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The decline of a superpower

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1. INTRODUCTION

From the end of World War II until the onset of the Reagan presidency, the USA held the leadership role in world finances and was one of two global superpowers (the other being what was the Soviet Union). However in 1981, American president Ronald Reagan implemented economic and international policies that put the USA into serious financial troubles, helping to speed up the nation's downfall. American consumers benefitted with Reagan's policies of large fiscal deficits, while Japanese investors took advantage of high interest rates on USA federal financial instruments and pumped dollars into the USA's economy, helping to finance the American buying spree. Japanese exporters profited from the large American market that was more than willing to absorb an accumulating surplus of Japanese goods. And furthermore the private sector in America took advantage of the favorable tax structure and borrowed moreso than ever, despite the Fed's attempts to curb borrowing. Almost everyone benefitted, but the end result was that the USA went from becoming a high creditor to a high debtor nation, and thus put its hegemonic position at risk. Meanwhile, the Japanese were gaining financial power and becoming the best suited to fill the hegemonic void that would be left by a weaker USA.

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2. THE BEGINNING OF THE DECLINE

To understand how the USA lost its position so quickly, one must first analyze what initially went wrong. The Japanese would have most likely been the natural successors to the world hegemony no matter how hard America tried to protect its position. However, had the USA government been more realistic and prudent, perhaps it could have avoided the change in the positions of Japan and the USA from occurring so rapidly. The key contributing factor in America's descent was that the country was no longer the lender of last resort; it had become a major debtor (owing mostly to the Japanese) by 1985 as a result of massive budget deficits, and was replaced by Japan as the world's foremost creditor nation (Gilpin, 1987).

Although this loss in position as the lender of last resort was probably the final blow to the American hegemon, the beginning of the nation's decline in global influence appeared as early as the Nixon presidency with the failure of the Bretton Woods monetary system. Under this gold standard, the USA maintained a constant price of US$ 35.00 per troy ounce of gold, and foreign governments pegged their currencies to the American dollar. However in the 1970s, foreign governments became more interested in holding gold than dollars, as inflation began to devalue the dollar and cause the real price of a troy ounce of gold to rise above US$ 35.00. Most notably, West Germany flat out refused to purchase the inflated American currency. In order to prevent a massive outflow of the United States' gold stock, president Nixon terminated the dollar/gold convertibility. This action ended the Bretton Woods gold standard and introduced a *de facto* dollar standard, as foreign currencies still remained pegged to the dollar. Many nations found themselves importing economic problems from the USA under this new system, and consequently sought independence from American economic policy. One of the first big steps towards economic freedom was the decision made at the 1976 Jamaica Conference to standardize floating exchange rates, automatically ending the dollar standard. Yet even more notable was West Germany's key role in the launching of the European Monetary System and the creation of the European Currency Unit (ECU) in 1978 (Gilpin, 1987). The ECU, made up from a basket of all Common Market currencies, gave the European nations an instrument other than the dollar to which they could tie their respective currencies. Measures such as these were definite warning signs to the USA that it was losing its privileged position as major player in world finances.

3. THE REAGAN PRESIDENCY AND "VOODOO ECONOMICS"

America got her biggest push down the hegemonic ladder with the 1980 election of Ronald Reagan as president and the resulting combination of blind management, uncoordinated policy and unfortunate circumstances that followed. The largest factor which stands out from that era is president Reagan's supply-side economic theory. Labeled by vice president Bush as "Voodoo Economics" (only when he was competing with Reagan for the Republican presidential nomination, before becoming his running mate) and by many others as Reaganomics, supply-side economics states that giving incentive to those who work (labor) and to those who invest (corporations) will

stimulate the economy, thus increasing overall production. The incentives Reagan had in mind were tax cuts that would allow workers and corporations to keep more of the money they earned. It was expected that natural human instincts (greed) would make them want to earn more. Although taxes would be cut, the tax base would become larger as incomes increased. This new base would be the foundation of a greater source of revenue for the USA government.

