

## **The Role of the U.S. in the Global Economy**

Garrett Roberts, Bala Maniam, James Bexley

### **Abstract**

*The American economy has had large amounts of influence globally for many years. In this study the recent events in the world market are examined alongside past and present trends and events in American history in an attempt to gauge the influence the U.S. has on the global economic stage. Also studied are the major account surpluses and deficits of the economies in America, China and Japan to illustrate the role these factors have played in the current market situation. This study will also analyze the trade relationships between these markets in an attempt to solidly establish if the U.S. economy is keeping pace with, or slowing down in relation to, a non-stop world market that has based its currency on the value of the American dollar and tailors its supply trends to the demand needs of the U.S.*

### **Introduction**

Is the U.S. economy losing its momentum as a global player? The global economy is in a phase of having growing sectors, while experiencing overall market shrinkage with the United States at the epicenter of the crisis due in part to large market imbalances. The concept of the “Modern Recession” (Hall, 2007) will be used to illustrate the unemployment rates and address past and present monetary policy as the recession in America is displaying factors that are not commonly associated with an economic downturn.

Even in the midst of a deep economic recession America plays, and will continue to play, an important role in the world market that, as a whole, is also in a recession. The current state of the market in the United States and its progression on a long-term, global scale will be studied from various angles through scholarly research and trends to assess the current standings of the market. The major account deficits and account surpluses of the key world players have created huge imbalances that are being credited with at least partial causation of the current market condition of our world today. In addition, the economies of several world leaders, specifically

China and Japan, will also be taken into consideration. The trends of their economies, affects of their major account surpluses, and comparison of the amount of influence each has, or has had, in the global economy will be accessed. By taking into consideration all the information gathered, it will become clear whether or not the U.S. will continue to play a vital role as a leader in global economics or fall behind and let another nation take its place

### **Literature Review**

Prasad (2010) studied the current state of the world economy and the various positions of several world leaders. He noticed in 2009 that the world economy seemed to be on course for an irreversible economic decline, but may have been saved due to the natural strength of independent nation-states and some healthy rations of stimulative fiscal and monetary policies.

Subramanian (2009) took into affect all the interconnections of small industries and national economies while looking at the global financial crisis of 2008. He noticed that as these systems went through phases of growth and decline, they created long, wave-like cyclical patterns as their trends were traced. Thus, illustrating the changes in power and influence of any given regime over time.

As a result of research and testing, Caballero, Farhi, and Gourinchas (2008) concluded that the world financial crisis had its origins in a global scarcity of assets, which led to large amounts of capital being drawn towards the United States. This relocation explains the “boom” in U.S. asset markets, and also the decline in real world interest rates. The affect of the decline caused the value of foreign investments in America to fall, while increasing the deficit and overall global imbalance.

Hall (2007) discusses the concept of the Modern Recession - the relation to productivity, employment and monetary policy. He observed the interesting fact that in this type of recession

the rise in unemployment does not occur with a major increase in job loss or noticeable fall in economic productivity. Hall also makes the comparison between modern and old fiscal policy and came to the conclusion that the outdated policies of the Federal Reserve not only caused recessions, but held rates high for long periods of time. In turn, extending the measurable economic slump.

Lee, Peek, and Rensel (2008) analyzed the idea of the “New Economy” which refers to the increasing move of massive amounts of technology and the Internet. This term is also used to suggest that the innovations in communication and information technologies, or globalization, changed the way the world market operates and the speed at which it moves. They concluded that the issues the new economy supposedly alleviated by increasing communication and access to information failed to solve or address certain issues in some aspects. It also created, some completely new and unique problems that would be associated with information globalization (i.e. technological bubbles and difficulty in real-time information forecasting).

Reuvenly and Thompson (2001) the authors dissected and tested the leading sector and leading economy concepts concluding that the United States was still currently the leader in both. In their research, the data showed that the economy in the U.S. exerted strong forces and had noticeable effects on the global economy due to the large share of world imports, exports, and foreign investments. These affects were even stronger when looked at in combination with its role as leading sector in technological innovation.

