Cambridge Economic Pluralism Competition

2. Is the US' political and financial strength good for its domestic economy?

I. Introduction

In this essay, we will separately investigate the impact of political and financial strength on the US domestic economy. There are essential interlinks; in a country with a strong political environment, fiscal policy is implemented prudently, positively impacting financial strength. However, in essence, these are quite different topics. While analysing financial stability, we will look at the benefits of the dollar being the global reserve currency for the US domestic economy and its potential negative impacts on domestic manufacturing industries and long-run exports. We will examine how a high dependence on the financial industry and its instruments can exacerbate inequality and harm future growth. We conclude that the extent to which the US's economic system has grown has become negative for the domestic economy. While looking at the US's political strength we will interpret this in two ways: firstly, its geopolitical influence. We will examine the costs of trying to ensure this influence, particularly excessive debt-financed military spending and its opportunity costs for future growth. Secondly, at its domestic government and how its strength benefits the US domestic economy.

II. The Mighty Dollar

The dollar's influence is vital to the US's financial strength. The U.S. dollar index consists of a weighted basket of six major global currencies, including the British pound, Euro, Japanese yen, and more. It provides a powerful tool to contextualise the dollar's relative strength today compared to a base index 100 in 1973. Currently, it fluctuates around 101 marks, exactly 50 years later.[1] While this makes the dollar seem mundane, its scale of standardisation makes it unique to other currencies. The dollar is the most held reserve currency for international trade and other transactions, making up 59 per cent of global FX reserves.[2] As former French Finance Minister Valery Giscard d'Estaing put it, the dollar acting as the global standard gives the US an "exorbitant privilege":[3]

Firstly, being the global reserve currency makes dollar reserve assets highly sought after due to a perception of reliability. U.S. Treasury bonds are considered the safest assets to hold, so many foreign governments demand U.S. bonds so the U.S. government can issue

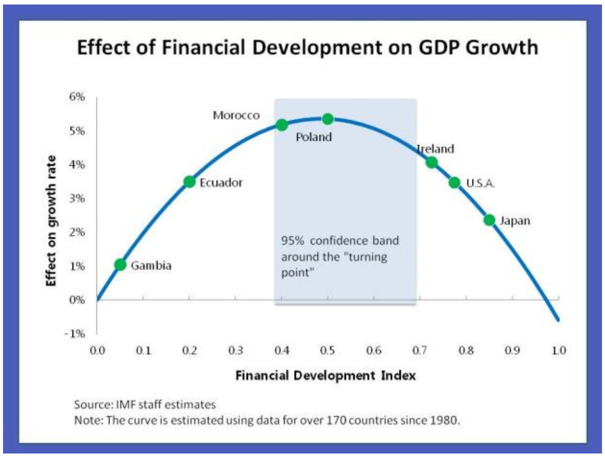
[1] Wayne, D, Forbes (2023)
[2] Siripurapu, A. Noah, B. (2019)
[3] Bernanke, B (2016)

bonds at lower yields. This reduces expenditure on interest payments to other currencies and allows the U.S. to borrow more.[4]

Secondly, the dollar's status mitigates the impact of running a deficit. While the US is 26.5 trillion down in external debt, a large part of US external liabilities is denominated in dollars. In contrast, substantial parts of its foreign assets are denominated in foreign currencies. This means the US gains on its foreign investments when the dollar decreases in value. In contrast, the value of its foreign liabilities, expressed in dollars, is unchanged, improving the NIIP.[5]. As a rule of thumb, a 10% depreciation of the US dollar improves the US NIIP by $1,000 billion.[6] This means that if markets start to worry about the US's substantial debt position and speculation leads to a weaker dollar, the US's problem of excess external liabilities for the US more or less solves itself.

III. The Dollar Dampening Exports,

However, being the global reserve currency has its cons. The US finance sector has 60.5 per cent of the world's total market value.[7] Demand for dollar assets makes imports cheaper for American consumers, leading to trade deficits; in 2023, America imported 758 billion $ more than it exported. As the dollar increases in demand, exports become more expensive, and the domestic US manufacturing industry suffers under the weight of America's financial might.[8] Since (exports-imports) are a component of aggregate demand, over-financialization can impede potential economic growth.



