



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

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Subject: Beyond what each candidate broadly claims he would do with the economy, and given the global economic context, what is most likely to happen in the alternative economic scenarios of a Bush or a Kerry Presidency?

Summary: The default scenario for Bush is one in which his desires to continue with policies which either increase the deficit or fail to pro-actively cut it, run into the increasing scepticism of Congress and the Federal Reserve. While this will allow growth to slow, the conflict between the Bush White House, on the one hand, and the Congress and the Fed on the other, could by itself spook the markets into the beginnings of a dollar crisis. The extreme Bush scenario is one in which he manages to secure the accommodation of the Congress and the Fed for continuing to inflate the economy, laying the foundations for a future horror story of dollar collapse and world crisis. The default scenario for Kerry would be to muddle through with no clear policy coherence, within the constraints laid down by a suspicious Congress and an increasingly hawkish Fed. On the other hand, the extreme Kerry scenario –accepting the ‘bitter pill’, pro-actively cutting the deficit, and consciously tolerating weaker growth sooner rather than later, despite the potential political repercussions– would actually be the most positive long run scenario for the US and the world.

Analysis: *The Extreme Bush Scenario: The Horror*

The extreme, yet possible, economic outcome of a Bush victory would be what we call the ‘horror’ scenario. The ‘horror’ would not imply any sudden or immediate crisis provoked by a Bush victory, but rather more of the same. Such a path would simply postpone an economic correction and deepen its impact. It is not outside the realm of the possible that the Bush Administration and the US monetary authorities would continue to do anything within their power to avoid the weakening of US economic growth that must eventually materialise. If the macroeconomic foundations of US growth were sound, there would be no real problem with Bush pushing for further expansion by maintaining loose macroeconomic policies. However, given the significant imbalances in the economy which have been allowed to deepen, even despite the soft recession in 2001, to continue on this path becomes increasingly dangerous, not only for the US but also for the world.

There is a chance that the Bush Administration will sober up and shake off its collective delusion that deficits do not matter. However, this is certainly not guaranteed. Bush and company seemed convinced the deficits typically contribute enough to growth to eliminate themselves rapidly enough to avoid further serious economic problems. Cheney’s maxim that ‘Reagan proved that deficits don’t matter’ is a blind refusal to acknowledge the fate of

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the Reagan-era deficits which terminated in a dollar collapse (despite the attempted policy coordination of the Plaza Accord), the October 1987 stock market crash and a lingering fragility in the financial markets which spawned the Housing and Loan Crisis and fed the recession that ultimately toppled the first President Bush.

Furthermore, Bush appears to be relying solely on further growth to reduce the budget deficit by half by 2009 –the same growth which is now running well ahead of its potential rate and is underpinned by historically unprecedented monetary policy stimulus–. Nevertheless, while healthy growth can potentially exert a positive impact on budget deficits by increasing tax revenues, rapid growth would only make the external deficit even larger, as growth encourages ever higher imports. Ultimately, the external deficit will have to stop growing, if not shrink, and this means slower –or even negative– growth for some time, or a significantly weaker dollar. In practice, reduction of the external deficit is likely to imply both.

If the US enjoyed a current account surplus, or even a modest deficit, then perhaps Bush's claim to seek deficit reduction through growth might have a chance, however slight, of success. But the US current account deficit is now larger than it has ever been before. Given that Bush has not vetoed a single spending item coming from Congress, and observing that his economic plan contemplates few if any spending cuts and no tax increases, it seems likely that he will not attempt to pro-actively cut the deficit. Indeed, he will face pressures to increase military and homeland security spending still further, and may even attempt to engage in further rounds of tax cuts seeking still more stimulus for growth and more 'efficiency-enhancing' resources for the well-off.

In short, if Bush can manage to return to the White House for 2005, he will be very tempted to try to continue to preside over the macroeconomic stimulus that has underpinned US growth since 2001 and to seek a sufficiently accommodative policy from the Federal Reserve. Because the employment market remains weak, it is highly possible that Bush will not accept the need for more restrained policies allowing for weaker growth. To do so would be to risk an even broader backlash at home against his pro-active, if not aggressive, foreign policy as weaker growth pushed up the unemployment rate.

