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United States' Economic Problems and Their Ripple Effects

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Abstract

This paper examines the agreement reached on 2 August 2011 between President Barack Obama and the United States (US) Congress on increasing the debt ceiling and discusses its likely ripple effects on the global economy. While South Asia is not well integrated into the global economy to feel the impact of developments a long distance from its borders, it too will be affected. The ripples will reach its shores.

Some Recent Development

It was not supposed to have happened this way. The great recession that lasted for a bit more than one year, from 2008 to 2009, was supposed to end with a sharp recovery. History tells us that the sharper the downturn the shaper the recovery. The latest data released by the US Commerce Department on the rates of growth in the country's economy paints a very different picture. It turns out that the recession was deeper than the earlier estimates.

According to the revised national income accounts produced by the US government going back to 2003, the downturn during the great recession was much deeper than previously thought – in other words, the great recession was even greater. The Commerce Department said that the economy contracted by 5.1 per cent between the fourth quarter of 2007 and the second quarter of 2009. The earlier estimate was 4.1 per cent. Under the revised data, the US economy declined by 0.3 per cent in 2008, lower than the previous estimate of no growth.

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The contraction in 2009 of 3.5 per cent was weaker than the previous calculation of 2.6 per cent. The economy grew a little faster in 2010, rising at 3.0 per cent rather than at 2.9 per cent thought previously.

The recovery has been even slower. The Commerce Department has revised the GDP (gross domestic product) growth estimates for the first two quarters of 2011. America's GDP grew at an annual rate of less than one per cent in the first half of 2011. The pickup in the rate of growth is much slower than most economists had predicted. GDP increased by 0.4 per cent in the first quarter and at only 1.3 per cent in the second quarter.

If history had repeated itself, the recovery from the recession should have been at a rate twice as high as the contraction; 10 per cent in the 2009-11 period rather than the anemic rate of less than 1.5 per cent. Why this departure from history? Should the history of recessions and recovery be rewritten? The answer to both questions is probably yes. The great recession was different from those that occurred before. The latest downturn took place while the global economy was being restructured. Some of the activities in the older but richer economies were moving to the new emerging states. The pace of change was measured by the speed of redundancy; as some of the established firms undertook new investments, they chose to locate them in the emerging world. Growth of demand was much higher in these countries. They also had cheaper labour and the state's involvement in the development of physical and human capital had provided an investment-supportive environment. This story has often been told.

The other development of import is the way the American political system handled the debt ceiling problem. A few hours before the deadline was reached for raising the debt ceiling in the US President Barack Obama reached an agreement with Congress to increase the limit so that the country would continue to service its debt to domestic as well as foreign bond holders. Even some of the Congressmen, who had pledged that the ceiling would not be raised unless the level of government spending was lowered by an equal amount, finally relented. They were scared that the rating agencies such as Standard & Poor's, and Moody's would lower the rating of the US debt from AAA to something lower if Congress failed to act. This rating downgrade would have rippled quickly through the US as well as the global economy, setting the stage perhaps for another recession if not a depression.

The debt agreement will have enormous consequences for the economic role of the American state. It promises a sharp reduction in public sector expenditure. This is being done at a time when the state needed to keep stimulating the economy in light of the slower-than-expected pace of recovery from the recession. Because of the contraction of government activities that will inevitably result, America will not be able to retune its economy and remain competitive against rising Asia. The country needs to invest massive amounts of public money in the rebuilding of rapidly deteriorating physical infrastructure and in improving the skill base of its population. This will be more difficult now, hastening the process of Asia's catching-up. This conclusion will be discussed below in greater detail.

