Introduction

The United States appears to be embarking on a transition on two major fronts: its own economy, both financial and real; and its relations with the rest of the world. There is some relation between these two transitions. Some of these changes will depend on the outcome of the U.S. national election in November, and some will not. This paper will present a brief overview of current trends, with some attention given to U.S. foreign policy in Latin America, as well as other areas.

US Economic Prospects and Their Implications

At the time of this writing all eyes are on the financial crisis currently facing the United States and international financial markets, which is widely considered to be the worst such crisis since the Great Depression. There is indeed a serious crisis in the financial sphere, as indicated by events of the last week, especially the freezing up of credit markets. The great fear on the down side is that this could lead to a widespread collapse of parts of the financial system. This was illustrated most vividly last week when some $224.3 billion was withdrawn from money market mutual funds, which investors had previously treated as though they were as safe as a checking account.\(^1\) There are about $3.4 trillion in these accounts. If this panic had spread, it could have amounted to something like a modern-day run on the banking system. Fortunately, however, the Treasury intervened quickly and announced that it would insure these funds, which were previously outside its system of federal deposit insurance.

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\(^1\) Pitt 2008.
These and other massive and unorthodox interventions indicate that the US authorities, including the Federal Reserve (in conjunction with other central banks such as the ECB and BOJ) and Treasury Department, are willing to do whatever is necessary in order to prevent a major breakdown in the financial sphere. They have engaged in the largest nationalizations and the largest transfer of debt in world history (the nationalization of Fannie Mae and Freddie Mac), as well as the nationalization of the country’s largest insurer (AIG), and pumped hundreds of millions of dollars into the banking system in response to liquidity crunches.

Given this willingness of the authorities to do whatever is necessary to prevent a run on deposits (now including money market mutual funds) and the freezing up of credit, the threat of a generalized collapse of the financial system appears to be exaggerated. More likely there will be more strains on the system as insolvent institutions go under – just as the disorderly collapse of Lehman Brothers precipitated the current crisis – and other unexpected events occur, in a process of “de-leveraging” and shrinking the bloated and over-leveraged financial sector. The sector has more than tripled as a share of GDP over the post-war period and before the recent downturn had accounted for more than 30 percent of corporate profits. Much of this profit was illusory and has since disappeared, as we are now seeing.

The current struggle over the conditions attached to the Bush Administration’s proposed $700 billion bailout are a more likely indicator of the battles ahead. It will be a fight over the distribution of losses – taxpayers and homeowners on the one hand, versus shareholders, CEO’s, and investors in the financial sector on the other hand. The Administration last week posed the question as one of “give us a blank check or risk financial collapse.” This was rejected by a populist revolt in both parties, and it appears that there will be at least some conditions imposed on the bailout. But given the power that the financial sector wields in the U.S. political system, these will fall far short of some very feasible and practical reforms that would protect homeowners, force the investors and executives who made bad decisions to absorb their share of the losses, and implement the regulatory reforms necessary to prevent a repeat in the future. (For an overview of such reforms and guidelines to a proper bailout, see Dean Baker, Progressive Conditions for a Bailout). Nonetheless these political battles will probably continue over the next couple of years.

There is a confusion in most of the public discussion of the state of the U.S. economy. The current economic problems are seen as overwhelmingly a financial crisis, when in fact there are major problems in the real economy that are dragging the economy into a serious recession. In other words, even if the problems in the financial sector are resolved, it would not prevent this recession from deepening. We are currently experiencing a recession that was brought on by the bursting of a massive housing bubble, one that created some $8 trillion of illusory wealth before it began to burst in mid-2006.

This bubble is only about 60 percent deflated, and that assumes that there is no overshoot in the other direction at the bottom. The arithmetic is fairly straightforward: from 1996 to 2006, U.S. home prices rose by about 70 percent above the rate of inflation. Prior to this, home prices over the long term did not rise faster than inflation. This means that home prices would have to fall about 40 percent to reach trend levels; in real terms (including inflation), they have so far fallen about 25 percent.

