

## America Still Rules

**Why The United States will come out of the crisis on top.**

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The recovery is here, tepid and uncertain as it may be. It may not feel much like one yet, especially in the U.S. and many parts of Europe, where trade is still moribund, foreclosures are rising, and unemployment is high. Yet both the IMF and the OECD, which have been cautious in their predictions this past year, say an upturn—however modest—is in sight. This month the IMF increased its global growth estimate for next year from 2 percent, which it projected in April, to 2.5 percent. And the OECD revised its growth projections for rich countries upward for the first time since the crisis began. Fears about a collapse of the international financial system have abated, and despite continued protectionist pressures, there's reduced concern in government circles that the world will descend into a 1930s-type calamity.

Although the upturn in the U.S. may be coming quicker than in most other countries, it is unlikely to be strong enough to be the locomotive for global recovery, as has happened in past recessions. If any country can accomplish that, it would have to be China, where growth is humming along at 7 percent at least. The fact is, America's economic house is still far from being in order; despite stronger profits at banks like Goldman Sachs and JPMorgan, there are dozens of other giants, most notably Bank of America, CIT, and Citigroup, that are foundering. There are still billions of dollars of toxic assets on the books, and the reshaping of the country's Balkanized regulatory structure has barely begun. Unemployment is nearing 10 percent (20 if you count desperate part-timers and people who've stopped looking), foreclosures are up, and trade is still contracting. Virtually all the individual states are running deficits, and many, such as California, Michigan, and Florida, are in dire circumstances and will remain that way for a few years at least.

So how, then, is America leading the recovery? Not by economic force, but, amazingly, by political circumstances. This is ironic because the Washington–Wall Street axis, that bastion of Anglo-Saxon capitalism, has been pilloried around the world these past 18 months. French President Nicolas Sarkozy and German Chancellor Angela Merkel have pronounced the end of the dominance of Anglo-Saxon capitalism, and a bevy of top Chinese officials, such as Vice Premier Wang Qishan and Central Bank governor Zhou Xiao-chuan, have scolded the U.S. for its profligacy. Even highly respected Americans such as Roger Altman, deputy secretary of the Treasury in the Clinton administration, have been pronouncing the end of U.S. financial

leadership. The fact, however, is that Washington acted quickly and decisively to save the global economy from collapse (even if it was responsible for the mess it had to clean up).

Moreover, despite the horrendous challenges that President Obama faces, he is indisputably the most impressive leader around, more secure, more articulate, more politically savvy than any of the others. British Prime Minister Gordon Brown is being savaged at home and is close to being a lame duck. Japanese Prime Minister Taro Aso is limping toward early elections he has just called for Aug. 30. The German chancellor is also facing an imminent election and has been too vocal in opposing the stimulus the world desperately needs, and France's president is too inconsistent and too mercurial to be effective on the international scene. This leaves only China, where growth is strong and the banks are flush with cash. But President Hu Jintao has no aspiration to be a global leader, and the world is still years away from thinking about a Chinese head of state in that role.

Washington's new clout is in large part due to the fact that there were capable hands on deck during the crisis. Despite the trashing that Congress recently gave to former Treasury secretary Hank Paulson, on the grounds that he acted too independently or too arrogantly, and despite some mistakes of the team of former president Bush, such as the failure to rescue Lehman Brothers, credit does go to Paulson and Federal Reserve chairman Ben Bernanke for swift and bold action in the face of a tsunami of uncertainties, a president with one foot out the door, and a hostile Congress. Today the world has considerable confidence that the Obama administration, including Treasury Secretary Tim Geithner, White House economic adviser Lawrence Summers, and Bernanke, will pursue sensible policies. Their cautious handling of regulatory changes (which are easy to get wrong) has left investors more relaxed than they would have been had there been a -Sarbanes-Oxley-type regulatory response. Moreover, had the crisis erupted when the Bush team of Treasury Secretary John Snow (who had virtually no financial experience) and Fed chairman Alan Greenspan (who bears much responsibility for the free-market fundamentalism that led to this catastrophe) was in charge, the world might look at the prospect of American leadership quite differently now.

The Obama administration is also helped by the fact that the world is hungry for leadership in the face of so much uncertainty. It is ready to cheer any progress, even if that is defined as just the slowing down of bad trends. The global economy will still face strong headwinds. But on the basis of a recent round-the-world trip during which I spoke to numerous business leaders, I believe that there is a strong perception in Europe, Asia, and Latin America that the right hands are on the wheel. Despite all the demands for more state intervention to prevent another crisis, and the questioning of the Anglo-Saxon model of capitalism, American leadership and full-throttle Anglo-Saxon-style markets may in fact be just what the world wants. It was this system, after all, that characterized the past 30 years of global prosperity. Europe, as well as big emerging markets such as China, India, Brazil, Mexico, and Turkey, all benefited tremendously from the status quo ante when money was cheap and trade was booming. They may understand that it would be difficult to go back to those times, but they have no other vision in mind and so would prefer to stay with the American model to the extent that they can, despite the "Bash America" political rhetoric that is necessary for hometown consumption. And they may be wrong, too, because without deep structural changes—such as the reduction of major trade and financial imbalances between the U.S. and China—another crisis could be around the corner.

