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A Working America is Good for Asia

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Abstract

America may be declining – in a relative sense, not in an absolute sense – but it still matters how it handles its stumbling economy. All the signs in the middle of September 2011 point towards a slowdown that could result in a double dip recession. Or the economy may just stay in a slump it went in early 2008. It matters for the world, including the countries in South Asia, as to how the American economy performs in the next few months. This Insight examines the current trends in the American economy and how they might influence Asia including South Asia. The main conclusion reached here is that the policymakers in Asia need to be exceptionally vigilant in following the developments taking place in the West.

Introduction

Confidence plays an important part in the health of an economy. When people are optimistic they spend more and save less. This increases the demand for goods and services. That leads businesses to hire more in order to meet the greater demand. Increase in employment increases spending even more and that leads to another investment-employment-spending cycle. The reverse happens when people lose confidence which is the case now in both the developed and the developing parts of the global economy. According to John Williams,

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President of the Federal Reserve Bank of San Francisco, 'the latest consumer sentiment readings are near the all-time lows recorded in late 2008 during the most terrifying months of the financial crisis'. He noted that 62 per cent of households expected their incomes to stay the same or decline over the next year, the bleakest outlook in the last three decades. 'It's hard to have a robust recovery,' Williams continued, 'when Americans are so dispirited.'[2] Slow growth in job creation was an important reason for the loss of confidence by the consumers.

Employment is not increasing in most parts of the world economy. In the United States, it is stuck at a bit more than nine per cent of the work force. Experts now believe that there is a 50-50 per cent chance of another dip in economic activity. How should policymakers respond to this developing situation?

But slow job creation in the United States was not the only reason for the loss of confidence. Europe's inability to handle the crisis of 'sovereign debt' – the large amounts of money owed by the weaker economies of the continent to the continent's commercial banks on which some of them may default – was another cause of worry. The G7 met in Marseilles, France a day after the American president addressed the country's Congress but came short in terms of finding a solution. The International Monetary Fund (IMF) Director General Christine Lagarde said on her way to the meeting that world is 'collectively suffering from crisis of confidence in the face of a deteriorising outlook. Countries must act now and act boldly to steer their economies through this dangerous phase of the recovery'.[3]

Tools for Managing an Ailing Economy[4]

One important legacy of the Great Depression of the 1930s was the development of policy tools that could be used to take care of economic downturns. Such downturns are inevitable. They are part of the way capitalist economies function and develop. These business cycles could be tamed by the use of monetary and fiscal instruments. Which of these two was actually used depended upon the taste and ideologies of the policymakers.

Those of Keynesian disposition were inclined to use the budget to reduce the adverse consequences of the cycle. The government could pump money into the economy and create jobs for the unemployed which would increase aggregate demand and provide incentives to the private sector to start investing again. The monetarists – or Friedmanites, after the

2 Binyamin Appelbaum, 'Fed Chief describes consumers as too bleak', *The New York Times* (9 September, 2011), p. B1 and B7.

3 Liz Alderman, 'Calls for bolder action as Europe enters a dangerous phase', *The New York Times* (10 September, 2011), pp. B1 and B3.

4 This section draws upon Shahid Javed Burki, 'Not a V, nor a W, but a flat-bottomed U', *The Business Times* (9 September, 2011), p. 11.

economist Milton Friedman – preferred to use money supply to tune the economy. The central bank lowered interest rates by printing money and money's lower cost provided the needed incentive for private entrepreneurs. Those in favour of this approach argued that the use of monetary instruments acted quickly whereas increasing public expenditure had longer time lag between policy action and desired results. In either event, the cycles were short, mostly of 'V' type. In most of the cases after the Second World War, the downturns were sharp but so was the recovery. Plotted on a chart, economic activity had a 'V' shape. The economies quickly returned to the level of activity they were at before the downturn.

This has not happened with what was called the Great Recession of 2008-09. It was great because of the severity of the collapse of economic activity in all industrial countries. The sharpest decline in real GDP occurred in Japan with a fall of 10 per cent from the first quarter of 2008 to first quarter of the following year. The gentlest fall was in France with a decline of four per cent. The United States with five per cent and Germany with seven per cent came in between these two extremes. Policy response to this event was a mixture of fiscal and monetary instruments. The governments acted together to provide fiscal stimulus to the economies. The central banks brought interest rates to near zero. The result was mild recovery in all Western economies. However, none of the economies regained the levels achieved before the downturn began. The United States was at the nearest point in the first quarter of the current calendar year while Japan, having recovered to four per cent below the start of the recession, dipped again to about six per cent decline. The GDP growth estimates for the US in the second quarter of 2011 indicated a slowdown in recovery.

