

The Tasks Ahead for the Next US Administration

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Foreword

The American voters have elected the president on November 2nd 2004. Though the election was too close to call for a clear mandate, the United States must face the very difficult condition in the economy and the security left as a legacy of the George W. Bush presidency from 2001 to 2004.

In this short paper, the state of the economy and security of the United States is surveyed first, followed by the short review of the policy proposals by the two candidates, Mr. Bush and Mr. Kerry; it will conclude with some elaboration on the tasks ahead.

1. The Current State of the Economy and Security

1) Twin Deficit at Home and Rising Tensions

The United States is running huge, ballooning deficits both at home and abroad. The deficits have created unprecedented imbalances and are not sustainable. A major correction is called for.

Domestically, the budget deficit of the federal government has reached \$521 billion (5% of the US GDP) at the end of June 2004¹ and could reach at a higher level in FY2005. The military expenditures related to the operations in Iraq and Afghanistan, which keep on rising, and the huge tax cut enacted by the current Bush Administration are the two most important factors that had contributed to this high level of deficit.

Another deficit and imbalances are in the household sector. The household saving rate in July and August 2004 was 0.5% and 0.9%, respectively. Though the household sector saving rate is still in the plus zone due to the change in definition of the statistics in recent years, it is still too low, even by the upwardly revised definition. American household spending has been increasing higher than the increase in disposable income. As a result of the excessive spending of the household financed by borrowing, total household debt has topped \$9.7 trillion at the end of June 2004. The ratio of household debt to the household disposable income (\$8.6 trillion) has reached 113% at the end of June 2004. Debt service ratio of the household sector has reached 13.10% at the end of

¹ Seasonally adjusted annualized rates from the National Income Account and Product Accounts Table available at the BEA home page.

June 2004, rising by some 2.5 percent points from 20 years ago.

The robust economic growth and the strong consumption were largely sustained by household borrowing over the years. Heavy indebtedness has made the financial conditions of the household sector precarious. The number of personal (non-business) bankruptcy filed in the United States was 1.6 million in 2003. This high level of bankruptcy has been continuing for more than 10 years. The total number of household was 109 million in 2002. It means that one out of one hundred household has been filing for bankruptcy every year.

If the interest rate goes up higher and the growth rate slows down, even more consumers will be filing for bankruptcy. The US consumer spending, the engine for growth of the US economy, is becoming increasingly vulnerable. Pressures for adjusting the consumer debt to a sustainable level are mounting.

The Gap between the Rich and the Poor

In the meantime, the income gap between the rich and poor is widening. Between 1980 and 2001, the share of income earned by the lowest fifth group in the five income brackets has decreased from 5.3% to 4.2%, while the top group's share has swollen from 41.1% to 47.1%. For the very rich top 5%, their income share has jumped from 14.6% to 21.0% in the same 21 years.

2) Deficit and Imbalance Abroad

Looking into the foreign economic relations, another deficit and imbalance appear. The current account deficit was \$531 billion in 2003, and in the second quarter of 2004, it was \$166 billion (\$664 billion at annual rate). Investment position of the United States was a negative \$2.4 trillion (with direct investment valued at current cost); it means US net foreign debt was some 22% of the GDP. The United States is the largest debtor in the world and the debt is still increasing by a few percentage points of GDP every year.

The future ability of the United States to pay out all those debts is now questioned by the global investors. The pressures on the United States to take some action for

reducing the current account deficit and slow down the pace of debt accumulation are rising.

3) Unreliable Financing from East Asia

The US reliance on foreign capital for financing its twin deficit (the federal budget and the current account) has come close to a dangerous point.

At the end October 2004, the United States was “borrowing a daily \$1.7 billion from abroad, mainly from China and Japan. As a result, the economy runs the ever greater risk that foreigners may decide they are not willing to lend or worse may decide to sell off large chunks of their \$10 trillion in the United States assets²”.

4) Needed: Deficit Reduction

The economy is in a sheer disarray. The household excessive spending and borrowing must be curbed to keep economic growth sustainable. Tax must be raised to reduce the budget deficit. By so doing the current account deficit could be cut down enough to restore some confidence on the US dollar by global investors. It will lead to the slower increase in the US net foreign debt.

Those policy measures, even taken in a very careful and gradual manner, could result in a global recession. Growth is preferable and recession had better be avoided. However, the US economy seems to have reached to a point at which painful adjustment is now unavoidable.

2. Security Situations

1) Quagmire in Iraq

The current schedule in Iraq is the following.

² New York Times Editorial, October 21st 2004

Table 3 Schedule in Iraq

<u>January 2 2005</u>	Election Based on the election results, the Congress will be organized. The Congress will elect the Prime Minister, adopt the Constitution. The Constitution is to be ratified by the referendum. The Congress dissolves.
<u>By Decedmber 31 2005</u>	Another election will be held based on the new Constitution. The new Congress will elect the new Prime Minister. The first Iraqi government with full legitimacy will begin.

In order to organize and implement the election, the US armed forces and the UN-trained Iraqi military forces have started the operation of pacification to root out the terrorist base in several cities and regions in Iraq. This operation can achieve some mild success or, to the contrary, it can strengthen the terrorist forces by rousing more anti-US sentiments among the Iraqi people because operation will inevitably create more casualties among the ordinary citizens.

If this operation does make moderate progress, the economic reconstruction of Iraq through numerous infrastructure projects can be started. However, there are pessimistic views as well.

