PROSPECTS AND SCENARIOS OF US ECONOMIC POLICY DEVELOPMENT UNDER THE NEGATIVE DYNAMICS OF THE NATIONAL DEBT

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Abstract

The main purpose of this paper is to examine the prospects and possible scenarios of US economic policy development under the negative dynamics of the national debt and its possible outcomes from the point of view of the world economic growth and stability. The effort is made to explain the underlying reasons for the significant US national debt accumulation and to devise steps in order to resolve the situation, especially as concerns rise over the unfolding EU countries debt crisis and imbalances in the world currency markets. One part of the paper is devoted to the internal US problems such as the unusually high rate of unemployment and great budgetary expenditures for social security. However, special emphasis in this research is made on the analysis of the short-term and long-term impact of the indebtedness of the US on the financial markets and world economic development, taking into consideration the prominent role of the US as the world top importer and the issuer of the international reserve currency. It is the authors' belief that the extent to which the US will be able to maintain its internal demand and uphold the high rate of GDP growth will largely determine whether the world economic system remains stable and balanced, given the role the US plays in international economic relations. All in all, this work can be quite useful for understanding the US role in the global context and for comprehending fundamental flaws ingrained in modern economic policies, leading to general systemic vulnerability of the world economy.

Key words: economic policy, US national debt, debt crisis, economic stability, reserve currency.

Introduction

According to the statistics of the fourth quarter of 2010, the global economy continues to show strong signs of gradual recovery: the real GDP of the U.S. has grown by 3,2% p.a. due to the seasonal leap of consumption, while Chinese GPD grew by 9,8%. Nevertheless, regardless of the external signs of the revival of the modern global economic system, there are still visible systemic faults in place, such as the high national debt of the United States, the principal global importer, the growing inflation in Brazil and China, the extraordinary amount of liquidity within the global financial system that puts the future of the global economy at risk.

According to the announcement by the experts of the Business Cycle Dating Committee of the National Bureau of Economic Research (NBER), the recession of the U.S. economy began in December 2007 and ended in June 2009.

Nevertheless, although as of today all the trends indicate that the recession is in the past, the recovery of the global economy is a matter of many years to come. In addition to this, all the present data proves that we should not rule out the possibility of the return of the recession.

1. Pending concerns

1.1. Unemployment and liquidity trap

During a year and a half 7,3 million of jobs were cut in the United States, and the real GDP dropped by 4,1%. After recovery from the recession, the actual GDP has grown by 2,9% only, in July the unemployment has grown from 9,5% to 9,6%, and as of November 2010 it remained steady on the mark. In December the unemployment rate has fallen to the mark of 9,4%, the lowest or 19 months, but such downfall can be explained rather by the reduction of the number of people looking for job than by the increased number of work places. In general, the unemployment level is still high. By the way, the Model developed by 2010 Nobel prize winners Peter A. Diamond, Dale T. Mortensen, and Christopher A. Pissarides is a tool for modeling and forecasting the dynamics in the labor markets, but according to the authors it does not explain the reason of such a high unemployment level in the U.S. market given such low interest rates (the average of 0,2% in the U.S.). In practice, everything indicates that the U.S. is in the state of liquidity trap. Liquidity trap is the economic condition, when the interest rates are close to zero, and the further growth of cash proposition is unable to stimulate the investment demand.

The first USD 814 billion Economic Stimulus Package that was adopted last winter, helped to preserve millions of jobs, but failed to reduce unemployment and stabilization of GDP growth. Ineffectiveness of monetary stimulus has painted the current Administration into a corner, forcing it to move towards quantitative easing, which, by essence, is the artificial creation of money with the purpose of buyout of assets and saturating the country's economy with money. In other words, they've switched the money machine on. In November 2010 the Obama Administration has determined the amount of quantitative easing, i.e. USD 600 billion. Without doubt, this will result in devaluation of the US dollar. But this is exactly what the Summit G20 that took place in October 2010 was against, because such development of events shall lead to sharp movement of exchange rates, as the leading countries will try to devalue their currency in order to stimulate the exports. It is also important to understand that the core inflation in the U.S. in November 2010 was only 0,6%, which raised the issue of the possible deflation that is why, from this point of view, the program of quantitative easing was well-grounded.