This led some to talk about a 'W' shaped recession – a drop in activity followed by a mild rise, followed again by a decline, followed once again by mild recovery. However, some economists believe that it was premature to declare that the Great Recession had ended in the first quarter of 2009. A more accurate way of describing it would be to call it a 'U' shaped recession, with a long and flat bottom. If this is the correct interpretation, what are the options available to those who make policy? This is where politics enters the picture.

With interest rates set near zero and with the Federal Reserve, the US Central Bank, having declared that they will stay there for at least a couple of years, the only monetary instrument left is something called 'quantitative easing'. The Fed has undertaken two of these – QE1 and QE2 – but there is political pressure on it not to go that route a third time. In fact, Texas Governor Rick Perry, now the leading Republican contender for President Barack Obama's job in the elections of 2012, has warned that he would regard QE3 as a treasonous activity. While toning down his rhetoric a bit in the first Republican candidates' debate on 7 September at the Ronald Regan Center, he stuck to his basic position. The ugly wrangling over the decision to raise the level of public debt in the US means that another large fiscal stimulation is not an option either.

The Europeans have severe problems of their own with a number of weaker economies in the Union close to bankruptcy. Greece has been rescued twice from defaulting on its foreign obligations. It is by no means certain that the second package will be any more successful than the first one. This helplessness in the West has turned the attention of some analysts towards emerging markets. The European banks are under great stress having acquired significant amount of government debt issued by weak economies. Much of this debt has been classified as 'junk' by the rating agencies.

Emerging Markets to the Rescue?

Since the downturn began, but especially after the weak recovery from it, the shift in economic power from the developed to the developing world is quite apparent. This was expected but the recession has quickened the pace of change. The International Monetary Fund has estimated that the output of developing Asia – which means all of Asia not including Japan – was seven per cent higher in the first half of 2011 compared to the level at the beginning of the recession. The estimate for Latin America is two per cent higher. This has obvious implication for the share of developing countries in world output. The emerging markets are expected to account for 38 per cent of global output by 2016 compared with just 25 per cent in 2007. This means that these economies are likely to increase their share in world product by 13 percentage points within one decade. Could they be relied upon to stimulate global economic activity?

The answer is not for the simple reason that together emerging markets have a current account surplus with the rest of the world. For them to stimulate global economy they need to run deficits. This is not likely to happen especially with China in the lead. A major appreciation in the Chinese exchange rate would act as a major stimulant for the global economy. If that were to happen, China will buy more from the West rather than run large trade surpluses with it. But the Chinese have resisted the pressure on them – which was intense at times – to increase the value of their currency. The IMF's projection is that China will go in the opposite direction with the current account surplus rising from 5.7 per cent in 2011 to 7.8 per cent in 2016. South Asia is also weakening because of the palpable decline in economic activity in India which makes up 80 per cent of the region's output. The Pakistani economy, the second largest in South Asia, remains weak mostly because of security concerns and unsettled politics. For the moment, therefore, the global economy will continue to depend on what actions the Americans take and on what the Asians might do. But in Washington bold action is constrained by politics. To paraphrase James Carville, an adviser to President Bill Clinton: 'It is politics stupid rather than economics.'

Possibility of Currency Wars

One of the lessons learned from the Great Depression of the 1930s was that competitive devaluations in order to promote exports ultimately harm everybody in the global system. It is this recognition that led to the creation of the fixed exchange rate system at the international conference held at Bretton Woods as the Second World War was coming to an end. The IMF was established to monitor the rates of exchanges among the member countries. The new system was centered on the linking of the currencies of all the countries admitted as members of IMF to the American dollar while the Americans pledged to convert their dollar at a fixed rate – US $35 to an ounce of gold – if demanded by those who held liquid American assets. That system lasted for 25 years and was abandoned on 15 August, 1971 by President Richard Nixon when the Americans ran up large deficits with Germany and France. By abandoning the dollar-gold link, Washington ushered in an era of floating exchange rates with the IMF continuing to oversee the operation of the new system.

This system is now threatened and the threat has come from an unlikely source – Switzerland. 'When even eternally neutral Switzerland enters a war, you know things have turned bad. On Tuesday [6 September, 2011], the Swiss National Bank stunned financial markets by drawing a defensive line at the an exchange rate 1.2 Swiss francs to the euro and promising unlimited firepower to prevent strengthening beyond that point', wrote Alan Beattie for the *Financial Times*.[5] The Swiss acted in their interest not in the interest of international financial markets. They became concerned as the value of their currency continued to increase when large amounts of capital flowed into the country looking for safe havens to park extremely mobile assets. The Swiss, depended on exports more than most European countries, were concerned that the rising franc will make them less competitive in the global market place. Exporting high technology products they were particularly fearful of competition from Germany.

