

Storm clouds gather over US economy

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The New York stock market ended the week with a 143 point fall amid rising concerns over the Brazilian financial crisis, whether the Internet stock bubble has finally burst and the long-term prospects for the continued expansion of the US economy.

It is now a week since the Brazilian monetary authorities decided to withdraw support for the *real*, during which time the currency has plunged 31 percent. While the fall is not yet of Indonesian proportions, it is still enough to cause nervousness in financial markets. The devaluation was aimed at trying to halt the flood of money leaving the country, but over the past five days money has moved to the tune of \$300 million a day. Since last September Brazilian currency reserves have dropped from \$75 billion to less than \$30 billion.

An ominous sign for financial markets was the intervention on Friday by the monetary authorities to try to defend the value of the *real*. Traders said the Central Bank used at least \$100 million of its dollar reserves amid speculation that if the decline continues, more drastic measures, including currency controls, may be implemented.

The international financial markets are demanding further tax cuts and reductions in government spending as part of the "austerity drive" already being implemented under the direction of the International Monetary Fund.

There are growing fears that the devaluation could bring higher interest rates, leading to a situation where the government will be unable to pay its debts and would have to renegotiate payments on its \$300 billion in domestic debt. And the figures point to some kind of "rescheduling" if not an outright default.

According to the government's own estimates, if interest rates are 22 percent the debt cost amounts to 7.3 percent of gross domestic product. But the Central Bank's official leading rate is already nearly twice that level, at 41 percent.

If Brazil were to default, then the conditions of credit crunch which gripped financial markets last September and October in the wake of the Russian default could quickly return.

Fears that the Internet bubble, which saw stocks like the on-line bookseller Amazon.com increase by 966 percent last year, may have now burst also sent stocks falling. Among those joining the chorus predicting a collapse of the Internet bubble was Morgan Stanley Dean Witter global investment strategist Barton Riggs who warned that the spiral in Internet stock "will come to a very bad end."

The inherent instability of Wall Street and the mounting problems for the US economy in general were the subject of testimony delivered by US Federal Reserve Board chairman Alan Greenspan to the US House of Representatives Ways and Means Committee.

While hailing what he called "America's sparkling economic performance", Greenspan pointed to a number of signs of emerging problems. There was, he indicated, a "decided softness in a number of manufacturing industries as weaknesses in many foreign economies had reduced demand for US exports and intensified competition from imports." This could bring about a quite rapid contraction because with corporations already relying increasingly on borrowing to finance capital investment "any evidence of marked slowing in corporate cash flow is likely to prompt a relatively prompt review of capital budgets."

The situation in Brazil and "its potential for spilling over to reduce demand in other emerging market economies also constitute a possible source of downside risk for demand in the United States."

Greenspan devoted a considerable portion of his address to what he called "one key element behind our current prosperity"--the rise in the stock market and its relationship to the increase in consumption spending in the US economy as a whole.

He pointed out that analyses of consumer spending tended to concentrate on income from labour and capital as the main source of funds. But during the 1990s, capital gains, reflecting anticipated future income, "have taken on a more prominent role in driving our economy".

This effect could be seen in the decline in the measured savings rates from around 6 percent in 1992 to virtually zero today. Coupled with the fact that almost all of the decline in savings is accounted for by the upper 20 percent of the population, where virtually all the capital gains arising from the appreciation of stocks have accrued, this indicates that the "wealth effect" has been significant.

As a consequence, Greenspan told the Congress committee, a "flattening of stock prices would likely slow the growth of spending, and a decline in equity prices, especially a severe one, could lead to a considerable weakening of consumer demand."

While Greenspan did not deal with the international ramifications of such an event, it would almost certainly lead to a global recession. With Japan in recession, the East Asian economies experiencing the equivalent of a 1930s Depression and with economic growth in Europe barely 2 percent, the US economy, and particularly US consumption spending, has become one of the major props of the world economy.

But with US consumption spending increasingly dependent on rising stock market prices this raises the \$64 billion question for the world economy: how much longer will the rise in US stock values continue?

Not much, it seems, in Greenspan's opinion. He told the committee that despite increased demand and improved productivity corporate profits had fallen in recent quarters and that therefore "the recent performance of equity markets will have difficulty in being sustained."

"The level of equity prices would appear to envision substantially greater growth of profits than has been experienced of late," he warned.

There were also dangers on the financial side, like those which developed last September and October during the credit crunch following the Russian default and the fears surrounding the hedge fund trader Long-Term Capital Management.

"Markets have doubtless stabilised significantly after the turbulence of last fall," Greenspan told the

Congress, "but they remain fragile, as the repercussions of the recent Brazilian devaluation attest. Moreover, our chronic current account deficit has widened significantly, in part reflecting the strength of domestic demand that has accompanied the further accumulation of capital gains. The continued increase in our net external debt and its growing servicing costs are not sustainable indefinitely."

Most of the discussion following the report centred on Greenspan's opposition to Clinton's plan to invest government funds in the stock market to finance social security. One question however raised the implications of the worsening trade and debt position of the US for the long-term stability of the economy.

Greenspan began by pointing out that for the past period the American balance of payments gap--largely the result of the excess of imports over exports--has been financed by the inflow of capital into the country as foreign investors and governments seek to hold dollars. But such a situation could not continue indefinitely.

The problem, he said, was that as net foreign debt rises, interest and dividends payable overseas continues to rise. This in turn created conditions where, if foreigners stop accumulating dollars, "it creates a major reverberation back on the American economy, which has to adjust."

"We have seen no evidence of that phenomenon arising. We know it as a problem only in the abstract and the arithmetic of the issue, that the rise in the net debt cannot continue indefinitely. And the question is: What does that mean? Where is the end of that rise?"

"It is a question we have addressed ourselves to in some considerable detail--that we have not been able to answer ... effectively."



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