VOLUME V No. 212 W E D N E S D A Y November 5, 2003

THE AMERICAN DOLLAR AND THE WORLD: HOW FAST IS TOO FAST ?

The potential for the **U**nited **S**tates (US) to cause international havoc, either by design or accident, over the next year or so is high.

The international havoc, to which **TARGET** is referring, is not connected to the country's problems in Iraq, Afghanistan and/or any other flash-point on the face of the globe, but with regard to any fast-track depreciation of the US dollar against other *'hard'* currencies.

Since the beginning of this year, the US dollar has depreciated not less than 10 percent on a trade-weighted basis.

A fast depreciation of the US dollar against other *'hard'* currencies would tend to reduce the US budget deficit, nicely, but it would be very telling on the economies of many countries.

Last Thursday, it was reported from Washington D.C. that the US economy had grown by about 7.20 percent in the third quarter of this year: It was the fastest pace of growth in the **G**rowth **D**omestic **P**roduct (GDP) in the past 20 years.

(GDP is the total market value of the final goods and services, produced by a nation's economy, during a specific period of time)

The US Administration was quick to state that the third-quarter explosion in the growth of the GDP was due, in part if not in whole, to the $US350-billion tax plan, passed by Congress in the spring of this year.

That plan lowered tax withholding rates and caused about $US13.70 billion to be rebated in child tax credits, those rebates, being in the hands of those entitled to them, during July and August, this year.

It has been estimated that each entitled household received a rebate cheque of between $US200 and $US300, at most.

Nevertheless, the GDP figures were impressive; and, they surprised a number of international economists.

In order to try to start to balance the books of exports and imports in the US, another de facto depreciation of about 25 percent in the value of the US dollar from its current levels would have to become a fait accompli.

Should such an eventuality come to pass, too quickly, however, it would be deleterious to many economies of the world – with the economy of Japan, which is the second-largest economy of the world, today, being one of the first economies to be hit hard.

It will hit Japan in the belly of its economy, with its motor-vehicle industry and its massive, electronics industry, being sliced up in the manner of a Parma ham.

The question is, of course: How long will it take for such a de facto depreciation of the US dollar to become a hard reality, assuming that it is inevitable and irrespective of that which Mr John Snow, Secretary of the US

Treasury, might state to the contrary?

<u>Weaning The U.S. Off The US Economic Teat</u>

Following a slow start, this year, the economic activity in the US and Japan picked up rather smartly.

Not so in Europe, however, which was, and is, still, in the grips of economic stagnation.

While the US Administration has embraced a strong monetary stimuli policy, real, short-term yields have been less than one percent.

Meanwhile, in the **E**uropean **U**nion (EU) and Japan, real, short-term yields were zero percent.

The series of economic stimuli, which the US Government initiated, earlier this year, must have had an effect on private-sector investments, correcting investment imbalances, which had been built up since 2001 – or even earlier.

Which, today, raises the question as to whether or not those corrections are sufficient to permit the recovery in the US to continue into the fourth quarter and beyond.

Breast-feeding an economy for a short period of time may result in some growth activity, but the trick is to wean the economy off the government's teat, permitting it to forage for its own *'milk'*.

Further, regardless of the economic packages, which were dished out, gratis, to US consumers by the Bush Administration, earlier this year, the effectiveness of the $US200-$US300 in cash per US family must be limited in its effectiveness, also.

And it would be interesting to learn what percentage of those rebate cheques went to repay old debts instead of being circulated, back into the economy.

To **TARGET**, it would still appear to be that US households, by and large, are stretched to their breaking point, today.

The economy of the US is, still, not doing much to put the working man, back on the assembly line and bottoms into chairs in offices.

The seeming gains in US corporate profits, in many cases, are the results of creative accounting practices, brought about by the requirement to make massive provisions and/or write-off/write-downs in the previous few years.

While this was going on in the US, in the EU, there were different and more pressing considerations.

Currency induced losses in net exports must be attacked by investment spending in the EU in order to generate greater domestic demand, sufficiently strong to countermand the losses, brought about by the weaker US dollar vis-à-vis the euro.

Stereo-selective and stereo-specific fiscal policies appear to have worsened the imbalance in demand for goods and services, internationally.

The US deficit, which is, now, forever widening, or so it seems, is seen most clearly in its Current Account.

In order to achieve a reduction in the Current Account Deficit to sustainable levels – between 3 percent and 3.50 percent of the GDP – within the next few years, it would require a de facto devaluation of the US dollar against the Japanese yen and the euro of the order of at least another 25 percent from prevent levels.