[9] Figure 1

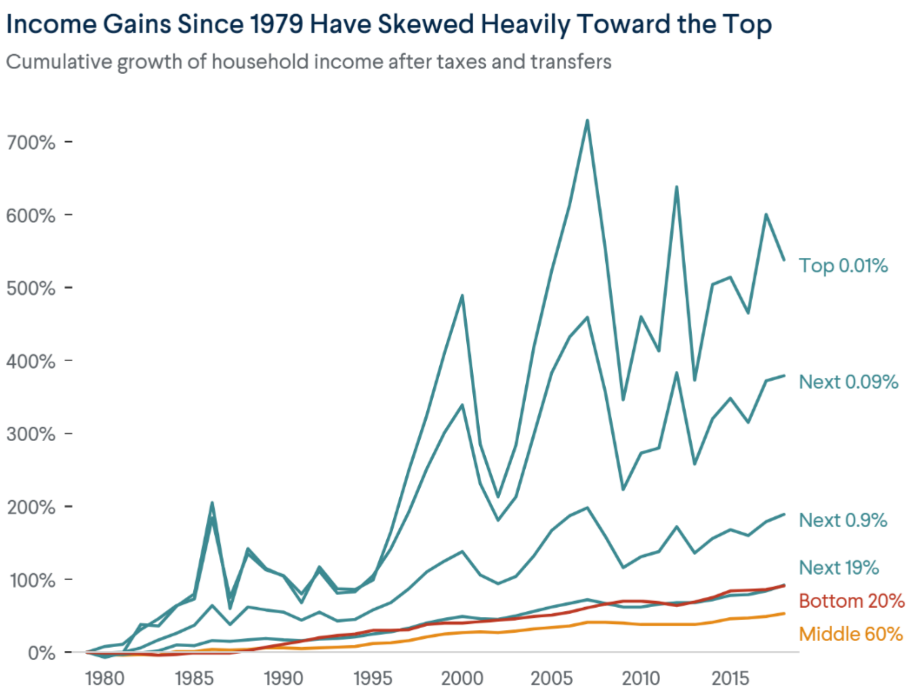
The Financial Development Index measures how much an economy is integrated with its financial sector. Figure 1 shows that improving financial systems benefits GDP growth to an extent; however, the marginal returns diminish after a point over, and the size of the financial markets in the US and Japan, the two largest shareholders of the global financial

[4] Siripurapu, A. Noah, B. (2019)
[5] NIIP - Net International Investment Position. calculated by subtracting a country's total external liabilities from its total external assets
[6] Wim, B, (2017)
[7] Newkeen, R (2024)
[8] Bureau of Economic Analysis (2024)
[9] Abbas, Zaheer, et al.

market at 60.5% and 6.2% respectively[10], are shown to be suboptimal for GDP growth. However, trade deficits provide the benefit of reducing inflationary pressures when unemployment is below 5%, and in the US it is 4.2%.[11] The Philips curve shows how high levels of employment lead to more household consumption that can create demand-pull inflation; the trade deficits help counteract this, ultimately benefiting the domestic economy.

IV. Financial Fortitude Causing Local Gaps

An important consideration is how the US's financial strength can lead to wealth concentration. Income and wealth inequality are higher in the United States than in almost any other developed country, and they are rising. According to the Gini coefficient, household income distribution in the United States was 0.47 in 2022, up from 0.43 in 1990.[12]



[13] Figure 2

Figure 1 shows that the rate at which rising income gains are heavily skewed towards the top earners, especially in recovery post-2008. Milton Friedman once said, "The free market keeps economic power dispersed."[14] This is true, but it is within the confines of a wealth strata. Progressively, the notion of the American Dream, an economy in which you can work hard to make it, has fallen short. Labour mobility is dire for future generations; Harvard University economist Raj Chetty's research found that children in some lower-income areas have less than a 5 per cent chance of reaching the top fifth of the income distribution when starting from the bottom fifth. [15]

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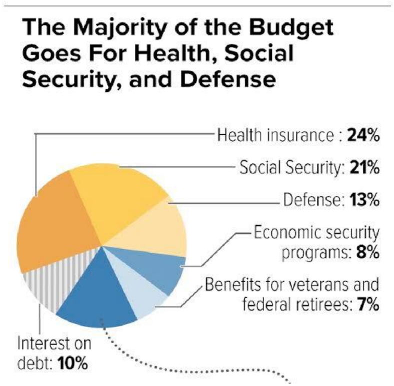
[10] Statista (2023)
[11]U.S Bureau of Labour Statistics (2024)
[12] Statista (Gini Coefficient) (2024)
[13] Siripurapu, A (2023)
[14] Friedman, M (2016)
[15] Chetty, R (2014)

These symptoms are partly due to the nature of the modern US financial industry. The collapse of the Bretton Woods System in the 1970s led to the "near exponential growth of finance and its liberalisation" and a dramatic increase in complexity that made the system susceptible to financial crises.[16] In the aftermath of the 2008 financial crisis, stock markets were first to bounce back with a 164% five-year-rebound for the S&P 500;[17] This provided a swift recovery for the wealthiest 10% of Americans, who hold 90% of stock assets.[18], as reflected in Figure 1. However, the lingering impact of unemployment took a heavy toll on millions of low-income Americans dependent on wages for a living.[19]