The Reaction

There was a sense of relief that the contorted manoeuvrings among the many actors on the political stage in Washington ended by saving the country from defaulting from its obligations. The politicians finally got their act together and the US averted a default. However, as discussed below, there was unease at both the content of the agreement and the way it was reached. All parts of the political spectrum were uncomfortable – the right, the left and the centre. Wall Street greeted the agreement with a plunge in the Dow Jones industrials, extending its decline to nine consecutive days, the longest declining trend since 1978. The trend was broken on 3 August 2011, but with only a slight increase. Larry Summers, former treasury secretary and a senior economic advisor to President Obama for a couple of years, can be placed at the centre of the US political spectrum. He quoted Winston Churchill – as did many other commentators – in expressing his misgivings about the debt deal in an article in the *Financial Times*.

Churchill had said at a moment of exasperation that the US always does the right thing after exhausting all other alternatives. Summers wrote that '…relief will soon give way to alarm about the US' economic and fiscal future'.[2] Centrists are also worried about the confluence of many adverse circumstances and their impact on the development of the global economy. Again to quote from Summers: 'With growth at less than 1 per cent in the first half of the year, the economy is now at stall speed with the prospects of adverse shocks from a European financial crisis that is decidedly not under control, spikes in oil prices, and confidence declines on the parts of businesses and households. Based on the flow of statistics the odds of the economy going back into recession are at least one in three – if nothing is done to raise demand and spur growth.'[3]

The reaction from the right – the informed rather than the ideological part of the political divide – was also expressed through the pages of the *Financial Times*. Carmen Reinhart and Vincent Reinhart – the latter from the conservative think-tank, the American Enterprise Institute – felt that 'negotiations between President Barack Obama and congressional leaders found a sliver of common ground…But a temporary ceasefire in this fiscal year will not address the country's long-run problems. The rating agencies are therefore justified in reconsidering America's triple-A rating.'[4] The political right's gripe was based on the fact that the Democrats had pulled off a deal by postponing fiscal adjustments to a much later

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[2] Lawrence Summers, 'Relief at an agreement will give way to alarm', *Financial Times* (3 August 2011), p. 7.
[3] *Ibid*.
[4] Carmen Reinhart and Vincent Reinhart, 'Deal or no deal, a downgrade is deserved', *Financial Times* (2 August 2011), p. 7.

date. This was called the 'back-loading' of the process with most of the promised decline in the deficit coming later in the 10-year period during which spending was to be cut by US$2.8 trillion. For them, cuts to spending should come quickly. 'If moves are made quickly, there is much good that can now be done. But the chances are that the stalemate will return, and any declarations of victory over a debt downgrade are likely to prove premature.'[5]

It was precisely the promised cut in public expenditure that made the left very unhappy with the agreement. Writing for *The New York Times*, Paul Krugman called the agreement 'a disaster, and not just for President Obama and his party. It will damage an already depressed economy; it will probably make America's long-run deficit problem worse, not better; and most important, by demonstrating that raw extortion works and carries no political cost, it will make America a long way down the road to banana-republic status.'[6] The left, following Keynes, was particularly worried that the state was being pulled back precisely at a time when it was needed to stimulate the economy. According to Krugman: 'The worst thing you can do in these circumstances is to slash government spending since that will depress the economy even further. Pay no attention to those who invoke the confidence fairy, claiming that tough action on the budget will reassure businesses and consumers, leading them to spend more. It doesn't work that way, a fact confirmed by many studies of the historical record.'[7] That the adjustment to government spending would be done so quickly that it would further weaken a weakening American economy was precisely the worry of the left (Krugman) and the centre (Summers).

The Ripple Effects

There were two aspects of America's current economic situation that were not expected even by those who were convinced that the country will eventually surrender its position as the world's predominant economy. One, the change will happen but would come slowly and, this being so, there would be time to make the needed adjustments by those who, in some way or the other, were deeply attached to the US economy. This was particularly the case for China and other economies of East Asia. Two, this process of delinking had already begun. It was called 'de-coupling' by some analysts. Gradually the economies in Asia in particular were being decoupled from that of the US. According to this line of thinking, China would be the centre of gravity for the Asian economies.

