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The fundamentals will always surface

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IF NOTHING else, the current crisis has underscored the accuracy of economics as a scientific discipline.

Economic fundamentals may be slow to manifest themselves, subject as they are to lags, psychological biases and government regulation. But in the end, they do indeed surface as described in textbooks.

Housing prices cannot rise faster than personal incomes indefinitely. People cannot continually re-mortgage their houses to buy new cars or pay for luxury holidays. There is a limit to the economic value of re-packaging mortgages into more complex securities for resale - and then further re-packaging the packages. Northern California police officers should not be paid more than engineers in the state, and Massachusetts should not pay its highway toll collectors more than its secondary school teachers.

It is reassuring that economics works as the textbooks predict. However, as the great 20th-century economist John Maynard Keynes observed once, the challenge with economics is that it might not follow the script in the short run.

A case in point is exchange rates. In the past few weeks, the US dollar has appreciated against all major world currencies, with the exception of the Japanese yen and the Hong Kong dollar (the latter is pegged to the US dollar).

Why? One explanation is a flight to safety - that is, in a time of crisis, investors seek a safe haven - and the US dollar provides that safe haven. So investors have liquidated their foreign holdings and repatriated the proceeds to the US.

Another explanation is somewhat technical. Typically, hedge funds operate in US dollars. As hedge fund returns fell over the first half of the year, many investors withdrew their investments from hedge funds. Simply to meet investor withdrawals at the end of the third quarter, hedge funds may have liquidated their foreign investments, and paid off their investors in US dollars.

A third explanation is an extrapolation of the above two more fundamental reasons. Just as speculators assumed the rising trend for commodity prices last year would continue indefinitely - Mr Arjun Murti, the celebrated Goldman Sachs analyst, for instance, predicted that the price of oil might reach US$200 a barrel - speculators might now be assuming the US dollar would continue to trend upward indefinitely.

I would not. And I would cite economic fundamentals as my reason. Let's return to police officers' pay in California for illustration.

In May, the city of Vallejo in Northern California declared bankruptcy. The bankruptcy can be traced to excessive compensation for police officers and firefighters. In 1999, California enacted a law providing public-safety workers with lifetime pensions at 90 per cent of their previous salaries.

Moreover, since it was in competition with nearby communities, Vallejo raised police and firefighter salaries by 20 per cent over 2007-09. The average police officer in the city now earns US$121,000 (S$177,000) annually - or, including benefits, US$190,000. By contrast, the average civil engineer in California earns slightly more than US$80,000.

One of the most hard-fought issues on the ballot today in the state of Massachusetts is Question 1 - a proposal to repeal the state income tax. Proponents of the measure pointed to highway toll collectors earning US$70,000 a year. The average secondary school teacher in the state earns just US$56,790 annually.

As of Oct 30, the total US federal government indebtedness was US$10.5 trillion. That amounts to more than US$33,000 for every man, woman and child - and that does not include unfunded Social Security and Medicare obligations, or state and local government debt, Vallejo's being an example of the last.

Neither Senator Barrack Obama nor Senator John McCain has proposed redressing this indebtedness. They have also not spoken of balancing the budget, which is a necessary first step to preventing further accumulation of government indebtedness.

It is not only the public sector, but also the US economy as a whole that has been living beyond its means. The United States has persistently bought more goods and services than it has sold to other economies. In economic language, the US persistently incurred deficits in the balance of payments on current account. Last year, the deficit was US$718.6 billion, equivalent to 5.1 per cent of gross national income. This deficit has been made up by foreign lending and investment.

An economy cannot borrow from other economies indefinitely. Foreigners would not continue to increase their loans to the US without limit. At some point, the US itself would become a sub-prime investment. And everyone knows by now what happens to sub-prime securities when the borrower keeps borrowing.

One way the US current account deficit can be reduced is for the US dollar to depreciate relative to other currencies. This would cause US goods and services to become more attractive to foreign consumers, and foreign goods and services to be less attractive to US consumers.

Indeed from 2002, until a few weeks ago, the US dollar had steadily depreciated against other major currencies.

The bankruptcy of Lehman Brothers overturned foreign exchange markets. So has the US dollar reversed course and begun a new upward trend?

Yes, in the short term, the US dollar might be driven up by a flight to safety, currency speculation, etc. However, the long-term fundamentals of the US economy have not changed. Indeed, the US$700 billion Troubled Asset Relief Programme and various other initiatives the incoming president will be forced to adopt will only add to US government debt.

In the long term, the US dollar will fall and continue to depreciate until America as a whole can live within its means. That's just economics.

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Economic Watch is a weekly column to be rotated among Senior Writer Tion Kwa and guest columnists.