The most important is why the United States have made this step. To answer this question, one has to understand several fundamental aspects of the current situation in the United States. First of all, the principal reason of the slow economic recovery at the United States is a very weak domestic demand that always used to be the driving force that put the United States out of crisis. But, during the period after the end of recession the households have only renewed a little more than 4% of the lost assets. In addition to this, according to Nouriel Roubini, the Professor at the New York University, even now the demand from the households is largely affected by the mortgage market, while Americans continue to lose their apartments even now. In the course of July 2010 the U.S. banks and credit agencies have received 95 364 real estate objects, which is a record-breaking figure in the history of the mortgage business. During the same period 339 thousand Americans have received warnings of the possible foreclosures on their property on account of debt, sale of property through the auction, or transfer of the ownership rights to the creditor. According to the experts, in the future this figure is going to grow.

1.2. Burden of the national debt

The statistics of the U.S. national debt is also an important thing to follow up on. In accordance with the official statistics, the national debt consists of the public debt (in the form of the U.S. Treasury Bonds held by investors except for the domestic debt) and the joint debt that includes the national bonds owned by the specific Government institutions, i.e. Social Security Trust Fund. Even based on these calculations, the U.S. has a huge debt, and it ever grows faster. Thus, based on the calculations of 2009, the joint debt of the United States was 86,1% of GDP (USD 12 311 trillion), taking into account GDP downfall of 2,44% in 2009 compared to 2008. The public debt of the United States in 2009 was 54,6% (USD 7 811 trillion). According to the forecasts, the U.S. joint debt shall hit the level of approximately 98,1% of GDP (USD 14 456 trillion), its public debt – accordingly 67,1% (USD 9 882 trillion). The joint U.S. debt had crossed the benchmark of USD 13 trillion in May 2010. It is interesting that the amount of the U.S. debt grows on a daily basis by USD 4,13 billion. In the U.S. the upper level of the state debt was officially established, and today it is on the level of USD 14,3 trillion. Technical default is possible when crossing this level. It is expected that in 2011-2012 the total debt of the United States shall cross the mark of 100% of GDP. It is also important that the method of taking the U.S. debt into account is very far from being perfect. For instance, it does not take the debt of the States into account, although evidently in case of default on debt securities of one of the States, the U.S. Government will step in to save it. Just for the record, the debt of California alone is USD 77,8 billion.

The reasons of such high debt are the largely inefficient Social Security System and the Health Care System of the United States. Social security costs take 20,8% from the Federal Budget of the United States, and the Health Care System – 20,1%, which may only be compared to the expenditures of 20,5% on the Defense System. And although these systems were the principle drivers for increase of demand in the domestic market, today they are the burden that may precondition the ruin of the United States.

2. In search of salvation

2.1. Choice without a choice

After all, as Professor Laurence Kotilikov had stated back in 2006, ultimately the United

States shall face only three possible ways out of the current situation:

1) The reduction of costs, which is unacceptable for the United States for the political reasons, and to date it deviates with the political course pursued by the President Obama that promotes the increase of the government sector's costs through its 2010 Healthcare System Reform.

2) The increase of taxes, which will be unacceptable as well, because it would contradict the logics of the minimal interest rates currently directed at stimulation of the production in the domestic market of the United States. Increase of taxation would bring the opposite effect: closure of businesses due to heavy tax burden, and further job cuts.