Both assumptions turned out not to be entirely correct. America's decline – both in absolute terms as well as in relative terms – was hastened by the great recession of 2008-09. There is now expectation – even by the economists working at the International Monetary Fund who are not given to radical thinking – that China, having overtaken Japan in terms of the size of

[5] *Ibid*.
[6] Paul Krugman, 'The President surrenders', *The New York Times* (31 July 2011), p. 19.
[7] *Ibid*.

its economy, may go on to overtake the US within a decade or a decade-and-a-half. And decoupling did not happen to the expected extent. The great recession, for instance, affected all parts of the world, even those that had built strong economic ties with China.

And, the realignment of the large economies within the global system was to happen differently. It was expected that some large Asian economies would grow at rates much higher than those of the old and rich nations in North America and Europe, thus ushering in a new period of ‘catch up’, closing Asia’s gap with the developed parts of the world. That is happening. The rates of GDP increase in China and India are three to four times the rates at which America and Europe are growing. However, there is an unexpected development. Some of the larger economies are seeing their currencies gaining ground on the dollar and the euro. China is moving slowly but at a deliberate pace to make its currency, the renminbi, a reserve currency. For the moment, it is concentrating on concluding currency-swap arrangements with some of its major trading partners. That way, a significant part of its non-American and non-European trade can be settled in renminbi without converting it first into dollars.

How will the deeper than expected recession of 2008-09 and slower than anticipated recovery affect the countries outside the US? How will the debt deal influence the global economy, in particular that of Asia – and within that continent, of South Asia? That the American economy would lose ground to the large economies of Asia is not news any more. What is news is that the pace of change will quicken. And what is still not fully recognised is that the weakening of the American state as a consequence of the debt deal would affect one aspect of the American economy that was supposed to prolong its status as an economic superpower.

Those who were not troubled by the loss of American manufacturing jobs to emerging economies took comfort in the fact that the country continued to retain an enormous advantage over all other nations in the areas of innovation, management and technological development. America had found a way of building new enterprises – or ‘start-ups’ in the language of finance – that combined these three attributes. The success of Google, Facebook, Twitter, and Gentex and before that of Microsoft and Oracle were examples of American enterprise that came to dominate the world in some of the newer sectors of the global economy. But in all these areas the American state had played a large role. Many of the technologies that have had an enormous impact on the way the global economy and the society function owe their development to the encouragement provided by the US government. This encouragement came in the form of government-subsidised research or in the form of government procurement. This will become increasingly difficult if the working of the state is seriously constrained by financial cutbacks.

What is also problematic for the American economy is that this emphasis on reducing the size of the government is happening along with a growing hostility towards immigration. Once again the American right has not recognised the larger implications of its anti-immigration stance. What has kept the American economy vibrant even when the rate of fertility was rapidly falling is its openness in bringing the needed workforce from abroad. Immigrants not only picked crops in the fields, built buildings and repaired roads. They also peopled the country's universities, research institutions and hospitals. Partly because of 9/11 and also because of the perceived threat to the American way of life, there is a growing sentiment in the country against immigration. This too would have an adverse effect on innovation, management and technological change. Without fully realising it, America seems to be moving in the direction Europe has taken. There the economic dynamism that only the young can provide is being sacrificed on the altar of cultural purity.

These developments have profound implications for the countries in Asia that have large and young populations. China has entered a different demographic phase compared with the populous countries of South Asia. Partly – but only partly since rapid economic growth also affects the rate of fertility – China will reach the stage of stable population long before South Asia gets to that point. In South Asia the human resource can be put to use in two different ways that will contribute further to the region's rise. By providing its people with advance education and appropriate skills, the region can offer partnerships to American firms constrained by the government's imposed frugality and also by the their inability to bring from the outside as many skilled people as needed. Also, these countries can leapfrog into those areas in which greater space will become available as a result of some of the financial and immigration constraints being imposed on the American economy and society. As economists have recognised for a long time, policies often have unintended consequences. This is likely to be the case with the debt deal done on 2 August in Washington.

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