If the devaluation of the US dollar were prolonged for a period of time, greater that is, than, say, 3 years, then, international adjustments could kick in, permitting the economies of Japan and the EU, especially, to accommodate the new-look, US dollar.

On the other side of the coin, there is the matter of the international investor who, fearing that the US dollar is likely to weaken further against the euro, etc, will stay clear of making material, fresh financial commitments in The Land of The Free and The Home of The Brave.

For US manufacturers, a weaker US dollar, vis-à-vis the Japanese yen and the euro, will mean easier pickings in the short term, as US-made products and services will be able to compete with like products and services, produced in the eurozone and Japan.

But US imports will tend to eat into the economy since they will become pricier, relative to the strengthening US dollar, because the buying power of the American greenback will be eroded, depending on the speed of the depreciation in value of the US dollar against other currencies of America's trading partners.

The higher costs of imports – and the US economy cannot avoid importing cheaper textiles, garments, computer parts, and a host of other items from the Asia-Pacific Region – will have to be passed on to the US consumer, who, in turn, will make more demands on employers in order to afford these staple goods and services.

As it is, it is estimated that US households' debt levels are reaching somewhere in the region of about 110 percent (or more) of disposable income.

Such a high debt burden could well choke off private consumption.

Private consumption in the US is a matter, which President George W. Bush has used as a yardstick of the country's resurgence to economic health.

The rising values of stocks and shares on equity markets of the US have helped to make adjustments to the so-called US wealth effect, following a number of years of fast declines in the market prices of equities.

As the *'darlings'* of the stock markets of the US continue to delight investors with seemingly higher profits, no doubt, more spare change will be pumped into the markets, causing them to rise even further.

After this, therefore, because of this (Post Hoc, Ergo Proctor Hoc).

But it remains to be seen as to what effect this will have on the price of cheese and crackers.

<u>Debt Burden Versus Debt Service</u>

The absolute debt burden of Mr and Mrs America is one thing, but the absolute debt service of Mr and Mrs America is something else, again.

Interest rates in the US, today, are at 45-year lows and, according to the US Federal Reserve Board, they are likely to stay at these levels for some time in order to continue to fuel the economy.

On Tuesday, October 28, the US Federal Reserve Board said:

> *'The Federal Open Market Committee decided today to keep its target for the federal funds rate at 1 percent.*
>
> *'The Committee continues to believe that an accommodative stance of monetary policy, coupled with robust underlying growth in productivity, is providing important ongoing support to economic activity. The evidence accumulated over the inter-meeting period confirms that spending is firming, and the labour market appears to be stabilising. Business pricing power and increases in core consumer prices remain muted.*

'The Committee perceives that the upside and downside risks to the attainment of sustainable growth for the next few quarters are roughly equal. In contrast, the probability, though minor, of an unwelcome fall in inflation exceeds that of a rise in inflation from its already low level. The Committee judges that, on balance, the risk of inflation becoming undesirably low remains the predominant concern for the foreseeable future. In these circumstances, the Committee believes that policy accommodation can be maintained for a considerable period.'

For many households in the US, debt levels are dangerously high, with debt service, on a national average, at about 14 percent of disposable income.

Mortgage loans in the US have, of late, been refinanced, thanks to the continuing low interest rates.

For banks and finance houses, lower interest rates are roundly welcomed for a number of reasons, with relatively higher profit margins, being the juiciest plum of all to such institutions.

When interest rates were at 10 percent per annum or higher, financial institutions' profit margins on mortgage lending may have been 20 percentile points, but, when interest rates dropped to 5 percent and below, profit margins on mortgage lending rose to more than 60 percentile points: Profit margins for lending institutions rise when interest rates fall.

As long as interest rates in the US stay at the current low levels, all things, being equal, it will tend to fuel the price of bricks and mortar since the price of real estate is tied, directly, to interest rates.

Today, in the US, mortgage loans are said to account for about 70-plus percent of total debt.

Many US households have increased their overall debt over the past year or so by refinancing, using real estate as collateral.

Debt service has declined, to be sure, and, as long as interest rates stay at today's levels, there is no perceived, or immediate impending trouble.

If interest rates should start to rise, again, however, there could be a sudden collapse in the US economy.

This collapse could be catastrophic.

The US Federal Reserve Board is well aware of this probability – and that must have been one of the reasons for the statement of Tuesday, October 28.

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