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Transcript

Is American Exceptionalism Reaching Its Economic Limits?

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DeAnne Julius:

I am pleased and honoured to be back at Chatham House to deliver the 2012 Whitehead Lecture. In doing so, I follow in the footsteps of many eminent speakers from the political sphere – former Prime Minister John Major last year, former Foreign Secretary Jack Straw the year before – but this year Mr Whitehead suggested that the lecture address the economic prospects for the US. Perhaps reflecting his long career as an investment banker, rising to the top of Goldman Sachs, and then as Deputy Secretary of State in Ronald Reagan's administration, he understands better than most the close connection between economics and foreign policy. As Robert Zoellick said in his recent lecture on security at the IISS: 'Sound economic policies are the underpinning of both individual freedom and national power.'[1]

For these reasons, I think John Whitehead was right to ask us at Chatham House to focus on the economic problems that have been building up in the US and their likely consequences. You will be relieved to know that I have decided to step outside my comfort zone and do this without the aid of graphs or equations – not an easy thing for an economist.

I also am not going to discuss who will win next week's election – partly because we will all know the answer to that soon enough – but mostly because I want to focus on a longer term horizon and the difficulties that will face whomever sits in the Oval Office. There are deep seated problems at home and challenges abroad that the new president will inherit and that will constrain his room for manoeuvre.

Let me briefly preview my argument. The question I am addressing tonight is whether American exceptionalism is reaching its economic limits. To answer that, I will first spend a few minutes defining what I mean by American exceptionalism, which lies at the heart of American patriotism and optimism about the future.

I will then develop the argument that, despite what both presidential candidates are promising, the US economy will suffer another three to four years of low growth and high unemployment. In addition, the structure of the economy has changed in ways that will further embed and perhaps increase income inequality. This has the dangerous potential to trap children in the social class of their parents.

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[1] Robert B Zoellick, "American Exceptionalism: Time for New Thinking on Economics and Security", the Alastair Buchan Memorial Lecture delivered at the International Institute of Strategic Studies, London, 25 July 2012.

Next I will turn to the political difficulties of reversing these trends – both structural deadlock in the US constitutional system and changes in the way political campaigns are run.

My conclusion is that Americans won't be very good at accepting a low-growth future. The next president will be leading a country that is – at best – disappointed and demoralized and – at worst – angry and looking for scapegoats, from Washington to Wall Street to Beijing.

American exceptionalism

Let me begin with a definition of exceptionalism, as I believe it is perceived by most Americans. In poetic terms, it is what the Statute of Liberty in New York harbour stands for, what Ronald Reagan once described as 'the city on a hill'. It is the land of freedom and opportunity that is a beacon for the rest of the world, although based on America's unique history as a frontier nation and enshrined in its constitutional form of government.

In less poetic terms, I believe American exceptionalism has three distinct, although related, elements. The first is the 'land of opportunity' where upward mobility is available to all who are willing to work for it and where each generation will be better off than their parents.

The second aspect is the belief in democratic accountability where every person has an equal vote and politicians seek those votes through an open (and often gruelling) process of public campaigning and debate.

The third aspect of American exceptionalism is the system of checks and balances built into its constitution by the founding fathers nearly 250 years ago. This is exemplified by its first words: 'We the people …' which make it clear that the citizens give certain rights to the government, and not vice versa. The tripartite system of president, Congress and Supreme Court, coupled with the Bill of Rights, limits the power of a president or political party to impose its will even if it were elected with a large majority.

I will return to this three-part definition as we consider the structural changes in the US economy and political process.

A low growth future

In the current campaign, both President Obama and Governor Romney are promising to return the US economy to strong growth and full employment. They have different prescriptions for how to do this, and much of the heated debate is about which is the better path. My contention is that neither candidate will be able to deliver on his economic promises. The US is in for a low growth future, regardless of who wins the election.

The global financial crisis has left the US government, like many others, with a large deficit and a much higher level of debt. While the deficit has come down since peaking at 11 per cent of GDP in 2009, it is still estimated to be seven to eight per cent of GDP this year. Every year of deficit, of course, adds to the debt. Using internationally comparable definitions, the US debt is now over 100 per cent of its GDP, compared to 62 per cent in 2007, before the crisis. A widely cited study by Reinhart and Rogoff[2], covering 800 years of financial crises across 66 countries, makes two observations relevant to the US situation. First, the recovery period after a financial and banking crisis is generally as long as the period of credit expansion that led up to it. And, second, when a country's debt-to-GDP ratio exceeds 90 per cent, then not only does the probability of another crisis rise, but the growth rate falls by about one per cent from its pre-crisis level. For the US, these cross-country conclusions would imply that its period of low growth will last until 2014 and that thereafter growth will be closer to two per cent per annum than the three per cent enjoyed prior to the crisis. It is interesting that the IMF has just published an update of its estimate for the potential growth rate of the US which is two per cent, revised down from its 2007 estimate of three per cent.

