

**Iwan Morgan**

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## Report

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# ➤ The American Economy and America's Global Power

Iwan Morgan

**A**merica's economic strength has long underwritten its leading role in world affairs. The buoyant tax revenues generated by economic growth fund its massive military spending, the foundation of its global hard power. America's economic success is also fundamental to its soft power and the promotion of its free-market values in the international economy. Finally, prosperity generally makes the American public more willing to support an expansive foreign policy on the world stage, whereas economic problems tend to engender popular introspection. Ronald Reagan understood that a healthy economy was a prerequisite for American power when he became president amid conditions of runaway inflation and recession. As he put it in his memoirs, 'In 1981, no problem the country faced was more serious than the economic crisis – not even the need to modernise our armed forces – because without a recovery, we couldn't afford to do the things necessary to make the country strong again or make a serious effort to reduce the dangers of nuclear war. Nor could America regain confidence in itself and stand tall once again. Nothing was possible unless we made the economy sound again'.

Today the United States has to deal with the impact of far worse economic problems than it did when Reagan became president. These include the fallout from the most severe financial crisis since 1929 (the near-meltdown of the financial system in 2008), the worst recession since the Great Depression (the so-called Great Recession of 2007-2009), a fragile recovery that could well falter into a double-dip recession in 2012, the blowback effects of a European debt crisis, and a future of unsustainable public debt without a correction of fiscal course. The current state of the American economy confirms the historical trend that downturns resulting from financial crisis (as in the 1870s, 1890s, and 1930s) are far more serious than other recessions. However, the debt overhang adds a new and very worrying dimension. Indeed America's fiscal and economic weaknesses are interlinked because the revival of economic growth is the necessary first step in dealing with America's public debt problem. To date, the woeful set of economic and fiscal indicators has not seriously diminished America's global power, but it has had some effect and threatens to have much greater – perhaps catastrophic – impact in time.

In immediate terms, it is clear that the United States is far from any tipping point where it has to scale back its military power very significantly because of economic and debt problems at home. True, its supporting rather than lead role in the NATO intervention in Libya owed something to the Obama White House's desire to contain defence costs while America is still actively engaged against the Taliban in Afghanistan and has just started to run down its Iraq commitments. In Obama's Fiscal Year (FY) 2012 budget plan, defence outlays are also scheduled to decline from 5.1 percent of GDP in FY 2011 to 3.4 percent of GDP in FY 2016. Nevertheless, the savings will largely result from the running down of commitments in Afghanistan and Iraq and waste elimination rather than the reduction of core strength. Even if a new crisis demanded expansion of military spending in the course of the next decade, the United States should be able to meet that need without imposing a strain on its economy.

On the other hand, the United States will likely face strategic restraints in the second decade of this century. While short-term defence budget expansion may be possible to meet a crisis, a sustained increase appears out of the question. The military future for the United States, therefore, is one of making do with less. It will not keep pace with the defence expansion of potential competitors. Russia and China almost doubled their military spending over the first decade of the twenty-first century and look set to continue this rate of growth in the second on the back of their buoyant economies. This does not represent a threat to the military supremacy of the US, which accounted for 46.5 percent of total global military spending in 2009, but its competitors will almost certainly use their fiscal advantage to disrupt and erode its superiority. Moreover, the pressure for deficit reduction is highly likely to impact negatively upon defence investment that meets future rather than immediate needs, particularly in procurement, research and development, and personnel development. In essence, therefore, the United States may have to develop a grand strategy that prioritises ends and links them to means, somewhat in the manner of Dwight Eisenhower in the 1950s rather than one based on assumptions that its economic power can underwrite military expansion as in the 1960s, 1980s, and early twenty-first century.

From FY 2020 onward, however, the future for US military power looks bleaker without a domestic correction of fiscal course. According to the Congressional Budget Office (CBO), the United States will exceed its historic peak for public debt-GDP size of 109 percent (reached at the end of World War II) in 2023 [a new Government Accountability Office report projects the somewhat later date of 2027] and will experience further fiscal deterioration to approach 190 percent by 2035. Under that scenario, the three largest entitlement programmes – Social Security (old age pensions), Medicare (medical assistance for the poor), and Medicaid (medical benefits for Social Security recipients) – plus interest on the public debt, will consume total budget revenues by 2030, requiring all other programmes to be funded from the deficit.

It is these entitlements that are the root cause of America's long-term fiscal problems. According to a Government Accountability Office projection, GDP is set to expand by 71 percent in real terms from 2007 to 2031, but spending for Social Security, Medicaid, and Medicare is set to increase by 127 percent, 224 percent, and 235 percent, respectively. The Social Security expansion reflects the aging of the population as the baby-boom generation, the population bulge born between 1945 and 1965, reaches retirement age. The growth of healthcare outlays is also attributable in part to this, but more significantly will result from the inflation of costs as medical treatments and technology improve. It is unclear whether the Obama health insurance programme will have much impact on aggregate costs: it will likely reduce demand for Medicaid but increase other healthcare outlays.