Supply-side ideology has its foundation in the Laffer Curve. This curve shows the relation between the level of taxation and income. Assuming that at 0% taxation there will obviously be no tax revenue and at 100% taxation there will also be little or no revenue, since not many would be willing to work just to give all of their money to the government, there must be a midpoint at which tax revenue is maximized. It was believed in the early 1980s that America had surpassed this midpoint and was overtaxing its residents. The supply-siders saw the high rates of taxation as the cause of the low levels of production in the late 1970s and early 1980s. President Reagan's objective was clear: put the USA economy back on track by reducing the tax burden to stimulate the economy, therefore making America prosperous once again. He passed massive tax cuts, but failed to provide the corresponding spending cuts that many supply-siders thought were mandatory (Bartlett, 1981). And although the economy was stimulated to some extent, the tax base did not grow enough to prevent a huge deficit from forming.

Of course, there was opposition to Reagan's economic policies. Many believed that the president was giving the wrong type of medicine to an improperly diagnosed disease. American production was indeed low in the late 1970s and early 1980s, however this was not due to a shortage of money in industry. On the contrary, businesses were sitting on large amounts of cash. However, seeing bigger profits with less risk in the high interest money market than in the shaky economic atmosphere that resulted from the Carter administration, businesses were purchasing securities with their excess cash instead of spending it on investment. Fickle energy prices and energy policy, among other things, lead businesses to believe that short-term investments yielded better pay-offs than uncertain long-term investments. Moreover, corporations were fearing another credit crunch like the one that occurred in 1974. The end result was that in 1978 alone, large companies like IBM held US$4.9 billion of cash assets, Exxon held US$4.4 billion, and General Motors had US$3.6 billion. The treasurer of Borg-Warner, William M. Valiant, summed up the situation quite accurately in saying that although tax credits would be helpful, in order to make long-term investments more profitable what was really needed was government security (Steve, 1978). The capital spending situation that began in the 1970s was present before president Reagan even entered office. He was either just oblivious to it or was simply ignoring signs from industry because he wanted to try out his new theory with the American economy. He proceeded with his Reaganomic policy.

Obvious faults existed with supply-side economics, which the eager republicans either ignored or just failed to see. Supply-siders thought that the increase in investment and the resulting increase in production would be absorbed by the American public as a result of Say's Law: "In an unfettered market, supply creates its own demand". However, just from observing a recession one can see that this is obviously not true. If it were, the only measure needed to avoid recessions would be increases in production,

as these increases in supply would create increases in demand. The supply-side line of thought implies that there is no reason for the existence of business cycles, however economists still have yet to come up with a way to avoid these cycles (Magdoff & Sweezy, 1981). Obviously, this type of reasoning cannot be applied to today's economy.

Another problem that the republicans didn't take into account was the danger of budget deficits, even though previously republicans were known to be very "balanced-budget" oriented. Oddly enough the democrats, who had once been in favor of budget deficits under certain circumstances, where terribly preoccupied with them. In fact, the early 1980s saw a complete reversal of opinions with relation to the fiscal debt. Yale professor and known Keynesian James Tobin was very worried about the deficit situation, and predicted a rapidly shrinking economy as a result. On the other hand Milton Friedman, probably the most famous monetarist, didn't appear to be extremely preoccupied with the sudden rise in the American deficit (Congdon, 1989).

Aside from the many predicted problems that the deficit posed to the economy, it also had some unexpected effects. The biggest surprise occurred with the value of the dollar that came about as a result of the integration of the Japanese and American economies. Although growing deficits are usually associated with a weakening currency, the dollar remained strong. Because America's debt was financed in its own currency, those who invested in it, mainly the Japanese, had to purchase dollars in order to buy federal securities. Therefore instead of the deficit's weakening the dollar, it pushed up demand and made the dollar stronger, albeit in an artificial sense (Banks, 1992). This stronger dollar meant lower exports and more imports, resulting in a shrinking trade surplus that rapidly transformed itself into a trade deficit. However, this seemed to matter little to the republicans, who were interpreting the rising dollar as a good sign that 1) the USA was following the correct policy, 2) the economy was strong, and most importantly, 3) Reaganomics was making America's economy prosperous once again (Gilpin, 155).