The Swiss will maintain the new fixed exchange rate by buying all the foreign capital that flows into the country at the specified rate. This can only be done by printing more Swiss francs. The result of this will be some increase in domestic inflation. Facing this barrier, those in search of new havens will move on to other places. The Swiss action was followed immediately by the flow of large amounts of foot-lose capital to the Scandinavian countries. If they also act defensively as the Swiss have done, capital flows will be directed at places such as Singapore. This has probably already begun to happen since the value of the Singapore dollar has been appreciating of late. This may move the authorities in Singapore to fix their dollar in terms of the US currency. In other words, the Swiss action may have set a chain reaction in motion which may reach Singapore.

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[5] Alan Beattie, 'Global economy: Desperate measures', *Financial Times* (10 September, 2011), p. 5.

Economists call this 'action and reaction' cycle of public policymaking 'beggar thy neighbour' approach. This was precisely the approach that deepened the Great Depression of the 1930s. One of the ways to arrest these moves would be to hold an international monetary conference of the type that was held at Bretton Woods in 1944. However, the Americans are resisting this move since they too are benefitting from the weakening of the dollar. Some experts believe that this 'tit-for-tat' weakening of currencies may have a positive impact. For instance, Professor Barry Eichengreen, once a staff member of the IMF and now at the University of California at Berkeley, has long argued that competitive devaluations helped pull economies out of depression in the 1930s. This is a contrarian view to accepted wisdom. He admits that while it is true that the countries following this approach could not all export their way out of depression, they loosened domestic monetary policy and thus unleashed demand[6]. In spite of all the experience gathered in dealing with recessions, economic theory has still not developed an unassailable position on how they should be dealt with.

President Obama's Second Stimulus Package

In an address to the joint sitting of the US Congress on 8 September 2011, President Barack Obama presented to the country's legislature another package aimed at stimulating the economy. It was much smaller than the first stimulation measure adopted in 2009 soon after Obama was sworn in as president. The new package is estimated at a bit less than US$450 billion and is built around the proposals developed by both the Democrats and the Republicans over the last several months. In presenting his programme, the President combined politics with economics. 'The question is whether, in the face of an ongoing national crisis, we can stop the political circus and actually do something to help the economy,' he asked[7].

Obama's liberal supporters, who were on the verge of giving up hope in the man who had won the 2008 election on the basis of a slogan 'yes, we can', were encouraged by the President's speech. 'With more than 14 million people out of work and all Americans fearing double digit recession, President Obama stood face to face Thursday night with a Congress that has perversely resisted lifting a finger to help. Some Republicans refused to even sit and listen. But those Americans who did, heard him unveil an ambitious proposal more robust and far-reaching than they expected – that may be the first crucial step in reigniting the economy', wrote *The New York Times* in an editorial a day after the President's speech. 'Perhaps as important they heard a President who was lately passive but now newly energised, who passionately contrasted his vision of government that plays its part in tough

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[6] Barry J. Eichengreen, *Global Imbalances and the Lessons of the Bretton Woods,* Cambridge, MA, The MIT Press, 2010.

[7] The White House, 'Address by the President to a Joint Session of Congress', (8 September, 2011), www.whitehouse.gov/the-press-office/2011. Accessed on 11 September, 2011.

times with the Republicans' vision of a government starved of the means to do,' continued the newspaper.[8] That the move towards redefining the role of the government in the US – an objective pursued with exceptional vigour by the American political right, in particular by the Tea Party movement – would have some profound implications for the Asian economies was a theme explored by the author in an earlier ISAS 'Insight'. [9] It was suggested in that article that if the American state does in fact withdraw from supporting such critical activities as research and development, innovation, and increasing the levels of the skills of the workforce, the country may no longer be in a position to produce the goods and services an ageing population will require in a modern economy. The populous countries of the Asian mainland could step in to fill the supply gap that would inevitably arise if such a policy posture were to be adopted. This may not happen if the programme advanced by President Obama gets to be implemented in its entirety.

