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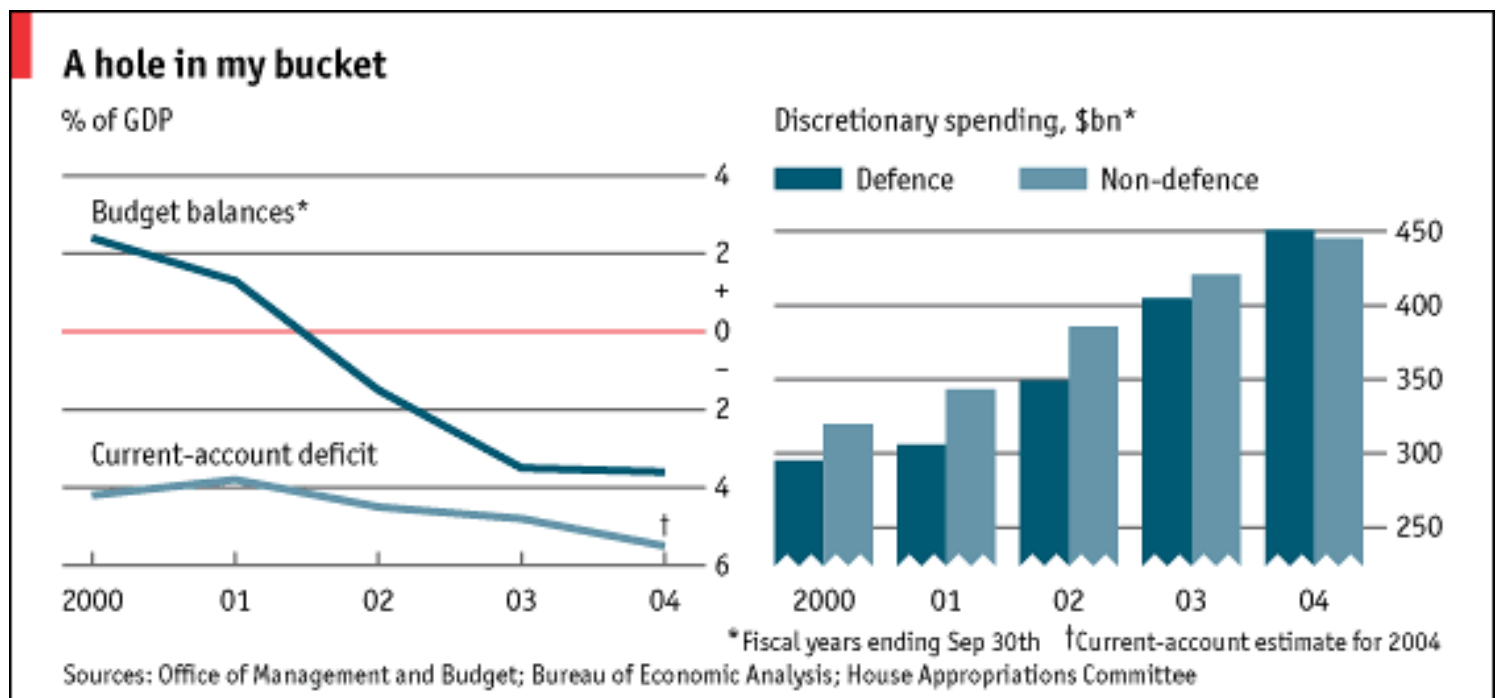
WORLD
NORTH AMERICA

The economy

A series of fortunate events

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The sliding dollar could help to redress America's economic imbalances. But don't count on a smooth ride



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CONVENTIONAL wisdom holds that George Bush's first-term team could not create jobs and did not care about deficits. Less than a month after the presidential election each of those views needs adjusting. With 337,000 new jobs in October, more than twice as many as analysts predicted, the supposedly "jobless" economy is looking decidedly perky.

Meanwhile, far from dismissing deficits, America's economic policy-makers are suddenly talking about little else. On November 17th, John Snow, America's treasury secretary, argued in London that America's fiscal deficit was his "most pressing issue". And Mr Bush himself claimed that America was "committed to deficit reduction, both short-term and

long-term". In Frankfurt on November 19th, Alan Greenspan, chairman of the Federal Reserve, endorsed the new emphasis with uncharacteristically pointed comments about America's current-account deficit, now 5.7% of GDP and rising. Given the size of the imbalance, he argued, "a diminished appetite for adding to dollar balances must occur at some point," before making clear that reducing the budget deficit should be part of the way out.

Right on cue, Congress passed a surprisingly frugal spending bill on November 20th. The bill allowed for a growth rate of only 1% in discretionary spending outside defence and homeland security, the lowest figure in almost ten years.

