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Will US debt lead to a financial crisis?

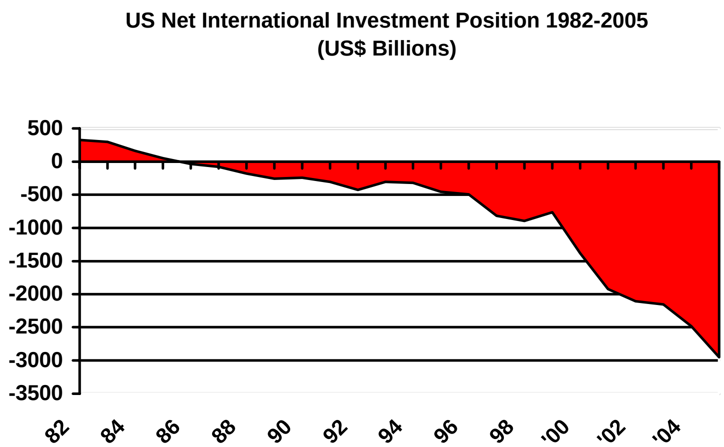
John Dillon

Former US Treasury Secretary Larry Summers warily compares the apparent calm on global financial markets to the tranquility that preceded the crises of the 1990s. Today, the imbalances that threaten global financial stability are rooted in the USA's burgeoning debt.

The US is the world's largest debtor. Its external debt, measured in terms of its "net international investment position", approached $3 trillion at the end of 2005.[1] The US debt is comparable in size to the total debt of all developing countries which reached $2.6 trillion at the end of 2004 as measured by the World Bank.[2] If US trade deficits continue to grow at their current pace the net debt could reach $7 trillion by the time George W. Bush leaves the White House.[3]

The US debt is growing because of its huge current account and budget deficits. The current account deficit, now nearly 6.5% of GDP, exceeds the level deemed acceptable by the International Monetary Fund. It is on course to reach 8% by 2008 and 12% by 2010. US trade deficits are largely (90%) financed by foreign purchasers of dollar-denominated financial instruments, such as US Treasury bills. As economist James K. Galbraith explains "[The US gets] real goods and services, the product of hard labour by people much poorer than [US consumers], in return for chits that cause no effort to produce."[4]

Former French President Charles de Gaulle called the USA's ability to print money to spend abroad an "exorbitant privilege."[5] Andre Gunder Frank calls this arrangement "a global confidence racket," one that can only continue as long as other countries keep on buying US financial assets.[6] Foreign investors own about 53% of all US Treasury bills and over half of these overseas holdings belong to central banks.[7] China will soon overtake Japan as the biggest investor, while Taiwan and South Korea also own substantial amounts.



Source: US Department of Commerce and Toronto Star 27/12/05

Southern Countries Finance US Debt

Developing countries hold a surprisingly large portion of US debts as part of the foreign exchange reserves owned by their central banks. At the end of 2004 all developing countries together had foreign exchange reserves worth $1,592 billion.[8] About 70% of these reserves are invested in dollar-denominated assets, either in the US itself or on euro-dollar markets. These reserves exceed the total public debts of developing countries -$1,555 billion in 2004.[9]

But only a handful of developing countries are in fact net creditors. Half of developing country reserves, $775 billion at the end of 2004, are held in East Asia, with China owning about four fifths of these assets. East Asian developing countries had $2.84 in reserves for each dollar of

KAIROS: Canadian Ecumenical Justice Initiatives • 129 St. Clair Ave. W., Toronto, Ontario, Canada, M4V 1N5
Tel: 416-463-5312 • Fax: 416-463-5569 • www.kairoscanada.org

external public debt. In every other region public debts still exceed foreign exchange reserves but by smaller margins than one might expect. Eastern Europe and South Asia have 89 cents in reserves for every dollar of public debt and the Middle East and North Africa 80 cents per dollar. Latin America and the Caribbean have less, 44 cents per dollar of debt and Sub-Saharan Africa the least with 34 cents in reserves for each dollar of public debt.[10]

