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At A Crossroad – The U.S. Economy

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ABSTRACT

The U.S. economy stands at a crossroad. Which path will it take – the one that leads to sustainable growth, recession or inflation? This paper will examine market imbalances which may indicate the future economic direction.

INTRODUCTION

The U.S. economy stands at a crossroad. In one direction is controlled expansion with low inflation, increasing productivity, and reasonable interest rates. In the other direction is unsustainable growth with high levels of inflation, low unemployment, and crushing interest rates. Which path will the economy take?

The direction of the economy is difficult to forecast as it is currently sending mixed signals. The low saving rate and large current-account deficit suggest that the economy's course is unsustainable. Yet, the economy is stronger than expected. Although the housing market seems to be cooling off, consumers are still spending, and business investment has picked up as well. And, even with low unemployment and high oil prices, inflation remains modest.

This paper will examine four factors that may aid in determining the future of the economy. These factors include the twin deficits, housing bubble, excess liquidity, resource utilization, and inflationary pressures.

THE TWIN DEFICITS

A **trade deficit**[1] is created when the aggregate imports of a country exceed its aggregate exports. The cumulative U.S. trade deficit set an annual record during 2005 of 6.1 percent of GDP up from 4.0 percent only three years earlier.[2] After pausing during early Spring 2006, the deficit picked up steam in May driven by imported petroleum prices.[3] An inflow of foreign capital has allowed the U.S. to import more than it exports and still finance its trade deficit. As a result, the U.S. soaked up three-quarters of the excess global supply of savings in 2005, increasing its current-account deficit to $668 billion.[4]

A **budget deficit** is created when a government's expenditures exceed its revenues. The brief surplus of the Clinton Administration was replaced by the deficit of the Bush Administration. Tax cuts to stimulate the economy were followed by increased government spending on the wars in Iraq and Afghanistan. The deficit passed $400 million in 2004, peaking at 4.0 percent of GDP with the U.S. government borrowing approximately $2 billion a day abroad. The deficit remains high in dollar terms, but fell as a percentage of GDP during 2005 as economic growth increased tax revenues.[5]

The twin deficits have made the U.S. dependent on attracting foreign capital. Increasingly capital flows not from the traditional route of direct foreign investment, but from Asian central banks, which have become major purchasers of U.S. Treasury securities. Through October 2005, Japan accumulated foreign currency reserves totaling $847 billion dollars, and China increased its currency reserves to a record $819.9 billion. Foreign currency reserves have grown because the two governments buy a large percentage of the foreign currency that flows in from exports, foreign investment, and speculative capital. This action helps to stabilize their currency against other currencies, especially the dollar, and protects the competitive prices of their exports. The reserves are then invested with China investing 70 percent of its reserves in dollar-denominated assets including $247 billion in U.S. Treasury securities.[6]

Governments in Thailand, Korea, Singapore and other Asian countries have followed similar strategies but on a smaller scale.

However in March and May 2006, foreign central banks were net sellers of U.S. Treasury securities with May sales of $14.3 billion the largest for any month since August 1998 – when the U.S. government was running a surplus and the supply of Treasury securities was shrinking.[7] Can the U.S. continue to depend on Asian central banks to finance the ballooning twin deficits? Events in Japan and China are not reassuring.

Japanese Intervention

The Japanese believe that exports, particularly to the United States, kept their economy afloat during the last, very difficult decade. Intervention to support the dollar was necessary to limit price increases on items exported to the U.S., which accounts for one-fourth of Japanese trade.

However, changes may have occurred which make the Japanese economy less sensitive to the yen-dollar relationship than in the past. These include the following. First, Japanese businesses have shifted their production to key international markets, increased local procurement of inputs, and, therefore, minimized foreign exchange risk. Second, companies in Japan have increased their business in other Asian markets, particularly China where exports and capital spending connected to export industries accounted for 1/3 of Japan's GDP growth last year.[8] Third, Japanese factories, through years of restructuring, have trimmed costs and reduced job growth providing a cushion to absorb at least some of the shock from a stronger currency. Last, Japan has benefited from a decline in the value of the yen against the euro, and increased their exports to the euro zone substantially.

Japan appears to have reduced its support of the yen and allowed it to appreciate against the dollar in recent months. If this policy continues, who will step up to support the twin deficits?

China Currency Policy

In 2005, the U.S. trade deficit – the amount that imports exceed exports – with China established another record, reaching $202 billion.[9] Most analysts believe that the Chinese yuan is currently undervalued[10], given the country's rising reserves and large surplus on its "basic balance" – the sum of its current account surplus and the net inflows of long-term capital, such as foreign direct investment.[11] Exports from China to the U.S. are now 5.7 times the value of imports – a gap that many experts say is caused by China's refusal to float its currency and allow the price of its exports to rise.[12] The Bush Administration, and some members of Congress, is pressuring China to relax its currency policy. The $14.6 billion trade surplus reported by China in July 2006 suggests that this pressure will continue.