If you think unexpected economic strength and unexpectedly prudent political rhetoric sound too good to be true, you are probably right. America's economy faces some big, possibly painful adjustments over the next four years.

The most striking economic news since the election has been the dollar's slide. Since November 2nd, the greenback has fallen steadily and this week hit new lows against the euro and several Asian currencies (see [article](#)). Foreign investors are finally fretting about America's imbalances.

The surprise is that this has not happened before. America's current-account deficit is in uncharted territory, both as a share of the economy and in terms of the share of foreign savings it soaks up. Most economists have long argued that this imbalance must, at some point, be corrected. That could come through greater demand outside America; or slower demand within America (implying higher saving and/or lower investment); or a continued downward slide in the dollar.

In public, the Bush team talks up foreign growth, domestic fiscal prudence and a strong dollar. Their real view, however, seems to be that much of the adjustment will come through a weaker dollar.

Look at the evidence to date, and you can hardly blame them for thinking this will be painless. The dollar has slid, but there has been no painful financial crash, no dramatic rise in long-term interest rates, no perceptible impact on America's asset markets (the Dow Jones Industrial Average is up almost 5% since the election). Equity and bond markets did dip a little after Mr Greenspan's recent comment; but Wall Street seems to share the Bush administration's sanguine view.

Can this continue? Economic theory suggests not. Sooner or later, a sliding dollar should bring higher interest rates, both because skittish foreigners will demand higher returns to hold dollar assets and because investors of all sorts will demand a premium for the inflationary risk that a depreciating currency implies.

In addition, there may have been special forces pushing down interest rates. Most obviously, those altruistic Asian central banks have bought vast numbers of American

bonds. But dampened expectations about America's economy have also helped: the surge in oil prices prompted concerns that the economy would stay soft, pushing down long-term interest rates. Finally, the central bank's decision to raise short-term rates four times since June has bolstered confidence that Mr Greenspan will not let inflation get out of hand, thus taking pressure off long-term rates.

A note of realism

These special circumstances may not last. Asian central bankers may lose their enthusiasm for treasury bonds. Far from feeling gloomy, America's economy is looking resilient—as the recent jobs figures showed. Firms are flush with cash and investing more. Both producer and consumer prices soared in October. To be fair, the headline figures owed much to oil prices and hurricane-related supply shocks. But even if you take out the volatile categories of food and energy, “core” consumer-price inflation rose at an annual rate of 2.3% between August and October. With productivity growth slowing and wages firming, unit-labour costs have begun to rise following two years of decline. Meanwhile, by pushing up import prices, the dollar's depreciation will increase inflationary pressure.

Add these factors together and it seems likely interest rates are headed higher. If any such rise were modest, it would bother no one in Mr Bush's team; it would be interpreted as a sign of economic vigour and an inducement to more private saving. But a big slide in the dollar might force interest rates to rise far more sharply than anyone expects, causing serious problems both for the frothy housing market and the debt-laden consumer.

This explains Mr Bush's sudden interest in fiscal prudence. Not only is bringing down America's budget deficit a direct route to higher national saving and thus to reducing the current-account deficit. Signs that America's huge budget deficit was being brought under control would also calm those skittish foreigners (and so control the dollar's slide) as well as reassure the bond markets. Both these things would reduce the chances of an unpleasantly sharp rise in long-term interest rates.

The short-term budget outlook is a lot better today than even a couple of months ago, largely because tax revenues have risen surprisingly fast. At 3.6% of GDP, the budget deficit for the fiscal year that ended on September 30th was smaller than expected. Provided the economy hums along, revenue growth could push the deficit to around 2.5% within the next couple of years, as long as spending is kept under control. The recent spending bill is a welcome, if small, step in that direction. Next year will bring tougher battles, such as the five-year transportation bill, a favourite for lawmakers to pack with pork.

But even if revenues hold up and discretionary spending is controlled, Mr Bush's goal of halving the deficit by 2008 looks tricky. His calculations do not include political imperatives such as fixing the Alternative Minimum Tax (see [article](#)) or reforming Social Security. Any diversion of pay-roll taxes into individual pension accounts would have to be covered by government borrowing. Administration officials plead that this would simply be an

accounting change—turning implicit liabilities (promises to pay future pensions) into explicit liabilities (government bonds). It is far more likely that the bond markets would treat a wave of Social Security bonds as fresh American government borrowing. That would not endear foreign investors to the dollar.

There is a virtuous circle there: if you combine a fiscal adjustment with a rise in Americans' private saving, a sizeable but controlled decline in the dollar and faster growth abroad, Mr Bush could reduce his country's imbalances with relatively little pain. Unfortunately, there are a worrying number of things that could go wrong.

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