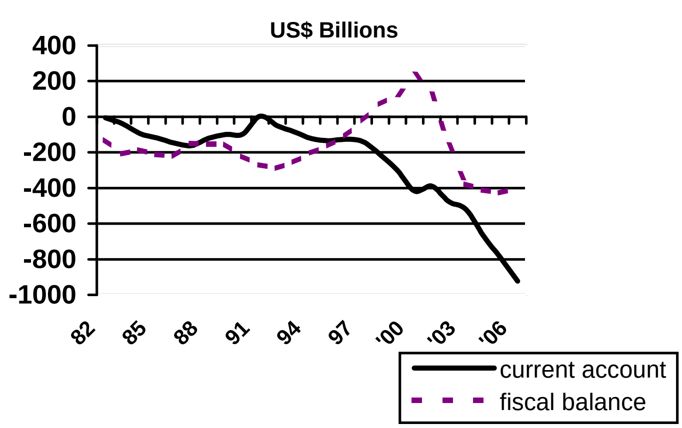
Why do central banks, particularly in Asia, hang on to such huge currency reserves? After the financial crisis of 1997-98, Asian governments decided to build up their reserves as protection against abrupt reversals of capital flows. They want more liquidity on hand to defend their currencies against speculative attacks by money traders.

Tax Cuts and Wars Increase US Debt

Washington's fiscal problems are not hard to decipher. George W. Bush has pledged $350 billion in tax cuts for the wealthy over a period of 10 years. The invasions and occupations of Afghanistan and Iraq have cost $250 billion so far, with another $6 billion added each month. Federal tax revenues were $145 billion lower in 2004 at the end of Bush's first term than they were in 2000, the last year of the Clinton administration, while 2004 spending was $503 billion higher than in 2000. During a private, off-the-record discussion in September of 2005, Alan Greenspan, chair of the US Federal Reserve Board, admitted that the US has "lost control" of its budget deficit.[11]

To finance its current account and fiscal deficits the US has to borrow $2.6 billion every day, appropriating an incredible 80% of the world's net savings.

Annual US Current Account and Fiscal Balances



Actual amounts for 1982-2004 and forecasts 2005-2006 Sources: US Department of Commerce; Global Insight, *Interim Annual Forecast*, October 2005 and US Budget Fiscal Year 2006.

Burgeoning US debt has made some overseas investors nervous about holding dollar-denominated assets. In November, 2004 Mr. Greenspan acknowledged that "foreigners may tire of financing the record US current account deficit and diversify into other currencies or demand higher US interest rates." In fact central banks are already diversifying their portfolios. The Bank for International Settlements reports that Asian governments reduced the ratio of dollar reserves to other currencies such as euros, pounds or Swiss francs from 81% in the third quarter of 2001 to 67% in September 2004.

Between June of 2004 and January of 2006, the US Federal Reserve has raised interest rates by three and a half percentage points, in part to keep foreign investments in the US. These rate hikes have helped to stabilize the dollar after it had declined by 38% against the Euro, by 25% against the Canadian dollar and by 23% against the yen between February of 2002 and March of 2005.

Any drop in the value of the greenback constitutes an effective default on a portion of the USA's debts because the "new" dollars it prints to service these debts are worth less than the "old" dollars it borrowed. This costs foreign investors in US assets billions of dollars in losses.

Why then do Asian countries, in particular, continue to take losses by holding so many dollar-denominated assets that earn low returns while allowing the US to live beyond its means? Japan has long been willing to pay a price for the protection the US military umbrella provides for its trade and overseas investments. Tokyo paid $13 billion of the $61 billion financial cost of the first Persian Gulf War in 1990 in order to keep its access to oil from the Middle East. Hence President George H. Bush senior got a better deal than his son as Japan paid for his Gulf war with grants while George W. Bush gets only loans.

China has lent the US billions of dollars from its enormous and growing trade surpluses as a type of vendor financing for its exports. China's bilateral trade surplus with the US now exceeds $200 billion a year as China exports six times as much merchandise to the US as it imports. Until recently China kept its currency, the renminbi (or yuan as it also known), strictly pegged to the US dollar to protect its export trade against the price increases and loss of market share that might follow a revaluation against the dollar. The US put enormous pressure on China to allow its currency to rise. In July of 2005 China loosened the link to the US dollar by moving the renminbi's valuation to a basket of currencies, effectively revaluing it upward against the dollar by just 2.1%.

While China will not openly bow to US pressure to revalue, it has to be wary of US Congress Members' threats of retaliation. But aggressive US protectionist measures could ultimately backfire. Wal-Mart, the largest US employer, imports 70% of its products from China where workers earn less in a day than US workers earn in an hour.[12] Many US manufacturers have already relocated production to China. Price increases resulting from a revalued renminbi could actually increase the US trade deficit if the US cannot produce the same goods at home.

A Balance Of Financial Terror
Asian governments and central banks, private investors, official Washington and Wall Street have mutual interests in avoiding a financial crisis. Former Treasury Secretary Larry Summers calls the situation "a balance of financial terror" since all stand to lose in the event of a financial meltdown.[13] Andre Gunder Frank likens the situation to the need to avoid Mutually Assured Destruction from nuclear weapons. He notes that both the wealthy and the poor would suffer from a financial crisis that would throw millions out of work and wipe out billions of dollars of financial assets.

