A Weak Deal in Washington but Hypocrisy Abroad

C. Fred Bergsten analyzes the United States' brush with default, the weakness of the deficit-reduction deal, the uneasy markets—and the hypocritical hand-wringing by China.

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Steve Weisman: The ten days of August have not been good for the faint of heart, at least for anyone watching the market turmoil instigated, at least in part, by the deal that avoided a default in the United States.

C. Fred Bergsten, director of the Peterson Institute for International Economics, is here to talk about that deal and its repercussions. This is Steve Weisman. Fred, do you think that the deal, or the weakness of the deal, had something to with the turmoil in the markets and what seems to be a lack of confidence in a US recovery?

C. Fred Bergsten: I definitely do, Steve. I think the deal is very weak. It's supposed to be a budget cutting deal, but there's no budget cutting in the deal. It sets up a bunch of processes, it puts in place procedures, it predicts, it promises future budget cuts, but it didn't do any budget cutting at all.

That in turn led to the downgrading by Standard & Poor's. All that in turn reminded people, not only of the weakness of US fiscal policy, but of the weakness of the US Economy, and it underlined the dilemma that we face.

We do have to take serious measures to put the long-term budget position in shape. But we have to find a way to do it that does not trash the weak economy even further in the short run.

So it's an acute policy dilemma, it's real, not just a political problem, not just a psychological problem. And certainly the debt legislation that was reached just a week ago does not get very far to help deal with it.

Steve Weisman: Before we get to alternatives, let me ask you: some analysts say that the markets are reacting to the fact that the deal will call for spending cuts and therefore weaken the economy. What do you say?

C. Fred Bergsten: I don't think the deal will lead to too much in the way of spending cuts, as I've mentioned. If the deal itself went through even as projected, it would have very, very modest effects on the economy for at least two or three years. I really don't think that's what's getting people to worry so much.

I think it's actually the failure of the deal – the recognition that a much stronger deal will have to be put in place, or else further downgrades will occur, and doubts will actually be raised about Treasuries, as well as the rest of the US economy.

But remember, too, all this comes right on the tail of a sharp reduction in US growth numbers. The second quarter growth number came in only a few days earlier. The first quarter was revised down very sharply. The US economy going into the debt deal turned out to be much weaker than people thought.

So that is a big reassessment worldwide, and of course domestically, about how close the US economy really is teetering to a second downturn.

Steve Weisman: What's your approach on how to address the deficit and debt issue in the medium and long term?

C. Fred Bergsten: As I say, there is a genuine dilemma. A program has to be adopted that will credibly, in other words tangibly, reduce the budget deficit over time, so that the debt numbers don't explode as they would on current projections.

That has to be done, however, in a way that will not trash the economy in the short run -- i.e. the budget correction has to phase in over a number of years.

I 'd add a third criterion to those two. The budget actions should support long-run policy objectives that are going to have be done anyway, such as putting Social Security on a solvent basis, putting Medicare on a solvent basis, raising the level of revenues to at least a higher share of GDP that the population seems to demand from government spending.

Those are all structural needs. They have to be pursued anyway, so let's find ways to pursue them consistent with the immediate need for budget reduction on a credible basis phased in over time.

Steve Weisman: Is it realistic to think that could be done this year? Or would we have to wait until after the 2012 election?

C. Fred Bergsten: If it's steady-as-she-goes Washington politics, we'll clearly have to wait at least until after the 2012 election. But if the markets continue to press, and indeed if the markets accelerate their pressure, I could see Congress, and the President, having to go back to the drawing board much sooner than they anticipated – namely, in the next couple of months, instead of waiting for a committee.

I think this is a kind of slow-motion version of what happened around the TARP [Troubled Asset Relief Program] legislation three years ago. The first effort to get the TARP legislation, by the Bush Administration, was voted down, you may remember, by the House of Representatives. The markets collapsed.

Three days later, the House reconvened and voted the legislation. I think we may be in a somewhat slowed down, but not too slowed down, version of that this time. This time, the Congress passed legislation, but the markets have responded with a resounding negative…

Steve Weisman: A Bronx cheer.

C. Fred Bergsten: A Bronx cheer, and not just to the legislation and everything around it…

Steve Weisman: Right.

C. Fred Bergsten: But the legislation was part of the catalyst for it. If that continues, then the Congress, I think, will have to go back to the drawing board – not in three days, perhaps, but maybe in three weeks or possibly even two or three months.

But I don't think they can wait through the presidential election, through the senatorial elections, through another year and a half, almost, which is the timetable they're now on. I think the market simply may not permit that.

Steve Weisman: Let's talk about the reaction around the world: first in China and then in Europe. China has been critical of US policy. They derided the deal, they said the US has to come to terms with its deficits and debts. That hurts, right?

C. Fred Bergsten: That hurts, and I wish it wasn't so. But of course, given what I've just said, I agree with the Chinese on their criticism that the deal is inadequate.

