SWP Comments

Stiftung
Wissenschaft und
Politik

German Institute
for International and
Security Affairs

Farewell to Markets?

Barack Obama Continues to Define his Economic Agenda

Stormy Mildner

"It's the economy, stupid" – again. The state of the economy, which already helped Bill Clinton win the presidential elections in 1992, once again paved the way to the White House for the Democratic candidate in 2008. But Barack Obama inherits a much more difficult economic legacy. He will be inaugurated at a moment of crisis worse than any economic downturn since the Great Depression of the 1930s. The President-elect therefore believes that the government should renew widespread economic security and create equal opportunities for all citizens, not unlike the Kennedy administration did in its New Economics. His economic plans include health care reform, a green revolution, stricter financial regulation, and a shift of tax burden from the middle class to the rich. The 2008 elections are thus likely to mark the restoration of the activist government. But while Obama clearly opposes Ronald Reagan's anti-government and deregulation philosophy, he will, just as his predecessors, continue to rely on market forces, believing in the importance of market incentives and efficiency.

During the 2004 elections, only 27 percent of the American voters named the economy as their top priority – for the majority the war in Iraq was of utmost importance. Surveys conducted in 2008 revealed a completely different picture. Whereas in January 2008 still only 34 percent of respondents said that economic policy was the main challenge for the next president, by summer, as oil prices continued to rise, this percentage increased to 61 percent. When the housing and banking crisis culminated in a near meltdown of the financial markets in September, 75 percent listed the economy as the single most important election topic. The weak economy was a clear advantage for the Democratic candidate Barack Obama: In general, Americans tend to vote for the candidate of the opposition party in times of economic downturn. And although neither of the candidates was a presiding president or vice-president, there was nonetheless a strong degree of continuity on the Republican side, since John McCain did not break explicitly with President Bush's economic policy. What's more, economic policy was not one of McCain's strengths, as he freely admitted himself. "The issue of economics is not something I've understood as well as I should", he told the newspaper *The Boston Globe*. In a survey conducted by the Pew

Dr. Stormy Mildner is researcher at SWP's The Americas division

Research Center for the People & the Press, 47 percent of the respondents believed Obama to be the better candidate as far as the economy was concerned, compared to only 33 percent who saw that quality in McCain. That the majority of voters thought McCain to be more qualified on foreign policy issues proved little helpful in the end, as only 27 percent of voters considered the war in Iraq as top priority.

The candidate's leadership styles and competencies were particularly closely scrutinized during the congressional debate on the 700-billion-dollar rescue package for floundering banks. Obama scored significantly better on this issue, with 48 percent of survey respondents saying that the Senator from Illinois had been more successful in communicating his intentions whereas only 29 percent believed this of McCain. Many found it incomprehensible that the latter interrupted his election campaign in order to be in Washington during the Senate debate on the Emergency Economic Stabilization Act. McCain's argument that overcoming the financial crisis was more important than the election campaign did not have the desired effect. Instead, voters saw this as further evidence of the Senator's weakness on economic issues.

A Window of Opportunity

The Democratic President-elect inherits an economy in turmoil. The crisis, which began with the bursting of the housing bubble has not only become a full-blown financial crisis, it has in the meantime spread to the real economy. The country is in a state of recession. It only remains to be seen how profound the contraction will be and how long it will last. Obama faces a further challenge: The high budget deficit and the rapidly growing national debt will restrict the new president's room for manoeuvre. Nonetheless, every crisis also offers a chance for a new beginning. History has shown that every major reform effort in the United States was preceded by a crisis. Without the depression of 1907 the Federal Reserve System, the United States' central bank, would hardly have been created in 1913. The Social Security Act of 1935, which introduced a national unemployment insurance and pensions system, would have been unthinkable without the world economic crisis of the 1930s. Obama will likewise try to use the present crisis as a chance to rapidly introduce fundamental reforms. He has given many indications of favouring activist government on questions of social welfare, jobs, income, health care, and energy.

Usually, a new administration has only a short window of opportunity to enact reforms since voters hold the President accountable at the next congressional mid-term-elections – not even two years after the President's inauguration. In Obama's case, however, the honeymoon period could be somewhat longer. The Democrats have increased their majority in Congress considerably, and loosing some seats in 2010 is, by all means, not to threaten this. In addition, Obama has repeatedly warned voters against excessive expectations, emphasising that many of his reform plans could not be implemented during the first few months in office. Obama is likely to initiate some minor reforms at the beginning of his term in order to avoid disappointing voters, but otherwise concentrate on the revitalization of the economy. He has already announced his economic team: New York Federal Reserve President Timothy Geithner will be Treasury Secretary, Larry Summers will be the President's top economic adviser as director of the National Economic Council. Obama named economist Christina Romer Chair of the Council of Economic advisors, and Melody Barnes as Director of the Domestic Policy Council. Big reforms, however, are not expected before his second and third year in office.