China took the first step to a more liberal currency policy on July 21, 2005. The People's Bank of China announced two changes in its policy. First, the value of the yuan increased 2.1 percent from 8.277 to the dollar to 8.11. Second, the yuan is no longer pegged to the dollar, as it had been since 1994, but to a basket of currencies. Since July, the yuan has appreciated an additional 1.4 percent, hovering around the symbolic 8:1 level.[13]

If China allows its currency to float against the dollar, the trade deficit should decrease as Chinese goods become more expensive in the U.S. and U.S. goods become cheaper in China. However, U.S. government restrictions on the export of high security and high technology equipment to China may limit the growth in exports. But, a floating yuan would also mean less Chinese intervention in the foreign exchange market. This could limit the amount of foreign capital into the U.S. to support the twin deficits.

U.S. REAL ESTATE MARKET

An asset bubble exists if prices are high today because investors believe they will be higher tomorrow – not because fundamental factors justify the rise in prices. Many believe that the housing market is a bubble about to burst.[14] There are some interesting parallels to previous asset bubbles including mortgage rates at 40 year lows as the

Federal Reserve (FED) used monetary policy to stimulate the economy, creative financing such as interest-only loans which allowed more households to qualify for mortgages, and low or negative returns on alternative investments such as the 21 percent drop in the value of stocks from 2001 – 2004 versus the 71 percent increase in the price of houses in California during the same period.[15] All of these factors led to an increase in demand for housing and a rapid increase in prices.

There is some evidence that the housing bubble is beginning to, if not pop, hiss. Late payment notifications have increased over the last few months, sales of existing homes fell by 1.3 percent in June 2006 to the lowest level in five months, and housing prices have stagnated or actually fallen in many areas of the country.[16]

The U.S. economy is driven by consumer spending which makes up approximately 2/3 of all spending. Consumers felt “rich” as the value of their houses increased rapidly, and if consumers feel rich, they spend. In addition, low interest rates and high real estate prices allowed consumers to convert their real estate investment into cash by either refinancing and pulling cash out, or borrowing with a home equity loan against the higher value. If consumers see the price of their houses stagnant or fall, they may cut spending and impact economic growth.

GLOBAL EXCESS LIQUIDITY

Low interest rates allowed American households to increase consumption expenditures and the government to finance military spending while the economy continued to grow and inflation remained low. What factors enabled the U.S. to sustain interest rates at 40-year lows?

The conventional wisdom is that a relatively weak global economy combined with loose monetary policy resulted in the low interest rates. Through 2003, the rate on 10-year Treasury notes stayed below 4 percent. Even after two years of gradual interest rate increases by the FED, the long-term rate stayed around 4.5 percent until early 2006.

However, this explanation seems flawed given that global economic growth was a healthy 5.1 percent in 2004. Instead in early 2005, Ben Bernanke, then a FED governor, attributed the low interest rates to a “global saving glut”. [17] He argued that excess saving by economies, including many emerging and Asian economies such as Japan, was to blame for both America's large current-account deficit and lower bond yields.

An additional explanation was provided in a study by J.P. Morgan. The study found that global companies were investing only enough of their profits to sustain operations, not to grow. The study concluded that in recent years, firms have been net savers instead of big borrowers. In the past 4 years, the total increase in corporate saving was more than $1 trillion or 3 percent of annual global GDP and five times the increase in net saving by emerging economies over the same period.[18] In short, it is the excess savings by some economies and the lack of investment opportunities for corporations that have led to global excess liquidity – and the low interest rates.

Excess funds from economies and corporations, seeking a safe harbor, have been invested in the U.S. However, Japanese and European economies are beginning to show signs of strengthening, and their central bankers are starting to increase interest rates. The Bank of Japan ended its policy of zero interest rates for the first time in almost 6 years, lifting its key rate to 0.25 percent.[19] The European Central Bank raised rates a quarter point to 3 percent – the fourth increase in the last year – and the Bank of London raised rates a quarter point to 4.75 percent – surprising market watchers.[20] This may cause investors to view them more positively and switch funds from the U.S. to these countries – particularly given the negative view currently held towards U.S. foreign policy by some areas of the world.

Until recently, it seemed that nothing bothered the bond market – not strong economic growth, record oil prices, rising short-term interest rates, or financing wars in Iraq and Afghanistan, and hurricane reconstruction. Long-term rates stayed near 40 year lows, causing former FED Chairman Greenspan to call the phenomenon a "conundrum." However, since February 22, bond prices have been dropping, pushing 10-year yield above 5 percent –

the highest level seen since June 2000. Bond rates may be increasing as the market perceives more risk. Or we could be seeing the first signs of shifting global liquidity.