The signal was clear from Obama in his 8 September speech. He would not allow the US to become a second-rate power. Some commentators saw in Obama's proposals a chance for America's revival. According to Thomas L. Friedman, 'I've been arguing that the only antidote to this debilitating situation is a Grand Bargain between the two parties – one that cuts long-term entitlement spending and raises additional tax revenues to get our fiscal house in order, while making short-term investments in the sources of our strength (particularly new schools and community colleges, scientific research and roads, bandwidth, mass transit and roads) that can also cushion this recession. While President Obama has talked generally about such a Grand Bargain, he has never put a detailed offer before the American people and his own party faithful. It was a failure of leadership. Thursday night in his speech before Congress, President Obama finally rose to that challenge in a thoughtful, credible and substantive fashion.'[10]

The American Economy and Its Impact on Asia

It matters for the world what happens to the American economy. It matters, in particular, for Asia. It matters to China since America remains the largest market for the country's exports. America is also the most important source of technology imports for China and the largest depository of the large surpluses it produces by exporting so much more than what it imports. In spite of China's misgivings for the future of the American dollar, Beijing continues to add to its holdings of America's government paper. It matters for India for which America accounts for most of its earnings from the sale of IT products and services. While China is

[8] 'The jobs speech: An aggressive president, at last challenges the defeat-everything Congress', *The New York Times* (9 September, 2011), p. A24.

[9] Shahid Javed Burki, 'Opportunities for South Asia in the Revolutions in the West', ISAS Insight No. 213, 15 August 2011.

[10] Thomas L. Friedman, 'Getting back to a Grand Bargain', *The New York Times, Week in Review* (11 September 2011), p. 11.

now India's largest market, Beijing imports mostly industrial raw materials from New Delhi. This earns India large amounts of foreign exchange but industrial raw material exports won't bring it economic and social modernisation. Exports of modern services to America will. It matters for Bangladesh for which America is a large market for garments, the country's most important export. It is only for Pakistan in South Asia that America now matters less since it is succeeding in reorienting its economy towards the East – towards China in particular – rather than towards the West.[11]

Lastly, America matters a great deal for the small city states of Asia – for Hong Kong and Singapore – who have been successful in tying their modern service economy with that of the US. This is the reason why the dip in Singapore's gross domestic product was the sharpest of all economies in Asia at the time of the slowdown associated with the Great Recession of 2008-09. There are many scholars and analysts in Asia who rejoice in America's decline while their own continent rises.[12] This is a good patriotic position to take but such a change would only help if it comes slowly giving the fast growing economies of Asia the time needed to make adjustments taking place in the structure of the global economy. Given the linkages that exist with the American economy, it won't help if American goes down fast. In fact to use an American sporting metaphor, Asia – China in particular –may have to step up to the plate to help the economically ailing West. According to one assessment, 'China has already apparently poured tens of billions of dollars worth of foreign reserves into euro dominated investments this year. But Chinese officials are still cautious about taking big risks with the country's US $3.2 trillion nest egg. When considered in the context of China's 1.3 billion people, the nest egg is not necessarily an infinite treasure'.[13]

Conclusion

Tim Geithner, the US Treasury Secretary, summed up well the situation America and the world faces in an article contributed to the *Financial Times*. 'With interest rates very low in the main economies, budget deficits swollen by the crisis and the financial imbalances of the crisis only party resolved, there are limits on what policy can do to help strengthen growth. But the biggest constraints on action in the large developed economies now have less to do with those economic realities and more to do with political paralysis, misplaced fears about

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[11] See Shahid Javed Burki and Iftekhar Ahmed Chowdhury, 'China's 'Look West' policy', ISAS Insights No. 134, 6 September, 2011.

[12] Singapore's Kishore Mahbubani is prominent among the scholars who have pursued this line of analysis. See his *The New Asian Hemisphere: The Irresistible Shift of Global Power to the East*, New York, Public Affairs, 2009.

[13] Liz Alderman, 'Calls for bolder action as Europe enters a dangerous phase', *Op. Cit.*, p. B3.

inflation and moral hazard, and unwarranted disaffection with the efficacy of the traditional fiscal tools of tax cuts and investment to encourage growth'.[14]

It is not entirely sure that the managers of the large economies are anywhere near finding a consensus on how to deal with the deepening economic crises they face. Lack of appropriate actions will have serious consequences for the rest of the world. This will be the case in particular if the countries act independently and defensively in protecting their narrow economic interests by resorting to measures such as competitive devaluation of their currencies.

In happier economic times, Asia's policymakers may have concluded that they had developed an internal dynamics which would have given them the freedom to act in their own interest. At one point this was called 'decoupling' of Asia from rest of the world. But that has not happened. Asia remains linked with the older and still richer economies of the West and Japan to the extent that the continent will be badly hurt if the latter finds itself in great economic stress. Asia will be hurt by economic chaos in Europe and North America. It may have to help by using its vast reserves of cash accumulated over the last two decades to provide liquidity the resource-strapped countries of the West desperately require. If that happens it would mean a sharp reversal of the roles played by these two parts of the world in the past – especially since the Asian Financial crisis of 1996-97 – with Asia becoming the creditor to a group of nations on whose financial largesse it had once been dependent for so much and for so long.

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[14] Tim Geithner, 'What the world must do to boost growth', *Financial Times* (9 September, 2011), p. 9.