As alluded to above, the increasing budget deficit would never have been possible without the help of the Japanese. Although it seems strange that such an apparently prudent group would want to invest in a declining economy, their reasoning was indeed clever. The Japanese had problems of their own, one of which was an abundant financial surplus. They needed a place to unload their excess capital, and Americans were more than willing to take in inexpensive Japanese goods, and borrow dollars to do so, without care about the effects of their actions on the global position of the USA. Furthermore, the large difference between American and Japanese real interest rates made American treasury securities very attractive investments for Japan. The result was that where the USA was dependent on the Japanese for financial support, the Japanese were dependent on the USA for economic support. Ten percent of Japanese jobs were linked to exports, and if the Japanese had ever decided to stop lending to America, they would have lost their largest export market. Furthermore, decreasing investment would ultimately have lead to a weaker dollar, and those Japanese investors with securities denominated in dollars would receive less yen for their American investments (Gilpin, 1987).

While the federal deficit was rising, Chairman of the Federal Reserve Bank, Paul Volcker, was trying to reduce the expectations of inflation that the American public had acquired due to past inflationary experiences. Many Americans borrowed money and

made profits from rising asset values in the 1970s. Since interest from borrowing was tax deductible, if asset values increased at 15%, which was common in the American real estate market during that time, a person in the 50% tax bracket borrowing at 10% would only pay a nominal interest rate of 5%, and gain a net profit in monetary terms of 10%. Mr. Volcker wanted to stop this borrowing cycle, so he tightened monetary policy in hopes that the people would see speculation as unprofitable and eventually curb borrowing. His weapon was high interest rates, however his timing was most unfortunate (Congdon, 1988).

While interest rates were rising to end the American credit spree, forces in Congress and the White House seemed to be working against the Fed, albeit unintentionally. The supply-siders were doing their best to stimulate the economy, and as a result passed the Economic Recovery Tax Act in 1981. This legislation provided for investment tax credits, higher corporate tax deductions for Research and Development expenditures and other incentive measures designed to make investment more profitable. The result was increased corporate borrowing. Further complicating matters for the Fed was the passing of the Depository Institutions and Monetary Control Act. This Act deregulated much of the banking industry, which had been heavily regulated since the depression. This increased competition among banks, as they were now able to offer lower interest rates with more competitive borrowing instruments. The end result was that borrowing and investment increased to such a high level that, when combined with the associated crowding out from deficit borrowing and the supposed tight fiscal policy from the Fed, the prime rate reached 21.5%. Although inflation and nominal interest rates eventually fell, real interest rates were floating at about 10% until June of 1985 — the highest in American history. This was bad news for the debt-ridden USA, but at least America's debt was denominated in its own currency. An even larger impact occurred in the indebted Third World nations that had borrowed so much during the credit spree of the 1970s and could now not afford the burden of the high interest payments in scarce American dollars (Congdon, 1988). The USA was headed downhill, and taking most of the underdeveloped world with it. Reagan's macroeconomic policy, along with other world economic policies, was increasing the severity of the Third World debt crisis (Gilpin, 1987).

4. AMERICA'S ISOLATION AND BENIGN NEGLECT

America's neglect for the state of the Third World economies was just another example of how it acted without taking into account the resulting effects on other countries. This was popularly known as Reagan's policy of benign neglect. It began during the beginning of his presidential term in the spring of 1981, when the president announced his dedication to America's well-being. He stated that the country was going to do what was best for itself without concern for the negative consequences that may occur in other countries. If there were foreign bodies that were unhappy with American policy, then it was up to those respective governments to improve their situation. In effect the USA would be "looking out for number one". And although he vowed to reverse this closed-minded policy in 1982, he didn't actually begin to cooperate with other nations until September of 1985, when it was convenient for the

USA (Gilpin, 1987). This selfish behavior would eventually help to further isolate the USA from the global community, which shall soon be seen.

