

Growing imbalances belie Greenspan's confidence

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US Federal Reserve Board chairman Alan Greenspan has given an upbeat assessment of the US economy, discounting concerns that, in the light of recent falls in consumer spending and manufacturing output, the 2003-2004 recovery may be somewhat short-lived.

Speaking to the US Senate Banking Committee on July 20, Greenspan said that economic developments had been “generally quite favourable in 2004, lending increasing support to the view that the expansion is self-sustaining.”

As far as the financial markets were concerned, most interest in the speech centred on Greenspan's comments on US interest rates, following the decision of the Fed last month to begin raising the key federal funds rate from its 40-year low of 1 percent. Greenspan told the committee that, based on the current outlook, policymakers “would likely proceed at a measured pace”—generally recognised as increases of 0.25 percentage points—to restore “monetary policy neutrality.” At present, monetary policy is expansionary, as interest rates are less than the rate of inflation.

In order to boost his confident message about the strength of the US economy, Greenspan said that even if they had to be increased faster than the predicted “measured pace”, the US economy “appears to have prepared itself for a more dynamic adjustment of interest rates.”

While financial markets generally welcomed Greenspan's upbeat comments—Wall Street and the dollar strengthened after his remarks—some observers are warning that the Fed's policies have contributed to the creation of huge imbalances both in the US and global economy which will have major consequences in the longer term.

The most glaring example of these imbalances is the balance of payments deficit and growing external debt of the US. In the first quarter of this year, the current account deficit reached an all-time high of \$145 billion,

representing more than 5 percent of gross domestic product (GDP). The US is able to finance this payments gap so long as there is an inflow of capital, either from private or government sources. But these sources could dry up.

In the late 1990s, the stock market bubble was a powerful attractive force for the inflow of private capital. But in the past three years, private capital inflows have fallen and the US financial system is increasingly dependent on funds from foreign central banks. Inflows from these sources reached \$501 billion in the first quarter of this year, representing 86 percent of the total, compared to a figure of 47 percent in 2003. Much of this comes from Asian central banks, which have been purchasing US dollar assets in a bid to prevent a rise in the value of their currencies, thereby maintaining a competitive position for their country's exports in American markets.

Demand levels in US markets have been sustained in large part by the Fed's low interest rate regime. But this has led to a situation where, in the words of the *Economist*, America has become “the world's biggest hedge fund”, as money borrowed in the US at very low rates is invested in higher yielding financial assets in the rest of the world. There are fears that if interest rates rise faster than expected, these financial transactions—so-called “carry trades”—could rapidly unravel with serious global financial consequences.

One of the most prominent US critics of the Fed's policies, Morgan Stanley chief economist Stephen Roach, pointed out in an article published on July 19 that “the world now lives from trade to trade” and that “with that precarious existence comes the ever-present risk of breakage—the aftershocks that follow the unwinding of every trade.”

Roach has blamed the Fed's accommodative policies for creating this situation, which he traces back to the stock market crash of October 1987, to which the Fed

responded by “offering up the unconditional palliative of an open-ended liquidity backstop.” Since then, the Fed has responded to every financial crisis in the same way—the creation of more financial liquidity leading to the creation of another financial bubble.

Greenspan has openly defended this policy. Answering critics who maintain that the Fed should act to prevent the emergence of financial bubbles in the first place, Greenspan told a meeting of the American Economic Association on January 3 that instead of trying to contain a bubble with “drastic actions”, the Fed sought to “mitigate the fallout when it occurs, and hopefully, ease the transition to the next expansion.”

But as Greenspan’s critics point out, this means that the US, and hence the world economy, is sustained by a series of bubbles, each one potentially more dangerous than the last. In response to the stockmarket bubble of 2001, the Fed lowered interest rates to record lows and set in motion a property market bubble.

In a comment published in the July 19 edition of the *Financial Times*, Stephen Roach noted that there had been an important transition in the dynamic of American growth. “The income-driven impetus of yesteryear has given way to asset-driven wealth effects.” The asset driven economy had turned many of the old macro-economic rules “inside out and could well pose the most profound challenge to sustainable recovery in the US economy.”

According to Roach, the “asset economy” burst forth in the mid-1990s, with the equity boom, followed by the housing market bubble, which has played a large part in sustaining consumption demand in the US. But this “wealth effect” has been critical in conditions where real incomes are declining.

“With jobs and real wages under pressure,” he noted, “there has been an unprecedented shortfall in the wages and salaries component of personal income. By May this year, real wage income was only about 3 percent higher than in the depths of the recession in November 2001—far below the 10 percent gains of the first 30 months of preceding cyclical recoveries. This translates into \$260bn of ‘missing’ income. In such an income-deficient recovery, there is an added urgency to draw on the wealth effect as a support to spending.”

But the property bubble contains even greater potential dangers than the share market boom because it has a much bigger impact on the level of debt, potentially “the biggest risk of the asset economy.” In the US, household debt rose to 85 percent of GDP last year, compared to 70

percent in 1995.

Financial Times economics commentator Martin Wolf is another who is concerned that while there is an optimistic short-term outlook for the world economy, there are worries in the medium term. “The new expansionary cycle has, for all its apparent vigour, inherited too many of the frailties of its predecessor,” he noted in a column published on July 19. “The doctors have, in response, injected monetary and fiscal stimulants in powerful doses. But burdened by both old and newer ailments, this expansion may not live to a healthy old age.”

Wolf also pointed to the external imbalances of the US, noting that after being a net creditor for most of the twentieth century, and with its net liability position moving into rough balance in 1988, external US indebtedness is now at around 24 percent of GDP. And the situation could worsen. Wolf cited a recently prepared study by Cambridge economist Wynne Godley that the US current account deficit could rise to 8 percent of GDP as a result of a fall in US investment income. “This would, in turn, generate an explosive further increase in US net external liabilities, to well over 50 percent of GDP by the end of the decade and, if the US private sector began to retrench, an explosive rise in the US fiscal deficit.”

According to Wolf, the threats to global stability posed by the growing US deficits and rising indebtedness could be overcome by a smooth downward adjustment in the US dollar, making US exports more competitive, lowering the US trade deficit, increasing global demand and lessening the dependence of the world economy on the US market. But in answer to the question “How likely is that?” he concluded “Not very”.



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