RESOURCE UTILIZATION

Strong economic growth has put pressure on the labor market. The unemployment rate in March stood at a low 4.7 percent. Low unemployment normally puts upward pressure on wages which account for about 70 percent of overall production costs in the economy. Surprisingly however, employment costs rose by only 2.8 percent in 2005 – the lowest annual increase since the Labor Department began collecting this data in 2001. In addition, as the economy grew a healthy 4.8 percent in the first quarter of 2006, salaries and benefits for all civilian workers increased only 0.6 percent – or adjusted for inflation fell by 0.8 percent.[21]

In the first six months of 2006, oil prices surged by almost $10 a barrel, from the mid 60s in December to mid 70s in June. Prices approached all-time highs in not only nominal terms, but also real terms. (Prices reached $80 a barrel in today's dollars during the early 1980s oil embargo.) However, the market seemed to shake off the bad news and stock market indices reached post-recession highs. Consumer confidence, as measured by the Conference Board, increased from 107.5 in March to 109.6 in April – surprising market participants who expected a slight decline.[22]

The question is how long can the economy absorb resource costs? The optimistic view is that the economy is less dependent on oil than before preventing high oil prices from stoking core inflation. And, when (if) tight labor markets cause upward pressure on wages, healthy corporate profit margins will allow businesses to absorb higher wages without increasing prices to consumers. The pessimistic view is that increasing wages coupled with costlier energy will eventually cause businesses to cover higher costs by passing them on to consumers through higher prices. Higher prices may decrease consumption, shake business confidence, and result in a weaker economy.

SIGNS OF INFLATION

Inflation concerns seem to be spreading. The FED noted its inflation concerns in its announcement following each of its interest rate hikes, and the market expects it to intervene at the first sign of inflation – although with a new chairman, there is some uncertainty about FED actions. Previously, monetary policy was clear as the FED increased the Federal Funds rate target by a quarter of a point after each of its meetings beginning in June 2004. Now that the interest rate is at 5.25 percent, where most economists believe it is close to "neutral" – a rate that will not stimulate or restrict economic growth – there is uncertainty as to what will happen next. That is, how long will the FED "pause" its increases – as it did following its August meeting? Chairman Bernanke stated that the FED sees the recent rise in inflation as a "temporary" response to energy prices and not an overheating economy.[23] However, if inflationary signs persist, the consequences for the U.S. debt laden economy may not be pleasant.

Signs of inflation have been creeping into the Japanese economy as well. On March 9th, the Bank of Japan declared that after 7 years, the days of flooding the banking system with free money – known as "quantitative easing" – were ending. It may take few months to soak up the excess liquidity in the system, but the era of zero interest rate is over. The Japanese economy continued to grow in the second quarter of 2006, but at a slower rate due to a decrease in public spending and the private housing sector.[24]

Jean-Claude Trichet, president of the European Central Bank, noted that the bank will continue to monitor inflation "very closely." He continued that geopolitical tensions and strong credit growth in the euro zone could cause prices to rise. The Bank of England stated that they expect inflation to stay above the bank's 2 percent target because of strong economic growth. Within the past month, 15 central banks around the world have raised their cost of borrowing citing inflation fears.[25]

Central bank actions demonstrate that the global financial conditions are beginning to shift. The days of excess liquidity may be coming to an end which may mean less global saving will find its way into U.S. Treasuries. With global rates rising, parking money in the U.S. may be less attactive given the risks of inflation and depreciating

dollar. The FED may have to keep the interest rates high to keep foreign capital flowing in and prevent it from flowing out. This implies that the dollar may have to fall substantially in order to make U.S. assets sufficiently attractive.

The rules governing the world economy have changed. Prices of everything from commodities to labor are determined by global market forces. The usual measurement of labor market tightness or capacity constraints traditionally used by the FED to gauge wage and price pressures have become increasingly less reliable. This complication increases the chances the FED could make a policy mistake by pushing rates too high or leaving them too low. With the U.S. soaking up most of the excess savings in a global economy, it is harder for FED to find the right level of interest rate to keep the economy growing while controlling inflation.

CONCLUSION

The U.S. economy, and to a certain extent the global economies, are standing at a cross roads. Growth continues to be surprisingly strong led by continued consumer spending and growing business investment. Inflation, despite high oil prices and low unemployment, continues to moderate. Interest rates, while increasing, are still below the historic average.

But there are signs of potential problems on the horizon. The most daunting of these are the twin deficits. The U.S. has been able to finance its deficits without substantially raising interest rates because of Asian central bank intervention and global excess liquidity. The changing economic picture has increased the chance that central banks will reduce their intervention to support the dollar and that excess liquidity may begin to shift to other markets.

Also worrisome is the possibility that prices in the real estate market in the U.S. are dropping or at least stabilizing after six years of tremendous growth. The consumer has been using their home appreciation to support their spending over the past few years. Without the continued growth in prices, consumers may pull back – and bring the economy with them.

So, where do we go from here? The next few months – or years – will give us additional information on which path the economy is following. But, until then, it should be interesting!

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