Reviving the Economy

Obama's single top-priority is reviving the economy. According to estimates by the Bureau of Economic Analysis, the Gross Domestic Product (GDP) of the United States fell by 0.5 percent in the third quarter of 2008. In the second quarter, the U.S. economy still grew at a projected annual rate of 2.8 percent, profiting from the tax rebates under the Recovery Rebates and Economic Stimulus for the American People Act. The drop in growth was caused by a drop in consumer spending by an annualized rate of 3.1 percent – the largest decrease since the second quarter of 1980. There is unlikely to be a quick economic recovery. Goldman Sachs expects the economy to shrink at a 3.5 percent annual rate in the fourth quarter and at a 2 percent pace in the first quarter of 2009. This would be the biggest contraction since 1982. The contraction in the construction sector has accelerated, corporate investment has decreased, and industrial production fell by 2.8 percent in September compared with the same month the previous year – the sharpest decline since 1974. The U.S. economy lost nearly 1.2 million jobs in the first 10 months of 2008, including 240,000 jobs in October. With 6.5 percent, the unemployment rate was at the highest level since March 1994.

America's consumers have become pessimistic. The Consumer Confidence Index has reached an all-time low. Rising unemployment, weakening incomes, falling home values, a declining stock market, record household debt and the credit crunch have a negative effect on household wealth. According to the Bureau of Economic Analysis, the disposable income of US citizens was 9 percent below the value for the same quarter of the previous year. Lower energy prices might bring some relief – the oil price has fallen from its peak of 147 dollars a barrel in July to 61 dollars a barrel at the beginning of November, also dampening inflation pressure. But private consumption faces a long period of moderate growth. Consumers are abandoning asset-dependent spending and are moving back to more prudent income-based lifestyles. Household debt averaged 129 percent of disposable income in the second quarter of 2008, down from a record high of 133 percent at the end of 2007. In contrast, exports were an important counterweight to weak domestic consumption, accounting for about one percentage point of economic growth. However, export growth slowed down to barely 6 percent in the third quarter of 2008, due to the appreciating dollar. The trade deficit was at 4.9 percent of GDP. Despite declining slightly, the trade deficit remains at a historically high and ultimately unsustainable level.

In response to the economic crisis, the Federal Reserve (Fed) has lowered its interest rate several times. Most recently, it cut the Federal Funds Rate by 50 basis points to 1 percent; another interest rate cut is expected. The potential for interest rate cuts to stimulate economic growth would then largely be exhausted. Whereas the Fed can still give an impetus to the economy via its discount window – it just launched a new lending facility for the consumer asset backed securities market – Chairman Ben Bernanke has voiced unusually strong support for monetary measures to be backed by fiscal policy. Late October, Bernanke supported the Congressional Democrats' call for a second economic stimulus.
The proposal did not only find Obama's backing, he announced that he would quickly propose a massive fiscal stimulus package once he took office in January, which could run into as much as 700 billion dollars over the next two years. If approved, it would be one of the biggest public spending programmes aimed at boosting the economy since former President Franklin D. Roosevelt's New Deal.

The money would partly be directed at infrastructure projects that are threatened by the financial crisis and partly at states and local communities to help them maintain their expenditure on health insurance, education and welfare programs, without having to raise taxes or insurance premiums. Obama also supported an emergency loan to the auto industry. The bill, currently discussed in Congress, would authorize loans to the auto industry from the Treasury's 700 billion dollar rescue package. Obama is not alone in calling for support of the auto industry, as many Democrats fear rising unemployment. General Motors, Ford and Chrysler – the Big Three – have been making heavy losses for several years. Credit ratings have fallen several times due to their high level of debt. In addition, rising demand for fuel efficient cars has unveiled the car maker's wrong investment decisions in the past. A study published by the Michigan-based Center for Automotive Research predicts that three million people would loose their jobs in the first year after a possible fall-out of the Big Three, increasing the ranks of the unemployed by nearly one-third nationally.

