A US default could send shockwaves across global markets: US banker

Dr Hani Findakly speaks in an exclusive interview with Reconnaissance Research

KUWAIT: A US default, directly or indirectly through inflation, can emit shockwaves throughout the global markets, disrupting trade, finance, and investments. For as long as the dollar is at the center of global finance, the risk of contagion is high, confirming the old maxim that when the US sneezes, the rest of the world catches a cold, said Dr Hani Findakly, an investment banker and Vice Chairman and Director of Clinton Group Inc, New York, in an interview with Reconnaissance Research. "The dearth of exit options creates a Hobson's choice as many financial indicators of US debt are fast approaching a red zone. The numbers are alarming, the trends are discomforting, and the solutions are elusive," Dr Findakly said during the interview. Excerpts from the interview.

Question: How serious is the US Federal budgeting process on the US and the Global markets?

Dr Hani Findakly: The US budgeting process is a very serious issue that has become increasingly intensely political reflecting the deep ideological fissures within the US. These divisions have rendered economic and fiscal policy fully dysfunctional. By 2001 Fiscal Year (which runs from October 1st to September 30th), the Afghanistan and Iraq wars forced the Government to drop all pretense of disclosing the cost of the wars.

Instead, it submitted a 'continuing budget resolution', an arcane provisional gimmick, based on prior budgets, which can be violated at will. Under this budgeting process, the equivalent of the military's 'Don't Ask, Don't Tell', both the Administration and Congress pretend to be fulfilling their constitutional mandates. Incredibly, this charade has continued for 20 years as the world's biggest economy ran without a formal budget.

Q: The world's biggest economy ran without a formal budget?

Dr Findakly: Yes. Meanwhile, profligate spending continued, as Congress approved successive budget ceilings to allow the government to operate. In October 2021, Congress approved a stop gap measure to extend the debt ceiling to $28.5 trillion, barely adequate to fund the government until December when another game of one upmanship will return. While there is high expectation that Congress blinks, as it often does, by finding a short-term solution to the debt ceiling, there is always a risk that a political impasse can one day lead to a catastrophic breakdown of a default on US obligations, including payments of salaries and social programs. A default also has negative implications for the domestic and international markets, and significantly, to the US dollar as a reserve currency.

Q: Have similar situations like this happened before in the US?

Dr Findakly: Yes. Unfortunately, it has happened more often than necessary, ever since Congress first adopted the concept of debt ceiling in 1917. The purpose then was to allow the government to borrow without having to revert to Congress every time it needs money, while keeping an overall constitutionally mandated congressional oversight over the budget. Over the past 50 years, the debt ceiling was raised almost routinely over 80 times. But the process of raising the debt ceiling has turned increasingly contentious, resulting in a series of crises starting in 1995 forcing a three-weeks government shutdown, followed by more shutdowns in 2011, 2013, 2018, and 2019. The increasing frequency of debt-extension crises is worrisome, as much because of its implication to the securities markets where US public debt is a key source of liquidity, but because of role of the US dollar as a major instrument of trade, international transactions, and the pricing of international commodities.


Dr Hani Findakly

Q: What are the possible solutions and what will it take to implement them?