There remains a large oversupply of housing in the United States, and homeowners are currently receiving foreclosure notices at the rate of about 3.6 million a year. In addition to the impact of the shrinking of construction and housing-related sectors, an even more important impact of the bursting housing bubble on the economy is through the wealth effect. U.S. households typically borrow against the equity in their

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3 See Baker (2007).
homes, and the expansion of the U.S. economy from the end of the last recession (November 2001) to last year was largely driven by this borrowing. At the peak of the bubble in 2006, consumers were cashing out some $780 billion a year from (then rapidly rising) home equity. Much of this borrowing and spending has come to an end. In the next quarterly GDP report (3rd quarter) we may see a drop in consumer spending, which has so far held up despite the collapse of the housing bubble.

Over the last four quarters of data, the main contributor to economic growth has been an improvement in the trade balance, as a result of the steep slide of the dollar (about 25 percent against a trade-weighted basket of currencies) that began in 2002. But trade is only about 26 percent of the U.S. economy; consumer spending is 70 percent. And the labor market has weakened to recession levels: unemployment, at 6.1 percent, is almost at its September 2003 peak from the last recession, and employment as a percentage of population is near its trough from the last recession. The economy has shed jobs at a rate of 81,000 per month over the last quarter, and real wages are falling. All of this will feed back into the housing market and also weaken consumer spending. In addition, the state and local government sector, which has so far been adding jobs, will contract in the near future as these governments begin to cut back spending (most have to balance their budgets) in response to falling revenues. The New York City government recently announced $1.5 billion in spending cuts over the next 15 months.

In other words, the U.S. downturn is just beginning, and will accelerate even if the problems in the financial sector were to be resolved in the most efficient manner possible. More likely, problems in the financial sector as it rids itself of insolvent institutions and bad debt will contribute to the downturn through restricting the availability of credit and undermining investor confidence generally.

This leads to what will be the next major battle over economic issues, after the financial crisis is resolved: fiscal policy. An expansionary fiscal policy will be needed to mitigate the effects of the recession, which is very likely to be the worst in at least a quarter-century. The Fed has already cut the Federal Funds rate from 5.25 percent to 2.0 percent, and so does not have much farther to go. But monetary policy cannot have even a small fraction of the expansionary effect that it had on the last recession, when it contributed to the massive expansion of the housing bubble. It is long-term rates that have the much larger impact on economic activity in the United States, and lowering the short-term rate does not necessarily lower long-term rates; in fact the 10-year Treasury markets have reacted several times to recent Fed rate cuts with rising yields. Furthermore, the Fed is much more worried about inflation now, with the CPI at 7.2% over the last year (core at 3.4%), as compared to 2.9% at the onset of the last recession (core at 2.7%).

Given the ineffectiveness of further interest rate cuts, fiscal policy will be the main potential tool for counter-cyclical policy in the near future. However, the national debt is already more than 67 percent of GDP; the current bailout will push this over 72 percent and there will probably be more bailouts (e.g. the re-funding of the Federal Deposit Insurance Corporation, which cannot possibly deal with likely bank failures) as well as further deficit increases due to automatic spending increases and revenue declines as the economy weaken. These are levels of public debt that have not been seen since the early 1950s, when the debt was still winding down from its explosive growth during World War II. Of course it would still be best policy during a recession to ignore these debt levels and proceed with a large fiscal stimulus package – especially since the bailouts, while adding to the debt, do not have the same effect on demand as other forms of deficit spending would. However, there remains a strong prejudice in the U.S. political system, in both political parties and in the media, against doing so. The size and growth of the national debt is a

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major issue in political campaigns, including the presidential campaign, and many Democrats in recent years have often been more conservative than Republicans on this issue.

Therefore, the depth and destructiveness of the current recession may well depend on how much the next government is willing to ignore this economic dogma and stimulate the economy. During the last recession the federal government went from a 2.4 percent of GDP fiscal surplus to a 3.5 percent deficit (2000-2003); and this was in conjunction with the interest rate cuts (from 6 percent in May 2000 to 1 percent in June 2003) and massive growth of the housing bubble. Currently, the Federal Funds rate is already at 2 percent and the federal budget deficit (using the unified budget that is customarily reported) is at 3.3 percent of GDP, not including the current bailouts.

