THE AUSTRALIAN

Greenback flood worse than fiscal cliff

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Illustration: Eric Lobbecke Source: The Australian

WITH the US facing both the prospect of the "fiscal cliff" and a looming showdown over the allowed debt ceiling, it is difficult to fault consumers and investors for being spooked. These are times to be prudent. And that makes it all the worse that the Gillard government has abandoned even the pretence of having a credible fiscal strategy.

The US's fiscal problems are hardly new. From 1975, successive administrations have run budget deficits, with attempts at imposing fiscal discipline unsuccessful until 1993. That year marked a sharp reversal in the trend, but it was not sustained, with a return to ever greater deficits in the 2000s. With budget shortfalls aggravating an already large gap between what Americans earned and spent, the result has been high trade deficits and rising net indebtedness by the US to the rest of world.

For any other country, ever mounting external debt would be unsustainable. At some point, concerns about solvency would force a steep increase in interest rates, reining in domestic demand and raising the costs of continued fiscal profligacy.

But the US dollar is the international currency. And with more than 70 per cent of international debt issues being denominated in US dollars, and the US dollar on one side or the other of 85 to 90 per cent of interbank foreign exchange transactions worldwide, the US government could, in extremis, simply print the means of payment to repay its foreign debts. Alone among nations, the US therefore enjoys a virtually unlimited line of credit on the world as a whole.

That allows it to operate largely free of international constraints. And paradoxically, the rise of China has accentuated that freedom. This is because the US dollar is even more pre-eminent in East Asian trade than it is elsewhere. Moreover, with relatively immature, tightly regulated financial systems, the East Asian economies, including China, manage their large pools of excess savings mainly through government channels, and notably by investing in US dollar assets, especially American public debt.

Persistent US deficits have therefore been financed by rapidly growing East Asian holdings of US Treasury bonds. But it is not only US budgetary recklessness that that freedom from constraint has allowed. It has also permitted American policymakers to conduct monetary policy with little regard for international consequences.

After all, public debt equal to more than 70 per cent of GDP and rising should make selling government bonds to foreigners at real interest rates close to or below zero a struggle. But the US can, and it is exploiting that ability to flood the world with dollars. The Bernanke-Greenspan shock of 2003-08, when American monetary expansion sparked a 90 per cent rise in commodity prices, shows the harm that causes. But the impacts are not limited to inflationary pressures in commodity and asset markets.

With US real interest rates at historical lows, flows of hot money seeking positive returns have revitalised the carry trade (in which funds borrowed at very low rates are reinvested in countries that still have positive interest rates), destabilising monetary policy in the inflow countries and forcing artificial appreciations in their currencies. As well as distorting world trade, the fear of being exposed to such uncontrolled revaluations makes the emerging economies, particularly China, even more reluctant to liberalise their financial systems, entrenching inefficiencies in those economies.

None of the proposed strategies for avoiding the fiscal cliff address these issues. Despite convincing signs of an economic recovery, President Obama's package leaves US government debt continuing to rise, albeit at a marginally slower pace. And far from tackling growing healthcare costs and the insolvency crisis threatening the American social security system, Obama has expanded entitlements, while shifting spending towards the Democrats' black and Hispanic constituencies.

But that hardly makes going over the fiscal cliff a good idea. Even putting aside the immediate impact on the US economy of increasing the tax take by $350 billion in 2013 alone, large rises in marginal income tax rates, in taxes on dividends (which would jump from 15 per cent to 39.6 per cent for most dividend recipients) and in capital gains tax would discourage savings, exacerbating America's savings shortfall and reducing its productivity.

Moreover, the across-the-board spending cuts the cliff would trigger are poorly targeted. Like the tax increases, they would soon prove politically unsustainable and be unwound, as happened with the cuts mandated by the Gramm-Rudman-Hollings Act of 1985 and the 1990 Budget Enforcement Act.

What is required is a credible commitment to reform of taxes and of public spending. But of that there is no sign on either side of US politics. Rather, even if a fix is found that averts the fiscal cliff, everything points to yet another round of posturing over the federal debt limit.

Introduced in 1917 as a way of facilitating war finance by giving the president greater control over the administration's borrowing (which until then required specific congressional agreement for even short-term operations) and further streamlined in 1939, that limit should simply reflect the federal budget, which congress approves. In practice, proposed debt ceiling increases serve as opportunities for grandstanding. Those reached a peak in 1977, when congressional failure to ratify the increase in time led to the US being briefly in technical default. To avoid repeating that, as of 1980 the Gephardt rule (named after the then Democratic majority leader) linked an increase in the debt limit to congressional approval of the budget resolution. Republicans waived that rule in 1995, and the Democrats (including then-senator Obama) used that waiver to obstruct every debt increase sought by George W. Bush. Playing tit for tat, the Republicans repealed the Gephardt rule in 2011, setting the stage for the confrontation that lies ahead.

But that confrontation is symbolic politics at its worst. Rather than solve problems, it engages a take-no-prisoners political dynamic that cloaks them in illusory righteousness. And it leaves the world economy exposed to the risks of American economic irresponsibility, aggravating the dangers of the eurozone crisis.

Faced with those uncertainties, Australian budget policy should underpin confidence by operating on a predictable basis, while providing the fiscal margin to counter adverse shocks. Instead, contrary to Labor's own much vaunted fiscal rules, Wayne Swan will deliver yet another deficit.

That makes us unnecessarily vulnerable to the fallout from possible political breakdown in the US and in Europe. With 2013 just around the corner, Australians are right to feel uneasy.