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Bush versus Kerry: The Economy in the Balance? (Part I)

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Subject: The Bush-Kerry debate on the economy and the differences in their respective economic programmes

Summary: Before the US presidential debates, it was widely agreed that while a majority of Americans still placed more faith in George Bush in matters concerning national security, most believed that John Kerry would deal with economic issues –such as employment, fiscal policy, health care or social security– more effectively and fairly than has (or would) President Bush. Furthermore, while a growing consensus of analysts now claim –almost to the point of cliché– that the foreign policy stances of the two candidates are not radically different from each other (distinguishing themselves only in terms of style and form, see Soeren Kern, *Bush or Kerry: Why the Substance of US Foreign Policy Will Not Change*, Elcano Royal Institute, ARI nr. 148/2004, 29/IX/2004), their positions on economic matters do appear –at least as they have coalesced during the campaign and the debates– to be quite distinct and materially different

Analysis: *The Context*

While Kerry's economic vision and instincts are very different from those of the President, he will ironically inherit an economic scenario which allows him very little room for manoeuvre. Once in the White House, President Kerry would be likely to be faced with a depreciating dollar and a significant weakening of the economy –the natural continuation of the same economic downturn which US economic authorities under Bush simply refused to allow to run its natural course in 2001, regardless of the long-term consequences for the US, its economy and its capacity to effectively lead the world (see Part II)–. Nevertheless, if Kerry had been the President during the last four years, his economic policies would almost certainly have been very different from those of Bush (whether he would have consequently lost a re-election bid as a result, is an open –and fascinating– question). During the next four years, while a President Kerry would find the economic situation highly compromised by the previous policies of the Bush Administration, if he could only survive the brewing economic storm he would probably act very differently on economic matters than has (or would) Bush.

Of course, Kerry's hands would be further tied should he face a Republican Senate and a Republican House of Representatives. Such an outcome is a distinct possibility, if not an outright probability. Furthermore, his independent room for manoeuvre would be restricted not only by Congressional Republicans but also by Alan Greenspan's Federal Reserve which, while formally independent, operated very much in sync with the Bush White House. Despite Greenspan's role as an 'independent' and 'neutral' technocrat, it remains an open question whether he would make Kerry's economic ride as smooth as possible.

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And even if Greenspan were inclined to do just that, he might not have the freedom to do so.

Domestic Economic Policy

President Bush claims to have boldly led on both foreign and economic policy. In the recessionary throes of the fallout from the stock market collapse, during the summer of 2001, he claims to have taken decisive action to cut taxes as a counter-cyclical stimulus. Later, as the economy suffered the secondary effects of September 11 (although not all of us agree that September 11 had much of an independent, lasting effect on the economy, at least outside the airline and insurance industries), the President took credit for enacting a second tax cut in 2002. Finally, yet another round of tax cuts came in 2003, along with measures to make many of the previous cuts permanent. The argument from the White House justifying these cuts, but particularly the final round, has been that lowering taxes, particularly on the owners of capital and wealth, will encourage more economic efficiency and more dynamic wealth creation.

The deficit that has developed in the meantime, so Bush would have us believe, is due almost exclusively to the depressive effects on government revenue stemming from the recession –and not from the depressive effects of revenues naturally resulting from tax cuts– and, in a minor but politically important way, from increased military and security spending which September 11 and the Iraq war have supposedly necessitated. Nevertheless, the President implies that growth is returning as a direct consequence of his stimulatory tax cuts and that they will therefore ultimately pay for themselves as faster growth stimulates higher government revenue which, in turn, should lower the deficit more rapidly in the future. This virtuous cycle –one of the central features of supply-side economics– would then allow the President to achieve his stated electoral promise of halving the government budget deficit over the next four years while enjoying dynamic growth and job creation.

Suffice it to say that Kerry does not see it this way. Beyond arguing that the Iraq War was not clearly necessary, he repeatedly points to three key, interrelated, developments that have unfolded during Bush's watch. First, Bush is the first president since Herbert Hoover to have presided over a net loss of jobs in the economy. From the beginning of 2001 to the end of 2003, nearly 3 million manufacturing jobs were eliminated. By all measures, the weakness of job growth during the ensuing recovery over the last two years has been the most pronounced in the history of US economic recoveries. While there has been something of a pick-up in employment creation during 2004, the fact remains that anywhere between 500,000 and one million fewer jobs exist in the US economy than in January 2001 when Bush assumed office. For Kerry –in his debate persona, at least– this is sufficient reason in itself to brand Bush as unworthy of a second term.