Chase, Jorgenson, Reifer, and Lio (2005) discuss the possibility for the technological innovations in the United States to bring about a new term of economic leadership and renew its predominance in the global market. They believe that the previous investment bubbles served as

protection for the new lead industries, allowing those that survive to become a platform for market growth.

Corden (2009) discusses that from 1997 until 2005 China's currency, the Renminbi, was fixed to the dollar until a new regime was created and allowed the RMB-dollar rate to appreciate. Corden believes that if the rate of Chinese currency were allowed to float and appreciate more, its high account surplus as well as the U.S. account deficit would be reduced. Due to the intervention in the exchange rate it is believed that China's large surplus was an integral part of the equation in causing the high deficits in the United States' current accounts.

Yoshida (2006) shows in his research that for the past several decades the United States and Japan have been essential trade alliances with the East Asia economies. Japan's role in this trade agreement has been mainly seen as an exporter to these countries (i.e. – Indonesia, Philippines, Thailand, etc.), but the U.S. has been a crucial destination for the exports of these Asian countries. Also, it was discovered while continuing to develop the idea of triangular trade that the more Japan exports to China, the more China exports to the United States, thus illustrating the trade relationship between these three key players.

### **The World Economy, Setting the Stage**

In the end of 2007 through the beginning of 2008, the world market entered into a deep and turbulent recession believed to have had a starting point in America, that would eventually and quickly spread to even the farthest reaches of the global economy. The world economic meltdown has foundations set on long-term financial decisions made during the second phase of market globalization with the United States as the lead advocate. Also proven in the global account imbalances, insufficient regulatory systems, and failures in said regulatory systems. As a result, all across the globe the concept of globalization has integrated the financial markets with

the product markets, interconnecting nations and economies like never seen before. While globalization is seen to have obvious benefits, it has also been suspected to cause financial calamity with increased frequency along with furthering the reach of monetary crises.

This crisis is believed to have begun greatly in part by the global imbalances that have been accumulating mainly between the leading nations such as the United States, China, and Japan over the last decade of economic activity. In March of 2009, unemployment rates across the globe were on the rise with predictions for the trend to continue seeing the European area currently at seven percent unemployment with the expectation to rise to over ten percent by year-end. During this, overall time unemployment in the U.S. was at six and a half percent and still rising. The situation in Japan is showing the highest unemployment figures since World War II. In response to the world situation, a nine percent decline in global trade volume is forecasted during the 2009 fiscal year. As a result of this decay, the world economy is set to see its first contraction in sixty years or more at an expected rate of half to one percent.

In 2008, the American economy experienced an astounding six percent of contraction. At the end of 2008, it was believed to be the largest waning in thirty-five years; similarly seen in the European area with a record contraction of one and a half percent (Subrahmanyam, 2009). With the highest rates of economic contraction and unemployment the U.S. clearly took a hard hit that would have collapsed a less resilient market with a smaller share of the GDP. Traditionally the measure of gross domestic product, GDP, illustrates the market size of a nation by taking into account the total net worth of all monetary transactions, services, and goods that take place during a fiscal year, combining demographic size and economic development (Chase-Dunn, 2005). Even in the midst of such information, the United States GDP is showing to be positively associated with that of the world's GDP. Pointing directly to heavy U.S. economic

growth influence on that of world economic growth through leading and secondary market sectors (Reuveny, 2001). Currently, the markets in continental Europe seem to be recovering with surprising promptness, especially France and Germany, but they are not expected to record high growth. However, emerging markets such as China, India, and other East Asian markets are a completely different story seeing as their economies are showing incredibly high growth rates even after their markets had seemed to come to a standstill in the end of 2008. With emerging markets seeing the return of private cash flows, global trade is beginning to return to levels that were being seen before the onset of the crisis in 2008. With these occurrences, business and consumer assurance in the market position are returning and allowing the stalled world economy to restart the process of moving forward (Prasad, 2010). The impact of the Asian markets showing such high growth rates while America struggles to show positive growth rate could mean that the United States could be losing ground as the Dominant market of the world, or could simply mean that it experienced the hardest economic impact in this modern recession.