While Asian governments are careful not to precipitate a crisis, private investors are not as inclined to take losses in order to preserve a shaky balance of terror. As one European banker explained to the Mexican newsmagazine *Proceso*: "When a financier lends money or invests capital, his problem is not to loan to someone or invest in an industry that will not go bankrupt. **Potentially, everyone can go broke. His problem is to lend or invest up to 15 minutes before the crash … [and then] get out on time."[14]** [emphasis added]

Private money traders watch for signs of a "tipping point" that might turn a gradual decline in the value of the greenback into a run on the dollar. For example, when the Korean central bank indicated in February of 2005 that it would diversify away from the greenback and hold more Canadian and Australian dollars, a minor panic went through global financial markets. *The New York Times* reported: "As the Korean comment ping-ponged around the world, all hell broke loose, with currency traders selling dollars for fear that the central banks of Japan and China … might follow suit."[15] The Bank of Korea quickly issued a clarification saying the proposal was not a statement of intent and the speculative fury subsided.

But the fear remains that some such incident could set off a global panic. The predictable result of a run on the dollar would be large increases in US interest rates in an attempt to attract investors back. The vulnerability of the US economy to a rise in interest rates can be seen in the following data:

- "The average US family spends $1.22 for every dollar it earns, has 13 credit cards and $9,312 in credit card debt – twice as much as 10 years ago."[16]
- US citizens have borrowed $1.6 trillion against the value of their homes at a time when many observers predict the housing bubble is about to burst.
- Non-financial US corporations carried $2.9 trillion in debt at the end of 2004.

Given this precarious situation what the world needs is what John Maynard Keynes once called "a program for financial disarmament." Keynes proposed an international currency to replace reliance on gold or national currencies to settle trade accounts. However, rather than take measures to reduce deficits, Bush is continuing his imperial adventures abroad.

Stage is set for a crisis
The stage is set for a financial crisis similar to, but not identical to, the debt crisis of the early 1980s. That crisis was set off by the huge interest rate increases engineered by then Federal Reserve Board chair Paul Volcker in response to speculation against the dollar and inflation deemed to be caused, in part, by high oil prices. Now the chief economist at Standard and Poor's estimates that a rapid decline in the dollar could again push up US interest rates to 15% or 20%, an uncomfortable reminder of the usurious level they attained in the early 1980's.

The irresponsible behaviour of the Bush administration, especially its unilateralism and militarism, also echoes the behaviour of the Nixon White House. In 1971, at the same time as he delinked the dollar from gold, Richard Nixon imposed a 10% across-the-board surcharge on all US imports in order to force a revaluation of other countries' currencies to make them bear part of the price of the USA's own crisis. Now "there is growing talk in Washington of more drastic unilateral and protectionist measures such as [another] across-the-board surcharge on imports."[17]

Another sign of US unilateralism is its own attitude to IMF advice. The IMF conducts an annual review of the US economy and then offers advice to the US Treasury and the Federal Reserve Board. *The Wall Street Journal* reports that: "Time and again, the Fed has nodded politely, and for the most part, [ignored the advice, unlike] poor countries that don't have the luxury of throwing its advice into the dumpster…. The US Treasury, even though it ignores the IMF's counsel itself, is usually the first to insist that developing countries toe the IMF line."[18] Does not Washington's cavalier attitude to the IMF, and the Fund's loss of prestige since its disastrous mishandling of the Asian financial crisis, give all the more reason for developing countries to ignore it as well?

Geopolitics of Oil, Money and Militarism Intertwined.
US militarism is both a cause and a potential victim of its financial weakness. Linda Bilmes, an assistant secretary at the Department of Commerce from 1999 to 2001, calculates that if the US military presence in the Middle East lasts another five years, the total cost to the US could be more than $1.3 trillion.[19] Her calculations take into account the costs of disability and health payments for returning veterans.

A collapse of the dollar could lead to the closing of some of the USA's 725 overseas military bases and the repatriation of some of the 446,000 troops stationed abroad.

In 1975 Henry Kissinger struck a deal with the Saudi monarchy offering military protection in return for a guarantee that revenues from petroleum sales would be recycled into petrodollars. The rest of OPEC followed the Saudi lead and officially agreed to sell oil only for US dollars. But that consensus has begun to break down. Saddam Hussein broke with this pattern by starting to sell oil for Euros in 2001, angering the Bush administration and providing another motive for his overthrow.