In addition to the drag on growth from deleveraging and debt, there are underlying demographic trends that are likely to mean that growth in the next decade will be slower than in the past. The US has enjoyed a demographic dividend since the late 1960s when the baby boomers born in the five years after the Second World War entered the work force in large numbers. The effect was turbocharged by the increasing share of women who took jobs outside the home and by the higher educational levels of both sexes driven by the expansion of state universities after the GI Bill. Their greater productivity and larger numbers combined to produce three decades of strong economic growth. With more women working and the widespread availability of contraceptives, families also had fewer children and thus were able to save more. This increased the demand for housing and financial assets, which fuelled investment and built up household wealth. A virtuous cycle.

But now those demographic trends have gone into reverse. The baby boomers are retiring as they enter their 60s. Their smaller families mean the

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[2] C Reinhart and K Rogoff, "This Time is Different: Eight Centuries of Financial Folly", Princeton University Press, 2009.

labour force is growing more slowly. The boomers are selling assets to fund their retirement. This creates a drag on the housing and stock markets. And meanwhile, they have used the political clout of their size and influence during the past decades to pass legislation that provides them with a very comfortable level of state pension and free health care once they turn 65. This will prove unsustainable if they live a long time after retirement. Either taxes will have to rise or entitlements will have to be cut if the federal debt is to be held at manageable levels. Neither will be easy in a period of slow growth.

These transfers from the young to the old directly undermine the first element of American exceptionalism: that each generation of children will be better off than their parents. The global financial crisis and the baby boomers have put a stop to that.

Widening inequality

Not only will growth be slower in the coming decade, but its gains will be less evenly distributed. The widening gap between the rich and the poor is even more worrisome than that between the young and the old. The data are striking. Over the past 30 years in the US the share of national income going to the richest one per cent of households doubled, from 10 per cent to 20 per cent. After taxes and transfers, their real income rose by a cumulative 300 per cent between 1997 and 2007 (just before the financial crisis). Over the same period, the bottom fifth's income rose by only 40 per cent and the middle class shrank as a proportion of the total population. Only 40 per cent of American neighbourhoods now have an average income within 20 per cent of the national median, compared with 60 per cent in the 1970s.[3]

The US is not alone, of course, in experiencing growing inequality. According to a seminal OECD study[4], income inequality has risen in most rich countries, but more in the US than in others. There is a lively debate amongst economists and social scientists about the causes of rising inequality. One can find statistics to support nearly every hypothesis. However, almost all the studies agree that globalization and technology are two of the predominant factors. Technology has replaced many administrative and manufacturing jobs, shrinking middle-income employment for both men and women.

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[3] The Economist, Special Report, October 13, 2012. See also the list of references for this Report, from which many of the statistics cited in this section are taken.

[4] "Divided we Stand: why Inequality keeps rising", OECD 2011

Globalization has worked at both ends of the income scale. It has depressed the wages of low-skilled workers through off-shore competition, while raising the returns to the upper end whether they be entrepreneurs, sports celebrities, film stars, investment bankers or chief executives. These stars operate on an international stage, where their rent is often based on the cachet of being at the top of their particular pyramid, rather than on the value they actually create. In many professions, being the best – or being perceived as such – commands a huge premium over being merely good. Such 'winner take all' markets may be the result of special protection or monopolistic tendencies, as Joseph Stiglitz claims in his latest book,[5] but they also may be the natural result of competitive markets for scarce skills or suddenly fashionable products. Two other American professors, Robert Frank and Philip Cook, have shown how 'winner take all' behaviour has grown in more competitive markets, not more monopolistic ones.[6]

Most of today's super-rich in America have self-made, not inherited, wealth. The problem for society arises when extremes of wealth are perpetuated, if not through inheritance directly, then through the special educational and other opportunities that richer parents can provide their children.[7] In nearly all countries there is a high correlation between educational attainment and income. Indeed, the big falls in inequality in the mid-20th century in America came about through the investment in mass education. But this trend was reversed in the late 1970s when high school graduation rates started to fall and university tuition fees began to rise faster than inflation. By 2009 tuition fees averaged 10 per cent of median income at public universities, and 45 per cent at private universities. Even with scholarships and subsidized student loans, many students were deterred from going to university or dropped out early. And by now, American men between the ages of 25 and 34 are less likely than their fathers to have a college degree. Another nail in the coffin of the 'American dream'.

In addition to education, changes in family structure have contributed to rising inequality. Divorce rates and the proportion of children born to unmarried mothers have risen over the past two decades. This matters because the median income for single parent households is only 40 per cent of that for married couples. In addition, graduates tend to marry other graduates

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[5] "The Price of Inequality", Joseph Stiglitz, 2012

[66] "The Winner-take-all Society", R H Frank and P J Cook, 1995.

