

Pulling out the rug

Commentary, by Kurt Richebächer

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Apparently, the consensus is that economists are still convinced that the growth acceleration in the second half of 2003 – and above all a sharp rise in profits – has laid the foundation for sustainable growth. In particular, whether there is sustainable growth with sufficient creation of employment.

We disagree.

We must admit that our own assessment is prejudiced by the postulate of the Austrian school, that “the thing which is needed to secure healthy economic growth is the most speedy and complete return both of demand and production to its sustainable long-term pattern, as determined by voluntary consumer saving and spending.”

Friedrich Hayek said in 1931: “If the proportion as determined by the voluntary decisions of individuals is distorted by the creation of artificial demand, it must mean that part of the available resources is again led into the wrong direction and a definite and lasting adjustment is again postponed. And even if the absorption of the unemployed resources were to be quickened in this way, it would only mean that the seed would already be sown for new disturbances and new crises.”

We think this precisely describes what has been happening and continues to happen in the United States. The Greenspan Fed has discovered a new, amazingly easy and quick way to create higher consumer spending virtually from thin air – by way of so-called wealth creation through asset bubbles. It began with the stock market bubble, and was followed by bubbles in bonds, house prices and mortgage refinancing.

Measured by real GDP growth, it seems a successful policy. However, measured by employment and income growth, it is an outright disaster. The so-called “wealth effects” are not for real, neither for the economy as a whole nor for the individual asset owners. The reality in the long-run is only the horrendous mountain of debt that consumers, corporations and financial institutions have piled up.

Given the general euphoria about the U.S. economy and its recovery, there appears to be a general apprehension in the markets that the Federal Reserve will be forced to raise interest rates in the foreseeable future. The Fed is clearly anxious to dispel any such fears – and this, in our view, is for a compelling reason. U.S. economic and financial stability have become inexorably dependent on the existence of a steep yield curve allowing and fostering unlimited carry trade in long-term bonds. Any major rise at its short or long end would shatter this artificial stability and send the economy and financial system crashing.

Considering all the imbalances impairing U.S. economic growth, we are unable to see the sustained, strong recovery. A closer look at the recent economic data [and last Friday's jobs report] confirms this skepticism. Possibly, if not probably, economic growth has already peaked. For us, the question rather is when general disappointment will gain the upper hand.

That, of course, is sure to soothe the bond market, allowing moreover the Fed to maintain low interest rates. It will conjure up another, even greater risk at the currency front. **It will pull the rug out from under the dollar.**

In our view, the U.S. trade deficit is big enough to cause a true tailspin of the dollar against all currencies. So far, two things have prevented this threatening dollar collapse: the gargantuan dollar purchases by Asian central banks and the still rather positive perception around the world of the U.S. economy. In our view, few people realize its true weakness and vulnerability.

There is widespread hope that the falling dollar will go a long way to lower the U.S. trade deficit. It takes a lot of wishful thinking to believe that. Its persistent growth has various reasons. One of them is that the gap between exports and imports has simply become too big to be reversible. Last year, exports amounted to \$1,018.6 billion and imports to \$1,507.9 billion. Just to prevent a further rise of the deficit, exports would have to rise 50% faster than imports.

Principally, the trade flows of a country are exposed to three major influences: first, relative prices and the exchange rate; second, relative demand conditions; and third, relative supply conditions.

Empirical experience suggests that exchange rate changes by themselves have very little effect on trade flows. One obvious reason is that Asian as well as European exporters readily adjust their prices to maintain their market shares.

For years, the United States has been top in the world with its domestic demand growth propelled by the loosest monetary policy in the world. For sure, lacking demand growth in the rest of the world has played a role in boosting the U.S. trade deficit. Yet what matters most for the trade balance is not U.S. growth in relation to other countries, but U.S. demand growth in relation to U.S. capacity and capital-stock growth. In essence, such a deficit indicates an equivalent excess of domestic spending over domestic output.

More precisely, the U.S. trade deficit reflects gross overspending on consumption on the demand side and a grossly unbalanced investment structure on the supply side. There was gross under-investment in manufacturing versus gross over-investment in retail, finance and high-tech.

Our assumption is that there is no intention or will on the American side to correct any of these maladjustments. Given their enormous size, it is a Herculean task, too Herculean, in fact, to be seriously addressed.

Principally, American policymakers and economists take only two economic problems seriously: high rates of inflation; and, in particular, slow growth and rising unemployment. They could not care less about the dollar. The low inflation rate is the excuse for more of the same extreme monetary looseness.

There is quite a variety of accidents waiting to happen in the markets, but the most predictable and biggest risk is a dollar crisis. In addition to the gargantuan trade deficit, looming in the background are existing foreign holdings of dollar assets in the amount of \$9 trillion.

As explained, the tremendous vulnerability of the U.S. bond market due to its underlying heavy leveraging prohibits any defense of the dollar through tightening.

Instead, the plunging dollar will pull the rug out from under the bond and the stock markets.