Unfortunately, if maintained or deepened, continued policy stimulus will prove increasingly less effective in maintaining growth at high levels. Even growth rates of 3% to 3.5% annually –the current potential growth rate, as opposed to the current actual rates of nearly 5% annual growth– will begin to appear optimistic, as both monetary and fiscal stimulus begin to lose effective traction on demand. Nevertheless, the renewed macroeconomic stimulus promoted by a re-elected Bush would continue to aggravate the already dangerous domestic (budget deficit) and external (current account deficit) imbalances. The ultimate effect of this renewed, if increasingly inefficient, policy stimulus, will be merely to provide the illusion of economic strength and to postpone and deepen the impact of the pending crisis in the US and world economies. This possible Bush strategy – an extension of the policy path followed during his first term, and a more pronounced and riskier duplication of the continued stimulus provided by the second Reagan administration– would aim to keep US growth rates as high as possible for as long as possible, even if this means an ultimate weakening of the economy and an undermining of the long-run foundations for growth –something, of course, that he would refuse to acknowledge–.

The end result could be a crisis as severe and intractable as that which has afflicted Japan since the end of the 1980s –or worse–. The only open question would be: When will it break? Before or after the elections of 2008? The budget and current account deficits could reach astronomical levels, even surpassing 8% of GDP. The long-feared –or ignored– dollar crisis would have set in by that time, with the dollar-euro rate moving beyond US\$1.50/€1.00, possibly slipping into the grips of speculative overshoot and J-curve effects. The dollar crisis would only be magnified if Asian countries began to withdraw from the current *de facto* Bretton Woods II mentioned above. Meanwhile, the US savings rate will have to rise, significantly depressing consumption growth, as income declines assist the weaker dollar in eliminating the current account deficit. Fiscal and monetary stimulus would no longer be a possibility for alleviating the worst pain of such an economic crisis, as both would have fully run their course, leaving interest rates and deficits with only one direction to move: up, in the case of the former, and down, in the case of the latter.

What about the Federal Reserve, which independently steers US monetary policy? At present, it appears that interest rates are on an upward path. The Federal Reserve is now expected to announce another 25 basis point rise in the fed funds target rate a week after the elections, bringing it to 2%. This would seem the responsible move, given the length of time the rate has been kept extremely low, and considering that real short-term rates remain negative. Nevertheless, while a continued moderate tightening may seem prudent, and may provide some support to the dollar, it could easily clash with the wish of the Bush Administration to continue to bask in the warmth of high headline growth rates. Furthermore, long-term rates are likely to respond and move upwards.

While one might argue that this would be the natural interest rate counterpart to a recovery that is catching hold, one should not forget that consumption remains the central pillar of US growth and even investment spending hinges to a large extent on perceptions of continued strong consumption. Yet consumption continues to outpace income, while disposable income has only kept pace with consumption as a result of tax cuts. Income growth is held in check by weak employment creation and the desire of companies to meet ambitious profit objectives to buoy the stock market. All of this points to weaker consumption, particularly if the employment market does roar sometime soon.

What would the Fed do? To tighten monetary policy may be prudent, but it risks undermining consumption strength. Wealth-effect support to consumption via asset price increases is not likely to continue, as the stock market continues to tread water and will not welcome higher rates. Although most Americans have managed to refinance their mortgages at fixed rates, higher interest rates imply a damping of the housing market boom, another wealth-effect support to consumption, while the sheer quantity of equity extraction from mortgage refinancing in recent years has been so large as to suggest that it will provide very little further support. The Bush Administration, as explained above, could easily fall to the temptation of further fiscal stimulus through military spending and tax cuts, but this might not even offset such a fall-off in consumption growth, as more and more households begin to rethink the wisdom of going further into debt even as interest rates are rising.

If employment creation remains weak and consumption begins to lag, and particularly if oil prices remain at the current levels, by next spring or summer the Fed will face a tough dilemma. Even if it remains moderate in its tightening, it will risk ushering in a period of

slowdown. Perhaps the Bush Administration will suddenly produce the necessary breakthroughs in international trade negotiations, but their short term effect on growth is likely to be minimal and their impact on consumer confidence –given that Bush has not proved capable of convincing Americans that more and freer trade is beneficial– will probably be negative in the immediate term. If Greenspan chooses again to try to bail out the economy –something which can certainly not be ruled out, particularly if the White House claims it is necessary to underpin the War on Terror– then the ground will be prepared for the ‘horror’ scenario.