While the authorities have so far proven quite flexible in response to the financial crisis – massive nationalizations, debt accumulation, and even a tolerance for higher inflation and inflation risks that are unusual for the Federal Reserve – it is not at all clear that the next government, regardless of who wins the election, will be willing to abandon fiscal conservatism as needed to help pull the economy out of recession. Most likely they will not make the kinds of mistakes that the Japanese government made after their stock market and real estate bubble burst in 1989; and the U.S. has other advantages, especially with regard to the dollar as the key currency in the international economy, that will make it easier for the United States to avoid falling into a prolonged period of stagnation. Nonetheless there is plenty of room for this recession to be much longer than necessary if there are policy failures.

Leaving aside for the moment the depth and length of the recession, and its dependence on policy responses, the current economic juncture is likely to leave lasting effects on the U.S. economic system, and because of U.S. influence, much of the world. Some of this has already taken place. The five top U.S. investment banks are no more: Bear Stearns collapsed earlier this year, Lehman went bankrupt, Merrill Lynch agreed to be bought by Bank of America; Morgan Stanley and Goldman Sachs gave up investment bank status. This brings them all within the Federal Reserve’s regulatory system.

What lasting impact can we expect, after the economy has recovered? We can expect some regulatory reform in the U.S. financial system to reduce at least some of the abuses that led to the collapse. It remains to be seen whether such progressive reforms as a financial transactions tax, which could reduce speculation and raise upwards of $100 billion annually in revenue, will have a chance.

Since this is the second recession in seven years that was caused by the bursting of an asset bubble, it is possible that the Fed will change its view of such speculative bubbles and begin to monitor them and try to counteract them. The position until now of Alan Greenspan and Ben Bernanke has been that the Fed should not try to do anything about asset bubbles until after the fact. However this does not make sense; the stock market bubble was identifiable and identified in the late 1990s, and the same is true for the housing bubble beginning in 2002. Also, the Fed does not necessarily have to raise interest rates in order to counter-act a growing asset bubble; much can be done to rein in speculation through informing investors and the public of the dangers of investing in bubble-inflated assets, as well as other regulatory measures. This is important because although it is now recognized that there were regulatory failures, e.g. in the case of the sub-prime mortgage market, that contributed to the current crisis, it is not widely known that failure to contain the bubble itself – which could have been done – is the single largest cause of the damage that we are seeing today.

6 See, for example, Greenspan (2002) and Bernanke and Gertler (1999).
7 See, for example, Baker (1999) and (2002).
8 See Baker (2008)
The shrinking of the U.S. trade deficit during this recession will adjust, at least to some extent, one of the biggest imbalances in the global economy. For the United States, it may help to restore the conditions for sustainable growth. Since the 1990s U.S. economic growth has been largely dependent on bubble-driven consumption, first from the stock market bubble and then the housing bubble. One reason for this is the United States' large and – until last year – growing trade deficit, which is a result of an overvalued dollar. Since the trade deficit, as a matter of accounting, reduces growth, the economy needs another source of demand to compensate. Bubble-driven consumption has played that role until now, but will no longer be necessary if the dollar's decline – plus the effect of the recession in shrinking demand for imports – reduces the trade deficit to a sustainable level.

After this recession, the influence of neoliberal ideas, which have their strongest base internationally in the United States, will emerge somewhat weaker. The libertarian variant espoused by the late Milton Friedman has already declined precipitously in recent years, and it will be increasingly difficult to make a serious argument for this kind of “free market” fundamentalism in the coming years. But what of the more mainstream neoliberal ideas, often inaccurately labeled as “free market,” or “free trade?” In reality, these policies have dismantled market barriers when such changes would drive down wages or redistribute income upward (e.g. international trade in manufacturing), while supporting protectionism and non-market solutions when this redistributed income upward (e.g. increased patent protection for pharmaceuticals, restricted competition in professional employment, CEO pay). These ideas too will be weakened somewhat in the years ahead. In some respects it may be similar to what happened after Japan's collapse in 1989, although a milder version. Prior to 1989, Japan's industrial policy and export led growth were widely admired as successful economic policies; after the collapse of Japan’s stock market and real estate bubble and the ensuing stagnation in the 1990s, Japan was no longer seen as an example to be emulated.