### **The Modern Recession**

After analyzing past recessions, a trend was noticed when an economic recession occurred, an increase, or spike in job loss was seen as the unemployment rate was rising. It was concluded that this unemployment increase was due to the combination of workers becoming unemployed from exiting the workforce at a normal rate and those that were currently unemployed experiencing more difficulty in finding new jobs (Dell 2004). A modern recession is characterized by some abnormal factors such as an increase in unemployment without considerable change in the rate of job loss and without an easily detectable change in productivity levels. This type of economic recession generally occurs in a market with a sound

execution of monetary policy and a large percentage of the workforce outside of the factory floor. When unemployment increases due to the fact that new jobs are more difficult to procure as opposed to the common way of thinking, it is due to a large amount of workers losing their jobs. The stream of workers losing their jobs remains relatively the same, as does the flow of workers getting hired into new positions, but the amount of the workforce without a job increases since they are much more difficult to acquire and sustain (Hall 2007).

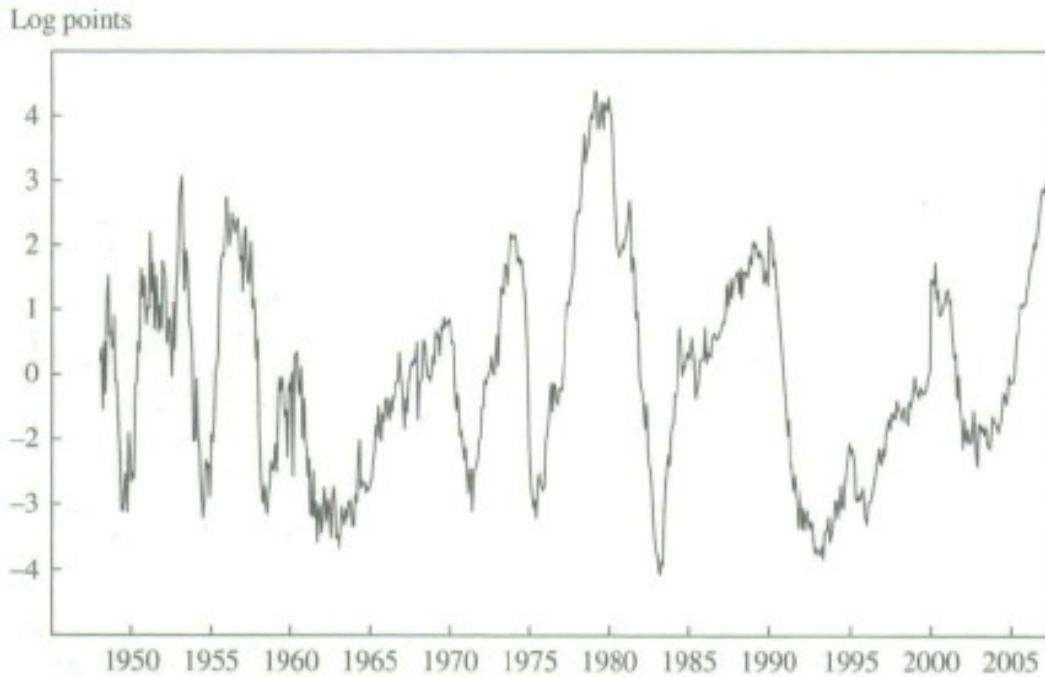
Research shows that during a modern recession, as in all recessions, the sectors in the labor markets relax and the opportunity for new employment tightens down to a drastically smaller percent. These facts are exemplified in the recession of 2001 where researchers noticed a severe drop in quantity of help-wanted ads placed in local newspapers. They also saw a drastic reduction in job openings that employers were seeking to fill across all seven-labor sectors, even in government employment. The United States economy has experienced a modern recession twice in the last twenty years. The first occurred during the 1990-1991 recession where a deviation from the employment trend of roughly five percent overall was seen. The second during the “dot.com” crash in 2000-2001 where the result was a deviation from the employment trend of only 2.61 percent, as you will see in Figure 1 (Hall, 2007).