Steve Weisman: However…

C. Fred Bergsten: Having said that, I think the Chinese reaction is the height of hypocrisy. Who, after all, is buying more Treasury bills than anybody in the world? Who, after all, is financing the US trade and budget deficits more than anybody in the world – all for their own selfish purposes?

China, remember, buys $2 billion every day in the currency market to keep their exchange rate undervalued to give them a huge, unfair advantage in world trade, and to propel their economy on the backs of the United States, and other countries, whose currencies are overvalued and uncompetitive as a result.

For the Chinese to then turn around and say, "You have to protect the value of our dollar holdings," which are, in my reading, ill-gotten gains pursuing very narrow, very unsociable objectives of China's government, is the height of hypocrisy. So I would not take their criticisms too seriously, and if at the end of the day they take a bath on their dollar holdings, so be it.

Steve Weisman: Let's turn to Europe and what some have thought was hypocrisy on the part of the Europeans who, two or three years ago, were saying that the United States had prompted this global economic crisis. We can see that the crisis is, if anything, deeper and more structural in Europe, although maybe you would have a more subtle analysis. What do you think of the European reaction?

C. Fred Bergsten: There's no doubt that the Europeans were in denial for a very long time. Through most of 2008, they were kind of smugly saying, as you indicate, that '"this is a crisis made in the United States – we Europeans are outside any risk of that, and you've got to put your house in order."

Then of course the house caved in and it turned out that their financial system was at least as suspect as ours, and they suffered even worse than we did between now and then.

Having said that, I have some positive words about what's been happening in Europe. Because they've been driven by a more acute crisis than we [have had], at least until now, they had been forced to start taking some serious policy actions.

All the European countries, even the strong ones like Germany and the United Kingdom, have adopted serious budget correction programs. Not processes and procedures like ours, but they have taken serious measures.4

The new UK government took some pretty tough action when it came in. The German government, which is under no pressure from the bond market vigilantes, has put in place a balanced budget amendment and is on a course to balance its budget, almost, over the next four or five years.

So Europe is clearly ahead of us in bringing its debt and deficit problem under control. On the monetary side, the European Central Bank has begun to escape from the abnormal monetary ease surrounding the Great Recession. I don't want them to carry that too far too fast, but they have raised rates a couple of times, whereas the Fed [Federal ReserveBoard] of course has not.

And the Europeans are, at least, beginning to strengthen their institutions in a way that most of us knew they would have to do at some point, because when they created economic and monetary union all they did was create a monetary union with the euro and the European Central Bank. But there was no economic union: no central fiscal policy; no central regulatory authority; no economic governance system, except the ECB [European Central Bank]. So they were a halfway house for a decade.

Now under the lash of the crisis they are being forced to correct that. I think they're moving -- sometimes by stealth, certainly in some ways that are sometimes inchoate -- toward a more complete fiscal and economic union.

In short, I think the Europeans are clearly ahead of the United States in the policy cycle. They come from a deeper hole, so they had to do that. But given the hole that we're now getting into, they may look relatively good over the next six months, year, couple of years.

I would not be surprised if the US continues to dither and Europe continues to respond to its crisis with constructive measures, so that a year or so from now the euro will actually look fairly good relative to the dollar. We could get a reversal of capital flows, and that might then, in fact, be a market force that really, really then brought pressure to bear on the United States to get its act together.

Steve Weisman: Both the Europeans and the Chinese are worried about another round of quantitative easing, which they fear will weaken the dollar. Is that fear justified?

C. Fred Bergsten: No. The fear is not justified for two reasons: If the Fed undertakes more quantitative easing, as I think it may if our economic numbers remain weak, that's the best tool we've got available in the short run to try to strengthen our economy. And a stronger US economy certainly is in the interest of Europe, China, and the world as a whole.

Secondly, again China is at the height of hypocrisy. If QE3 [a third round of quantitative easing] were to lead to a weaker dollar in the exchange markets, that's a good thing. The United States needs export-led growth. You could say, "Well everybody wants export-led

growth." True, but the United States is the world's largest deficit country. It's the world's largest debtor country.

If any country in the world is justified after 30 or 40 years of running huge trade deficits to accommodate other country's export-led strategies, it's the United States.5

The United States, in my view, has to get a positive thrust from the trade component of this economy if we are to restore any modicum of acceptable growth, and get unemployment down to anything like acceptable levels over the next few years.

I don't think our domestic demand alone is going to do it in the current circumstances, with housing weak, consumer demands still short-circuited, private saving rate up, so consumption is down.

I think we have to get a stronger trade account that in turn will require a more competitive dollar in the exchange markets. If that leads to a reduction in the outsized Chinese trade surplus that has enabled them to pile up $3.5 trillion of foreign exchange over the last five years, so be it.

Europe's a little more in the middle. But Europe, too, with high reserves, a more-or-less balanced international position, could certainly accept some modest external deficit to accommodate a rebalancing of the US economy that reduced, if not totally eliminated, the huge, huge external imbalance that we have been willing to run at our own economic cost for well over a generation.

Steve Weisman: Fred, thanks for covering a lot of ground.