Furthermore, the Bush Administration's response to the 2001 recession and its aftermath has contributed to the elimination of a healthy budget surplus (some US$236 billion in annual terms) left by the Clinton Administration and the creation of a significant deficit (over US$400 billion), equivalent to some 4% of GDP. Anywhere between one- to two-thirds of this deficit swing is attributable to the three rounds of Bush tax cuts. However, due to the structure of these cuts, they were particularly inefficient in producing economic stimulus. As Kerry points out (and as independent assessments show), between one-third and one-half of the money the government allowed to stay in private hands went to the tiny fraction of the wealthiest Americans –precisely those with the lowest marginal propensity to consume–.

In effect, Kerry would argue, the tax cuts have provided far less stimulus than they could have and instead were designed to mask an enormous, unnecessary and unfair gift to the most powerful elite in history which has concentrated more wealth and income than any ever before. Without these tax cuts to the wealthiest Americans, the deficit might be closer to 2% of GDP rather than the current 4%. Meanwhile, the long-run fiscal outlook has deteriorated substantially. The 10-year cumulative surplus forecast in 2001 when Bush assumed office ranged between US$2,500 billion and US$5,000 billion (depending on the source) while the 10-year cumulative forecast now foresees a deficit within the same range of magnitudes.

Bush has countered this attack by arguing that 'the proof is in the pudding', pointing to the highly visual event of US$300 cheques arriving in the mailboxes of many citizens. The fact of the matter is that the economy is now growing at nearly 5% on an annual basis, with job creation –albeit weakly– returning. What is more, investment spending has rebounded since the recession, demonstrating that tax cuts to the wealthy have translated into more savings and investment and, hence more growth and jobs.

The Kerry camp rebuts that while a recovery is indeed underway, it has not been more than mildly influenced by the tax cuts. Indeed, the recession was shallow and short because consumption remained strong. However, this was due primarily, not to tax cuts but rather to the Federal Reserve's aggressive monetary policy which drastically lowered US interest rates to historically low levels for a number of years. This, in turn, sparked a housing market and mortgage refinancing boom which supported continued high consumption levels via the wealth effects of rising asset prices (as opposed to rising income levels which, with the weak job market, have lagged dangerously behind). This process, while 'saving' consumption levels, and with them US growth rates, has also left American households indebted like never before, holding property assets whose inflated value is increasingly vulnerable to market decline. Investment rates also rebounded as rates were aggressively slashed, but the corporate sector used its new-found profits to improve debt positions on their balance sheets and to begin to return funds to shareholders, rather than to create jobs quickly.

Finally, Kerry argues that the elimination of the surplus and the run-up of fiscal deficits has been the product of misguided foreign policy and ineffective and unjust macroeconomic policy. More fundamentally, this cocktail of misguided policies has irresponsibly frittered away the legacy of Clinton-era fiscal prudence which could have served to shore up Social Security, or even to finance a transition from the current pay-as-you-go pension system to one based increasingly on personal accounts –a reform which is central to Bush's economic platform, however he might choose to flip-flop on this issue at critical moments along the end of the campaign trail–. Indeed, the estimated cost of such a transition, were it to finally be undertaken, is some US$2,000 billion. Not only is it likely that this could have been paid for by the Clinton-era surpluses, this sum is also equivalent to the budgetary cost of making all of Bush's previous tax cuts permanent, something the President wants to do immediately, long before he is forced to consider exactly how to pay for whichever Social Security reform is ultimately agreed upon.

For his part, Kerry's campaign talk on deficits, pensions, other social spending and broader economic policy issues like trade, often leaves even his supporters wondering whether what they see is what they will get, or whether the Democratic candidate really knows that his rhetoric must defend the political centre and extend his reach over it. Presumably, Kerry assumes that the most sophisticated segment of his political base will go along with him no matter what, regardless of the uncertainties generated by some of his more contradictory or unclear economic positions.

Kerry too claims to be able to cut the deficit in half over the course of the next presidential term. However, one of his most appealing promises to many Americans –to roll back the Bush tax cuts on the small group of the richest American's (ie, the millionaires and billionaires, or at least those with taxable annual personal incomes over US$200,000)– would be offset fiscally by his other equally appealing promises to expand social spending, particularly on health and education. So it remains unclear how Kerry would or could roll back the deficit as fast and as far as he promises. The same, of course, is true of Bush. On pensions, while Kerry has engaged in less rhetorical flip-flop than Bush, the only thing we know from his talk is that he will not touch the system, leaving us all in the dark as to whether he would attempt anything that might make the system more sustainable in the long run as the baby-boom generation's demographic time bomb comes over the horizon.

Nevertheless, given Kerry's links to the fiscal prudence of the Clinton era, and his insistence on continuing to use the 'pay-go' budget criteria (which force the government to finance every new spending or tax cut project with a specific set of tax increases or other spending cuts), Kerry does appear marginally more credible in his fiscal positions. For his part, Bush has also refused to extend the pay-go restrictions in their entirety (choosing not to tie his hands in the case of tax cuts) and has meanwhile claimed that it will be possible to finance the privatization of Social Security pensions during his second term –somehow– so long as voters only trust him now to work out a bipartisan consensus on the programme and its financing. Furthermore, while both candidates seem inclined to increase military and homeland security spending, Bush is likely to increase this spending more than Kerry. What is clear, however, is that John Kerry does not fit the caricature of the 'tax-and-spend liberal' as President Bush has repeatedly claimed. On the contrary, given the President's own fiscal policy record, one might be forgiven for thinking that this has been a case of the pot calling the kettle black.

