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The Economic Melt-Down (1): America

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The dramatic collapse affecting US banking and capital markets has spread to the rest of the world, thus making a recovery even harder to achieve. This financial crisis, by far the most serious the world has faced since 1929, has already resulted in dramatic policy changes - including the proposed partial nationalization of banks by a Republican administration - that leave the doctrine of unfettered markets in tatters. It is also pushing the US economy from a status of weak growth into a recession: unemployment is now 6.1 percent and 760,000 jobs have been lost since the beginning of 2008. The International Monetary Fund forecasts 1.6 percent economic growth this year and 0.1 percent in 2009. This will push the unemployment rate up significantly. President George W. Bush leaves office with the US and world economy in a perilous state, and his administration carries much of the blame.

In 2000, President Clinton's last year in office, the US had a budget surplus of \$236 billion. By 2007, the budget deficit had reached \$162 billion, and in the fiscal year that ended on 1 October 2008 it reached \$455 billion. The huge budget deficits have led to a massive increase in debt, both at home and abroad. Federal government debt rose from \$5.7 trillion in 2000 to \$9.7 trillion in 2007, a 70 percent increase, while the gross foreign debt more than doubled between June 2004 and June 2008 to reach \$13.7 trillion. The latter is close in size to the United States' national income. These factors weakened the dollar, helped to push up oil prices (until the current crisis forced them back down); increased the cost of imports, accelerated inflation and deepened US reliance on foreign sources of finance. The \$700 billion bail-out plan will add to the domestic deficit and debt.

The government is spending far more than it receives in taxes, thanks to the huge rise in defense spending to cover the wars in Iraq and Afghanistan

coupled with massive income tax cuts implemented by the Bush Administration. The United States economy has been overburdened by war expenditures that have been largely funded from borrowing at home and abroad. According to the Congressional Budget Office, between 2001 and 2008, the wars in Afghanistan, Iraq and the "War on Terror" will have cost a total of \$752 billion. This excludes huge extra-budgetary costs such as caring for thousands of wounded soldiers for the rest of their lives. As a result, the share of defense spending in the federal budget rose from 15 percent in 2000 to about 20 percent in 2008.

It is not only the government that is spending more than it earns: the national savings rates have fallen and so the economy as a whole has become dependent on foreign funds to support investment. The public, or significant sections of it, have put funds into real estate and invested in securitized funds that invested in sub-prime mortgages. The real estate and related Wall Street boom was based on rising property prices that created a bubble which inevitably burst. In 2006, 750,000 properties were subject to foreclosure. In 2007, the number increased to nearly 1.3 million (one percent of all U.S. households). During the last few years, millions of Americans lost their homes, but the Bush Administration and the Federal Reserve did little in response until 2008.

The crisis developed because of declining and unregulated lending standards and low interest rate policies designed to encourage economic growth. There is much to be said for a permissive monetary policy when the economy is on the right track, but the property boom that it helped to encourage proved disastrous. There was another reason why the bubble developed: the dismantling in 1999 of much financial oversight, a move initiated by the Republican-dominated Congress and agreed to by the Clinton Administration. This was part of the free market ideology that dated back to the Reagan years in the US and those of Thatcher in the UK that encouraged financial institutions to seize every opportunity to make money and innovate, often in highly complex and non-transparent ways in order to sidestep what little regulation there was. In the United States, low interest rates were accompanied by lax budgetary policy policies and this fed speculative waves in real estate and associated financial markets. At the same time, because of its ideological opposition to public spending, the Bush Administration continued to neglect the country's social and economic infrastructure, which had long-term negative effects on the economy's competitiveness.

Nor have the problems been confined to the domestic economy. The United States' balance of payments is also in trouble. In 2000, it had a balance of payments current account deficit of \$417 billion; by 2007 it had reached

\$713 billion. Although an improvement is expected in 2008, the imbalance remains serious. One of the major causes of this increase was the rise in oil prices. The failure to reduce the United States dependence on foreign oil has been one of the worst lacunae of both the Bush and Clinton Administrations' policies. Had the United States reduced its reliance on imported oil, it would have achieved multiple objectives in terms of foreign policy, strengthening the balance of payments and improving the environment. The reason why it did virtually nothing is because it would have required reducing reliance on oil altogether. This would have involved a fight with the oil and automobile lobbies in which neither the President nor the Congress was interested. It is worth noting that much discussion about US policy in the Middle East takes reliance on oil as a given, rather than treating it as something to be changed. Integrating economic, energy and foreign policy in this regard will be one of the most important tasks facing the next president.

The United States has been financially, economically and ideologically humbled by its own failures. What will be the impact of these developments on the Middle East?

The first is that the United States will have less money to spend abroad. A Democratic administration will be keen to end the war in Iraq for economic as well as military reasons. Foreign aid bills will be harder to pass through Congress and, equally important, there will be much less private capital for investment abroad or for philanthropic purposes, at least in the short term. The rest of the world - and especially China - may find US markets less eager for their products, although the current strengthening of the dollar may mitigate this somewhat. The world economy will experience a slowdown in growth and some countries will slide into a recession. Turkey's currency has collapsed in value, Egypt and other Arab countries are suffering from inflation and slower growth, and anxiety about the economy is increasing in Israel. The effect on overall political stability in the region remains to be seen, but one can assume that it will be negative.

The second is that there will be attempts to reform the international monetary and trading systems to encourage world economic growth and thus prevent a major international recession. This will involve, inter alia, much greater regulation of banks and capital markets within countries and quite possibly between them. It may also require much less protection against imports from developing countries by the United States and the European Union so as to encourage international trade. This could ultimately help Middle East countries trying to export manufactured and other goods to developed countries.

Third, this crisis has caused the price of oil to fall by 50 percent in three

months. This will have profound implications for oil producers. Iran, with its large population, is the most exposed and has already acknowledged that it is in difficulty. The Gulf Arab states have suffered large stock market losses. These implications will be examined in future TEL AVIV NOTES.

Does this dismal economic picture mean that the world's only superpower has become weak? The share of the United States in world GDP has remained steady during the last twenty years. This is the basis of its strength, but growth potential has been weakened by financial and economic mismanagement and an ideology that has led, among other things, to underinvestment in the country's infrastructure and reliance on foreign finance to fund domestic deficits. However, economic strength, like political power, is relative, and in order to assess the position of the United States in light of this crisis it is necessary to look at what has happened to some of its adversaries. This will also be the subject of forthcoming NOTES.

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