According to the pessimists, several routes into and out of Iraq for suicide bombers have already been established. The terrorists can reinforce their troops freely and there is no way that the US armed forces can block those routes completely. Therefore, even successfully attacking those places identified by the US forces as the terrorists base will not eliminate terrorists. Terrorists can build another base elsewhere. The US is engaged in an unwinnable war of attrition because the US has lost the support of the general public in Iraq.

There can be some similarity with the Vietnam. As the unwinnable war of attrition persists and the American casualties mount in an apparently endless war, the public opinion in the US will decisively turn against the war. Some 30 years ago, realizing the impossibility of victory and sensing the shift in public opinion, President Nixon gradually changed the Vietnam policy toward "Vietnamization", and "Retreat with

honor”.

Whether the experience of Vietnam will be repeated in Iraq remains to be seen. If the Iraqi people fail to conduct a reasonably credible election and to establish a more or less legitimate government, chaos will come and the US armed forces will have to eventually pull out. We are at an important crossroad in Iraq: toward a more or less democratic, stable Iraq or a civil war followed by dictatorship, possibly by Shiites, which could provide fertile ground for terrorist training.

Broader Initiative

In this regard, more than the outcome of the military battles in Iraq, the prospect of building a secular, democratic and politically stable Arab world on the way to economic prosperity is critically important. The project of the Broader Middle East and North Africa Initiative, aiming at economic, political and educational reform in the Arab world, proposed by the United States and adopted at the G7 summit meeting of June 2004, is a good starting point. The Arab youth must have a hope in their country's future to be built in cooperation with the developed countries, not a hope in an envisaged eternal life after destroying the West through Jihad and martyrdom. Politics is about hope after all. The rapidly increasing population, the stagnant economy and the ideology that repudiate secularism and economic prosperity have brought about the current poverty and desperation to the young Arabs. The developed countries must provide a different vision for the future and implement those economic recovery and social reform projects in the Middle East.

This is the task before the American President and the entire developed countries.

2) Needed: Success of the Election and the Broader Initiative

Though the war against Iraq conducted in the name of “the war on terror” was a horrendous mistake by the Bush Administration, the developed countries cannot allow Iraq to become the bastion of terrorists. The developed countries must cooperate for the successful implementation of election in Iraq scheduled for the 2nd of January. At the same time we must provide a hope and vision for the entire Arab world that would

be put into practice over the next several decades. We need to go through a long roundabout route.

3. Proposals of the Two Candidates

1) Economy

Mr. Bush has promised to carry on the tax cut and is likely to maintain the current policy that is somewhat supportive of free trade and strong dollar. If Mr. Bush chooses to stick to the current policy line on the whole, it is likely to result in large budget deficit and current account deficit. The downward pressure for the US dollar could become stronger in the foreign exchange market.

Mr. Kerry wrote an article titled "My Economic Policy" in the Asian Wall Street Journal on September 14th 2004. According to that piece, he will try to protect and create good jobs in the manufacturing sector by taxing companies that "outsource" jobs to foreign companies, eliminate tax cut for the richest 2% of Americans and use that tax revenue for health care, restore America's competitive edge by federal support for R&D, and cut the budget deficit in half in four years. Though it is not mentioned in that article, Mr. Kerry has proposed, on other occasions, to make China upvalue the RMB. He also believes that Japanese car market and Chinese market for high technology products are closed and promised to take some action against those markets.

On the whole, Mr. Kerry's seems to lean toward a protectionist trade policy and a weaker dollar.

Though both Mr. Kerry and Mr. Bush promise to cut the budget deficit in half, chances are that the budget deficit will remain at a high level. In the absence of a major tax increase, the budget deficit will loom larger because of the rise in medical cost and pension cost, which is inevitable as the US population slowly ages. The expenditure for the "the war on terror" is also an item that will cause sizable drain from the federal government in the foreseeable future.

2) Security

The United States has no choice but to keep occupying Iraq and stay on course for transition to building the new government in Iraq. The only difference between Mr. Bush and Mr. Kerry is that Mr. Kerry will try to organize support from major European countries and utilize international institutions such as the UN and NATO.

We must anticipate little change in international security policy of the US government.

4. Tasks Ahead

1) Economy

A major tax increase is needed to reduce the budget deficit and finance the needed expenditure for health care and for “the war on terror”.

At the same time, some depreciation of the US dollar might be needed to reduce the current account deficit.

The rest of the world has been enjoying prosperity made possible by the excessive spending and borrowing of American consumers over the past 20 years. This boom may not be sustainable. Policy actions for tax increase and lower dollar might be needed, hopefully in a least disruptive manner.

2) Security

“The war on terror” is not actually a war in the traditional sense of the word. It is a long lasting campaign to isolate, weaken and eliminate the terrorist organizations. Though actual fighting on the ground and drying up the sources of terrorist funding through international cooperation are needed, those measures are not enough. The root of terror is the fanatic belief held by some people in the Islamic world. The anger and desperation of the young people in the Islamic world is another factor that make terrorist organization succeed in getting new recruits. The unresolved state of Palestinian issue is also an important factor that creates more anti-American sentiment.

Over the longer term, the Arab youth must have a hope in the future for living a better life in this secular world. By spreading that hope, terrorist organizations will be gradually isolated from the general public and weakened, then eliminated in the long run. Instead of taking lesson from the Vietnam war, the British experience of the eventual weakening of the Ireland Republican Army and the disbanding of the communist guerrilla forces in Malaysia might be helpful as Professor John Gray of the London School of Economics has pointed out³.

In this regard, not only fighting the terrorists but also the successful implementation of the projects such as the Broader Middle East and North African Initiative is important to capture the heart and light up the hope of the young Arab people.

³ John Gray, *Al Qaeda and What It Means to Be Modern*, 2003, London: Faber and Faber Ltd.