International Economic Policy: Trade

On international economic policy, both candidates have remained fairly silent. Only trade policy has seemed to warrant any comment at all, with Bush claiming to continue his push forward on free trade and Kerry seeming almost superficially protectionist, concentrating his attacks on the jobs lost from 'international outsourcing' stemming from freer trade or, as he would put it, 'unfair competition'. Bush's own record is far from impressive on trade liberalisation, particularly the Doha Round negotiations and other regional trade accords, to say nothing of his failure to generate support at home for such goals and his repeated slips into special interest pandering (granting special tariffs for steel and new subsidies for agriculture). Nor has there been any convincing evidence from either candidate that as President he would be able to wield effective international leadership on trade liberalisation, capable of generating a sufficient consensus on further trade integration in the US and among competing factions in the world.

Kerry simply has not forcefully backed –at least not on the campaign trail– the Clintonian idea of compensation for trade-related job losses, along with spending on training and education to equip the lower-middle classes to be in a better position to benefit from globalisation. Nor has Bush made a peep about standing up to special interest groups –and not only agriculture and steel– whose lobbying influence continues to undermine the credibility of the US's position in international trade negotiations, to say nothing of their capacity to steer Congress in increasingly protectionist directions.

International Economic Policy: The Twin Deficits and the Dollar
Perhaps the loudest silence of all in the debates between Bush and Kerry on economics has been on the most sensitive and dangerous of the US macroeconomic imbalances which continue to threaten the stability of the world economy: the growing current account deficit and the fragile position of the dollar. One hopes this is because both candidates realise that the majority of voters either do not clearly understand the realities of international economics or simply refuse to acknowledge them, making rhetorical ventures into this terrain inefficient, confusing and even risky.

One of the most basic dynamics fuelling the external deficit and weakening the foundations of the dollar is the rapidly expanding fiscal deficit. Bush's stated solution for this is to rely on the current expansion to continue, allowing for job creation to take hold more intensely. This of course assumes that the recovery is riding atop stable macroeconomic foundations and that recent growth has not been overly dependent on the unprecedented policy stimulus undertaken in the last few years –something which is unlikely to continue into the future with the same effectiveness in terms of growth–. Interest rates seem to be on an upward path again, and further fiscal stimulus would seem to be ruled out if rapid deficit reduction is indeed the goal.

Bush's growth hope also collides with another Bush objective: to make all of his tax cuts permanent. Without other corresponding spending cuts, this would require growth to be even more phenomenal –and more sustainable further into the future– than even a free-wheeling clairvoyant could feel comfortable in predicting. What is more, a long period of rapid growth will only work to increase the external deficit as imports continue to rise, and as rapid growth relative to Europe and Japan continues to provide a floor for the dollar. Indeed, with imports rising 5% annually, exports would need to increase by 7.5% a year just to keep the current account deficit stable at today's levels. Furthermore, even if imports were not to grow at all in response to further growth, exports would need to grow more than 5% annually for at least five years in order for the current external deficit to be halved to below 3% of GDP.

Rhetorically, however, this reality puts Kerry in a difficult position (see Part II). He cannot easily argue against continuing to generate growth –at least not during an election campaign–. Nor can he place too much emphasis on the weak economic foundations of the recovery as neither he nor Bush could easily correct these weaknesses without accepting a significantly weaker dollar and, probably, slower growth for at least some time –and perhaps even a recession– in order to redress the growing imbalances in the economy, both external (the trade deficit) and domestic (low savings and high private debt). Of course, slower growth would also work against budget deficit reduction.

Nevertheless, the growing current account deficit –driven by expanding trade and budget deficits, and now over 5% of GDP and rapidly heading towards 6% and beyond– remains the single largest stumbling block to another sustained period of strong economic growth. Unless, of course, the international investment community is willing to continue financing this historically large and ever-growing external deficit, thus enabling US economic authorities to put off the inevitable correction until such time as its proportions will need to be enormous enough to redress the spending and debt imbalances generated by not one, but two intense economic booms put together. Already the current account deficit is being financed less and less by private investors, and is now almost exclusively supported by Asian central banks, which continue to intervene in foreign exchange markets, accumulate dollar reserves and recycle them back into US Treasury bonds, even as private agents buy fewer and fewer US financial assets.

