US debt ceiling to be lifted

Nick Beams
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In a sign of financial turmoil ahead, the day after the presidential election the Bush administration announced that it will have to ask Congress to raise the debt ceiling in order that it can organise the government's massive borrowing needs.

The current debt ceiling of $US7.384 trillion was reached on October 14, but fearful of the political consequences of increasing the national debt in the lead-up to the elections, the administration undertook a series of manoeuvres to keep financing government activities without breaching the debt ceiling. However these measures can only be continued until the middle of this month, necessitating a new authorisation from Congress.

The need to raise the debt ceiling stems from the record budget deficits of the past two years. The deficit for the 2004 budget year, which ended on September 30, was $413 billion, following a deficit of $377 billion in 2003.

The growing fiscal debt is only one of the indicators of growing imbalances in the financial position of the US. The other major sign of disequilibrium is the balance of payments deficit, now running at just under $600 billion per year, or almost 6 percent of gross domestic product (GDP).

In a study published just before the elections, well-known economists Maurice Obstfeld and Kenneth Rogoff warned that the risk of what they called a "current account collapse" sparked by the withdrawal of funds from international investors, had to be "problem number one on the new president's international financial agenda."

However, they doubted that it would be because of the "proliferating versions of the revisionist theory that there is simply no problem." According to this view, the US international debt presents no problem because foreign investors, particularly official ones such as central banks, will continue to finance it, and even if the value of the dollar did fall dramatically the consequences would not be severe.

"We are very sceptical," Obstfeld and Rogoff wrote in a *Financial Times* article. "When one looks closely at the US twin deficits (current account and fiscal) in the context of open-ended security costs, geopolitical tensions, rising old age pensions, higher energy costs and extraordinarily stimulative macroeconomic policies, we see stronger parallels to the early 1970s than to the late 1980s. The years following Richard Nixon's 1972 re-election were not pretty for the dollar or for the world economy. If current accounts are forced towards balance in the context of a difficult global economy, the effects could include financial crises, higher interest rates and a big drop in global output."

The US dollar is at the centre of a series of processes that are contributing to global financial imbalances. On the one hand, the growing US balance of payments gap threatens to bring about a collapse in the dollar's value. On the other hand, action to close the balance of payments gap would almost certainly set off a global recession as the US is the chief market for the export industries of China and East Asia, many of them US-based firms.

So far intervention by the Asian central banks which have sold their own currencies in order to purchase US financial assets, including a growing amount of government debt, has prevented a precipitous decline in the dollar's value. But they need to keep the money flowing in and with the US needing around $2 billion a day the amounts are not small. In 2003 dollar purchases by foreign central banks were $616.6 billion, compared to $351.9 billion the year before. The total reserves of the countries of so-called "emerging Asia" rose by more than $350 billion in the year to March 2004, with the central bank of China the biggest buyer of US dollar assets.

While some economists have argued that this system of "recycling" can go on virtually indefinitely, it does have objective limits. For example, the continued dollar purchases by the central bank of China are helping to fuel a financial bubble in the property market and generate financial speculation in the economy as a whole. So far the Chinese authorities have sought to contain the expansion of credit with so-called administrative measures, but the recent decision to lift interest rates indicates that these measures are not working and stronger action may be needed. The danger is that action to prick the bubble can set off a financial crisis in China, leading to a withdrawal of funds from the US in order to help prop up the banking system.

There are also objective limits to this "recycling" process on the US side. The continued inflow of foreign funds has allowed US monetary authorities to pursue a low-interest rate regime. This in turn has produced a rise in the housing market, facilitating in turn an expansion in consumer debt which has helped sustain US economic growth.

But in the face of slow growth in incomes this process cannot continue indefinitely. National accounts figures for the third quarter show that the US economy expanded at a less-than-expected rate of 3.7 percent, below the 4 percent level considered necessary to ensure an increase in job numbers.

Consumers, however, increased spending at a rate of 4.6 percent, well above the 1.4 percent increase in after-tax personal income. This has been the trend for at least the past three and half years with consumption spending growing at a rate of 3.2 percent while pre-tax income has grown at a rate of 1.3 percent, and after-tax income at 2.6 percent.

The upshot of these trends is that there is a rising ratio of household debt to income.

In a recent speech Federal Reserve Board chairman Alan Greenspan pointed to this process and acknowledged that the ratio of household debt to income had risen "especially steeply over the past five years and, at 1.2, is at a record high." But he concluded that "measures of household financial stress do not ... appear overly worrisome."

Greenspan based his assessment on the fact that property values have continued to rise and therefore the debt does not represent an increasing financial burden. In other words, the process can continue so long as money keeps flowing into the property market. But that depends on whether the US can continue to attract a sufficient inflow of foreign funds.

According to Morgan Stanley chief economist Stephen Roach, Greenspan's argument reflected the circular thinking that now pervades financial markets. Greenspan's assessment, he insisted, "ducks the key risk factor—interest rates" and whether "rates can stay low for a saving-short US economy with massive current account and budget deficits."

Noting that the increase in household liabilities over the 2000-2003 period was 65 percent faster than the cumulative growth of GDP over the same interval, he warned that "America's consumer debt bomb is ticking louder and louder in a climate where the artificial depressants to interest rates and debt service are on thinner and thinner ice."