In the table below, we see that although a modern recession may include drawn-out periods of economic growth that are below the trend norm, employment volatility in the workplace market does not decline as has been seen overall in earlier economic times known as “The Great Moderation.” This is where the market in America saw a widespread decrease in economic unpredictability during the most recent decades. In reaction to the two most recent financial calamities, the Federal Reserve answered with the textbook response of cutting the interest rate in an aggressive fashion as soon as recession indicators in the market place became

apparent (Semoon, 2010). Now, the world is experiencing the modern recession concept and learning of the pitfalls of navigating this unique financial crisis. Nations that would normally respond independently are seeing their actions improve the local situation but adversely affect other global economies where they have a financial stake causing their investments to be at severe risk to becoming devalued (i.e. – the large financial investment China has in the American economy and the effects of China’s large surplus on the value of the currency in the United States that will be discussed later.)



## Deviation of Employment from Trend



Source: Author's calculations using Bureau of Labor Statistics data.

a. Data are monthly. Deviations are the residuals from a regression of log employment on a cubic polynomial in time.

**Table 1. Employment Declines Associated with Post-World War II Recessions<sup>a</sup>**

<i>Previous peak in detrended employment</i>	<i>Trough in detrended employment</i>	<i>Decline in employment (percent)</i>
1981:4	1983:1	5.74
1990:1	1993:1	5.04
1973:11	1975:6	4.38
1960:6	1963:2	3.02
1969:8	1971:6	2.99
2001:1	2003:9	2.61
1979:2	1980:8	2.58
1953:3	1954:7	2.21
1957:7	1958:7	2.15
1948:6	1949:10	2.13

*Figure 1.* Illustrates the total deviation from the employment trend for the period dating 1948 until 2007. Also, Table 1 shows the declination in employment percent for each of the last ten recessions over the span of sixty years.

## **The American Situation**

The U.S. economy has endured four serious economic recessions over the last one hundred years. The first being The Great Depression, followed by the Crash of 1987 and the Dot.Com Crash of 2000 and finally bringing us to today with the Sub-Prime Crisis in the end of 2007 setting into motion the global financial crash of 2008. The Great Depression was caused by a twenty three percent crash of the Wall Street stock market over a five-day period in October of 1929 (Subrahmanyam, 2009). By 1932, ninety percent of the value of the current shares had reached near zero leading to a complete financial meltdown and eventually the shut down of the entire banking system in 1933. With the entire American market in financial ruins unemployment rose to a staggering one-third of the labor force and the real economy declined by half.

The second instance was the Crash of 1987 that was brought about by a twenty-two percent drop in the Dow Jones Industrial Average on October 19, 1987. With an already slowing economy and Americans beginning to worry about the value of the U.S. dollar combined with rampant speculative rumors of large corporation takeovers and mass amounts of insider trading taking place it was only a matter of time before financial crisis took hold as it did on that day in October (Subrahmanyam, 2009).

In the late nineties, a fresh breath of air arrived in the United States market known as a 'new economy' on the wings of the rise of Internet companies. Over the last one hundred years America has seen three major jumps of technological change. The first being the manufacturing rise of the 1890's, the second being the surfacing of national corporatism and mass-production in the 40's and 50's, and finally the rise of the technology industry and the surge of entrepreneurialism in global internet services in the 90's. The term 'new economy' as stated

earlier describes the shift towards the massive use of the internet and information services since 1995, being considered “new” since most every corner of the globe has begun to utilize these technologies and create additional dimensions in their markets (Lee, 2008).

