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## Soon there may be nobody left to lend to America

Irwin Stelzer

Anyone who thought Ben Bernanke and his Federal Reserve Board colleagues were out of ammunition received a rude, or pleasant, shock last week. Rude, if you worry that a few extra trillions sloshing around the economy might one day trigger a wave of inflation; pleasant, if you worry that the economy is sinking fast, and the Obama administration and Congress haven't a clue what to do about it.

The Fed plans to buy \$300 billion of Treasury IOUs in the next six months (more to come if needed), pour \$1.45 trillion into the mortgage market, and keep interest rates close to zero for "an extended period". There's more in the Fed's "do whatever it takes" arsenal if these steps don't bring interest rates down so people can borrow more cheaply to buy houses, cars and other durable goods. But so far, so good: interest rates on 30-year mortgages fell below 5%. Whether that will encourage enough creditworthy borrowers to sop up the huge inventory of unsold homes, much less trigger new construction, is difficult to predict.

But the dollar dropped like a stone. Earlier, Chinese premier Wen Jiabao said he was "a little bit worried" that America might cheapen its currency and pay back the \$1.2 trillion it owes in depreciated dollars. Now that the Fed has moved, he must be a lot worried.

The Fed's decision to pump trillions into the money markets comes on top of President Barack Obama's proposal to drive the federal deficit to 12% of GDP by borrowing trillions to fund a few stimulus projects, universal healthcare, a green energy system and a host of other programmes on his wish list. Obama's assurance that America will never default on its debt hasn't completely soothed the markets: The Wall Street Journal reports that it now costs seven times as much to buy insurance against an American government default as it did only a year ago. Besides, America can always inflate its way out of its obligations.

Not to worry, says the president. The economy will soon be growing at an annual rate of about 4%. Along with the tax increases to be imposed on the top 2% of earners, billions from the sale of carbon-pollution permits and reductions in age-related entitlements, the growth will drive the deficit down to 3% of GDP in 2013. Unfortunately, 2% of earners can't or won't carry the entire burden, the carbon-permit programme might not produce the predicted revenues after Democratic congressmen from coal-producing states chop away at it, and Congress has told the president that any proposal to reduce the huge entitlement payments due the ageing baby-boomers will be DOA – dead on arrival.

Where China's Wen sees problems, Paul Paulson (no relation to former Treasury secretary Hank) sees opportunity. Paulson, you will recall, is the hedge-fund manager who made \$10 billion in 2007 betting that the subprime mortgage market would implode. The day before Bernanke's announcement, Paulson made another wager. He shelled out \$1.28 billion for a stake in the gold-mining company AngloGold Ashanti. He is betting that by debasing their currencies, governments will trigger inflation that will cause a flight from paper currencies to gold. Within 24 hours of Paulson's bet, it paid off, thanks to the Fed: the price of gold jumped 7%, one of the many commodities to experience large increases.

So here is where we are at. The combination of the Fed's surprise attack on the credit markets and the president's decision to borrow-and-spend will give the economy a lift. My own guess, and that of many economists with whom I have spoken, is that by the middle of next year, if not sooner, the economy will start growing again at a decent rate.

At that point, Bernanke will have to decide whether to start pulling money out of the system by selling off some of the assets on his swollen balance sheet, and the Obama administration will have to decide how to bring down the fiscal deficit. Bernanke is keenly aware that during the Great Depression the Fed tightened the money supply prematurely, nipping a nascent recovery in the bud. So he is likely to stall.

Meanwhile, there is little prospect that Congress will do what is necessary to bring spending and borrowing down to levels that do not trigger inflation. Politicians just don't worry as much about inflation as about catering to their multiple constituencies. So the Treasury will have more trillions in IOUs to peddle.

But its best customers just might be unenthusiastic about adding significantly to their holdings. Wen already owns trillions in Treasury bills that are depreciating in value. Besides, China's mounting needs for infrastructure and an improved safety net will sop up funds once used to buy American securities. Japan, another large customer, is now running a current-account deficit, and so it won't have as many dollars to recycle. Nor will Middle East buyers, no longer receiving a flood of dollars from \$140-a-barrel oil. Little wonder that Larry Lindsey, former economic adviser to President George W Bush, says he "cannot figure out what combination of foreign buyers is going to acquire . . . [the] debt" that Obama's plans will generate.

Which leaves Americans and the Fed as customers. Even if they save more, domestic consumers can't absorb all the Treasury bonds that will be on offer. And if the Fed keeps buying, it will pour fuel on the inflationary fires.

I have never before doubted the resilience of the American economy – its ability to survive inevitable downturns after periods of excess, and to weather the burdens heaped on it by politicians. Obama, however, has me shaken, perhaps because I am not stirred by his rhetoric.

Fortunately, even some liberal Democrats are suffering from "bailout fatigue". More important, Bernanke has so far shown a sure touch in managing monetary policy, and might head off a bout of inflation by shrinking the money supply when the economy is no longer too cold, has not yet gotten too hot, and is in just the right condition for such a move. If so, Goldilocks might just have a new life.

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