

America's War-Torn Economy

by Joseph E. Stiglitz

NEW YORK – Some say there are two issues in the coming American elections: the Iraq war and the economy. On days when the war seems to be going better than expected, and the economy worse, the economy eclipses the war; but neither is faring well. In some sense, there is only one issue, and that is the war, which has exacerbated America's economic problems. And when the world's largest economy is sick – and it is now very sick – the entire world suffers.

It used to be thought that wars were good for the economy. After all, World War II is widely thought to have helped lift the global economy out of the Great Depression. But, at least since Keynes, we know how to stimulate the economy more effectively, and in ways that increase long-term productivity and enhance living standards.

This war, in particular, has not been good for the economy, for three reasons. First, it has contributed to rising oil prices. When the United States went to war, oil cost less than \$25 a barrel, and futures markets expected it to remain there for a decade. Futures traders knew about the growth of China and other emerging markets; but they expected supply – mainly from low-cost Middle East providers – to increase in tandem with demand.

The war changed that equation. Higher oil prices mean that Americans (and Europeans and Japanese) are paying hundreds of millions of dollars to Middle East oil dictators and oil exporters elsewhere in the world rather than spending it at home.

Moreover, money spent on the Iraq war does not stimulate the economy today as much as money spent at home on roads, hospitals, or schools, and it doesn't contribute as much to long-term growth. Economists talk about "bang for the buck" – how much economic stimulus is provided by each dollar of spending. It's hard to imagine less bang than from bucks spent on a Nepalese contractor working in Iraq.

With so many dollars going abroad, the American economy should have been in a much weaker shape than it appeared. But, much as the Bush administration tried to hide the true costs of the war by incomplete and misleading accounting, the economy's flaws were covered up by a flood of liquidity from the Federal Reserve and by lax financial regulation.

So much money was pumped into the economy and so lax were regulators that one leading American bank advertised its loans with the slogan "qualified at birth" – a clear indication that there were, in effect, no credit standards. In a sense, the strategy worked: a housing bubble fed a consumption boom, as savings rates plummeted to zero. The economic weaknesses were simply being postponed to some future date; the Bush administration hoped that the day of reckoning would come after November 2008. Instead, things began to unravel in August 2007.

Now it has responded, with a stimulus package that is too little, too late, and badly designed. To see the inadequacy of that package, compare it with the more than \$1.5 trillion that was borrowed in home equity loans in recent years, most of it spent on consumption. That game – based on a belief in ever-spiraling home prices – is over.

With home prices falling (and set to continue to fall), and with banks uncertain of their financial position, lenders will not lend and households will not borrow. So, while the additional liquidity injected into the financial system by the Fed may have prevented a meltdown, it won't stimulate much consumption or investment. Instead, much of it will find its way abroad. China, for example, is worried that the Fed's stimulus will increase its domestic inflation.

There is a third reason that this war is economically bad for America. Not only has America already spent a great deal on this war – \$12 billion a month, and counting – but much of the bill remains to be paid, such as compensation and health care for the 40% of veterans who are returning with disabilities, many of which are very serious.

Moreover, this war has been funded differently from any other war in America's history – perhaps in any country's recent history. Normally, countries ask for shared sacrifice, as they ask their young men and women to risk their lives. Taxes are raised. There is a discussion of how much of the burden to pass on to future generations. In this war, there was no such discussion. When America went to war, there was a deficit. Yet remarkably, Bush asked for, and got, a reckless tax cut for the rich. That means that every dollar of war spending has in effect been borrowed.

For the first time since the Revolutionary War, two centuries ago, America has had to turn to foreigners for financing, because US households have been saving *nothing*. The numbers are hard to believe. The national debt has increased by 50% in eight years, with almost \$1 trillion of this increase due to the war – an amount likely to more than double within ten years.

Who would have believed that one administration could do so much damage so quickly? America, and the world, will be paying to repair it for decades to come.

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