TOUGHER TIMES AHEAD FOR THE US AND THE WORLD ECONOMY

President Obama cannot afford to blink, let alone celebrate his meteoric rise to the most powerful position on earth as the President of the United States of America. He has the unenviable task of cleaning up the mess the Bush Administration has left behind especially at the economic front. While the economic crisis has arguably helped Barack Obama win the election, it is going to keep him uncomfortably at the edge of his coveted seat for quite a while.

All indications are that the US economy's downturn is just beginning and that it is going to be a long haul by any measure. It is not going to be easy for the Obama Administration to fix the problem, as the fault lines run very deep. The much talked about sub-prime problem is no more than a symptom of an ailing economy. Had it been a mere liquidity crunch, one can overcome it by simply pumping more money into the system. If it were purely a cyclical downswing, expansionary monetary and fiscal measures would have sufficed. Obviously, there is no silver bullet for a problem that is structurally so complex.

The crux of the problem, put in a nutshell, is that the United States has been living beyond its means. The US growth has been driven largely by consumer demand, which in turn has been fuelled by credit expansion. The United States has long been suffering from a widening domestic resource gap with domestic savings falling far short of domestic investments. All this is reflected in the country's huge current account deficit, which stands at about 6 per cent of GDP, way above the 3 per cent sustainable level.

The ballooning budget deficits, which represent the other side of the coin, are the result of mindless tax cuts on the one hand and reckless public spending on the other, consumed significantly by the invasion of Iraq and the war on terror in Afghanistan.

The US economic woes had been exacerbated by the Republican penchant for deregulation, which had led to careless expansion of credit without adequate check and balance.

All this notwithstanding, the US economy was flying high, thanks mainly to massive capital inflows, at the cost of rising external debt. The United States has faced no problem in raising debts, as many countries with substantial foreign exchange reserves are ever willing to buy and keep the papers issued by the US Treasury. For it is in their interest to ensure that the United States continues to import from them and that the US dollar remains strong so that their exports stay competitive and their dollar-denominated reserves are safe and sound.

It does not take a genius to figure out that all this is unsustainable. The sub-prime turmoil was just a precursor to a far more serious crisis in the real sector of the US economy. And yet, the US economy was able to register 3.3 per cent growth in the second quarter of 2008, contrary to predictions of an impending recession. It is not difficult to explain why. Interest rate cuts by the Federal Reserve had kept consumer demand up; bailouts could provide the much-needed liquidity; and the dollar depreciation was boosting US exports.

The United States was thus able to postpone a recession but not for long. The third quarter witnessed a 0.3 contraction in the US gross domestic product. The prognosis looks bleak for a variety of reasons. Paradoxically, the US dollar is strengthening in the wake of a contraction in the real sector of the US economy, thanks to external borrowing that tends to raise the demand for the greenback in the foreign exchange market. A strong dollar is bad for US exports and good for US imports, which means that the United States cannot count on external demand for growth or for that matter current account rebalancing.

It appears that the United States is running out of bullets. On the monetary front, interest rates have been slashed down to just one per cent. The space for further reduction is extremely limited. On the fiscal front, bailouts and stimulus packages have run into hundreds of billions of dollars at the risk of fiscal fatigue. The situation the United States is in seems precariously similar to that of Japan with near-zero interest rates and huge budget deficits, a recipe for prolonged sluggish growth.

Given the minimal interest rates and the severe budgetary constraints, if the Japanese experience is anything to go by, the United States is likely to be stuck in the mud for quite some time. It even appears the US situation is relatively more worrisome than that of Japan, which is blessed with substantial domestic and external savings, which is not the case with the United States. A strong greenback will obstruct economic recovery in the United States. The chances are that the US dollar will eventually depreciate enough to trim the country's current account deficit to manageable levels.

The perception is that the new president will focus on creating jobs for the Americans at home, which may rekindle protectionist forces that may hurt US imports. Such a policy would be counterproductive, as it would only serve to delay the recovery of the global economy, on which the US recovery itself is predicated. It is hoped that the United States will be more sensitive to the impact of its policies on the rest of the world from now on. It is important for the US to factor in the concerns of its trading partners in its own policy formulations. If not, the United States may only be hurting itself by not caring for others.

As the unfolding crisis is global in scale, the solutions will have to be global as well, which means that the United States, being the largest player, will have to play a leadership role in bringing about institutional reforms that would reshape the global financial and economic architecture. This warrants an approach that is pretty inclusive, accommodating the interests and concerns of all countries. It is in this realm that President Obama can make a real contribution and impact by not acting unilaterally.

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