many under the domination of the few.

James Madison, 4th U.S. President (April 20, 1795)

"Let me issue and control a nation's currency and I care not who makes its laws".

Nathan Rothschild, 1791

Last summer, I observed that there was a "solvency crisis" underneath the ongoing subprime mortgage liquidity squeeze. Central banks can alleviate a "liquidity crisis", but they cannot solve a solvency crisis.

Last year also, before the events, I warned that the U.S. was heading toward stagflation.

This was due to three fundamental factors.

First, the structural fiscal imbalances of the federal budget in a period of prosperity, as a result of the Bush-Cheney administration's continuous deficit spending linked to the Iraq and Afghanistan wars and to its large tax cuts;

Second, the over-indebtedness of the overall U.S. economy coupled with an overall saving rate close to zero (in 1981, it was 12 percent), and, as a consequence, the rapidly increasing foreign debt of the U.S.; and,

Third, the required decline in the U.S. dollar to reverse and correct the deteriorating American balance of payments. The second factor was a harbinger of less consumer spending in the coming months while the third factor would stoke the fire of overall inflation. And with already high budget deficits, there would be less leeway for an aggressive fiscal policy to sustain economic activity. The table was thus set for a bout of stagflation, i.e. slow growth and rising inflation.

Now, stagflation is here. —Economic growth is slowing down, M3 money supply numbers, as a measure of overall liquidity in the economy, are in the double digits range, the yield curve has inverted and become negative (short term rates higher than longer term rates) and the U.S. dollar has become one the weakest currencies in the world. All this as American twin deficits (balance of trade and federal government budget deficits) are at record levels. —As I pointed out last year, " A lower currency translates into more imported inflation and makes it difficult to maintain low interest rates," even if, in due time, it will improve the trade balance. This means that, for all practical purposes, monetary policy is also severely constrained in what it can now accomplish. For all of 2007, inflation hit 4.1 percent, which is two-thirds more than in 2006 when inflation registered at 2.5 percent. Moreover, the surge in wholesale prices announces even higher inflation in the months ahead.

With inflation being on the rise and real interest rates already in negative territory, aggressive monetary stimulus would likely be counterproductive, because too low interest rates would encourage capital outflows, pushing the dollar further down, and translating into more imported inflation. On top of that, one has to remember that monetary policy shifts take at least nine to twelve months before impacting the real economy. One has also to keep in mind that the U.S. operates, more and more, in an international environment, and is less and less capable of influencing the domestic economy by manipulating one variable only, such as the interest rate.

Of course, the Fed could have played a better preventive regulatory role if it had intervened in 2003-04 to reign in the unsound banking lending practices that have led to the subprime debacle. But the milk is out of the bottle now, and nothing can erase the damage done to the housing construction sector and other parts of the economy because of this lack of oversight.

After seven years of continuous indulging, of borrowing and debt building, the U.S. federal government is also in a fiscal bind and will find it difficult to effectively counteract the slowdown in the economy. Indeed, over the last seven years, the Bush-Cheney administration has run fiscal deficits on the average of $461.29 billion each year, for a grand total of $3,229 billion of cumulative of on-budget deficits.

This makes it harder to embark upon a new round of deficit spending to stimulate the economy. For one, fiscal policy shifts have even a longer time horizon before impacting the real economy. Secondly, the coming slowdown and recession will worsen an already high federal government deficit, as government receipts decline with the rise in unemployment and the drop in income growth. On the spending side, the Iraq war, in particular, is a black hole that siphons off more than $100 billion each year, with no end in sight. Oil prices are also very high, partly because of high world demand, partly because of geopolitical instability and partly because of the lowered dollar.

After seven years of foreign policy madness and of empire building on a mountain of debt, and of public indulging and private gouging, the financial crisis and credit crunch, the plummeting dollar, the high price for oil will all contribute to the 2008 economic slowdown, which is likely to turn into a recession, during the first half of the year, if it is not already into one since last December. The downturn in the world stock markets during this month is another clear indication that something is wrong, not only with the U.S. economy, but also with the world economy.

All that would seem to be very bad news for George W. Bush's Republicans, just as it was bad news for the Democratic Carter administration in the late '70s. Indeed, over the last century, the U.S. economy has been in a recession four times in the early part of a presidential election year, according to the National Bureau of Economic Research. In each of those years — 1920, 1932, 1960 and 1980 — the party of the incumbent president lost the election.

Rodrigue Tremblay is professor emeritus of economics at the University of Montreal and can be reached at rodrigue.tremblay@yahoo.com

He is the author of the book 'The New American Empire'

Visit his blog site at: www.thenewamericanempire.com/blog.

Author's Website: www.thenewamericanempire.com/

Check Dr. Tremblay's coming book "The Code for Global Ethics" at: www.TheCodeForGlobalEthics.com/