In March of 2000, the technology bubble that was caused by tech-stock knowledge gaps burst and led to a decrease of stock value of almost eighty percent by October of 2002. As a result, the terrorist attacks on September 11, 2001 in New York, Washington D.C., and Pennsylvania added to the investments in business declining while the market slowed to nearly a crawl (Brenner, 2009). In response to both the Crash of 1987 and the Dot.Com Crash of 2000, the Federal Reserve responded by cutting the Federal funds rate drastically to stimulate growth and recovery for that period of time. With the Dot.Com crash the rate was cut down so severely that it took the current rate of six and a half percent and lowered it to a desperate one percent before the economy began to show signs of responding and beginning the process of recovery.

Unfortunately, this same process would also lay the foundation for the global financial crisis of 2008. With cheap labor available and the current low interest rate policy, there was no drive to invest in the upcoming technology sectors, leading instead to a housing expansion boom that helped maintain a moderate growth rate for a lengthy period of time. People began to develop fears of not being able to afford purchasing a home and a rash outbreak of home buying began, even for individuals for whom a house was beyond their ability to afford. This policy of banks lending up to 120 percent of the purchase as collateral quickly became the norm, as opposed to the exception, and soon these sub-prime lending practices reached over twenty percent of monetary lending in the American market (Subrahmanyam, 2009). Another practice that became a norm in the lending community was originating split loans. Instead of authorizing one loan, lenders would originate two separate loans, one for eighty percent of the desired value

and a second for the remaining twenty percent. By splitting the loan into two separate entities originators attempted to ensure that if a borrower defaulted on their loan then the investor would still receive part of their capital (Gerardi, 2008). In large part, these high-risk mortgages were gathered together and securitized into Collateralized Debt Obligations, CDOs, then sold to investors all over the world. Far removed from their point of origination, the investors purchased these CDOs with very little knowledge of the quality or steadiness of their cash flows. Once homeowners began to default on their variable rate mortgages, with payments climbing so high that few could afford, uncertainty began to surround the CDOs causing the investors required rate of return to increase and the eventual selling off of many of this type of investment. By authorizing high numbers of such loans numerous large banks were on the run into the red, in a market that had become extremely volatile. Between systematic risk, rising risk correlations, and herd behavior the American Sub-Prime Crisis led the U.S. economy to disaster and the eventual implosion of the global financial market in 2008 (Caballero, 2008).

Currently the United States of America is the largest debtor nation in the history of the world, and these enormously high levels of debt could cause global instability in years to come. In 2009, America had a documented budget deficit of \$1.4 trillion dollars with China holding a staggering \$797.1 billion dollars in U.S. Treasury notes, while Japan held \$731 billion. Together, these two key players in the global market held 44.3% of the total \$3,448.8 billion dollars worth of foreign purchased U.S. Treasury Securities. To put the investment figures of China and Japan in perspective, other major U.S. debt holders are the United Kingdom holding \$225.8 billion dollars worth of investments and Russia holding \$121.6 billion dollars; small shares in comparison to the two Asian market leaders (Chang, 2010). It has been studied and

reported, that for a lengthy period of time the U.S. has been the driving force and the dominant economy of the world.

It has been considered the economy of first resort, due to the consumption of intermediate and final products. In addition, America's financial stability and large pool of available capital for investment and its sizeable amount of trade with sophisticated product manufacturers make its market the first stop for growing companies looking to invest (Hallett, 2009). But, in the midst of these troubling financial times, it is forecast that the American market still has a long, difficult road ahead in returning to a decent growth rate. There are major obstacles standing in the way of the U.S. market recovery such as a weak commercial real estate sector, feeble consumer demand, and an ever-rising unemployment rate. Fortunately, there is still a large amount of government stimulus money working its way into the economy that could potentially aid in strengthening the commercial sector and reassuring consumers in the market place that better times are ahead (Prasad, 2010).