There has been a powerful effort in recent years, in the most important European political and media circles, to push Europe in the direction of emulating the United States, which is portrayed as a more dynamic and successful form of capitalism. It is widely believed that the Eurozone countries cannot afford their welfare state in the new global economy, and that labor market regulation and unions have increased unemployment and undermined productivity growth. The economic evidence for these arguments has been entirely lacking, but they helped elect French President Nicolas Sarkozy in 2007, and the German Social Democratic Party leadership has repeatedly defied its own voters by trying to move in this direction. These ideas are likely to lose some steam as the reality of the current crisis and U.S. recession are presented to the European public. Neoliberal ideas are likely to lose some credibility in developing countries as well; they have already fallen sharply in popularity in Latin America over the last decade.

The U.S. recession will also reduce its influence in the world more generally, which has been falling rapidly under the Bush Administration.

**US Foreign Policy in Years Ahead**

It is generally agreed that Washington has lost considerable influence and prestige in the world in recent years, most importantly due to most of the world’s rejection of Washington’s invasion of Iraq, but also other international scandals and human rights abuses (secret detention centers, Abu Ghraib, Guantánamo, extra-ordinary rendition and torture), as well as a generally unilateralist and “with us or against us” posture espoused by the Bush Administration.

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9 See Baker (2006)
10 See, for example, Howell et al. (2006), Schmitt (2006a ) and (2006b), and Schmitt and Zipperer (2006).
There are other reasons for the decline of U.S. influence that are in some cases greater contributing factors but have received very little attention. The most important of these is the collapse of the International Monetary Fund (IMF).\textsuperscript{11} This was the most important avenue of U.S. influence in developing countries for the past three decades. The IMF was positioned, by informal arrangement, at the top of a creditors’ cartel. Governments who did not reach agreements with the Fund on various economic policies were in most cases denied credit not only from the IMF, but from the larger World Bank, other multi-lateral lenders such as the Inter-American Development Bank, the governments of rich countries, and sometimes even the private sector. This gave Washington, which has dominated the IMF since its inception in 1944, a powerful lever to promote a whole series of economic reforms in developing countries.

Over the last decade this leverage has virtually collapsed in middle-income countries. Although some poor countries, especially in Africa, are still subject to IMF conditions, almost all of the middle-income countries are not. In the last four years the IMF’s total loan portfolio has shrunk from $105 billion to less than $10 billion. The organization itself is currently running a $400 million annual deficit and has been forced to downsize.

The collapse of the IMF has greatly contributed to Washington’s loss of influence in Latin America. Most of the governments in the region are now more independent of Washington than Europe is. This is also because left-of-center governments have been elected in the last decade in Argentina, Brazil, Bolivía, Chile, Ecuador, Guatemala, Honduras, Nicaragua, Paraguay, Uruguay, and Venezuela. A major reason for this revolt at the ballot box has been the economic failure of neoliberal policies that were actively promoted by Washington and the multilateral institutions where it holds sway, including the IMF, World Bank, and IADB. From 1960-1980 the region’s per capita income grew by 82 percent. From 1980-2000 it grew by only 9 percent, and despite a few good years recently, it has grown by only 14 percent in the current decade. Even ignoring the distribution of income, which is the most unequal of any in the world and has worsened in some countries, Latin America’s long-term economic growth and development failure in the neoliberal era is unprecedented in its modern history.\textsuperscript{12}

Washington’s response to Latin America’s leftward shift has accelerated its loss of influence in the region. The Bush Administration supported the military coup against the elected government of Venezuela in 2002, and then continued to fund and support opposition groups and tacitly support serious destabilization efforts (including the 2002-2003 oil strike) after the coup. Teodoro Petkoff, currently one of the most prominent and respected leaders of the Venezuelan opposition in international circles, recently described the opposition “strategy that overtly sought a military takeover” from 1999-2003, and its use of the oil industry for purposes of overthrowing the government.\textsuperscript{13}

Washington’s support for this strategy, and continued support for the Venezuelan opposition to this day has created a serious rift with Venezuela. Instead of trying to re-establish normal relations with Venezuela, for example through direct talks, it has engaged in a continuing series of hostile actions that seemed designed to provoke enmity – most recently threatening to put Venezuela on a list of nations designated as “state sponsors of terrorism.”\textsuperscript{14}

In addition, Washington has pursued a strategy of trying to isolate Venezuela from its neighbors. This has also backfired and served more to isolate the United States rather than Venezuela in the region. The Bush

\textsuperscript{11} For an overview of this collapse since the Asian Financial Crisis see Weisbrot (2007)
\textsuperscript{12} For more on the decline of U.S. influence in Latin America, see Weisbrot (2006).
\textsuperscript{13} Petkoff (2008).
\textsuperscript{14} Runningen (2008) and US DOS (2008).
Administration’s support for opposition groups in Bolivia, including funding from USAID, led to the expulsion on September 10 of the US Ambassador there; Venezuela expelled the U.S. ambassador as a gesture of support, and Washington then expelled the Venezuelan and Bolivian ambassadors.