Learning from the Financial Crisis

Obama does not plan to continue the deregulation policy of *Reaganomics*, which characterised not only the presidency of George W. Bush, but also the Clinton era. Moreover, he is strongly advocating a comprehensive reform of financial regulation and oversight. Restructuring the financial markets and their monitoring system is likely to be a painful process as financial markets have a particularly strong influence on the real economy in the United States. One of the major challenges will be to improve financial system stability, without forgetting that innovative financial markets are essential for a prospering economy.

In September, financial crisis management reached a new peak, when the government took temporary control of the struggling mortgage companies Fannie Mae and Freddie Mac in a bid to ward off even greater turbulence on the financial markets. This was only one of several rescue operations. At the end of that month, the Fed rushed to aid the world's second biggest insurance company, American International Group (AIG), with an emergency loan of 85 billion dollars after its share price plummeted following a loss of confidence. In return, AIG was put under government control. At the same time, the Securities and Exchange Commission (SEC) forbade short selling of shares of around 800 companies, because it suspected that this trading practice, whereby speculators bet on falling share prices, had contributed considerably to the bankruptcy of the investment bank Lehman Brothers. Only two of the former five leading investment banks remain: Goldman Sachs and Morgan Stanley – and even these have now applied to the Fed to be granted the status of regular commercial banks, subjecting themselves to stronger regulation.

Obama had supported President Bush's *Emergency Economic Stabilization Act*. The draft legislation, which initially failed in the House of Representatives, authorized the Treasury to buy troubled assets from financial institutions, in particular mortgage-backed securities, and make capital injections to prevent the collapse of further banks. However, in the course of the debate, Obama also demanded significant modifications, including stronger oversight of the Treasury, aid for home owners, tax rebates and new regulatory mechanisms for the financial market. Many of his demands entered the bill, which was eventually approved early October. But Obama does not stop here: He plans to provide help for homeowners to pay their mortgages, stay in their homes, and avoid painful tax increases by instructing the Treasury to use its existing authority to more aggressively modify the terms of mortgages, and reforming the bankruptcy code. He also plans to improve consumer protection via a credit-card law (Credit Card Bill of Rights). Credit card defaults rose to a record of 5.5 percent of all credit card debt by the second quarter of 2008. The credit-card law aims at increasing the transparency of credit-card contracts, revealing the risks of any credit card via a rating system and giving credit-card holders better protection from unilateral changes to contracts.

Alongside these short-term measures, Obama is also calling for a comprehensive re-regulation of the financial sector as he assigns responsibility for the gravity of the crisis to the outdated and deficient regulatory system. Commercial banks, investment banks and insurance companies are all subject to different supervisory bodies at the federal and the state level. This system evolved in large as a consequence of the Great Depression in the 1930s and has been gradually expanded and modified ever since in response to market innovations or crises. The regulatory structure is highly fragmented and does no longer suit the requirements of the financial markets. Obama therefore wants to establish a more transparent system. His ideas are similar to those spelled out in the Blueprint for a Stronger Regulatory Structure presented by Treasury Secretary Henry Paulson in March 2008. Obama is not only calling for stronger regulation of investment banks, mortgage issuers, and hedge funds, which until recently were subject to more lax controls than commercial banks, but also for better oversight of and disclosure by credit rating agencies.

On November 15, the leaders of the G20 countries met in Washington on invitation of President Bush to discuss the causes, the impacts and the political consequences of the financial crisis along with representatives from the World Bank, the International Monetary Fund and the UN. For once, the summit started a six-month process of consultations. The G20 plan to circulate a detailed proposal by March 31; the next summit is planned for early April. The G20 countries also agreed on more oversight of rating agencies and stronger regulation of hedge funds. They also proposed clearer accounting standards and affirmed the importance of free trade, agreeing to refrain from new barriers to investment and trade in goods and services for the next twelve months. But – not entirely surprising – immediate action was not taken. Concrete steps will have to wait until Obama takes office. What still needs to be negotiated is the future role of the IMF in the supervision and regulation of the global financial system. As Obama did not take part in the summit, it still remains to be seen what his position will be.

New Budgetary Discipline?

Obama believes that the government should renew widespread economic security and create equal opportunities for all citizens. He does not attribute the increasing income inequality to technological and market forces but to specific policies. The Princeton political scientist Larry M. Bartels finds in his book “Unequal Democracy” that the causes of inequality are essentially political: real incomes of middle-class families have grown twice as fast, real incomes of working poor families six times as fast under Democrats than under Republicans. Accordingly, Obama does not share the conservatives’ belief in the trickle-down effect, according to which tax cuts for the rich ultimately benefit the lower income groups. Moreover, he proposes an active redistribution of wealth: The centrepiece of his economic program are tax cuts for the middle-class and increased taxation of high incomes.