In the assessment of the CBO, which has a reputation for realism rather than hyperbole, 'The explosive path of federal debt ... underscores the need for large and rapid policy changes to put the nation on a sustainable fiscal course'. It is unthinkable that the US government will not take action – it is a matter of when, not if – but the longer the debt problem remains unaddressed, the greater it will grow and the more difficult it will become to resolve. Nevertheless, when Washington policymakers do face up to the issue and make the difficult choices involved in reining in public indebtedness, defence will be very vulnerable to retrenchment. Even though its claim on the public purse is smaller than that of domestic entitlements, military cutbacks are politically easier to effect than those on pension and healthcare support.

Replicating the pattern for its military power, America's economic and fiscal problems are likely to impact on its position in the international economy more in the medium to long-term than in the short-term. Henry Kissinger once remarked, 'Who controls the food supply controls the people; who controls the energy supply can control whole continents; who controls money can control the world'. Allowing for some hyperbole in this assessment, it did offer insight into the benefits for US international influence of the dollar's status as the world's major reserve currency.

As the dollar declined in value over the last decade, its share of allocated global reserves fell from 72 percent to 62 percent, suggesting that reserve managers were diversifying their holdings into other currencies. The main beneficiary of this trend was the euro. Standard & Poor's ([S&P]) downgrading of America's AAA+ credit rating in the wake of the political imbroglio between Republicans and Democrats over raising the debt limit appeared to spell further trouble for the dollar.

However, the greenback has become an increasingly safe haven for foreign currency holders in light of the Eurozone's deepening financial crisis that threatens the very existence of the single currency project. Reports that foreign central banks and managers of large private funds were shedding Treasury securities in 2009-10 were also exaggerated. China, the largest holder, was shifting from long-term to short-term securities rather than moving out of the dollar. In 2011, however, there has been a general move back to long-term securities that carry higher interest. Signifying this, Bill Gross, chief executive of PIMCO (the world's largest fund manager), which had previously begun shedding its long-term US bonds, announced in October that it was increasing its holdings in them.

Paradoxically, therefore, America's reserve position has actually strengthened in the last two years despite its economic and fiscal problems. Its current account deficit – its external balance with the rest of the world – has also shrunk from a worrying 7 percent of GDP in 2006 to a more manageable 3.3 percent in mid-2011 because the fragile economy has reduced demand for imports. Moreover, its capacity to borrow from abroad remains undiminished because the US broadly remains a reliable haven, notwithstanding its S&P credit rating downgrade. Indeed the annual cost of its repayments on its rising public debt which itself grew from 40.3 percent of GDP in 2008 to an estimated 72 percent of GDP in 2011, actually declined from 1.8 percent of GDP to 1.4 percent of GDP over this same period thanks to low interest rates.

However, low interest rates will not last forever. The United States at some juncture will face increasing costs to service its debt. And unless it brings its borrowing under control, it may eventually find its only recourse is to have massive interest rates to

overcome creditor fears about a possible default or a reversion to debt monetisation (namely printing more money to cheapen the dollar and thereby ease interest payments). This is unlikely to happen until the late 2020s or early 2030s, but the impact on the economy will be severe if such monetary manipulation becomes necessary.

If the economic effects of America's indebtedness are not yet great, there are signs that it has had an impact on its political influence within the international economy. In 2004, former Treasury Secretary Larry Sumner famously remarked, 'There is something odd about the world's greatest power also being its greatest debtor'. It is even odder that its biggest creditor is also its greatest economic challenger, the People's Republic of China (PRC). Contrary to the usual assumption that economic power goes hand in hand with a strong currency, the PRC engaged in massive purchase of US Treasuries and other dollar assets in the first decade of this century to ensure that its currency had a low value against the dollar, thereby reaping huge advantages for its products in the giant US market. The Bush administration and the Obama administration have both sought to persuade Beijing to abandon this practice in order both to reduce America's huge bilateral trade deficit with the PRC and to head off protectionist sentiment in the US Congress. However lack of leverage has blunted America's capacity to get the Chinese to do what it wants. (Of course, the US should beware what it wishes for in this regard, since the PRC would have little reason to extend it easy credit if there were no currency exchange benefits to be gained.)

Being America's leading creditor gives the PRC a certain advantage in dealing with it. Beijing has been a very vocal critic of the Federal Reserve's quantitative easing (QE) initiatives to improve the flow of credit at home. It worries that this action will ultimately cheapen the dollar, thereby undermining the value of its holdings. Some analysts believe that concern about China's reaction is one reason why the Fed has not engaged in a third round of QE despite the evident fragility of the post-recession recovery. Others are fearful that the PRC might use its creditor clout to bring pressure to bear on the US in the event of a geopolitical showdown between the

two countries, for example over sovereignty issues in the South China Sea. In their view, this could be America's 'Suez Moment', a reference to Eisenhower's use of economic leverage to force the withdrawal of the 1956 Anglo-French intervention in Egypt.

