

## Begging Indulgences: Bleak News from the Economic Front

By Robert Avila

*FSG welcomes Robert Avila as the contributing author of this month's FSG Outlook. Robert, an economist and former colleague, is an iconoclastic thinker, with a keen eye and a sharp wit. Robert warns that a soft economic landing looks less and less likely this time around.*

Among political leaders and too many business writers there is a popular and dangerous belief that mere time and good will among central bankers will cure the global economy of the ills that it is facing: \$100 per-barrel crude, the sub-prime mortgage rot eating away at global balance sheets, and the growing multi-trillion-dollar U.S. foreign debt.

As Asian and Middle Eastern financial interests bail out one Wall Street giant after another, perhaps the generally relaxed, ho-hum view that "along with some adjustments there may be a recession in 2008" should make us ask: are we missing anything? Could we be facing something a tad more challenging than a reprise of the last two lazy recessions that the Fed so nicely eased us through?

The Federal Reserve, lacking any real theoretical basis for what it does, has, since the death of monetarism, been mainly twiddling with interest rates in an effort to keep inflation under control, and occasionally providing liquidity to financial markets that have gotten a bit too tangled up in their financial-engineering underwear.

The problem with this approach is that their measure of inflation has not included assets, and this at a time of double-whammy falling production costs. Between technology-driven productivity gains and the outsourcing, offshoring, and imported-labor cost gains, there has been no upward pressure on most end-products for at least 15 years; but instead of prices falling, as one would expect when production cost are coming down, Fed twiddling has ensured that we have all experienced stable prices, with just a bit of mild inflation to keep low interest rates positive.

Net-net, in the face of falling costs, end-product prices have been kept stable while the Fed's "stabilization" policies have overstimulated one asset market after another. The last time that there was a similar mix of falling costs and stable price levels was in the 1920s, when a similar, if simpler, technology and trade revolution was taking place.

### WHAT, US WORRY?

But today's policy has been doubly generous in that it has also enabled our Federal government to indulge in the ultimate fantasy of "guns and butter." Like some medieval French king, George W. Bush has been able to finance foreign adventures without asking the estates general for a

tax increase, by borrowing from foreign bankers – in our case, the Chinese.

What is fascinating is that so much of their lendable funds, as with the Medici's, comes from indulgences. Consumer indulgences, rather than Papal ones; but still, the sale of so many things whose value rests largely in the mind of the buyer. Instead of buying War Bonds, the American public has OD'd on Squawking Elmo and Thomas the Lead-Lined Tank Engine, but the result has been the same: the war has been financed with IOUs.

As with any profligate who spreads his markers too widely, his notes soon lose some of their value. What is fascinating in America's exceptional case is that, as our currency has fallen in value (the euro has gone from \$0.85 in 2001 to \$1.45 today, an increase of 80%), our prices have not really risen (over the same period the CPI has risen just 17%). This is only because most Asian countries, despite pressures to the contrary, have tried to keep their currencies in line with the dollar.

The reason why neither European nor Asian goods have appreciated in the U.S. is that Americans are the global consumers of last resort. Americans buy so many of these consumer indulgences – indeed, in many cases Americans are the only people who even want them – that the world price is set by Americans. Over the past 15-20 years, selling Americans what they want at prices that Americans were foolish enough to pay has been a very profitable business. If the prices were raised on much of this stuff, the producers fear that no one would want it, so it is better to let margins slide than to lose the market entirely.

### WHY THE EURO CANNOT REPLACE THE DOLLAR... JUST YET

America's role as consumer of last resort is, in a sense, the obverse of the economy's role as central banker to the world. Like it or not, the dollar continues to be the reserve currency of the global economy. It is not just that the dollar is the preferred currency of black-marketers, smugglers, and drug dealers globally. Nor is it even the political reality that the Saudis continue to price oil in dollars.

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Rather, it is the unavoidable fact that, in terms of the sheer volume of transactional liquidity required to make the mare go, there is no close second. The U.S. has been running trade deficits ever since the end of the early 1950s' famed "dollar shortage." The massive growth of the global economy that has transformed the lives of billions, and that may destroy global ecology due to the heat and waste of its hyperactivity, has not been the result of America's willingness to buy whatever gewgaw has been on offer, but rather our willingness to provide the global liquidity needed to make markets work everywhere.

Given the size, scope and financial depth of the global economy, there is no plausible substitute. The euro and the yen pale into insignificance by comparison. What matters is not the size of the currency's home market, but rather *the volume of denominated wealth holdings and transactional claims globally*. To switch from dollars to euros or dollars to yen is not simply a matter of replacing one silly symbol with another; nor is it a matter of going to the *Cambio/Wechsel* window at the airport. Rather, it is a matter of *trading one massive set of assets for another, much, much smaller set, drastically dropping the price of one, while running the other up far beyond the point of absurdity*. This is not going to happen.

There remains the curious fact that even in hyperinflating economies -- Weimar Germany, Brazil, and Argentina a few decades ago -- people have continued to use the depreciating currency to buy and sell things. They just did it very, very fast. So, perhaps global hyperinflation on the way to abandonment of the dollar is a credible scenario. However, something else is far more likely to happen if America continues to do a substandard job of maintaining the marginal transactional value of the global currency which it is supposed to be managing.

### BALZAC OR BUST?

Transactional liquidity in today's global economy is an odd substance that makes little sense on close examination. It is an artificial commodity, a promise to pay; but to pay in what? Nixon closed the gold window decades ago. The only promise of the dollar is that you can buy something with it, that it will maintain its purchasing power, or maintain it at least as well as anything else. Now, once upon a time, what you could always buy with U.S. dollars was U.S. goods, but these are becoming rare, with the country producing so little and importing so much. (Of course, Europeans and Asians had a great time this last Christmas flying to the U.S. so that they could buy goods that they had produced themselves here in America at bargain prices.)

Other than tourist fantasy shopping (which is a limited play for major global financial institutions), that leaves assets: yet more IOUs at higher interest rates, or U.S. equities and real estate. As the dollar weakens, a growing volume of open and low-profile acquisitions of corporate equities and real property should be expected, marked occasionally by a futile protest, such as that we witnessed when the once excessively rich Japanese bought Rockefeller Center in 1989-90.

As the U.S. becomes too expensive for Americans to own, and the country's economy increasingly becomes an instrument of foreign interests, the question becomes just how big a say these interests will have in assuring that things are run better than they have been in the past. Given their holdings, they will have a vested interest in maintaining the value of the dollar by curtailing past indulgences both at home and abroad.

In short, the United States appears to be heading toward receivership as surely as any hero from a Balzac novel.

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