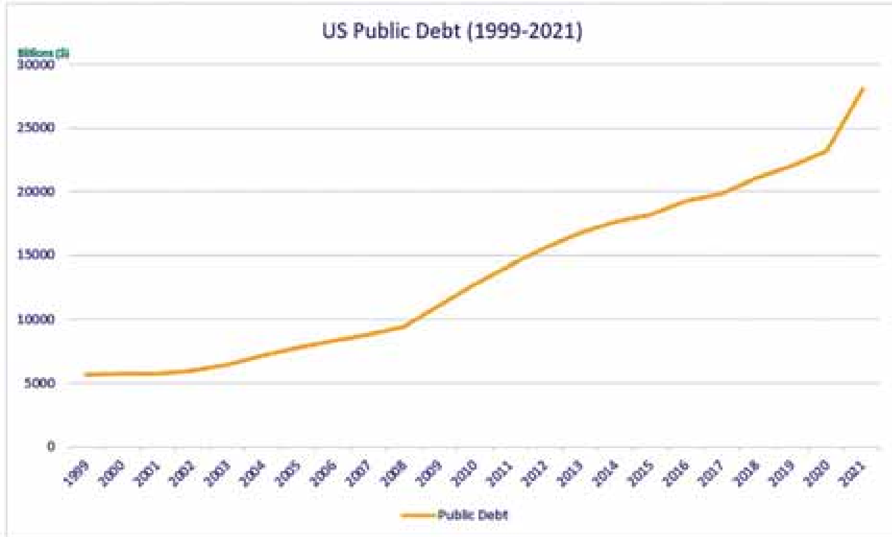
Dr Findakly: This is an intractable problem, deeply embedded into the US system where Congress has the 'power of the purse' and the debt has spun out of control. The only way to avoid it, other than a constitutional amendment, which is nearly impossible, there are no feasible short-term solutions. Broadly, there are three ways to ease the debt burden: faster economic growth, higher taxes, or lower spending. While faster growth is possible, the size and maturity of the US economy preclude a sustainably high growth. Raising taxes, as the third rail in American politics, is a major challenge in a combustive political atmosphere and corrupt powerful interests. Finally, cutting spending is nearly impossible since discretionary spending constitutes only 30 percent of the Federal budget of $1.5 trillion, half of it is defense. The non-discretionary spending now absorbs 62 percent of the budget (29 percent in 1969) including 48 percent for social security and healthcare (19 percent in 1969), and 8 percent for interest payment.

Aging population and the future cost of medical care for several million veterans of the Afghanistan and Iraq wars, estimated at $4-6 trillion, will keep the cost of the social safety net programs high for decades.

Absence of a major reduction in defense spending (America's sacred cow), there is little room to cut spending as red ink will endure. A conceivably palatable solution to the political elite in the near term is to allow inflation to rise at a faster rate. By inflating our way out of this dilemma, real spending and the real value of the debt will shrink, offering some short-term optical relief, but potentially creating more problems in the long term. This solution was adopted in the mid-1970s after the Vietnam war that ultimately caused a series of economic crises including the breakdown of the Bretton Woods system where the US dollar fixed convertibility into gold was abandoned leading to a major devaluation of the US dollar against the Japanese Yen and major European currencies (save for the UK). It is not inconceivable that a similarly unwise option may be contemplated again, adding further uncertainty into the post-COVID-19 economy.

Q: Who might gain or lose from this matter?

Dr Findakly: There are no major winners. First, since most financial crises arise out of excessive debt, uncertainty over default could stress the credit markets and snowball into a 2007-type crisis. Second, a cycle of inflation and devaluation could undermine the banking system as the prospect of rising defaults curtails lending and investments. Third, currency and market instability will impact developing countries who could struggle to finance their debt as well as shrinking demand for their products. Fourth, the prospect of higher inflation discourages savings and investments, slowing economic growth. Fifth, the US-China standoff can deepen the fissures in the global economy, aggravate geopolitical tensions and increase the likelihood for accidental conflicts. Sixth, economic crises hit the poor the hardest, thereby widening an already bad economic inequity. While there may well be certain marginal winners, e.g., large borrowers who will pay back in depreciated money, and possibly some geopolitical winners, e.g., China, the dynamics of any crisis often produce unpredictable consequences.



Q: What else keeps you awake at night?

