Consumer confidence supports value of the dollar

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FULL TEXT

In the past economic crises deepened when governments stalled, says Jack Slibar

Guelph - If you think the value of the dollar is built on something as concrete as pools of petroleum, pockets of gold, patches of timber or bricks and mortar, think again.

"It comes down to an issue of confidence," Jack Slibar told members of the Canadian Association of Farm Advisors.

"If you had a choice between a dollar in your pocket, or a potato, which would you rather have?" asked Slibar, who is a senior manager for Deloitte Consulting, in Kitchener. He's the former executive director of Ontario Pork. He'd choose the potato "because you can eat it."

The U.S. greenback "is actually made from recycled bluejeans." So, it has little value beyond what people believe it represents - and people are no longer sure.

The financial crisis began with housing, and its seemingly endless appreciation. Families in the U.S. and Europe quit saving because they felt confident the value of their house would continue to increase. Some even borrowed against the equity in their home to support their lifestyle. This wasn't sustainable and the bubble has burst, dropping residential property values by a fifth.

The mortgages on these homes had been repackaged and resold to financial institutions in such a way they "couldn't deconstruct the security," said Slibar.

"So, no bank knew what another bank had. The banks were effectively afraid to lend to each other," either overnight, or longer - and this interbank lending is a $3 trillion business.

The banks backed off lending, and raised their premiums because they wanted to protect their own money, and were "truly concerned about their sister banks going insolvent."

Then, they began refusing to lend to even their best creditors, further eroding confidence. In some cases where corporations have standby letters of credit they moved to access the money and there was a run on bank capital. The negative feedback loop sped up.

Meanwhile the global economy has been shaken by "commodity price inflation" in the form of rising food costs. "Biofuels, no question had an impact," said Slibar, estimating they account for a third of global food inflation. The rest was a combination of weather challenges, trade restrictions and energy prices being passed through to the "soft commodities".

The impact is marginal in developed countries where people spend 10 to 15 per cent of disposable income on food. But in places like China, where basic necessities take 35 per cent of income, if that rises to half, people become extremely unhappy to the point of political unrest.

There were food riots in the Philippines, Mexico, and Argentina this summer. Even in Canada there was a shortage of rice in some grocery shelves as Asian families bought the grain to ship overseas.

More than 30 countries have imposed significant restraints on food costs this year, said Slibar.

"If you're spending more money on food, you're not spending on other items," said Slibar. So food inflation reinforces the downturn.

"There is nothing as volatile in the global economic system as capital, and nothing promotes capital movement greater than political and economic instability.'

Collectively, as a society, we are probably only two hot meals away from anarchy, said Slibar. This is why governments have intervened.

As Slibar was speaking, Canada's Finance Minister Jim Flaherty had just antied up another $50 billion - in addition to $25 billion announced in October - to allow the Canada Mortgage and Housing Corp, a crown corporation - to buy mortgages from the banks, with a goal of pre-empting a financial meltdown.

Meanwhile, south of the border, markets "cratered" as U.S. Treasury Secretary Henry Paulson announced that some of the $700 billion U.S. bailout will be redirected from banks to consumers through a new loan facility to be operated by the Federal Reserve.

China also got into the game, announcing it would direct $500 billion into infrastructure and social welfare by the end of 2010.

"Many say that the U.S. government and Europe have injected too much liquidity. I don't agree," said Slibar. "In the past, crises deepened because the government delayed reacting."

"The bailout has done nothing to provide stimulus," said Slibar, "It has only prevented a collapse."

Currently Canada is the only developed country for which the International Monetary Fund is projecting any growth - and that growth is just 0.3 per cent. "While we are tied to the North American economy, we are nevertheless distinct. We have monetary policies that will soften the level of impact."

"A lot of confidence in the Canadian economy is because of the resources it has, the political and economic stability, low sovereign debt, and intellectual ability."

The one risk in Canada is that consumers, bombarded by American reports of financial collapse, begin to lose confidence in the

Canadian economy and stop spending. The other risk is inflation, although numbers out recently make that unlikely.
Yet, even as the U.S. faces unprecedented challenges, countries are still gravitating to the U.S. as a reserve currency. Slibar says this is "because it's the only country that can exert its view of the world through military force and economic prowess."
The U.S has another advantage: world debt is denominated in U.S. dollars. "Since China is the largest holder of U.S. debt, it's not going to do anything to undervalue that debt."
China is very much dependent on the Western world as a market for its consumables, but the country's expanding middle class can generate enough demand, internally, to generate six per cent growth in its economy. However, it needs eight to nine per cent growth to maintain political stability, which explains its "stimulus" package.
There's opportunity there, suggested Slibar. And there's opportunity for agriculture. He sees "strong soft commodity prices for five to eight years...largely because of demand."
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