In another sign of the United States’ declining influence in Latin America and especially South America, UNASUR met on September 15 and issued a statement strongly supporting the government of Evo Morales. Among the signers were Colombia, Washington’s closest ally in the region, as well as Peru, and Chile, the convener of the summit. This demonstrates the importance of structural changes that are solidifying Latin America’s independence as well as its pursuit of economic and political integration, through such institutions as UNASUR and the Bank of the South.

There are a number of factors that would tend to support current trends in the coming years. First, the United States’ market for Latin America’s exports, which expanded very rapidly from 1994-2006, as the U.S. trade deficit reached a peak of 6.2 percent of GDP in 2006, will not do so in the years ahead. This is because of the reduction of the U.S. trade deficit (see above). The impact will be most felt by countries that have “free trade” agreements with the United States, especially Mexico, Canada, Central America, and the Caribbean. Countries such as Brazil and Argentina, which export less than one percent of GDP to the United States, will not be significantly affected. This differential impact will in turn reinforce the movement toward diversification away from over-dependence on trade with the United States, including Latin American economic integration. It would not be surprising if even Washington’s strongest allies, such as Colombia, end up joining such institutions as the Bank of the South.

Declining support for “free trade” agreements, both in Latin America and in the United States, will also reduce the relative importance of U.S. commercial relations with Latin America. The proposed “Free Trade Area of the Americas,” negotiated between 1994 and 2005 is dead, and the proposed agreement between the U.S. and Colombia does not look likely. The economic success of the left governments that have been elected over the last decade will also encourage countries to seek more policy space than was allowed during the neoliberal era. Venezuela and Argentina, for example, have pursued heterodox macroeconomic policies and have had the fastest growing economies in the hemisphere over the last six years.

As the world becomes increasingly multi-polar, U.S. influence will continue to decline not only in Latin America but in the rest of the world. The breakdown of negotiations in the World Trade Organization this past July, for example, is another manifestation of this process. Developing countries, including India and China, are much bigger and more influential than they were when the WTO was created – with rules stacked against the developing world – in 1995. Going forward, they will no longer sign off on deals that benefit the rich countries at their expense, such as the Non-Agricultural Market Access (NAMA) proposals that would force steeper proportionate tariff reductions on developing countries than on high-income countries in manufacturing – this contributed to the current impasse.

What are we to expect in the realm of changes to U.S. foreign policy if Barack Obama were to win the presidency in November? While more moderate than McCain, Obama has adopted some of the same hostile rhetoric toward Venezuela, pledged to maintain the embargo on Cuba, and even showed support for Colombia’s March 1 raid into Ecuador. This was a violation of sovereignty and a dangerous regionalization of Colombia’s conflict – supported by the Bush Administration – that was publicly rejected by nearly every government in the hemisphere.

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16 See Weisbrot and Sandoval (2008); Weisbrot and Sandoval (2007)
On the other hand, Obama has said he would meet with President Hugo Chavez of Venezuela and Raul Castro of Cuba. Also, it is difficult to assess the meaning of statements from either candidate as they compete for the votes of hundreds of thousands of right-wing Cuban-Americans in Florida, a state with 27 electoral votes that swung the last two presidential elections.

But the problem is much deeper than the candidates or their beliefs or strategies. There is an influential foreign policy establishment based in Washington, which includes the major media and biggest policy institutes, as well as key members of Congress and the State Department. This foreign policy establishment – ignoring the neoconservatives who are among McCain’s top advisors but would have no role in an Obama administration – have a deep-seated world view that is decidedly unsympathetic to the political changes that have taken place in Latin America over the last decade. Obama’s advisors are very much part of that consensus; their main difference with the Bush Administration’s handling of U.S.-Latin American relations is that the Administration did not pay sufficient attention to the region.

