Global Letter Radical changes in the US

Two changes in the US, taken together, will have immense global consequences

It is becoming increasingly clear that the US is on its way to energy self-sufficiency. Meanwhile the public finances – fiscal cliff aside – are on a path to economic and political unsustainability. Taken together, these stand to be game-changers.

The US is en route to energy self-sufficiency, and fiscal unsustainability

The hydrocarbon game-change results from a huge responsiveness of both demand and supply to high prices. While demand and supply are at first unresponsive to higher prices, several years of high prices reduce demand, and induce substantial increases in supply and substitutes.

The fiscal sustainability issue is not about the 'fiscal cliff': it is about the massive fiscal tightening that, the IMF reckons, the US would have to undertake progressively were it to take its public-debt ratio down to a sustainable 60%-odd of GDP. US politics would scarcely tolerate this, so the public debt seems set to build, mild growth recovery notwithstanding.

The prospect of energy self-sufficiency, or more, will free a President and country, weary of foreign excursions, of the need to be polite to foreigners. Able both to feed and fuel itself, the US will be able to slip back into a pre WWI- and pre WWII-like stance of standing-off from the problems of the world at large.

Agreeable though this prospect might be to a US president, however, the spectre of having to tax Americans ever more to service the national debt is not. At present, with bond yields only around 1¼%, it takes only about 2% of GDP in taxes to pay bond holders. But as bond yields revert to a more-normal rate, say 5%-odd, the President will have to raise around 5% of GDP in taxes – about the same as the defence budget – to service the national debt.

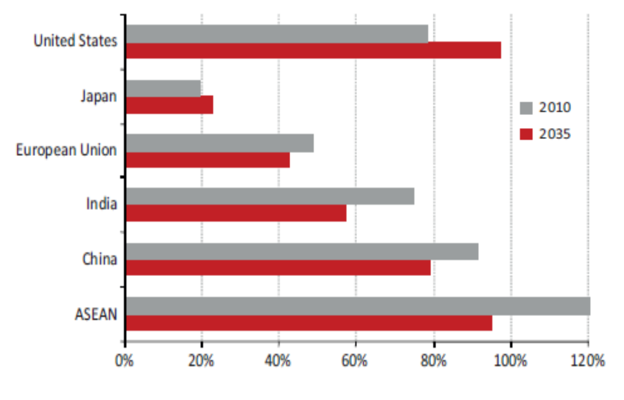
Politicians hate paying debt service. They like spending tax dollars on schools, roads, education, even defence: but not debt service. While formal default is out of the question (presumably) the President is bound to ask his new Treasury Secretary "How can you get me out of this?"

The risk is of growing isolationism and financial repression

The stock answer is 'Inflation'. But by itself that is not sufficient. The 1980s proved that: higher inflation merely turned up as higher bond yields. The complete policy is a package: inflation; bond yields held down by the Fed; capital controls to prevent people from taking their money abroad in search of higher yields; and perhaps regulations to force savers (pension companies and the like) to hold more government bonds. This is exactly what the US, the UK, France, and other Western countries did, successfully, to bring down public debt ratios after WWII.

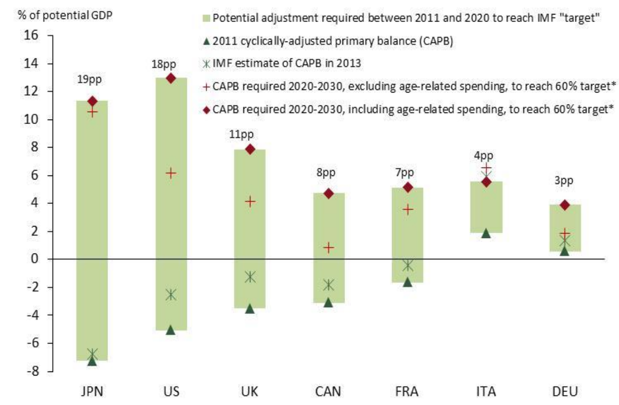
There is no guarantee that matters will turn out in this way. But there is a risk. So watch for: unusually low yields for unusually long on government paper; regulations forcing savers to hold greater amounts of government bonds; strengthening rhetoric against foreign countries that are large holders of US government bonds; and perhaps even hints of capital controls.■

Figure 1: Net energy self-sufficiency, 2010 and 2035



Source: IEA World Energy Outlook, November 2012
Note: self-sufficiency is calculated as indigenous energy production divided by total primary energy demand

Figure 2: Illustrative medium-term fiscal challenge



Source: IMF Fiscal Monitor, July 2012
Note: For Japan, the IMF illustrative calculations target an 80% net debt ratio

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