However, if the United States is incapable of getting its astronomical budget deficit under control, and decreasing the amount of borrowing it does from other countries, disaster could be in the cards. In the short run, benefits could be seen such as the continued increase in exported products, the decrease in the ever-growing government debt and the continued ability to borrow in U.S. denominated currencies. In the long run, the trouble becomes apparent. Inflation will begin to rise sharply as the cost of importing products increases and eventually the value of the dollar will reach a point that the world market will quit buying U.S. Treasury securities. Which will result in the selling off of current holdings in favor of other, more valuable investments. If this process were to reach full speed, the ability to change course without risking a world recession remnant of the 1929 crisis in the United States would be impossible. Looking ahead,

the environment could be prime for a financial recession world economist's fear, the devaluation of the U.S. dollar, forcing an agonizing economic alteration for the economies of the world.

### **The U.S.-Chinese Relationship**

The economic relationship between the United States and China has been turbulent, yet vital. For a period of roughly seven years, beginning in 1997 and ending in 2005, the Chinese Renminbi (RMB) was fixed to the U.S. dollar. After a new regime came to power in July of 2005, the RMB-Dollar rate began to show signs of appreciation and at the close of the 2007 fiscal year there was an estimated, cumulative appreciation of nine percent (Corden, 2009). When distinguishing between a fixed and floating exchange rate, the differences are as follows. A fixed rate is a protocol for the exchange of international currencies where a country's currency value is affixed, or matched, to the value of a more reliable, sturdy currency. A floating exchange rate is where a country's monetary value increase and decrease according to foreign exchange market rates.

Back to the RMB, the small increases that were seen in the rate were looked at as insufficient by American critics because they believed if the RMB were set on a floating scale there would be substantially more appreciation. Subsequently resulting in the reduction of the current account surpluses in China and high deficits in the United States. Many scholars believe that by intervening in the Chinese exchange rate the government had a hand in causing the overall account deficit of America (Corden, 2009). Considerable nations like the gulf oil exporters, Japan and China, put a policy into affect of purchasing U.S. debt with their surpluses in net product exportation helping to finance the American deficit (Subrahmanyam, 2009). China is considered to be one of the largest surplus economies in the current global market

following the European Union, the United States and Japan. In Figure 2, we see the percentage of world GDP that the Chinese account surplus represented from the year of 2000 until 2008 (Corden, 2009).

*Figure 2*

China: Surplus on Current Account % of GDP	
Year	% GDP
2000	1.7
2001	1.3
2002	2.4
2003	2.8
2004	3.6
2005	7.2
2006	9.5
2007	11
2008	10
Source. International Monetary Fund, World Economic Outlook, April 2009.	

As you can see from the table above, China's surplus alone accounts for ten percent of the overall world GDP illustrating the sheer size of their account excess.

The effects on trade in relation to China's account surplus are that the price and amount in exportation of labor-intensive products has declined, falling in relation to the American imports price level. Also, the economy of first resort stigma and U.S. market dominance were showing signs of declining slowly with respect to Chinese economic influence until 2002. Surges in trade volume between the markets have played a major role in helping to restore United States influence on the Chinese economy. The belief that China has achieved greater influence through trade expansion arrived with some costly conditions, such as the short-term financing uncertainties, bubbles in asset markets, excess liquidity and the high risk of market

inflation (Hallett, 2009). Leading research indicates links between these two economic giants may have weakened in some aspects and strengthened in others.

The trade relationship with the U.S. is considered to be much more complex than previously understood (Hallett, 2009). To many peoples surprise, it is becoming apparent that the U.S. still has the ability to influence the shape of the business cycle in China through its control and management of financial and monetary conditions (dollar denominated exchange rates, interest rates, and supply of investment capital). It is also being seen that China is able to project “spillover effects” into the U.S. market, effectively controlling the monetary size of the business cycle through influence over cheap intermediaries, product components and the control of outsourcing manufacturing processes (Subrahmanyam, 2009).

