NOTES OF SPEECH and DISCUSSION

American Council on Germany

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Dr. Eckart Woertz, Visiting Fellow at Princeton University and Middle Eastern expert, gave an impressive but sobering overview of the world's economy and especially the US role in it.

One would have thought that the problems in Greece and the other "Club Med" countries and Ireland would have strengthened the dollar. The Greek deficit was just now determined to be higher than expected. We have also experienced the Japanese disaster and widespread unrest in the Middle East. Yet the Dollar is at 1.45 to the Euro and worth much less than only a few months ago. As bad as this is for the US, how must the managers of the Middle Eastern sovereign wealth funds feel? The controlling families in these countries are concerned about the purchasing power of their overseas assets, which they might want to repatriate some day for financing social and economic development programs at home.

We saw great changes in and challenges to the world financial order in the 1970s, with the demise of the Bretton Woods sytem of fixed exchange rates, President Nixon's uncoupling of the dollar from gold and shortly thereafter the oil shock. Over the coming years it was increasingly financial markets not central banks that financed the growing international imbalances. This was a revolution and resulted in a massive redistribution of wealth. How was the world's economy to be financed? The old system had been overthrown.

The dollar has been a mid-term solution and until now this worked out sufficiently well. It was not just a free lunch for the US. Others benefitted, too China and other Asian manufacturers built their whole strategy of export led growth on US deficit spending.

The current crisis is likewise a combination of oil and finance. Over 50 percent of the US current account deficit stems from oil imports and if the Middle Eastern oil rich countries stop buying US debt, not to mention selling it, bond prices will fall and interest rates will go up with dramatic consequences for US mortgage borrowers.

The oil exporters are now the most important financers of the US deficit alongside China which began to play an ever increasing role in 2002-3.

US Treasury officials promoted the sale of US debt to Middle Eastern countries in the 1970s. The Saudis enjoyed preferred treatment, buying debt on favorable terms. US “shuttle diplomacy” in the Middle East was not confined to Arab-Israeli issues. It also applied to US Treasury efforts to sell debt there. This is like any debtor keeping a good relationship with his banks.

The US deficit grew dramatically in the Reagan years and exploded in the mid-1990s.

In the 1980s and 1990s the surpluses of oil exporters all but vanished because of falling oil prices. Germany and Japan took over in financing the US deficit. However, by 1990 Germany needed the money itself for financing its reunification and did not play a role anymore. Today the oil exporters are back in the game, with Saudi Arabia, Kuwait, UAE, Qatar, Libya, Norway and Russia undertaking huge overseas investments with their sovereign wealth funds. Other oil exporters like Canada or Mexico do not play a role as they run current account defícts themselves.

What difference does this make? Well, during the 1956 Suez crisis, President Eisenhower told the British that the US would start selling pounds sterling and the British fell in line with US policy. The Chinese are now in the same position vis a vie the US.

The fate of the dollar goes beyond the US. The local currencies in the Middle East and elsewhere are tied to the dollar. Petroleum products , priced in dollars, are about 20% of the world's physical trade. But only half of this is actually crude oil and the other half processed and refined products. Thus, the role of oil in international markets is substantial but not as huge as it is sometimes assumed. The real litmus test for dollar stability are the foreign investments. As long as oil producing Middle Eastern countries and China buy US bonds, the current system works. But there is a significant difference between China and the Middle East in this system. For China, dollar accumulation is essentially a function of an export-led growth strategy and an undervalued exchange rate, while the oil exporters invest in dollar assets as a true saving for future generation. Should there be a dollar devaluation, the Chinese already got something for their dollars, i.e. a capital stock and industrialization, while the oil exporters still want to buy something with theirs. Capital preservation and long term risk adjusted returns are much more important for them than for China.

Q&A Discussion

The Chinese need to buy US treasuries to continue to finance their main export market. The Chinese do have some hedging opportunities. They can put up US treasuries as collateral for loans to buy hard assets, such as raw materials in Africa. Dollars are essentially illiquid because there are so many of them. If you own them, it is difficult to find sufficient assets denominated in other currencies to allow you to diversify. The Euro is the only alternative so long as the market capitalization of Asian markets remains relatively small. The amount the US pays China as interest on US treasuries is enough to pay the Chinese annual defense budget.

The Europeans [somehow] do not pay attention to the current US debt ceiling discussion. They think there will be business as usual.

So many countries export so much, there has to be a trade deficit somewhere.

True, the US has some advantage by reason of its average age. Many countries are aging, including even Latin America. As populations age, they grow calmer. The ones with a large number of young men go through substantial changes and often upheaval. Terrorism in the Middle East is also a matter of a youth bulge in the population. A major difference in Lebanon and its calmer recent reaction to political events is that its population has aged. Countries with a birth rate of only 2 tend to be more stable.

The educational system in the Middle East is particularly bad. Korea went through the same birth explosion and trained its youth for good jobs. Today, however, we are seeing economies grow without job creation.

According to Karl Polanyi, the world's economy is based on two institutions - the nation state and capitalist markets. These have been around for only about 500 years, a short period. When the current system of trade and finance stops working - which it will - there will be tremendous strain put on these two institutions. They will have to adjust. This will be very difficult, even violent. Possibly cities and regions will globalize and replace nation states.

The United States has been developed based on cheap oil. US cities cannot exist as they are without cars. As gas prices continue to climb, the value of suburban real estate will decline (further).

Germany is betting on alternative energy by shutting down its nuclear reactors. It will become the leader in alternative energy. The question is whether this kind of energy will be economically feasible. The US does not make this kind of national commitment.

One possible bright spot for the US is its shale gas. Shale oil is too dirty and expensive, but shale gas holds promise. Yes, there are environmental issues, but these exist with all development. The US built LNG terminals for importing natural gas, but now the US talks about using these facilities to export gas. Even if US oil production goes up, it will not have an effect on world oil prices.

The US has subsidized the internet for decades. Now the new US industries which are world leaders are all internet companies.

There is no clear solution to the weaknesses of the current system. Not even theoretical ones. The question is how it will change, how much disruption and pain the change will cause. Either the US currency or the US consumer will go through major changes.

Gold will definitely go up, at least in the long run. But it does not produce wealth; it only maintains it.

Rudolph (Rob) Houck
rhouck@rhoucklaw.com
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