If Obama wins, the most likely scenario is that President Chavez will welcome the new administration and offer an olive branch. If Obama listens to his advisors, he will reject these overtures in a way that reinforces the status quo ante. There is, of course, the possibility that Obama will go against his advisors and abandon Washington’s campaign against Venezuela. But that is not the most likely outcome.

Nonetheless, over some years there is likely to be some significant change in U.S. policy toward Latin America and the rest of the world under a Democratic congress and president. That is because the bases of the two parties are vastly different. This is not noticeable in presidential politics, for a number of reasons. Every Democratic U.S. Senator with presidential ambitions voted for the Iraq war. The calculation in such decisions is simple: they know that if they vote for the war and it is a disaster, their base will forgive them; but if they vote against it and it is a “success,” they will lose some support from the center-right (including the media).

But over time, the difference in the base of the two parties exerts a significant influence on foreign policy. This is even more true today than it was 20 years ago, when the Democratic Congress cut off funding to the Nicaraguan contras as a result of grass roots pressure. President Reagan was forced to run the war from the basement of the White House, with illegal funds, which almost cost him his presidency in the Iran-Contra scandal. Among the base of the Democratic party today are millions of people, including activists, that see the whole “war on terror” as a farce and do not believe that the United States has either the right or need to impose its will on other countries.

The candidates already have some significant differences over other key foreign policy issues. Obama says he is willing to negotiate with Iran without preconditions. The present policy towards Iran, which McCain would continue if not exacerbate, insists that Iran must suspend the enrichment of uranium before negotiations can take place. This is a recipe for military conflict, since Iranians themselves, and not just the government, strongly support the idea that they have the right (which they do under international agreements) to enrich uranium for peaceful uses. So Obama’s difference with current policy on Iran is

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18 See, e.g., Castañeda (2006) and (2008), Hakim (2006), and Shifter (2006) – all in Foreign Affairs, published by the Council on Foreign Relations, perhaps the most influential foreign policy publication in the United States. Foreign Affairs articles have been consistently hostile to what is referred to as “Latin American populism.”
19 For example, see Green (2008) and Bachelet (2008).
20 Hillary Clinton may have lost the presidential primary over her vote for the war, but that is more likely because she defended that vote for too long into the primary rather than apologizing for it, as Edwards did.
significant. This has implications for the rest of the region. For example, Iran’s co-operation with regard to Afghanistan might facilitate a withdrawal from that war.

With regard to Iraq, there are also significant differences. McCain is much more committed to the war being a “success,” and thus likely to stay longer and try to maintain a bigger troop presence indefinitely. He is more committed to confrontation with Iran, whereas the Iraqi government is likely to pursue close relations with Iran. These commitments, plus his own neoconservative world view, would make McCain more likely to remain in Iraq for a longer time and with more permanent military bases there. The Iraqi government has increasingly been pushing back against the United States; they have forced agreement on a timetable for a withdrawal of foreign troops from Iraqi cities and are likely to get an agreement for a timetable on overall withdrawal. They have also increasingly confronted Washington with regard to the role of foreign oil companies. Obama is more likely than McCain to accept these realities sooner.

On Afghanistan, Pakistan, and Israel/Palestine there are less obvious differences between the two candidates. Both want to increase troop levels in Afghanistan, and pursue a more aggressive posture towards Pakistan. These policies, as well the failure to even oppose the expansion of Israeli settlements in the occupied territories, are counter-productive and dangerous. Both candidates also want to expand the number of troops in the U.S. military.

On the latter question, the level of national debt that is likely to emerge at the end of this recession and bailouts may prove to be a constraint on expanding the military. Although the United States is capable of sustaining higher levels of public debt without damage to the economy, there are political constraints that come into play, as noted above. At the height of the Vietnam war, when Martin Luther King Jr. warned that the War on Poverty was being abandoned because of military spending, the national debt was about 43 percent of GDP and falling; as compared to the 67 percent of GDP and rapidly rising debt/GDP ratio today. Eventually, Americans may finally begin to see themselves as having to choose between fighting to defend an empire in decline, and enjoying the quality of life – including such amenities as universal health care – that their counterparts in other rich countries have.

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21 See, e.g, Thompson (2008), and Glanz and Oppel (2008).
References