The Extreme Kerry Scenario: The Bitter Pill

The unpleasant reality that John Kerry would face as President is that he will have no easy options. To contemplate what would be the extreme Bush strategy would be the easy short-term temptation, but it would come at the cost of destroying his credibility as an economic manager. After all, Kerry is surrounded by people who believe that deficits do matter. Furthermore, the Fed is far less likely to accommodate a Kerry expansion than a Bush expansion. The ‘tax and spend liberal’ label would be merited if Kerry were to try to follow in Bush’s footsteps, and would likely influence the perceptions of Fed governors, to say nothing of market actors. The dangers of the twin deficits will suddenly become a priority for the Fed –and an outright fear in the market– particularly as Kerry will not be able to wield the argument of national security as a justification for maintaining the deficits and the recovery as effectively as might Bush.

The reality Kerry would face is what we call the ‘bitter pill’. Flinching in the face of the ultimate horror of further artificial stimulus and the likelihood of ultimately provoking a dollar crisis, Kerry will likely accept the need for fiscal restraint, slowdown and even a weaker job market in the interests of redressing US economic imbalances and restoring a stronger foundation for middle term growth and, with it, the basis for more credible US leadership into the future. The problem for Kerry with this scenario is that it implies a high likelihood of his becoming a one-term president. No president has attempted to tell the American people that they need to tighten their belts since Jimmy Carter.

The required fiscal restraint necessary to head off a dollar crisis would require President Kerry to say ‘no’ to many people, particularly his supporters who will be waiting for increased spending on health and education and some relief on jobs and import penetration from Asia. He will also have to field a barrage of attacks from Bush supporters accusing him of destroying the Bush recovery. Together with the difficulties that Kerry could face in Iraq, such grumblings would mix a very nasty election cocktail for the Democrats in 2008, a ‘bitter pill’ indeed.

The situation of the dollar and the twin deficits would now be much healthier had Bush said ‘no’ to tax cuts during his term, and had the Federal Reserve, after taking the actions required to moot the 2001 recession, at least been conservative enough to allow for a period of more moderate growth. Now the ultimate price of not saying ‘no’ –both for Kerry and Alan Greenspan– has become extremely high, while the benefits of belt-tightening will not be immediately apparent to very many.

The default scenario for Kerry then is to simply muddle through with no clear policy coherence within the constraints laid down by a suspicious Congress and an increasingly hawkish Fed. On the other hand, the extreme Kerry scenario –accepting the ‘bitter pill’, pro-actively cutting the deficit and consciously tolerating weaker growth sooner rather

than later despite the potential political repercussions— would actually be the most positive long-run scenario for the US and the world.

Implications for the World Economy

The implications of the Bush deficits would be less severe if other economies could produce a rapid increase in their own domestic demand. However, given current realities in Europe and Asia, this is not a feasible scenario in the short-term. Even if the US attempted to broker another Plaza-like accord to exchange some deficit restraint for increases in domestic demand from Europe and Asia, it is unlikely to have any chance of success unless the US commitment to reduce the deficit were perceived as serious and credible. Furthermore, Europe still has its hands tied by its incapacity to move quickly ahead on Lisbon Agenda reforms and by the Stability Pact which constrains easy—or even coordinated—fiscal stimulus. Meanwhile, Asia is also locked into an export growth model underpinned by currency undervaluation and linked in a symbiotic relationship with Asian central bank financing of the US twin deficits. Any Plaza-like deal would have to come to grips with the Asian desire to avoid rapid currency appreciation from undermining growth in the short run and the US need to maintain enough external financing to sufficiently manage a gradual reduction of US deficits and dollar depreciation—a very tricky task in the current climate—.