During Reagan's second presidential term, Congress and the American public in general began to notice the threat of the growing budget deficit. Whereas it had once been believed that deficits wouldn't have a huge effect on the economy, it was now realized that this reasoning was erroneous. There was a new economic team in the White House headed by Secretary of the Treasury James Baker III. Although Baker managed to lower the rate of inflation and increase economic growth to some extent, he saw the overvalued dollar as something harder to cure. But it was necessary, as America's trade deficit had risen from US$9.3 billion in 1976 to US$108.3 billion in 1984. Net investment, which at the beginning of the Reagan presidency had a healthy surplus of US$34 billion, was falling below zero by 1985. In addition the overvalued dollar, combined with high American wages and capital costs, was forcing industry out of the USA and into other countries where labor and raw materials were relatively cheaper. Those industries that remained in the USA no longer manufactured their own materials, but were dependent on foreign suppliers. American cars, *per se*, were not American, but a montage of foreign parts assembled in Detroit. And the US$860 manufacturing cost of an American IBM PC was really only US$235 of American labor; the other US$625 came from foreign production. Nonetheless, high Japanese demand kept the dollar strong, and imports continued to rise as exports declined (Gilpin, 1987).

During the same period, president Reagan noticed his past mistakes and took an active interest in trying to fix the economy. His biggest concern appeared to be the overvalued dollar, which he now recognized not as a sign of a strong economy, but as that of an uncompetitive economy in trouble. The Group of Seven (the seven largest world economies) agreed that the dollar was indeed overvalued and set out to reduce it at the famous 1985 Plaza Accord gathering. The main result of that meeting was a devaluation of the dollar by one-third, which was good for America's increasing trade deficit. But at the May 1986 Tokyo Summit, president Reagan tried to convince leaders to return to past conditions, and play by the USA's rules to manipulate exchange rates. The other nations, most notably the European ones that already had learned from past lessons such as Bretton Woods and benign neglect, saw this as a sign of the USA once again trying to regain a strong hegemonic position in world finances. Their leaders refused. At the summit's end, the nations finally agreed not on a policy of the USA being the leader, but instead on a policy of enhanced surveillance. Under this system, countries would monitor other exchange rates, and at the first signs of trouble they would convene to try to work together on an acceptable solution (Gilpin, 1987). Although the dollar was still a strong power in international markets, the other countries were not going to allow it to regain the strength it had during Bretton Woods. It appeared that the USA had permanently lost its position as world financial leader.

5. THE USA AND JAPAN AFTER THE SWITCH

By this time America had borrowed so heavily and lost so much influence that the Japanese appeared to be in the driver's seat as the world hegemon. Nonetheless, the

USA still continued to suffer other blows to its economy, such as the stock market crash of October of 1987, the crash in the real estate market that helped launch the Savings and Loan Crisis, and most recently an extensive recession that began in July, 1990 and only in March of 1992 began to loosen its hold on the American economy (although signs of a full recovery still remain to be seen at the time of this writing, August of 1992). And even though the economy appears to be showing some healthy signs of life, the recovery is expected to be sluggish. This is due not only to the declining importance of the USA in world financial markets, but also to the decrease in defense spending that came about from the end of the Cold War, which resulted in a loss of thousands of jobs.

However, there have been signs of hope for the USA's troubled economy in the international arena. Exports have increased at a rate of 9.5% since 1985, faster than imports. Consequently, the trade deficit has fallen from US$146 billion in 1987 to a mere US$7 billion in 1991. And America's 1991 trade balance with the European Community was a surplus of US$16 billion, up from a deficit of US$266 billion in 1986. According to a recent article in Forbes magazine, this change can be attributed to three factors. First, since the 1985 Plaza Accord, the dollar has depreciated by about one-third. Second, there has been a steady rise in American productivity since 1982, higher than in all other developed countries with the exception of Great Britain (Japan fared as well as the USA , but with a smaller real increase due to a lower base level). And finally, since 1982 American wages have not increased as much as in other countries with highly advanced economies. This increase in Japan was 10,5% and in West Germany it was 9,7%, whereas in the USA wages only increased an average of 3% (Banks, 1992).

As far as Japan's hegemony in the world financial markets, the nation still has yet to assume full control. At the time of this writing, the Japanese economy was experiencing a recession. However, a recession by Japanese standards is not as threatening to its economy as recessions in other countries such as the USA. Furthermore, this recession seems to be all part of a master plan by Bank of Japan's chief central banker, Yasushi Mieno, to cure the country's economy of the rash of ills that recently have been effecting it (Curran, 1992).