3) Or US dollar's devaluation, which leads to inflation of the US debt, creation of the favorable climate for exporters, excellent conditions for substitution of imports, e.g. from China or Europe. There is another interesting (and, perhaps, the main) result of this particular scenario. Given that as of today the domestic market of the United States is not sufficiently attractive to the investors, "qualitative easing", in other words pumping liquidity into the U.S. economy, will ultimately result in the outflow of the cheap financial capital from the country to the centers of the most active growth, i.e. to China, India, and Latin America, to where they would get both through the banking system – in the form of cheap loans, and through the direct and portfolio investments at the very low "cost" given the present conditions. On this account we shall see the growth of the tendency to take the manufacturing out of the United States. As a result, the United States shall turn into the "rentier" of the new century. The negative part to the situation is that such capital inflow shall lead to overloading of the Chinese and other developing countries' economies thus causing inflation. The decision on "quantitative easing" is the signal that the United States have chosen the third scenario. Perhaps this is the reason of the high level of unemployment in the U.S., as the excess capital is used to create working places overseas, and not at home. Unfortunately, such policies are associated with significant danger. The country's currency being a global reserve currency, it allows the issuing country to support the comparatively high budget deficits (according to the recently published Federal U.S. Government Budget, the deficit was planned at the level of 10,6% of GDP, while in 2009 this amount was 9,9% of GDP, - Moody Rating Agency already threatened to reduce the credit rating of the Federal Government from AAA mark) and the State debt, thus covering the lack of ready money through additional emission and exporting inflation. But as long as there is a demand for currency, it will remain stable. In case of a dollar, the stability is guaranteed by its wide usage in international settlements and the demand for it as a reserve currency, especially in the countries that export production to the U.S., which means that in order to keep the underestimated rate of their currency they shall have to purchase and to keep a large number of the U.S. dollars in their inventory. Thus, China keeps U.S. treasury bonds for more than USD 891,6 billion of their USD 2,85 trillion in gold holdings.

2.2. The grim future

The fall in the demand for the global reserve currency and reduction of its portion in gold holding of the countries of the world shall be the definitive signal of the significant and sudden devaluation of the global reserve currency. For instance, this may be seen today in China that has been steadily decreasing the dollar portion of its state reserve during the recent years.

In case of the similar developments, the chain reaction and panic in the foreign currency markets shall lead to sudden devaluation of the U.S. dollar. This would mean the devaluation of all the global deposits in the U.D. dollars, both for natural persons and legal entities, and for the governments. The risk of the similar scenario is rather tangible, although it is not clear yet what might trigger these events, - another debt crisis in Europe, aggravation of the situation at the Middle East, or the further reduction of the dollar share among the global reserve currencies. However, it must be mentioned that in the near future we shall see the contrary situation, as investors who are trying to get away from Euro choose US dollar in order to retain their capital.

The dynamics of prices to gold is yet another sign of the possible turbulence in the Forex market. In 2009 China has doubled their supplies of this valuable metal up to 1054 tons. Today the gold metal shall set the new record. At the recent sales at New-York Mercantile Exchange the price for December Gold Delivery have reached the mark of USD 1388,1 per ounce (compared to USD 248 per ounce in 1999). This is not the historical maximum, because at the

rate of the today's prices the price in 1999 would make USD 2,3 thousand. Thus, we see the large space for the further growth of gold prices, which, in fact, is a bad sign, characterizing the times of recession, when investors are risk-averse.

Conclusions

Given the above, it must be noted that the manner in which the situation with the national U.S. debt is regulated, and the currency policy of China, will determine the further course of events. Although, taking into account the fact that the majority in the House of Representatives was seized by the Republicans in November 2010, Obama lost the possibility to implement his policy single-handedly. In the view of passing of the Act which provides for filing for bankruptcy by the separate States, there are reasons to assume that the debt problems of the United States shall not be solved in the nearest future. The effect of the very probable increase of interest rates in 2012 may also be a reason for concerns. It is quite possible that in the near future we shall see the shifting of balance in the global markets. Whether it happens or not, and, if yes, when will it happen, depends primarily on the further developments in the United States' economic policy.

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