Dr Findakly: Debt! It is a ticking time-bomb. Historically, every systemic financial crisis has been rooted in excessive debt and leverage. For a perspective on the rise of US public debt, consider that US federal debt was at an interim high of $250 billion in 1945, which in current Dollars equals to $3.8 trillion. Today, US debt is $28.3 trillion or 7.5 times its 1945 real value. While interest on the debt remains low at around 1.5 percent of GDP, because of the low and negative real interest rates, an anticipated rise in rates could raise the cost of borrowing significantly. A 1 percent rise in interest rates could raise the annual interest on the public debt by $285 billion. Already, the staggering fiscal deficit of $3 trillion in FY2020, will top $3.7 trillion in FY2022, or 15 percent of GDP. Meanwhile, low interest rates and fear of inflation have unleashed a borrowing binge that has catapulted household debt to a record $16 trillion, while non-financial corporate debt reached $12 trillion. Excluding unfunded liabilities, overall US debt exceeds $56.5trillion, or 2.5 times GDP. Repaying this mountain of debt under persistent twin fiscal and current account deficits is a Herculean task.

Q: What is needed then?

Dr Findakly: It requires draconian measures and a consensus on priorities that the US political system lacks. Although US debt is in US dollars, a quarter of it, or $7 trillion, is held by central banks, including 15 percent of which held by China. Therefore, a US default, directly or indirectly through inflation, can emit shockwaves throughout the global markets, disrupting trade, finance, and investments. For as long as the Dollar is at the center of global finance, the risk of contagion is high, confirming the old maxim that when the US sneezes, the rest of the world catches a cold. The dearth of exit options creates a Hobson's choice as many financial indicators of US debt are fast approaching a red zone. The numbers are alarming, the trends are discomforting, and the solutions are elusive.

Note: Dr Hani Findakly is Vice Chairman and Director of Clinton Group Inc, an investment management firm in New York. He is a graduate of Baghdad University (BSc, Magna Cum Laude), and the Massachusetts Institute of Technology (MIT): Master of Science (SM, Systems Analysis) and Doctor of Science (ScD, Decision Theory).

UK retail sales extend slump

LONDON: UK retail sales volumes dropped for a fifth month in a row during September, official data showed Friday, as the country suffers supply constraints and high prices. Sales volumes dropped 0.2 percent last month from August, the Office for National Statistics said in a statement revealing the longest retreat on record.

"Household goods were the main driver of... (September's) decline, with a fall of nearly 10 percent," noted ONS economic statistics director Darren Morgan. "Despite the lifting of (lockdown) restrictions, in-store retail sales remain subdued, with many consumers still opting to shop online."

Although sales of petrol surged in late September as drivers rushed to fill up their tanks, a UK fuel-shortage crisis likely meant consumers visited stores only for necessities, analysts said.

"Whether the products aren't available, the price tag is too high, or shoppers have simply finished fettling with their home decor, non-food sales pulled down September's figures," added AJ Bell financial analyst Danni Hewson. "Furniture stores have been warning for months that big ticket, big size items have been caught up in the shipping crisis and that seems to have worked its way through to consumer sales."

The UK is facing delays to the shipping of goods owing to an acute shortage of lorry drivers. Helen Dickinson, chief executive of the British Retail Consortium, said UK retailers will be concerned "just as they begin their preparations for the all-important Christmas period" which last year was disrupted by a pandemic lockdown.

This time around, the run-up to the festive season has been affected by supply disruptions as economies reopen from lockdowns. Nevertheless, UK private sector business activity expanded at the fastest pace in three months in October, a key survey showed.

Growth was however accompanied by an unprecedented rise in inflationary pressures due to higher wages and supply chain costs, according to the survey from IHS Markit and the Chartered Institute of Procurement and Supply. Britain is meanwhile forecast to see an interest rate hike from the Bank of England as soon as November to help dampen inflation, which could force consumers to cut spending ahead of Christmas. The BoE's new chief economist Huw Pill said in an interview with the Financial Times on Thursday that the UK annual inflation rate risks shooting above 5.0 percent in the coming months from 3.1 percent currently.

British annual inflation cooled slightly in September but remained close to a nine-year peak, data showed earlier this week. The rate fell to 3.1 percent from 3.2 percent in August, which was the highest level since early 2012.

