Debt-fueled US economy set up for a fall

Nick Beams
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While the headlines have focused on Europe, the real issue in the recent currency market intervention by the Group of Seven (G7) nations to prop up the value of the euro is the increasing dependence of the United States economy on the inflow of foreign capital.

For the euro to begin to rise against the US dollar, the flood of capital pouring out of Europe in search of higher returns in the American market—currently running at about $3 billion a week—will need to be reduced substantially.

But the US has become so dependent on foreign capital inflow that were such a reversal, or even a significant slowdown, to take place it could set off a financial crisis leading to a US recession.

How such a slowdown might begin is canvassed in a new book, *The Coming Internet Depression* by *BusinessWeek* economics editor Michael Mandel, an extract from which was published in the October 9 edition of the magazine.

Mandel raises the question of how long the already record boom in the US, resting on the technology-based “New Economy”, can last and what will follow when it comes to an end.

He warns that “the New Economy is more than a technological revolution, it's a financial revolution as well—and that makes today's economy far more volatile than most realise. Just as forecasters seriously underestimated the growth potential of the US economy in the 1990s, they are underestimating the possibility of a steep decline in the near future.”

According to Mandel, the key financial factor in the technology boom has been the growth of venture capital, used to launch new hi-tech and Internet companies. Venture capital funding has risen from about $5 billion annually 10 years ago to an annual rate of around $100 billion today.

Venture capital in turn has depended on a rising stock market. Having provided the capital for startup companies, venture capital has been able to secure high returns when those companies are floated on the stock market, thereby providing the funds for further investments.

However Mandel points out that when the next downturn begins, “the virtuous circle of the 1990s could start going in reverse. Instead of a rising stock market generating more funds for financing innovation, a falling market will reduce the risk capital for new startups.” This would lead to slower innovation and lower productivity growth depressing the stock market still further.

Unless corrective action were taken to counter falling asset prices and slowing technology demand “then the downturn could morph into something deeper and more sinister: an Internet Depression. Such a depression would start in tech and devastate the entire economy.”

One of the consequences of such a downturn would be that foreign capital, which has been pouring into the US in search of the higher returns made possible by the technology boom, would begin to move elsewhere. The implications of such a shift are made clear by the following figures.

In 1993 net foreign investment formed less than 5 percent of the gross investment taking place in the US. By 1994 it had risen to just under 10 percent, where it remained for the next three years. But over the next three years the proportion more than doubled, from under 10 percent to 23 percent.

With the US economy now dependent on foreign capital inflows, a tech slowdown, Mandel points out, could have major consequences, sending “foreign investors rushing for the door, especially since it would hit the tech-driven US economy harder than others.” These problems would be compounded if the Federal Reserve Board then intervened to lift interest rates in order to try and prevent a fall in the value of the dollar.

Other economic analysts have pointed to the same

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underlying structural imbalances in the US and global economy.

A comment-piece published by the London-based firm Lombard Street Research last month noted that the US trade and current account deficits were continuing to widen, even though they had already reached "historically unprecedented levels."

The trade gap for July was $32 billion, or nearly $400 billion on an annual basis, and could be expected to climb for the rest of the year and into 2001, bringing a trade deficit of $450 billion by the middle of the year. On top of the trade gap, there is the deficit on international investment income, resulting from the increase in foreign ownership of US assets. This has been averaging around $5 billion per quarter in the recent period but may even increase. When foreign expenditure by the US government is added in, the current account deficit may reach as high as $500 billion in 2001, equivalent to 5 percent of gross domestic product.

The comment notes that the US has only been able to run an increasing deficit and yet maintain a strong currency because of foreign capital inflows.

"For example, foreign purchases of US equities were higher in the year to mid-2000 than ever before, totaling almost $150 billion. The remarkable scale of this international demand for US equities is demonstrated by comparison with 1995 and 1996, when foreign purchases of US equities were a meagre $16.6 billion and $11.1 billion respectively. Apparently, the more over-priced the American stock market becomes, the greater the foreign buying. It is difficult to avoid the conclusion that—as and when the American stock market returns to more normal valuations—the financing of the $500 billion deficit will prove very difficult."

In an analysis of the international investment position of the US, the Financial Markets Centre noted that throughout 1999 and in the first two quarters of this year, the US "sank deeper into net debtor status as foreign inflows cascaded into American financial markets". Foreign investors now hold more than one-third of all outstanding government debt and nearly one-fifth of all corporate bonds.

It pointed out that while recent interest rate rises had prolonged foreign financing of America's consumption boom, they had done so by increasing US external debt, raising the question, "how long can this go on?"

An examination of the figures for household and corporate indebtedness would suggest the answer, "not too much longer."

According to the Federal Reserve Board, outstanding debt of US households was a record 97 percent of disposable income in 1999, up from 83 percent in 1991. Household debt has nearly doubled over the decade, rising from $3.55 trillion in 1990 to $6.59 trillion last year. Corporate borrowing, excluding the finance industry, has risen from $2.47 trillion in 1991 to $4.31 trillion last year.

Overall private sector spending in the US economy exceeded income by $600 billion, or 6 percent of GDP in the second quarter of this year. According to Jerome Levy Institute economist Wynne Godley: "Nothing remotely like this has ever happened before in the United States. Private spending is growing faster than income, and it cannot continue forever."

Godley argues that if the growth of corporate and household indebtedness ceases, as it must, the American economy faces the prospect of falling into a severe recession.

It is, of course, impossible to predict exactly how and when the debt-fuelled US boom will come to an end, but the imbalances in the economy make clear that when it does the consequences will be far-reaching.

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