This is not just a moral issue; it should be a significant concern for the US economy. Rising inequality transfers income from low-saving households in the bottom and middle of the income distribution to higher-saving households at the top, and this is no slight shift. The wealthiest 1% of Americans (the people who save) account for 30.9% of the GDP.[20] This is strongly reflected in MPC values:[21] In Germany, for every 1% increase in national income, household expenditure increases by 0.71%; in the US, it is 0.35%. This reduces consumption, which compromises nearly two-thirds of US aggregate demand, which can hamper the long-run growth potential of the domestic US economy. [22]

V. Being the Global Superpower Is Costly

One of the main reasons for the US's geopolitical leadership is its legacy of excessive military spending following the events of 9/11. In 2023, military spending reached an all-time high of USD 916 billion, followed by China at USD 296 billion, less than a third of US spending.[23] From a fiscal standpoint, each dollar spent on the military is not spent on other public resources such as infrastructure, health, and social services. The pie chart below illustrates the breakdown of the budget expenditure in 2023.



[24] Figure 3, from the Centre on Budget and Policy Priorities

[16] Coppola, F (2023)
[17] David, B (2024)
[18] Sor, J (2024)
[19] Looney, Adam et al. (2011)
[20] Frank, R (2022)
[21] MPC - Marginal Propensity to Consume
[22] Dinnerstein, M (2021)
[23] Tian, N. Silva, D. (2024)
[24] CBPR (2022)

One billion dollars in military spending would create approximately 11,300 jobs for the US economy compared with 26,700 if it were spent on bolstering education.[25] If the US," An increase or decrease in each item in the chart has different impacts on domestic economic growth. A good measure of this is the *multiplier*. For the defence industry, the multiplier is between 0.6 and 1.2, with recent studies suggesting a lower value. This means a $1 increase in military spending might only lead to a $0.60 increase in GDP growth. On the other hand, long-run infrastructure spending has an estimated multiplier of 1.5.[26]

However, unlike most other segments of budget expenditure, most military spending is financed through debt. The $2.3 trillion "Overseas Contingency Operations following 9/11 were funded by debt, causing a high debt-to-GDP ratio and higher interest rates. The Congressional Budget Office estimates that net interest payments account for 1.4% of the GDP and are expected to rise to 2.4% by 2031. A larger share of the federal budget is spent paying off interest payments, which leads to opportunity costs in other funding fiscal measures. Since the beginning of 2000, US debt as a per cent of GDP has increased dramatically from 35% in 2000 to 95% in 2022, reaching USD 24 trillion. If this expenditure remained at 35% of GDP, total debt would have been reduced by USD 15 trillion.[27] Most of the borrowing has been for military expenses. Higher borrowing leads to increased domestic interest rates, which hurt the domestic economy and stunted growth.

Overall, maintaining global political strength has increasingly negatively impacted the US economy.

VI. Positives of Domestic Political Strength

When considered from a domestic perspective, political strength has a different impact. A strong government executes prudent fiscal and monetary policies, leading to less uncertainty, higher consumer confidence and spending, higher business investments, and higher GDP growth. An unstable political environment shortens policymakers' horizons, leading to sub-optimal short-term macroeconomic policies and increased volatility. Moreover, an unstable political environment can reduce foreign confidence and lower foreign direct investment. The US's credit rating is AA+, with a stable outlook.[28] The inflow of investment into the US produces growth for the domestic economy.

A famous quote from Franklin Roosevelt is, 'The only thing we have to fear is fear itself'.[29] In such an environment, consumer and business spending is reduced, leading to slower growth. From a domestic perspective, a robust political environment is perfect for the domestic economy.

[25] Watson Institute (2024)
[26] Rooney, B. et al. (2021)
[27] Brabenec, R (2023)
[28] Standard & Poors (2023)
[29] Roosevelt, F

VII. Conclusion

In conclusion, the US's global financial strength provides benefits such as the use of the dollar's use as a reserve currency, which allows the US to handle more significant deficits and increase fiscal stimulus to boost the domestic US economy. However, we have found that the extent to which the US's financial industry has grown is detrimental to overall US GDP growth—especially considering how this has harboured an increase in wealth concentration, which leads to more savings that dampen the circular flow of income in the US economy. Regarding political strength, we have concluded that the US's high expenditure to ensure a geopolitical power position can heavily impede domestic growth. Moreover, the use of debt to finance military spending further increases the prominent burden n of interest payments on the government budget. In contrast, we found that domestic political strength will likely lead to positive domestic economic growth.

(1825 words, no use of AI)

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