Such a successful deal would, however, seem essential in order to avoid a continued build up of the twin deficits and dollar reserve accumulation in Asia. If it were not to occur, any further dollar weakening would take place against the euro, threatening the fragile European recovery and the outbreak of protectionist pressures as European exporters begin to suffer both in US and Asian markets. Managed and balanced dollar decline would not only make clear to Europe and Asia the imperative to undertake necessary reforms and policy stimulus so as to generate more domestic demand, but it would also buy some time to allow some of their politically sensitive adjustments to occur. But the US must take the lead. After all, the Americans claim—probably rightly—that only they have the credibility and the capacity to lead. Nevertheless, it would require extremely dextrous multilateral—or at least international—financial diplomacy. Which of the candidates is more likely to attempt such leadership? Which is most likely to succeed? Given the record to date, and the only two candidates available, one would have to say, at least tentatively, that Kerry is the man.

A dollar crisis, when and if it comes, would imply extreme instability in the world economy. It would probably usher in a world recession, as US growth also weakens, compounding the hit to exports from all the current account surplus regions now relying on strong US demand and an overvalued dollar. It would compound international acrimony and likely kill off the Doha Round, cut off regional trade talks and even spark new trade wars. The only precedents the world economy has for such a crisis during the 20th century would be the decade of the 1970s or, more depressingly, the interwar years. Who is more likely to provoke a dollar crisis, Bush or Kerry? And which would be more likely to successfully manage a soft dollar landing through the world's tough economic straits? If Bush manages to barrel forward, then the answer is easy. If Kerry can gain the confidence of markets and credibly begin to reduce the deficit, then he would be a more likely candidate for the soft landing scenario.

Europe and Spain

Indeed, a quick and mild weakening of growth in US and China (ie, a soft landing) would still mean lower oil prices. This implies the potential for faster growth in other parts of the world which could increasingly be based on domestic demand, opening the way forward towards of a rebalancing of world demand. Lower oil prices would also mean less upward pressure on interest rates in most of the world, contributing to the possibility of faster domestic demand-driven growth. This would be particularly important for Germany, the growth engine of the EU, which is still experiencing very weak growth, and for Spain, whose recent relative growth rates continue to be supported by what for Spain is a very loose monetary policy which has underpinned a construction, housing market and consumer borrowing boom for several years.

Any upward pressure on interest rates would put Spain in a particularly tough economic position. Furthermore, it would come at a time when there is renewed upward pressure on the budget deficit, as the new government grapples with its objective to increase spending on education, R&D, other productivity-enhancing Lisbon objectives and a range of other social spending. Spain is also soon to face a phasing-out of its European funds. A slowing of growth in the world economy which implies looser rather than tighter monetary policy for Spain would by itself be helpful given Spain's other economic challenges. On the other hand, any upward movement of interest rates –whether designed to keep demand-pull inflationary pressures in check in the euro zone as the world economy heats up, or to maintain anti-inflationary discipline in the face of a cost-push supply shock from high oil prices– could possibly push the Spanish economy over the edge, deflating the construction-housing boom. This would be dangerous, given that Spain still has the highest unemployment rate in the OECD, at around 11%, and one of the highest levels of household debt in the EU, and very little influence over the ECB. An alternative counter-cyclical loosening of fiscal policy would, on the other hand, cost Spain dearly in terms of credibility and prestige within the EU and the Ecofin, where Spain has most recently been one of the most pronounced hawks opposing leniency for the Stability Pact breaches of France and Germany.

Conclusion: Maybe the Congress facing a re-elected Bush would refuse to countenance further tax cuts and further increases in the deficit. Perhaps the Federal Reserve would refuse to accommodate even the current fiscal stance, to say nothing of further deficit growth. In either, or both, cases, a second Bush presidency might be forced to swallow the same bitter pill that a Kerry White House would face. The big difference would be that Bush would not be seeking re-election whereas Kerry presumably would. There is even a chance, however slight, that Bush's gamble pays off, with firms finally halting their process of shoring up balance sheets and paying shareholders, and then diverting funds to job creation. This wishful scenario would imply stronger employment –and eventually higher income– growth, taking pressure off the White House to continue to seek further tax cuts. It would also free the Federal Reserve to leisurely continue a moderate normalization of interest rates. Such an optimistic scenario, however, places all hope in a quick and solid spurt in the job market. All bets are open.