Studies of American demand for components and intermediate inputs combined with the Chinese need for capital and raw materials have concluded that presently the U.S. is set to lead markets in the Chinese economy by about three quarters (or nine months). This lead-time was shown to decline from 1992 until 1999, becoming unsteady from 2000 until 2003, but recovering to the full value in 2005. When this study is observed from the opposite angle (China to U.S), China is recorded to have a minute lead of one month for non-financial cycles and none at business cycle lengths. Essentially, changes in the U.S. market will be seen right away or up to a month later in China (Hallett, 2009)

The amount of bank-backed financing spikes in China may have adversely influenced the Asian market by encouraging growth-by-investment as opposed to growth on the back of the creation of new employment. If the housing industry and employment sectors do not continue to grow at the same rate of the country’s output growth rate, the Chinese market could be seeing a trend of asset market bubbles bursting and massive deflation of manufacturing processes. Not to



mention the effects on the equity, consumer and commercial real estate markets. China continues to rely heavily on their exports to the United States, and other leading importers, to generate employment opportunity and produce profit from the surplus in product output. Results from this investment inspired growth trend that cannot be paid down by household domestic demand (Prasad, 2010).

### **What could this mean?**

Currently the world economy is on the tail end of a recession that is believed to have begun in the United States with the housing “boom” that resulted in the Subprime Crisis in 2007. This meltdown is considered to be the fourth of what we understand to be a serious financial crisis. The same extremely low interest rate that made the housing rush possible, combined with the availability of cheap labor, led investors to the housing industry as opposed to the growing technology sector. Large mortgage firms began authorizing high-risk home loans, with capital they did not have, for buyers that were nowhere near qualified, then sold them to investors all over the world in CDO packages.

When the new homeowners were no longer able to afford their payments, banks were forced to foreclose and sell the property for a loss, leaving the financial institution in the red and seriously devaluing the CDO investment, causing numerous investors to sell their holdings. With the U.S. financial system near shambles and unemployment on the rise, the Federal Reserve acted with the predictable response of undercutting the interest rates in an effort to encourage consumers to spend money. This action was also in the attempt to persuade the investment of foreign and domestic businesses in the American market and jumpstart the economy.

With the market of the still recovering U.S. beginning to show positive growth indicators, it still does not compare to that of other superpower nations, such as Japan and China. The economies in these two countries are showing astounding growth rates and are moving forward carrying large current account surpluses while the United States continues to take on debt. These uneven account balances are due to the fact that they have been in the practice, along with other Asian and Gulf countries, of investing the surplus of their net exports in dollar denominated securities financing the ever-growing U.S. deficit, the largest holder of U.S. debt being China.

As the information shows, America and China (leading economic competitor) have a complicated, yet reciprocal relationship. China relies on the U.S for the capital to fund their growth, provide jobs, and raw materials to supply their production processes. The U.S. relies on China for primary and secondary product imports and investment in government debt. Each of these nations is able to influence the other domestic economy through trade interaction and also has a substantial amount of economic influence on the global stage.

With the current amount of U.S. account deficit, it cannot continue at this rate for much longer. If the debt situation were to continue to a point that it causes the value of the U.S. dollar to drop drastically, America would be headed to a financial state it has never seen before. The reduction of the dollar value could prompt foreign holders of U.S. securities to sell their holdings in favor of more valuable investments. This would trigger an even steeper drop in the dollar value. Once reaching this point, it would become necessary for the world to find a new standard currency. American citizens would be exposed to tremendous inflation rates, complete the devaluation of any dollar denominated securities and allow another nation to step in place as the engine for growth in the world market.

### **Summary and Conclusion**

The current global market place is turbulent and risky no matter what view point is taken. For decades the United States has been a major driving force for growth and investment and the place to look for venture capital. With an enormous budget deficit and the continued need to rely on debt financed growth, America could be slowing down and losing its stance on global economic influence. As of now, the U.S. economy still shows evidence of substantial influence in the tides of the ever changing world of economic interaction, even in the shadow of a far reaching housing and banking crisis.

However, with impressive growth rates and broadening of trade markets, China and Japan are quickly becoming markets to contend with. Their influence over global economics increases on a daily basis and if asked if the United States is losing its momentum in the global market the answer would be, "it's complicated." The U.S. economy is resilient, but if foolish decisions keep being made in relation to budget deficits and national debt, no amount of help will save the status of the market, or the value of the dollar, resulting in the end of times for American influence in the global economy.

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