[7] For examples see "Coming Apart: the State of White America, 1960-2010" by Charles Murray, 2012

('assortative mating') and the highest earning households are those with married parents, both working and both with university degrees. Marital status and education levels are more important, statistically, than race in explaining American inequality.[8]

But education itself is no guarantee of job security or high income. The dark side of the exceptionally flexible job market in America is the lack of security or long-term benefits available to many working people. University teachers are a case in point. So-called 'adjunct professors' are on temporary contracts, paid only for the hours they teach, without healthcare or holiday entitlements and with no guarantee that the contract will be renewed for the next semester. A recent survey found that 67 per cent of university faculty are on such short-term contracts. For them, a typical annual income from a full teaching load was less than $20,000, about one-fifth of the salary of a permanent faculty member.

I could go on citing more statistics, but these findings are depressing enough. However you look at it, income inequality in America is embedded in its social and economic structures. In a low growth environment, the losers from globalization and labour-saving technologies will outnumber the winners – at least in the short-run. Pressure will build for change, for government to *do* something. But can the political system respond?

Politics in America

I said at the outset that a belief in one-person, one-vote and the democratic accountability of elected politicians are core elements of American exceptionalism. These have been undermined by two key developments: gerrymandering and campaign financing.

Gerrymandering is the practice of redrawing the boundaries of election districts in ways that group together like-minded voters. This helps to ensure a majority for the dominant party in each oddly-shaped district but it disenfranchises those voters in the minority. It also favours candidates that reflect the more extreme ends of their party rather than centrists who could appeal to voters from both parties. The net result is that the House of Representatives has become polarized along party lines. When the Senate is also fairly evenly split, it becomes nearly impossible to pass legislation introduced by either party or the president.

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[8] "Who's Got the Money and Where It's Located", Sentier Research, May 2012.

The impasse around budget legislation is a case in point. Despite sensible compromise proposals from the cross-party Simpson-Bowles Commission, Congress was unable to agree. The result was to set up a trip-wire into what is now called the Fiscal Cliff. Unless an agreement can be reached before the end of the year, automatic spending cuts and tax rises will hit the sacred cows of both parties. The Congressional Budget Office has forecast that the effect would be to remove four per cent of GDP in 2013, almost certainly tipping the US into recession.

Faced with such a dire prospect, President Obama has declared that ‘it won’t happen.’ Most commentators agree, but at this point it is an act of faith to think that the lame duck Congress will find a compromise post-election that it was unable to find pre-election. They may prefer to trip the wire and leave it to their successors to patch something together in the new year. Meanwhile, the IMF has warned that a failure of the US to deal with its fiscal cliff is one of the two main risks facing the global economy (the other being the eurozone).

The second key development in US politics is the change in campaign financing since the Supreme Court decision allowed unlimited donations through so-called Super-Pacs, so long as their spending was not directly linked to a political party. Both candidates have used this mechanism to raise huge amounts of private funds, in place of the public funding which would have come with constraints on their total spend. A record $5.8 billion is the estimated total spent so far on the election. It is probably impossible to quantify the effect of the Super-Pacs, but their emergence has clearly given more political influence to those with more money. This works against the grain of one-person, one-vote.

What can be done?

So, what will happen to American exceptionalism? If I am right that low growth is ‘baked in the cake’ for most of the next president’s term and that a deadlocked Congress will lurch from one stop-gap measure to the next, unable to agree a sensible compromise to cut the deficit, then how will Americans react? Will they accept slow growth, rising income inequality and political paralysis? Will they simply sit back, sigh, make a cup of tea, keep calm and carry on? I very much doubt it!

More likely the blame game will intensify, with China and Wall Street remaining the biggest villains. The debate about the proper size and role of government will grow more raucous. With the White House out of contention for four more years and Congress out of action, solutions will be sought at the state level. Most states have a requirement to balance their budgets. Within that constraint, experimentation will be the name of the game. Some will decide to raise taxes – perhaps on property rather than income – to fund better schools or support business start-ups. Other states will cut taxes to attract the wealthy and rely on their philanthropy to pay for everything from soup kitchens to universities. Church groups and the growing ranks of well-off retirees will boost the role of the voluntary sector in helping those who lack public support. Meanwhile, the Federal Reserve will do its bit by keeping interest rates low to support the mortgage market.

With a bit of luck, all of these diverse efforts will help the US economy to complete its deleveraging process and bring its debt-to-GDP ratio back onto a sustainable path. I have said that I expect that to take another three to four years. This will not be a comfortable time for impatient Americans. But as well as being impatient, they are generally hard-working, optimistic and inventive. Perhaps those qualities are what really define American exceptionalism. If so, it will persist, although based on a romantic myth. The next few years will be the test.