At the end of the 1980s and the very beginning of the 1990s, Japan was facing an inflation threat, a bullish speculative stock market, and high real estate prices. As a result, in 1991 alone the country had over US$60 billion of bad debt, inflation reached the high level (in Japanese standards) of 4% per year, and wages were increasing at an extremely rapid level as the number of job offers outnumbered the number of job seekers by 48%. The purpose of the imposed recession is to end the threat of inflation, kill speculation in the stock markets, end the rapid increase of wages and improve the overall quality of life in Japan. The recession has slowed the economy down: Industrial production has fallen and corporate profits were down 19% for fiscal years from March 1991 to March 1992. A recovery is planned for 1993, but even if the economy doesn't regain speed, the Japanese government can easily stimulate it by pumping in some $40 — $50 billion dollars. Although this is a lot by American standards, when the savings rate in the country is over 20%, it amounts to barely a drop in the bucket (Curran, 1992).

It still remains to be seen whether or not the Japanese will take the active role in world finances. The country has grown at a rapid rate: from 10% of the USA's economy in 1960 to over 60% today, and with a trade surplus that has doubled in the last seven

years despite a 50% increase in the value of its currency. But, even though the country is a large economic power, it is coming into a different world than the USA entered when it assumed the global hegemonic position. Kenneth Pyle, the president of the National Bureau of Asian and Soviet Research, predicts a different type of world leadership. He believes that the Japanese are more interested in taking a large part in the control of Asia, while the West Germans augment their role in the European Community and the USA increases its alliances with the Canadian and Latin American economies. He thinks that instead of considering Japan as an enemy to American hegemony, the USA should instead try to strengthen its relations with the powerful Asian nation so that both countries can benefit (Kirkland, 1992).

And the world indeed is a much different place that possibly may not allow for a leader as strong as the United States was during the past fifty years. When America assumed its hegemonic role at the end of World War II, there wasn't any other country suited to take on such a responsibility. Most nations were too busy attempting to rebuild their economies that were destroyed as a result of the war. This situation proved to be most favorable to the USA, who quickly took advantage (Gilpin, 1987). However today there are a multitude of highly advanced economies, along with a well-developed free market. There is also no large threat to market economies such as that posed by the communist regimes during the 1940s, and thus no search for a protector of these economies. Although Japan may be have the capacity to assume a leadership position, it is doubtful that any country will try to take such an active global role and try to force its policies on other countries the way the USA has done for the past fifty years.

There are many in the USA who see the Japanese position as a threat to American superiority, but this line of thinking appears to be highly unfounded. Paul Kirgman, of the Massachusetts Institute of Technology pointed out during a recent interview with *Fortune Magazine* that the USA would have eventually lost its world position due to its increasing domestic problems, and that Japan should only be seen as successor to the hegemonic position. He stated that even if Japan were destroyed in an earthquake or other act of God, America would still suffer from stagnant productivity, an increasing amount of income inequality and 20% of the nation's children living in poverty. He believes that America should focus on domestic problems such as the falling standard of education and the lowest savings rate in the industrial world (Kirkland, 1992). However, with president Bush in the White House, domestic problems are taking the back seat to all others. Changes in the White House need to happen before changes in America's domestic situation can be expected.

6. THE USA: IS THERE STILL HOPE?

The predictions for America's future are a little shaky, but far from gloomy. Although the USA will probably never regain the leadership it had following World War II, possibly a tripartite role with Japan and West Germany may be feasible. However, the American economy does appear to be making a comeback. At present the USA exports 7% of its GNP. Japan also exports 7%, whereas the European Community exports 9%. American industry is changing its outdated "home market" thinking, and now reflects on a broader, global market scale. If the dollar continues at its present level

and American business continues to become more competitive, exports will continue to increase. If they rise to the point where the USA exports 9% of GNP as the European Community does, this would effectively create enough jobs to cover those lost in the defense industry due to the end of the Cold War (Banks, 1992). Although this doesn't mean a booming economy will result, perhaps at least a competitive economy will take shape, one that will be able to compete with the integrated world market that is coming about in the 1990s.

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