High inflation is weighing on companies and consumers globally, while rate tightening is used by central banks to try and dampen price rises.—AFP

Flying green will be more expensive

PARIS: Under huge pressure to go green, the aviation industry needs to spend billions of dollars to become more climate-friendly in what risks ramping up fares and making air travel the preserve of the rich once again. Like many countries, airlines the world over have pledged net-zero emissions by 2050 as has the European Union, putting pressure on the aviation industry among other sectors.

The 27-member bloc also wants to tax kerosene. All of this will come at an unprecedented cost for the industry. The International Air Transport Association (IATA), whose 290 member airlines make up 82 percent of global air traffic, estimates that the industry's green transition will cost "around 1.55 trillion dollars."

Cleaner fuel

In order to make that transition, airlines need to invest in the latest planes, more efficient than their current fleets. Airbus for one hopes to see aircraft running on hydrogen, which emits not pollution when burned, enter service by 2035. Meanwhile, a production chain for sustainable aviation fuel (SAF) that the EU is going to make compulsory in incremental proportions needs to be created almost from scratch. IATA hopes to accomplish two-thirds of its emissions reductions by using SAFs-non-conventional fuels derived from organic products including cooking oil and algae.

Fuel currently represents between 20 and 30 percent of airline costs. But SAFs are, "as things stand, three times more expensive for (those using) used (recycled) oils, five times more expensive for biomass and five to ten times more expensive for synthetic fuels", Jean-Baptiste Djebbari, France's transport minister, told AFP. He said it was crucial to "scale up production to bring down prices." Patrick Pouyanne, the head of oil and gas giant TotalEnergies, which is producing SAF, warned earlier this year that the cost of these non-conventional fuels were far from matching less expensive conventional ones.

"The energy and ecological transition will have to be financed not only by airlines or energy companies, but also by the whole chain, including customers," he said. Djebbari added that flight prices could rise "in the short term." He warned that the pandemic could also see many airlines disappear, thus reducing competition and pushing prices up.

Drowning in debt

Higher prices would mark a big change for a sector that was once the preserve of the rich but gradually became accessible to more people, even if it still excludes up to 95 percent of the global population.

In 1970, 310 million air trips were taken, according to the World Bank. In 2019, that figure stood at 4.4 billion. And despite the pandemic, IATA is banking on the figure rising to 10 billion in 2050. IATA says the cost of air transport has plunged by 96 percent since 1950 thanks to the introduction of jets in the 1960s, which led to dramatic industry growth, and the 1978 deregulation of the sector in the United States. It adds that this "downward trend continues due to improved technology and efficiency as well as strong competition."—AFP

Eurozone growth slows as prices jump on supply woes

BRUSSELS: The recovery of the eurozone economy is losing steam, a closely watched survey said on Friday, with big supply chain problems at factories causing price hikes not seen in twenty years. "The ongoing pandemic means supply chain delays remain a major concern," warned Chris Williamson, Chief Business Economist at IHS Markit. This was "constraining production and driving prices ever higher both in the manufacturing and in the services sector," he said.

The purchasing managers' index (PMI), which measures corporate confidence, demonstrated the slowdown clearly. IHS Markit said it slipped to 54.3 in October, after posting 56.2 points in September and a high 59 points in August. A figure above 50 indicates growth. IHS Markit said supply problems were especially felt in Germany, the EU's export powerhouse that depends on the global economy to churn out high-value goods, such as cars and machinery.—AFP

Russia sharply raises key rate

MOSCOW: Russia's central bank aggressively raised its interest rate for the sixth time in a row Friday in an effort to slow soaring food prices, and did not rule out further hikes. Rising prices, falling incomes and a lack of tangible government support during the pandemic have been eroding popular support for President Vladimir Putin's two-decade rule, and authorities are under pressure to ease inflation.

At a meeting on Friday, the Bank of Russia increased its key rate by 0.75 percentage points to 7.50 percent, surprising many analysts who had expected a smaller hike. The bank said that more hikes could follow and revised up inflation predictions. "Inflation is developing substantially above the Bank of Russia's forecast and is expected to be within the range of 7.4-7.9 percent at the end of 2021," the bank said. —AFP