US economy: How long can 'impossible balancing act' continue?

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As befits the central banker of the world's most powerful capitalist nation, US Federal Reserve Board chairman Alan Greenspan tries to convey the impression that he has a firm grasp of what is taking place in the world economy. But every so often one gets a glimpse that behind the delphic utterances on the state of the American economy and the international markets, the financial chiefs of capitalism do not fully understand what is taking place, much less have policies to deal with the mounting crisis of the global economy.

One such incident took place on Tuesday during Greenspan's semi-annual Humphrey-Hawkins testimony to the US Senate Banking Committee. Answering a question on the escalation of US stock market prices--a process he famously described over two years ago as "irrational exuberance"--Greenspan said that "the dramatic acceleration in technologies and the marked increase in productivity and profitability of American businesses has undoubtedly had significant impact on the underlying prices of all capital assets, including equities".

But the Wall Street spiral could all go horribly wrong.

"Whether or not it is gripped by irrational exuberance is an issue you won't really know for sure, except after the fact," Greenspan said, citing the case of the Japanese share boom in the late 1980s.

His reference to the Japanese experience and his admission that no-one really knows what is going on until "after the fact" should provide material for sober reflection on the part of those who consider that US capitalism has become a "new economy," in which the share market spiral and economic growth can continue indefinitely, or who naively believe that those in charge have found an answer to the destructive anarchy of the market.

In the late 1980s, on the basis of a rapid expansion of credit and the money supply, the Japanese share market raced ahead in leaps and bounds, prompting predictions that Japan had become a new economic Leviathan. The escalation in share prices and land values was so steep that at one point the land under the Imperial Palace in Tokyo was worth all the land in California.

Today, as Internet and technology stocks rocket into the stratosphere, it is worth recalling the Japanese experience. The Nikkei share market index, which reached a high of around 39,000 at the end of 1989, today stands at between 14,000 and 15,000. But the banks and other financial institutions are still burdened with bad loans that were based on the previously inflated land and equity values.

As a result, the Japanese economy has been mired in recession for the past seven years, with all attempts by the government and the central bank to revive it having failed.

While the stock market seemed to take his testimony in its stride, remaining stable after a dramatic 212-point rise on Monday, Greenspan warned that after eight years of expansion--the longest period of peacetime growth--the US economy "appears stretched in a number of dimensions, implying considerable upside and downside risks to the economic outlook".

"Equity prices are high enough to raise questions about whether shares are overvalued. The debt of the household and business sectors has mounted, as has the external debt of the country as a whole, reflecting the deepening current account deficit."

The counterpart to the high and rising current account trade deficit--the latest figures show it reached $169 billion in 1998--has been "ever-faster increases in the net indebtedness of US residents to foreigners," Greenspan noted.

"The rapid widening of the current account deficit has some disquieting aspects, especially when viewed in a longer-term context. Foreigners presumably will not want to raise indefinitely the share of their portfolios in claims on the United States. Should the sustainability of the buildup of our foreign indebtedness come into question, the exchange value of the dollar may well decline, imparting pressures on prices in the United States."

In other words, if the buildup of the US debt is so great that it prompts a move by foreign investors out of the dollar into the euro or some other currency, then the Federal

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Reserve could be forced to raise interest rates.

Greenspan, however, did not draw out the implications of his remarks, preferring instead to offer reassurances to the market that the widening deficit had some "beneficial aspects" by providing a "safety valve for strong US domestic demand, thereby helping to restrain pressures on US resources" and cushioning to some extent "economic weaknesses in our trading partners".

While Greenspan issued soothing remarks, other voices are warning of the implications of the growth of US debt.

Writing in the *Financial Times* last Friday, the British economist Wynne Godley noted that the US economy faces an "impossible balancing act".

Commenting on a report by the Council of Economic Advisers, forecasting that GDP will grow by 2 percent a year for three years and 2.4 percent thereafter, he noted that the prediction implied that expenditure would continue to rise faster than income for the next five years and more, with a consequent accumulation of debt.

"Those who draw comfort for the US economy from the fact that the rise in equity prices has boosted households' balance sheets despite high levels of debt are missing the point," he continued. "The expansion of the US economy since 1992 has depended on the growth of net lending to the private sector; and it is on the continued growth of that lending that the further expansion of the economy must now depend, given that the budget is in surplus and trade is in deficit.

"This is not a reassuring prospect. Neither the growth in net lending nor the acceleration in the money supply [it expanded by a postwar record of 10.2 percent in 1998] can continue forever, breaking records year after year. Nor, by the same token, can the private sector financial deficit continue to disappear down the plughole indefinitely, for this can happen only for as long as debt continues to grow exponentially."

Following the events of last autumn, when the debt default by Russia threatened to produce a global credit crunch, Greenspan's testimony provided the most detailed account so far of the situation which led to the decisions by the Federal Reserve to cut interest rates three times between late September and early November.

He noted that in August the Federal Reserve had decided to leave nominal interest rates unchanged but the subsequent deterioration in financial markets, leading to a sell-off of securities issued by private-sector institutions, began to pose a "serious threat to financial stability".

"In the wake of the Russian crisis," Greenspan told the Senate committee, "and subsequent difficulties in other emerging-market economies, investors perceived that the uncertainties in financial markets had broadened appreciably and as a consequence they became decidedly more risk averse. Safe-haven demands for US Treasury securities intensified at the expense of private debt securities. As a result, quality spreads escalated dramatically, especially for lower-rated issuers. Many financial markets turned illiquid, with wider bid-asked spreads and heightened price volatility, and issuance was disrupted in some private securities markets. Even the liquidity in the market for seasoned issues of US Treasury securities dried up, as investors shifted toward the more actively traded, recently issued securities and dealers pared inventories, fearing that heightened price volatility posed an unacceptable risk to their capital."

While the economy had weathered these disturbances with "remarkable resilience," some market indicators still reflected "a hesitancy on the part of market participants to take on risk".

Bankers and financial officials such as Greenspan always couch their statements in the arcane language of the financial markets, but the social realities and the class struggle which underlie these seemingly objective pronouncements are never far from their consideration. And so it was on this occasion.

Greenspan referred to his remarks in earlier testimony that "worker insecurity" over job losses might be an important reason for dampened wage demands and reduced inflation. However, there was now a danger that wage pressures could re-emerge because even with the substitution of capital for labour this had "not prevented us from rapidly depleting the pool of available workers".

Emphasising that it was up to the Federal Reserve to continue the "favourable inflation developments of recent years," he warned that "this worker depletion constitutes a very critical upside risk to the inflation outlook because it presumably cannot continue for very much longer without putting increasing pressure on labour markets and on costs".

In other words, if wages begin to rise too rapidly and threaten profits, then the Federal Reserve will not hesitate to take action to increase the "labour pool" and ensure that "worker insecurity" increases.

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