Such a correction, however, would be deep and have unfathomable implications for the world economy. But to bet that it can be eternally postponed or muted away by the protean economic capacities of the United States would be like walking into a Vegas casino with one's life savings, heading straight for the roulette wheel and staying there until either the money had doubled or until it was gone. In this case, the wheel's green single zero is the dollar and the green double zero represents the twin deficits.

The fate of the dollar, to say nothing of the related economic implications, has been entirely absent from the Bush-Kerry debate. Perhaps this is understandable, if we assume that both Bush and Kerry are mindful of the old wisdom that the best thing for the dollar is to not talk about it. If we were to give both candidates the benefit of the doubt, then we would have to assume that they both understand that the only way for the dollar to move is down, but that pointing this out would not by itself help secure an orderly and gradual depreciation but could also actually contribute to a messy and painful dollar collapse.

Given the size of US deficits, and the lack of sustainable domestic demand coming from Europe or Asia (at least as of yet), most economists both in the US and around the world agree that the dollar must fall further, perhaps as much as another 20% or 30% in real effective terms (including further depreciations against the yen, the yuan and the Canadian dollar), if the current account deficit is to begin to reverse itself and open the way for another extended period of vibrant growth.

So far the dollar's decline has been relatively gradual and relatively smooth. Nevertheless, the depreciation has occurred almost exclusively against the euro and the pound. Both electoral camps have occasionally referred to the supposed "currency manipulation" of the Asians which has prevented the dollar from depreciating against the yuan and the yen. But neither candidate seems to come to grips with the fact that one of the policy terrains over which most of the world still jealously guards its economic sovereignty is the choice of exchange rate regimes –at least in a world in which the US fails to take the lead in establishing an international economic architecture in which exchange rates might be transparently managed or even simply coordinated between economic blocs–.

Until such a scheme is up and running, it is unrealistic to expect the Chinese to tamper with their exchange rate regime, particularly since they must still continue to create upwards of 15 million jobs a year to absorb those migrating into the work force from the countryside and will need time to prudently reform their financial sector. Furthermore, China and other Asian countries like Japan continue to mop up the world's excess dollars and recycle them back to the US as essential financing for the twin deficits. The Chinese may nod their heads politely and correctly as guests at G-7 gatherings in response to proddings to allow to yuan to strengthen, but to expect that this might happen anytime soon in the current international context would be wishful thinking.

There has been no discussion from either candidate about the US leading –or at least consenting to– a re-articulation of global economic governance that might credibly allow for the shifting burdens of the global economy's ongoing adjustments to be equitably shared by the world's major economic blocks. Such a bid to forge clear and credible US leadership in this regard is probably the only influential lever the US has to prod Asians and Europeans in a friendly manner to undertaking useful or even necessary actions on their own –like the Chinese allowing the yuan to strengthen or the Europeans undertaking the necessary policies to help stimulate domestic demand–. The G-7/G-8 process is clearly not sufficient. It remains too ad-hoc and continues to lack adequate international legitimacy (China, for example, is not formally included).

But without more attention paid to the deepening of global economic imbalances (including US deficits) and without more genuine collaboration and coordination of macroeconomic policies and exchange rates, the world risks passively accepting a dollar collapse –which would have very painful repercussions for Europe, Asia and the rest of the world– instead of proactively engineering a less damaging, *gradual* –if managed– decline in the dollar's value. The ultimate difference between these two scenarios –a hard or soft landing for the dollar– essentially boils down to two alternative results: world economic crisis or no. Which candidate would be more likely as President to provoke a hard landing for the dollar, or to manage a gradual adjustment, is a difficult question to answer. How such alternative scenarios would impact the world economy, in general, and Europe and Spain in particular, is also an extremely relevant question. Part II of this analysis will attempt to address such issues.

Conclusions: From the available evidence, it appears that John Kerry would be marginally better than George Bush for the US and world economies, particularly from the point of view of the budget deficit and potential improvements in the healthcare and education systems which, due to spiralling costs and eroding quality, continue to work against US economic competitiveness and productivity. However, it is important to underline that this positive evaluation in favour of Kerry is tentative and relative, and depends to a large degree on the amount of cooperation Kerry can ultimately count on from Capitol Hill and the Federal Reserve.

In any event, circumstances will present John Kerry with enormous economic challenges –an issue we will address in Part II of this analysis–. Nevertheless, even despite the lingering doubts haunting many of Kerry's most adamant supporters, it is interesting to note that an independent, objective survey undertaken by the *Economist* of academic economists (mainly from the US, and chosen at random from among the referees of the *American Economic Review*, see "The Dismal Science Bites Back", October 7, 2004) shows that by far most expert economic opinion has a more favourable impression of Kerry than of Bush when considering a range of economic issues and based on the two candidates' respective campaign rhetorics, economic records and likely future policy directions. Part II will proceed to analyse the most likely economic scenarios under a President Bush or a President Kerry.

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