

Greenspan points to "imbalances" in US economy

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26 June 1999

Testimony delivered by US Federal Reserve Board chairman Alan Greenspan to the Joint Economic Committee of Congress earlier this month at least clarified one short-term issue—interest rates appear certain to rise at the end of the month. But as far as the long-term questions hanging over the US economy are concerned, the Greenspan and the Fed acknowledge that they really have no idea.

Greenspan began his testimony by again pointing to a “proliferation of new technologies” that is “inducing major shifts in the underlying structure of the American economy”—processes which are far from complete. But as a consequence of these changes, he went on, “many of the empirical regularities depicting the complex of economic relationships on which policymakers rely have been markedly altered”.

He told the Congress committee that economic models based on historical experience had failed to anticipate the acceleration in productivity and consequently overestimated likely inflation while underestimating economic growth. Had policy been based on them it would have “unduly inhibited what has been a remarkable run of economic prosperity”. In other words, had the Fed gone by past precedents, it may have already lifted interest rates by now, possibly bringing on a recession.

But even while hailing “this stellar noninflationary expansion” which still appeared “remarkably stress free on the surface”, Greenspan pointed to “developing imbalances that give us pause and raise the question: Do these imbalances place our economic expansion at risk?” The answer was yes, but we will not be able to tell until they hit.

The chief “imbalances” in the US economy are the rising stockmarket, widening balance of payments gap and the growing debt.

Recently the Japanese vice minister for international affairs in the Ministry of Finance, Eisuke Sakakibara,

characterised US economy as “bubble.com”. It was, he said, the most vulnerable in the world and headed for the type of financial collapse which Japan entered in 1989. The figures certainly underscore his warning.

In the middle of April, just before the market peaked, the top 36 internet stocks had a market capitalisation equal to the entire Japanese market, some \$2,769 billion. Such comparisons recall those which were made before the Japanese collapse when it was calculated that the value of the land under the Imperial Palace in Tokyo was equivalent to that of California.

The price-earnings ratio on the Standard and Poors index is now at the record level of 35 (in normal times it is under 20) while the dividend yield on shares is at a meagre 1.2 percent. This means that shares are being purchased not in anticipation of the dividend they will bring, but in the expectation that a capital gain will be made when they increase in value. Such a process can bring rapid profits ... but only so long as money keeps pouring into the market.

Significantly, one of the chief sources of new money is the major corporations themselves. They have gone heavily into debt into order to finance mergers or simply to buy back their own shares.

Borrowing by non-financial corporations in the US is running at an annual rate of \$370 billion, an increase of 80 percent over the past two years. This debt is not being used to finance capital expansion in the form of new buildings or plant and equipment with which to increase production; it is being used to boost share values.

According to information published by the London-based Lombard Research group “the central fact about American corporate finance in the last few years has been companies' massive buying of existing equity with the help of borrowed money. Overall US companies' purchases of existing equity—partly by acquisition and partly by share buybacks—exceeded their issue of new

equity by \$262.8 billion in 1998. The net withdrawal of equity last year was by far an all-time record, comparing with \$114.4 billion in 1997 and \$64.2 billion in 1996.”

However, such a process cannot continue indefinitely—the more share values are boosted by debt-financed purchases, the greater the finances required in the future to maintain the rise in share values.

Moreover, the growth of indebtedness means that corporations become increasingly sensitive even to relatively small increases in the rate of interest.

Another source of “imbalance” and one commented on in the past by Greenspan, although not in his most recent testimony, is the growing US balance of payments deficit. The latest figures from the Commerce Department show that the deficit in the US current account—the broadest measure of US financial transactions with the rest of the world—rose to a record \$68.6 billion in the March quarter, with estimates that the payments gap will go over \$300 billion for the year.

The main component in the growing deficit has been the widening balance of trade gap, measuring the difference between the value of exports and imports. At the end of the 1980s a typical monthly trade gap was between \$3 billion and \$5 billion. This increased to between \$8 billion and \$10 billion up to the outbreak of the Asian financial crisis in July 1997. But since then the monthly trade gap has widened to more than \$15 billion, reaching an all-time record of \$19.4 billion in February.

In other countries, such a growth in international indebtedness would be accompanied by a fall in the value of the currency, and rising interest rates. But because the dollar functions as a world currency, the US is able to finance the deficit through an inflow of foreign capital.

In the past four years, the total inflow from Europe, comprising investment in both bonds and equities, has totalled \$227.6 billion while the inflow from Japan over the same period was \$129.2 billion.

Much of this capital inflow is a result of the relatively low growth in Europe and the near-stagnation of the Japanese economy. Paradoxically, while greater economic expansion in both these regions would tend to lessen the US trade deficit, it could, nevertheless, bring on a financial crisis, if financial capital began to move out of the US in response to better rates of return in Japan and Europe.

For anyone still naïve enough, even after the global turmoil of the past two years, to believe that Greenspan and the other financial authorities are somehow in control, the Fed chief offered little reassurance. He pointed out

that the 1990s had witnessed one of the great bull stock markets in American history but “whether that means an unstable bubble has developed in its wake is difficult to assess” largely because “bubbles are perceptible only after the fact”.

In other words the guardians of the US financial system are in the position of a structural engineer who, if asked to determine the safety of a building, replies that he can only decide if and when it collapses.

While acknowledging that bubbles that burst were “scarcely benign” Greenspan claimed that they “need not be catastrophic” and pointed to the example of Japan where the bursting of the financial bubble a decade ago “did not lead immediately to sharp contractions in output or a significant rise in unemployment”.

This is hardly the basis for reassurance. Since the collapse of the financial bubble, the Japanese economy has stagnated for nearly a decade, despite the largest government spending boost in history. A similar outcome in the larger and more dynamic US economy would have even more far-reaching consequences.

Concluding his remarks, Greenspan noted that if the present expansion continued to next February it would become the longest period of growth in American history. However, he noted, “someday the expansion will end” and it is the job of policymakers to “mitigate the fallout when it occurs, and, hopefully, ease the transition to the next expansion”.

But anyone who believes that with the exponential increase in the power of the financial forces driving the US economy over the past few years, the end of the present “boom” will see a smooth transition to a new phase of expansion is in for a rude awakening.



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