Now Iran is contemplating opening its own oil exchange to trade crude for Euros. Some observers say this proposal, and not its nuclear program, accounts for the White House's renewed belligerence towards Iran.[20]

Implications for Canada

Canada is more vulnerable than any other country to a US financial crisis. Around 40% of our economy depends on export, investment and tourism linkages with the US. When Richard Nixon unilaterally imposed his 10% surcharge on all imports in 1971, Ottawa pleaded for an exemption but received a cold shoulder from the White House. Membership in NAFTA won't make much of a difference given the way the Bush administration has ignored its obligations in the softwood lumber dispute.

Just as the financial crisis of the 1980s led to the Great Recession in Canada where unemployment soared from 7.5% in 1980 to 11.9% in 1983, a new crisis would have devastating effects. Since the signing of the Canada-US Free Trade Agreement in 1988, Canadian exports to the US, expressed as a percentage of GDP, have doubled. In 2004, 85% of Canada's exports went to the US. Canada will pay dearly for this overdependence.

It is time to recapture the vision behind Prime Minister Trudeau's "third option". Far from being simply a diversification of trade away from the US market, Trudeau's third option was "essentially a *domestic* policy option, very much in line with Trudeau's determination to strengthen national institutions in Canada. It aspirations were those of the [1972] 'Gray report" which outlined how massive foreign ownership had reduced Canada's leverage over domestic economic development, eroding research and scientific capabilities."[21] The third option sought to reduced Canada's over-reliance on the export of raw commodities, as well as dependence on the USA.

Implications for the Illegitimate External Debt of Southern Countries

In December of 2004 *The Economist* noted that if the decline in the US dollar continues it will "amount to the biggest default in history."[22] This unilateral change in the terms of the USA's own debts is another example of the exorbitant privilege attached to being the issuer of the world's principal reserve currency. This same privilege is not available to Southern countries that cannot borrow funds in their own currencies. But the example of a unilateral default by the world's largest debtor gives Southern governments another reason for refusing to make payments on debts that are clearly illegitimate by virtue of their origin as odious debts incurred by dictatorial regimes or because they accumulated due to sky-high interest rates.

How will Southern governments react to another financial crisis like that of 1982 that suddenly reduces their export earnings and raises interest rates making it impossible to service their debts?

Much will depend on the strength of the global justice movement and peoples memories of the disastrous results of following IMF dictates during the crises of the 1980s and 1990s. When a new crisis occurs this movement will pressure Southern governments to repudiate illegitimate debts and refuse to sign agreements with the IMF.

John Dillon is Debt and Finance Program Coordinator for KAIROS. He may be reached by email at jdillon@kairoscanada.org KAIROS: Canadian Ecumenical Justice Initiatives unites eleven churches and religious institutions in work for social justice in Canada and around the globe.

Endnotes

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[1] All figures are in US dollars. A country's net international investment position includes foreign direct investment, bonds and loans.
[2] The World Bank's *Global Development Finance* (2005) measures debt excluding foreign direct investment.
[3] Dean Baker, "Dangerous Trends: The Growth of Debt in the U.S. Economy", 7 September 2004, www.cepr.net
[4] Cited in Asad Ismi "U.S. can't keep relying on other countries to pay for its imperial excesses" *The CCPA Monitor* May 2005 Ottawa:
[5] Ibrahim Warde "Le sort du dollar se joue à Pékin" *Le Monde Diplomatique* Mars 2005
[6] Andre Gunder Frank "The Naked Hegemon" *Asia Times* 10/01/04
[7] *Financial Times* 16 August 2005
[8] World Bank *Global Development Finance 2005* Washington.
[9] Eric Toussaint "Utopie pour briser la spirale internale de la dette" CADTM 8 juin 2005.
[10] calculated from World Bank *Global Development Finance 2005* .
[11] *The Globe and Mail,* Toronto, 26 September 2005, B1.
[12] Ibrahim Warde, op. cit.
[13] *Financial Times* 7 December 2004
[14] *Proceso* No. 1020, 20 May 1996, p.19, Mexico DF
[15] cited in Asad Ismi op. cit.
[16] *Financial Times* 16 August 2005
[17] *The Globe and Mail,* Toronto, 23 December 2004
[18] *Wall Street Journal* 30 September 1999
[19] *The New York Times* 20 August 2005
[20] *Muckraker Report* 4 January 2006.
[21] Jeremy Kinsman, "Who is my neighbour? Trudeau and Foreign Policy" *London Journal of Canadian Studies* 18: 2002/2003, p.110.
[22] *The Economist* 4 December 2004, 9.