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No. 115/2011 dated 8 August 2011

Too Big to Fail? The US Debt Crisis & Its Implications

By Sophie Ng

Synopsis

The US has managed to pull back from the brink of bankruptcy, saved by a last-ditch effort to raise the debt ceiling. The danger is not over as the shadow of a possible downgraded credit rating, and further indebtedness, threaten to affect global stability.

Commentary

THE START of August saw a flurry of activity taking over the US Congress as the administration of President Barack Obama battled to save the American economy from defaulting on its ballooning debt. On the other side were the Republicans, who felt that the Democrat proposal for monetary salvation would further thrust the embattled US into the throes of debt.

In the past decade, involvement in the Middle East, cuts from the previous administration, and government rescue packages stemming from the sub-prime mortgage crisis, had all contributed significantly to the burgeoning US debt. This led to the Treasury announcement that it would run out of money to pay its bills unless the debt ceiling was raised by midnight of 2 August 2011.

What it could have been

On the eve of the deadline, Obama announced a bipartisan compromise – in exchange for raising the US borrowing limit through to 2013. Government spending would be slashed by up to two trillion dollars over the next decade, with a committee set up to explore further ways to reduce the budget deficit. The Republican-dominated House of Representatives had backed the measure by a 269-161 margin, allowing for its approval by the Democrat-led Senate, staving off the crisis, temporarily.

Had the US economy defaulted on its debts, it essentially meant the US would have gone bankrupt. The implications are enormous: It would have further stressed the already weakened Eurozone and pulled down the emerging economies. It would have also adversely affected the Asia-Pacific economies, all of which are dependent on the world economy, which in turn is intertwined with US economic fortunes.

In addition, crucial US involvement in other areas of the world would be curtailed drastically, affecting security and humanitarian concerns. Indeed, if there was logic to the 'too big to fail' thesis, it would be self-evident in the case of the US.

Implications for US

The US compromise was crucial, as an acrimonious split in both parties over how to handle the debt crisis had resulted in an impasse. Still there are concerns over whether the deal would be sufficient to fix the problems of the budget deficit. A credit rating downgrade soon followed when Standard and Poor's cut the US standing by a notch from AAA to AA+. This was an unprecedented development widely seen as damaging to the US economy.

The downgrade would see US borrowing costs rise, further weakening the economy, as well as scaring off potential investors. With unemployment at about 9.2 percent, a credit rating downgrade would worsen prospects of an economic recovery and impede measures by the government to stimulate employment and spending. With federal debt expected to be at about 70 percent by the end of this year, the strain of the demands on government spending is expected to grow.

Implications for global economy

The deal calls for several key measures, notably spending cuts in discretionary and defence spending; the raising of the debt limit; a call for an amendment to the US Constitution that requires a balanced budget; as well as the setting up of a powerful committee to debate further possible cuts in all aspects. This was to ensure that at least US\$2.1 trillion in deficit reduction would be saved by 2021.

Although it seems the US is 'too big to fail'- being the world's largest economy, its currency the world's reserve, and its bonds used throughout the banking system as a proxy for cash - its rating being downgraded casts a long shadow. Economists have judged that the current deal 'falls short of the optimal outcome' and that a downgraded credit rating would hurt, although how deeply remains to be seen. Some lessons could, however, be learned from the past: in 1998, when Japan lost its AAA rating from Moody's, the yen fell less than 1 percent, raising the possibility that global markets may be able to accommodate a change in the US credit rating after all.

Effect in Asia

Already the impact of the debt crisis has been felt in Asia. Currencies such as the Japanese yen have strengthened in turn, as investors looked to the continent as the potential balancer. This is a worry for the Japanese due to fears over the impact on its export sector, leading to Tokyo's decision to devalue the yen. Billions of dollars were also wiped off the stock markets in the aftermath, leading to some analysts to call it as 'flashback to the 2008 recession'.

Elsewhere, the central bank in South Korea increased the amount of gold it bought for the first time in 13 years, citing the need to diversify away from the greenback and towards 'an investment class widely considered a safer bet during crises'. In Singapore, Deputy Prime Minister Tharman Shanmugaratnam has warned of a 'tough 3 to 4 years ahead' with sluggish growth and possible recession expected.

What these events highlight is the persistent inter-dependence of the global economy, with the health of the US economy a critical factor. Japan, still recovering from the consequences of the nuclear fallout in March, can ill-afford to have a trade imbalance to add to its woes. Secondly, the world's reserve currency has lost credibility, with South Korea's actions suggesting an erosion of confidence in the greenback, and a need for stability in the market to prevent further landslides.

The scenario of a financial domino effect worldwide is threatening to become reality. A crashing US economy would not only hurt other individual economies but also have implications for overall global stability. The question is whether there will be alternatives to stem the tide of possible financial disarray.

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