Undoubtedly being a debtor nation diminishes America's standing in what can be called geo-economics. This is true with regard to allies as well as rivals like the PRC. Treasury Secretary Tim Geithner found this out when he participated in a meeting of European financial leaders in Wroclaw, Poland, in September 2011 to discuss the Eurozone sovereign debt crisis that threatened to spread from Greece to other nations. His calls for stronger action by member nations of the single currency project to provide larger bailout funds as security against a Greek default, and for greater aid to European banks that were holding bad government debts, were dismissively rejected by a number of his EU counterparts. Austrian Finance Minister Maria Fekter commented, 'I found it peculiar that even though the Americans have significantly worse fundamental data than the Eurozone, that they tell us what we should do'.

The world also watched on in horror at the showdown between the Tea-Party-influenced Republicans and the Democrats over the passage of a bill to raise the debt limit in mid-2011. The US narrowly avoided a default that could have had serious ripple effects throughout the global financial community. In effect, conservative Republicans resorted to political blackmail to force acceptance of large budgetary cuts as their price for a deal. Clearly, American legislators have every right to pursue the political aims they were elected to achieve, but it seemed that the whole world – not just the Obama administration – would have to bear the cost of their intransigence. The episode damaged America's reputation as a reliable debt payer, leading directly to the S&P credit downgrade. The antics of what Britain's Trade Secretary Vince cable dubbed 'a bunch of right-wing nutters' also exposed the US to international ridicule.

The debt limitation imbroglio showed that America is an increasingly polarised nation amidst today's difficult economic circumstances. Internal divisions have not yet affected its capacity to act on the world stage, but

they may do so in years to come if the economy does not recover its vigour. However American policymakers have failed to find the solution to restore growth, jobs (unemployment remains stubbornly high at around 9 percent of the work force), and optimism. The monetary instruments of economic management helped to end the recession in mid-2009 but have had little effect in strengthening recovery. Easing the supply of credit has done little to boost demand, which remains anaemic. Having binged on credit card and loan finance for over a decade, consumers are now reining in their borrowing habits because job uncertainties (or actual joblessness) make them more circumspect about their capacity to repay debt. Meanwhile, American banks remain reluctant to lend to business because of concern that blowback from the European sovereign debt crisis might threaten their reserve position.

In current circumstances, the best way of kick-starting the economy is through expansionary fiscal measures that would actually create jobs or put money in people's pockets – through initiatives like public works and infrastructure projects, extension of unemployment compensation beyond 2011 for workers who have exhausted their benefits, extension of payroll tax cuts into 2012, and more generous assistance to hard-pressed state governments who lack the federal capacity to borrow because of the balanced-budget requirements of their constitutions. Such measures could form part of a second stimulus package since the first one, enacted early in the Obama administration, has come to the end of its three-year duration.

However, the political paralysis that has resulted from separate party control of government make it highly unlikely that such an initiative will be enacted. The Republicans have no interest either in approving a statist solution for economic revitalisation or in letting Obama claim the credit for economic recovery with an election looming. Conversely, the Obama administration and the congressional Democrats appear unwilling to engage in a political battle to force acceptance of their agenda. The likelihood is, therefore, that there will be no fiscal initiative to head off the threat of a double-dip recession and there will be no strong recovery in the short-term.

Without a strong economic recovery, America will also find it more difficult to resolve its fiscal problems. The depressed receipts that are the product of a weak economy – in FY 2011 tax revenues equated to less than 15 percent of GDP, well below their annual average of 19 percent between 1980 and 2005 – increase the difficulties of deficit control. In other words, fiscal actions to boost the economy may increase the deficit in the short-term but they will facilitate its eventual reduction. However, economic growth alone cannot get the budget under control. Most fiscal experts are in agreement that the United States will have to reform entitlement programs to control costs, find ways of enhancing revenue (which would likely have to include high taxes, particularly for the top 20 percent of the income distribution), and economise on other programs – including defence. Whether the political will exists for such a sweeping assault on public indebtedness is unclear. Such a course of action involves slaying two large sacred cows. The Republicans would have to swallow higher taxes and the Democrats would have to accept diminution of entitlement benefits.

Americans like to claim they are good at dealing with a crisis. Perhaps they are less effective when it comes to pre-empting one. The mushrooming debt is not yet a crisis but it will eventually generate one if left to fester. If America awaits a financial crisis before taking action, there is a danger that the scope of the course correction it would need to undertake might prove too great. The United States is slowly awakening to the reality that growing public indebtedness represents the greatest threat to its power and prosperity in the twenty-first century. It remains to be seen whether its political parties and the separate institutions of its government can work together for the long-term good of the nation. Winston Churchill famously observed that America could be relied on to do the right thing after it had tried everything else. It is to be hoped that there will be a timely demonstration of the truth of his remarks with regard to US public indebtedness. ■

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