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ECONOMIC NEWS UPDATE

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27 March 2009

Will the G-20 become the G-2?

The American President heads into the G-20 meeting having been told by his top advisers that the US economy is showing signs of recovery. New home sales rose by 4.7 percent last month, durable goods orders were up, the stock market is at least sitting up in its sick bed, and applications for mortgages soared as mortgage rates fell to a low of around 4.5% for 30-year fixed rate loans. Many of these applications are aimed at refinancing existing, higher-rate mortgages, but as one administration economist put it to me, that is the equivalent of a tax cut, as homeowners who pay less interest each month have more to spend in the shops. But he is nevertheless warning his boss that these positive signs just might be the real economy's equivalent of the sort of dead-cat bounce that occurs in bear markets -- share prices rise,

only to fall back again. Braver thinkers are wondering whether the real economy might lead the financial sector out of the recession, whether the other way around, as we have always assumed.

Obama is also being advised that he should tamp down expectations of what might come out of this meeting, lest disappointed investors run for cover at its conclusion. After all, the Europeans will not go along with his request for a coordinated stimulus, and he will not go along with all of their demands for heavy-handed regulation of financial markets. The problem is that the British Prime Minister and host, Gordon Brown, who sees this meeting as his ticket to victory in his first-ever general election, is raising expectations faster than Obama and others can lower them.

Obama is confident that his budget, which adds trillions to the government deficit over the next decade, tripling the national debt, will not drive the dollar down. This, despite the massive borrowing that will be required to fund both his stimulus package and his wish list -- extending health care coverage to 50 million more Americans, constructing a "smart" grid powered by renewable energy, and improving access to superior education from kindergarten through college. The President continues to insist that we can't wait to tackle what he sees as long-term problems lest we never achieve a widely shared recovery. Proof for this proposition is, to put it mildly, not abundant.

Republicans are not alone in claiming that a budget deficit that hits 13 percent of GDP next year and never falls much below the 5 percent range in the next decade, according to the non-partisan Congressional Budget Office, is something to worry about. Even the Democrats in congress, led by a band of 16 senators largely from the mid-West, are taking a sharp pencil to some of the President's proposals.

But mere trimmings-around-the-edges will not satisfy China, which fears that Obama-level deficits will leave it with vaults full of depreciated dollars. After Chinese premier Wen Jiabao announced that he is "a little bit worried" that his country will be paid back in dollars that don't buy very much, Zhou Xiaochuan, Governor of the People's Bank of China, went further. He wants to replace the dollar as the world's main reserve currency with a quasi-currency managed by the

International Monetary Fund. Or says he does.

Obama was quick to turn thumbs down on any such move, and sources at foreign embassies knowledgeable in the ways of the Chinese tell me that they were merely flexing their muscles. They feel under-represented in the international economic forums and institutions, and know they will be asked to make a major contribution to increase the IMF's ability to cope with the current recession and future financial crises. They are letting it be known that he who pays the piper should get to call the policy tune.

The Americans also head for London confident that Treasury Secretary Geithner's plan to set up public-private partnerships to take "toxic assets" -- renamed "legacy assets" by an Obama advisor who says an asset can't be toxic if you would rather own it than not own it -- off the books of the banks will further ease the credit markets. The taxpayer will provide most of the money and guarantee the debt, and the private sector will reap a disproportionate share of the profits. Sounds good, but the investors I talk to are frightened by the populist backlash against the bonuses paid to some A.I.G. executives.

Obama's economic advisers are well aware of this problem, and so told the President to tone down his rhetoric and urge congress not to make policy in anger. The Geithner plan does include specific protections against ex-post attacks on the profits of private-sector participants. But we won't know until the plan becomes operational in May whether that protection will be

sufficient to reassure investors that they will not end up under the klieg lights in a congressional hearing room, or with busloads of protesters on the doorsteps of their homes. The President did his best to calm the bankers: he invited them to the White House to assure them of his anti-populism. But he could not promise that congress would not remain on the war path, especially since attacking what Teddy Roosevelt once called "malefactors of great wealth" is worth its weight in headlines and television coverage.

The Geithner plan is running into another potential problem: "I don't see how they are going to get the banks to sell," an executive at a large bank told the press. The banks value these assets on their books at something like 90 cents on the dollar -- and are likely to be offered 60 cents for some and perhaps 30 cents on the dollar for others. If they sell these assets, the banks would have to record the resulting losses on their books, which would reduce their ability to pass the "stress tests" now being run by the Treasury to determine whether they can withstand a worsening of the recession. That would result in a government takeover.

The most important development at the G-20 meeting will not find its way into the communiqué. Members of the US delegation are not alone in believing that Europe is in a state of denial, and that the worst is yet to befall its economies. Europe continues to look back, one participant told me -- to protectionism, in the case of France, and to the devastating effects of inflation in the case of Germany,

which makes chancellor Angela Merkel reluctant to sign on to a real stimulus package.

China and the US, privately dubbed the G-2, know they must look ahead, and create a workable new world economic order by eliminating their trade imbalance. The Chinese will have to let their currency rise to stem the tide of goods flowing from China to Wal-Mart, and create a domestic safety net so that Chinese citizens can stimulate the world economy by spending more instead of saving 25 percent of their incomes. America will have to provide assurances that it will not print so much money that the dollar drops in value. There is a deal to be made in the interest of both the present and the emerging superpowers. It will take time but, say the optimists in the G-20 crowd, it will be done.

A version of this Update appeared in
The Sunday Times (London)