Obama wants to ease the tax burden for poor and middle-class families and has promised to preserve tax breaks up to an annual income of 250,000 dollars while reversing most of the Bush tax cuts for the wealthiest taxpayers. Under the slogan “Making Work Pay” he plans to grant tax relief to 90 percent of all workers – roughly 150 million people – in the form of tax credits. In addition, Obama wants to extend the Earned Income Tax Credit, a refundable federal income tax credit for low-income working individuals and families, and help families pay for their children’s college or university education via an “American Opportunity Tax Credit”. The Tax Policy Center estimates that currently planned tax programs will raise the real incomes of middle-class wage earners by 5 percent in 2012. Obama also plans to introduce tax relief for small and medium-sized businesses. Small businesses and start-ups will be exempted from capital gains tax in order to encourage investment. As to mitigate the effects of the financial crisis, Obama is also proposing an "American Jobs Tax Credit" – a two-year refundable tax credit of 3,000 dollars for every additional employee that a company hires.

To finance his tax cuts, Obama wants to phase-out the tax cuts of the Bush era in 2010, close loopholes in corporate taxation, and increase the income tax for top earners as well as the capital gains tax. Obama also plans to impose additional taxes on oil companies, such as Exxon Mobil – albeit not in the midst of the economic recession. Nonetheless, the Tax Policy Center estimates that the national debt will grow by 3.3 trillion dollars in the next ten years (2009–2018), unless Obama's tax relief programmes can be financed by additional revenues.

The federal budget deficit skyrocketed to 455 billion dollars for the fiscal year that ended September 30, and is certain to continue to rise this year – possibly reaching 1 trillion dollars as the costs of financial bailouts and economic stimulus packages aggravate smaller-than-expected tax receipts. Against that backdrop, Obama argued that budget reform was not only an option but an imperative. Accordingly Obama wants to reintroduce a more stringent budgetary discipline in Washington. He wants to restrict the practice of pork-barrel spending, in which bills are linked with other spending items, which only benefit the constituents of particular members of Congress. Obama also plans to enforce pay-as-you-go (PAYGO) budgeting rules which require new spending commitments or tax changes to be paid for by cuts to other programs or new revenue. He pledged a "page-by-page, line-by-line" budget review to root out unneeded spending. Obama has chosen Peter Orszag, currently director of the Congressional Budget Office, to achieve this goal. Orszag will head the Office of Management and Budget, which reviews federal agency funding requests.

Yet, what was much more important than balancing the budget in the current crisis was jump starting the economy, Obama emphasised. In any case, a reduction of the deficit will only be possible once the economy is growing again. Even the Clinton administration did not manage to convert a deficit into a surplus through stringent budgetary discipline alone. The real key to this was eight years of economic growth resulting in higher tax revenues.

Energy Policy: Going Green

Dependence on dwindling foreign energy sources is growing, and the signs of climate change are becoming ever more apparent. The United States accounts for about 24 percent of world consumption of crude oil; around 64 percent of crude oil is imported, mainly from Canada, Saudi Arabia, Mexico, Venezuela, and Nigeria. Furthermore, the United States are responsible for about a quarter of world CO_2 emissions. The pressure to act is strong. Obama thus proposes an economy-wide cap-and-trade program to reduce greenhouse gas emissions 80 percent by 2050 through auctioning of emissions certificates. The profits are to be invested in clean energy. Furthermore, Obama wants to make sure that 10 percent of electricity comes from renewable sources by 2012, and 25 percent by 2025. Due to the high costs and unresolved questions with regard to nuclear waste storage, Obama has a critical stance towards nuclear energy. Within the transport sector he intends to cut fuel consumption by half in the next twenty years by introducing stricter limits on emissions (CAFE standard requirements). At the same time, dependence on crude oil imports is to be reduced by using more biofuels, particularly those of the second generation. 150 billion dollars are to be made available for the environmental and energy sector in the next ten years, from which Obama expects the creation of five million new jobs. Energy policy, climate policy, and labour market policy are all closely linked for Obama. The chances for a new direction in climate policy are good. However, the currently low oil price may prove to be an obstacle as investments in renewable energies become less attractive when oil prices fall.

Trade Policy: New Protectionism?

