**The global fallout**

By Ishrat Husain | [From the Newspaper](http://www.dawn.com/author/newspaper)

**IN downgrading the US sovereign credit rating, Standard and Poors gave the following reason:**

“The political brinkmanship of recent months highlights what we see as America’s governance and policymaking becoming less stable, less efficient and less predictable…. The statutory debt ceiling and the threat of default have become political bargaining chips in the debate over fiscal policy. …[I]n our view the differences between political parties have proven to be extraordinarily difficult to bridge.”

US politicians have taken the global economy hostage with point-scoring and parochial interests between the Republicans and Democrats. The Republicans wanted to shift the blame on the president and the Democrats for the stalemate on the debt ceiling. The Democrats did not want the Republicans to get all the credit for the breakthrough. The markets did not consider the last-minute compromise credible There are several reasons for the markets to believe this deal will not put the US budget on a sustainable path.

First, the deficit-reduction target should have been about $4tr if stabilisation and reduction in the debt-to-GDP ratio were to be achieved. The compromise deal of $2.4tr is considered inadequate as the debt ceiling debate will resurface in the next 15 months, close to the US presidential elections. The political atmosphere then would be highly charged. The markets perceive the risk of renewed paralysis at that time.

Second, the modalities of this $2.4tr reduction will be decided by a bipartisan committee. The possibility of reaching a consensus solution is low in view of the polarisation between the two camps. While the Republicans want to extend the Bush tax cuts and resist cuts in defence expenditure, the Democrats feel they have gone too far in accepting discretionary expenditure cuts and that further concessions in the core social protection programmes or universal healthcare will hurt their traditional constituency.

Third, the debate of continuing with fiscal stimulus in the short term as opposed to fiscal austerity is inconclusive. Liberal economists argue that in the current circumstances when growth is anaemic, unemployment high and businesses are focused on enhancing their productivity, an early withdrawal of fiscal stimulus would be damaging. Conservative economists believe that to build up the confidence of investors and businesses the government has to demonstrate seriousness in tackling imbalances. The unending debate has contributed to an adverse market sentiment.

In addition to the intransigence of the two parties some additional factors that are beyond the control of US policymakers also impinge. Normally, economic recessions are not synchronised except for the last one in 2008-09. If adverse economic circumstances hit the US, the slack is picked up by the EU and/or Japan and vice versa.

At present, the EU is facing a domestic economic crisis with even reasonably staid economies being affected.

Despite the resolution of the Greek debt crisis, divergence and discord among major EU players do not exude a feeling of comfort. Banks are extremely cautious in extending credit to slow-growing EU economies. Japan, after an extended downturn, is trying to cope with the aftermath of the recent tsunami and is unable to do much for the global economy.

Then, the international commodity prices, particularly spikes in oil prices, do not allow the Federal Reserve to resume quantitative easing. Inflationary pressures are low but likely shocks from price hikes must be factored in and tackled. It is not obvious that the Federal Reserve Board would agree on the need to pursue an expansionist monetary policy. Interest rates having remained close to zero for a long time have aided the corporate sector in raising their profits but have done nothing to stimulate growth or job creation. Further loosening of the monetary policy will hardly reduce the rate of unemployment.What are the consequences of the US setback for the global economy? Stock markets in Asia including Pakistan reacted in unison with the New York Stock Exchange after the downgrading. Investors will remain wary; small investors particularly will make a hasty exit to minimise losses.

The US dollar is the reserve currency of many central banks in Asia. China alone has almost $1tr invested in the US treasuries.

The capital loss, if not contained by policy response, will reduce the value of the stock of the assets of central banks and the sovereign wealth funds of capital-surplus countries. The only redeeming feature is that alternatives to the flight from the US dollar are not many. Cash, gold and commodities have taken the role of a substitute but they cannot match the depth and liquidity of the US currency market.Emerging and Developing Economies tied to the US through trade, investment and financial flows will also suffer. Some can partially bear the burden of filling in the vacuum created by the US but their combined weight is small. To the extent that these countries get affected negatively because of ties with the US their leadership in an economic turnaround role will be less effective.

Pakistan has bilateral official aid and trade ties with the US. Exports from Pakistan are unlikely to be hurt because they cater to the low end of the market. Official aid may be slashed by both political parties in the US. In their quest to find candidates for expenditure reduction, they may penalise a defiant Pakistan for not ‘doing more’ and also save $7.5bn for the budget. The endgame of whether the US will go through a double-dip recession or recover quickly falls squarely on the shoulders of the two political parties in the US. Will it be self-interest or collective interest?

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