But for now, government and business leaders are really not preoccupied with this problem. So, what's next? There are two major imperatives for the U.S. to maintain its reemerging leadership and steer the global ship in a direction that will make it more stable.

The first imperative is for President Obama and his economic team to show they are serious about dealing with the trillion-dollar-plus deficits that loom for at least the next decade. So far they have not done this, even though they mouth the words. Yet such an effort is critical from both an economic and a political standpoint, because it's key to calming growing concerns in markets about future inflation and the erosion of the dollar's value—concerns that could easily become reality.

To be credible, the administration would have to create a framework for fiscal discipline of the kind that does not exist in any shape or form now. That would mean setting public targets, endorsed by Congress, for various economic metrics. I'll leave it to the economists to decide which metrics should be used, but examples include the budget-deficit-to-GDP ratio, the national public debt to GDP, and debt service as a percentage of public spending. These ratios would have to show an improving trend over the next several years, even as spending for government-supported Social Security and health care (Medicare) increases for the 75 million-strong baby-boomer generation. For ex-ample, next year the budget deficit will be 13 percent of GDP, the highest since World War II. The goal should be for a reduction of 1 percent every year starting, say, in 2012, until it reaches 4 percent.

The only way such a system could be enacted is with substantial tax changes, probably in the form of a national sales tax that includes taxing gasoline at the pump (some of which should be rebated to low-income citizens to ease the burden on the poor). The U.S. will also need a major shift in the philosophy of who is eligible for Social Security and old-age medical benefits. This might include raising the age at which seniors can begin collecting Social Security, and reducing benefits for people with high incomes. These are extremely difficult measures, to say the least, and highly problematic politically. But if Washington doesn't do it, my prediction is that the markets—namely, those who hold U.S. bonds at home and especially abroad—will force such changes on the U.S. in a harsh, blunt way by demanding precipitously higher interest rates, tanking the currency, or both. The scene would be reminiscent of 1987, when the U.S. markets went into free fall as trade and budget deficits soared. The day after the Oct. 19 crash, Congress raced to enact meaningful budget restraints. Today, however, the deficits are relatively larger—government debt is 68 percent of the economy, compared with about 50 percent in 1987—and the degree of pain that creditors may impose could be much worse.

On the political front, the administration should continue engaging more broadly with all countries on the future of the global economy. In economic terms, it's not clear how much is accomplished at the meetings of the G7, G20, or G2 (the U.S. and China). But for the U.S. to lead, it must have followers. For that to happen, Uncle Sam must be a good listener. The political dimension of economic collaborations is not all that different from what goes on domestically. Stakeholders want to have a sense that their concerns are being heard and understood. The administration may need to augment its team with more distinguished high-level emissaries—perhaps drawn from the ranks of accomplished and experienced business leaders who are now conspicuously underrepresented in the upper echelons of the

administration; Secretary Geithner cannot shoulder the burden alone. The administration must be careful, too, not to slide back into the habit of arrogant preaching that characterized so many of its predecessors, Democratic and Republican.

Finally, the next global financial system must still be designed. Despite two meetings of the G20, two meetings of the G8, and countless studies by international organizations, both in official and private sectors, the big issues are still on the table, including the disconnect between a global market and diverse national regulatory institutions, and the inherent weaknesses of international coordination. In fact, the tug of nationalism is growing, at the worst possible moment. Here are some of the issues that are being hotly debated but on which there is no consensus at all: Who should regulate big global financial institutions that affect many countries, and who is responsible for managing their restructuring? How can they oversee complex derivatives? How much capital should financial institutions hold as a cushion against losses in a roller-coaster world economy, and how should they be compelled to do it? Who is orchestrating the bevy of (weak) global institutions—the IMF, the Bank for International Settlements, the Financial Stability Forum? If Team Obama were to take the lead in dealing with these kinds of issues, it would go a long way toward ensuring an extended era for American-style capitalism, which not too long ago was given up for dead.

The bottom line is that America can lead the global recovery politically without having to do all the heavy lifting economically. To continue to do this, it will have to make excruciating decisions at home and extend itself diplomatically as no administration has in many decades. Weighed down by debt and deficits for years to come, the U.S. and the world could do worse than to adapt to this new reality.

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