With the end of the Bush Presidency, the direction of U.S. trade policy will be hotly contested on whether or not to increasingly use trade policy to promote the environment and labour rights, on how to employ trade remedy laws against unfair trade practices abroad, and on how to design and fund programs which assist displaced workers. Public support for free trade is weakening. According to a CNN/Opinion Research poll in late June 2008, half of registered voters think that trade threatens the economy. Many blame the presumably misguided free trade policy of the Bush administration for the large U.S. trade deficit, declining wages, increasing income disparity and growing unemployment. Anxieties concerning job loss are more severe than in most other countries because of a relatively weak social net. Obama has catered to this sentiment, repeatedly criticizing free trade agreements such as the North American Free Trade Agreement (NAFTA) as unfair to American workers. Due to insufficient standards Obama voted against the Central America Free Trade Agreement and opposed the trade agreements with South Korea, Columbia, and Panama that are currently up for decision in Congress, arguing that he would stand firm against agreements that undermine economic security. Even more, he also voted in favour of Senator Schumer's Chinese Currency Bill (2005) to take action regarding China's undervalued currency. In 2007, he urged Treasury Secretary Henry Paulson to take action against China for manipulating its currency. Thus, neither his record nor his statements during the campaign are encouraging. Furthermore, in times of economic turmoil, both political elites and the public – regardless of party affiliation – have a tendency to turn inwards and focus on domestic issues, many viewing protectionism as a viable solution.

However, Obama is not a protectionist. His policies will be a lot more moderate than his election rhetoric. The presidential elections were decided in a few key states such as Ohio, Pennsylvania, and Michigan, states that rely on heavy industry and manufacturing, which have been hit hard by structural change and increasing global competition. To win these states, Obama had to take negative attitudes towards free trade into account. But not only is commercial engagement important for the attainment of U.S. foreign policy goals. Market access around the world is important for the U.S. economy, even more so because of the present economic slowdown. While a u-turn in trade policy is therefore unlikely, trade policy will also not be a high priority of the Obama administration in the first two years in office.

Nothing Is Possible without Congress

Obama depends on the support of Congress if he wants to implement his economic policy plans as the power of the purse as well as the authority over trade policy does not rest with the executive but the legislative branch of government. On first sight, the situation looks favourable for him: The Democrats have gained seats in both the House of Representatives and the Senate in the congressional elections. Previously, 51 of the 100 senators were Democrats, and 49 were Republicans. According to the provisional results (two seats are still undecided) the Democrats were able to increase their majority to 58 mandates. As things stand, they also have a clear majority (254 seats) in the House of Representatives.

Yet, a Democratic majority in Congress is by no means a guarantee that Obama will succeed in realising his economic program. While he can count on the support of his party with regard to further stimulus packages for the economy, tax cuts for the middle-class and above all a reform of the health system, conflicts may arise when it comes to consolidating the budget. In many areas there are already signs of a polarisation between the fiscally conservative Blue Dog Democrats and the more traditional liberals, who are close to trade unions and whose first loyalty is to employees' interests. Only when Obama presents his first budget in 2009 it will become clear whether or not his party will gather unanimously behind him.

Furthermore, he will not be able to avoid seeking support for his fundamental reforms among the Republicans. This applies both to his energy plans – above all the introduction of a cap-and-trade system – and to the reform of the health care system since Democrats still do not have the 60 votes in the Senate that would be necessary to pass bills against a filibuster.

Economic Pragmatism

Obama is often compared to Franklin D. Roosevelt, who promised a "new deal" amidst the Great Depression, when a quarter of Americans was unemployed, banks were failing across the country, and hundreds of thousands of homes were foreclosed. To different observers this meant vastly different things from a planned economy to a balanced budget. While Obama made a greater commitment to specific plans during his campaign, his narrative of change also leaves him considerable room for manoeuvring. Furthermore, Obama will not take a single economic ideology to the White House, unlike Kennedy, who believed in demand-side economics, Reagan, who was a strong supporter of supply-side economics or Clinton, who followed the Third Way. According to his chief strategist David Axelrod, Obama's economic influences are rather eclectic.
In any case, his economic approach will be characterized more by pragmatism than ideology. This is not without danger. As history has shown, American politicians tend to exaggerate in times of crisis. Obama's biggest challenge therefore is to find a healthy equilibrium between the state and the market and to develop a consistent economic approach.

SWP
Stiftung Wissenschaft und Politik
German Institute for International and Security Affairs

Ludwigkirchplatz 3–4
10719 Berlin
Telephone +49 30 880 07-0
Fax +49 30 880 07-100
www.swp-berlin.org
swp@swp-berlin.org

ISSN 1861-1761

Translation by Melanie Newton

(English version of SWP-Aktuell 78/2008)