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Overview

The Global Economic Crisis and U.S. Power

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EXECUTIVE SUMMARY

This chapter examines both the effect of the global recession on the prospects of capitalism remaining the predominant mode of economic organization and the impact of the downturn on U.S. power and hegemony.

MAIN ARGUMENT:

Although the current capitalist system is acutely susceptible to crises, capitalism as a model of economic organization has been far from irreparably harmed by the current economic crisis. Instead, capitalism will continue to persist as it has for centuries, its capacity to evolve and ability to efficiently distribute resources being its greatest strengths. Though capitalism may not be at risk, its current form, fundamentally shaped by U.S. economic and political hegemony, could be challenged. These challenges will be greatest if China experiences a quick recovery while the U.S. economy languishes interminably. However, current projections of U.S. economic growth, combined with a Chinese stimulus package emphasizing increased production rather than consumption, make such disparate recoveries unlikely. In sum, the current crisis is not a watershed signaling the shift of hegemony from Washington to Beijing.

POLICY IMPLICATIONS:

- Sustaining U.S. hegemony over the long run will require engineering a controlled global adjustment of the international economic system that does not put the U.S. at an inordinate economic and geopolitical disadvantage.
- Overcoming structural disincentives to avoid reducing budget deficits and devising a non-inflationary exit from present deficit spending are key medium-term challenges to preserving hegemony for the U.S.
- Decreasing the current accounts and budget deficits through both lower spending and steady dollar depreciation is essential in protecting the dollar as the dominant international reserve currency. This exorbitant privilege of being the world's banker is fundamental to the preservation of U.S. political hegemony.

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The current global recession is certainly the worst economic crisis that has afflicted the international system since the Great Depression. What began in the United States in 2007 as a financial crisis centered on failing subprime mortgages soon expanded into a larger recession that engulfed the real economy and thereafter was transmitted globally. The Business Cycle Dating Committee of the National Bureau of Economic Research has now concluded that the current recession in the United States began in December 2007 when payroll employment peaked before beginning the downward slope from which it has yet to recover.[1] By September 2008, when the shocking bankruptcy of Lehman Brothers publicly signaled the advent of the financial crisis, the recession in the United States had indeed become severe measured by either the contraction in national output or the aggregate hours worked in the national economy. At the time of this writing in June 2009, the current national downturn has already exceeded the longest previous contraction since the Great Depression—the 1981–82 recession, which lasted sixteen months.[2] Thanks to the consequences of globalization, this recent crisis has left a dramatic impact on the international economic system as a whole.

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[1] "Determination of the December 2007 Peak in Economic Activity," Business Cycle Dating Committee, National Bureau of Economic Research, December 1, 2008, http://wwwdev.nber.org/cycles/dec2008.html.

[2] "US Business Cycle Expansions and Contractions," National Bureau of Economic Research, http://www.nber.org/cycles.html.

The transmission of the deepening U.S. economic crisis to the global economy has occurred through multiple paths. For starters, weakening U.S. demand has depressed the imports of foreign goods and services, thereby affecting all of the United States' major trading partners irrespective of how healthy their own economies might have been otherwise. The slowing of U.S. economic growth has also affected the major natural resource exporting states, including oil and energy producers, whose own economic prospects are tied substantially to the high resource prices that were the norm during periods of sustained growth.

Further, the failing financial markets in the United States and the falling stock prices in all U.S. bourses not only eroded the asset base of many multinational businesses but also undermined the ability of numerous foreign firms to raise capital in the United States. Declining securities prices in U.S. stock markets led to a dilution of the values of assets traded in other foreign stock exchanges as expectations of a contracting real economy both globally and within individual countries found quick reflection in falling stock prices, which are little other than indices reflecting investors' anticipation of future income. The spiral of contracting credit triggered by the initial failures of U.S. financial institutions also resulted in reduced portfolio and direct foreign investments in foreign countries, a change that exacerbated macroeconomic balances and balance of payments problems in countries whose economic fundamentals were already precarious.

Finally, states that were afflicted by their own asset bubbles, manifested through the presence of non-performing loans in their financial systems, also experienced crashes. In many cases, the exposure of domestic financial institutions to troubled international partners and to problematic contracts, including derivatives, that have seen sharp reductions in value contributed to replicating the U.S. contraction with varying degrees of intensity and scale.

The cumulative effect of the U.S. economic crisis and its international spillover has been a global economic recession of significant magnitude. As the World Bank has noted, the current recession could result in the global economy contracting for the first time since World War II, with global trade also expected to fall for the first time in three decades. With both direct and portfolio-based foreign investment tightening, the bank estimates that sharply constrained credit and higher interest rates will become significant constraints in many developing countries, with GDP growth in 2009, for example, expected to fall to 1.6% from the relatively high level of 5.8% the previous year. Since any global growth of under 2% per annum is considered a recession, the bank calculates that this depressed economic performance

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will likely trap some 90 million more people in poverty in 2009, with a billion or more people going chronically hungry.[3]

Even as these tragedies unfold in the developing world, however, the situation in the developed market economies is barely recognizable. The extent of state intervention that the current crisis has engendered in countries that were long the example of successful capitalism is mind-boggling. While significant monetary easing generally occurs in any recessionary environment, the difficulty in stimulating economic growth despite the persistence of a zero nominal interest rate in the United States has once again breathed new life into the old fears that the U.S. economy might find itself in a Keynesian "liquidity trap" where even low interest rates cannot stimulate increases in investment and employment. In an effort to escape this snare, government spending in the United States and across much of Western Europe has ballooned dramatically, producing huge budget deficits of the kind not witnessed before. Sustaining these unprecedented budget deficits has been complemented by historically exceptional large-scale state acquisitions of troubled private sector assets—from banks to automobile makers—as governments struggle to keep major private employers afloat even as they attempt to resuscitate economic activity through loose monetary policies.

The continuance of such intervention has raised fears about the long-term impact of growing national deficits, which could precipitate inflation and rising interest rates leading to stagflation in the worst case. The United States has been able to sustain such massive government spending in the near term only because the dollar still remains the international reserve currency. Because international lenders appear willing to sustain U.S. deficit spending on a significant scale, policymakers in Washington enjoy the luxury of being able to sustain such expenditures without triggering inflationary pressures immediately. Whether the United States can continue to live beyond its means indefinitely, however, is a critical issue and one that in many ways remains the underappreciated cause of the current crisis. This problem raises important questions about whether the binary deficits—the budgetary deficit and the current account deficit—can be sustained without severely undermining U.S. hegemony and with it the current global system that ultimately serves U.S. interests.

The current economic crisis and the character of state responses to that crisis, then, bear upon two consequential matters: first, the future of capitalism as a mode of economic organization and, second, the future of U.S. power. Both these issues are undoubtedly interlinked. If capitalism as a mode of production has been irretrievably damaged by the current economic

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[3] "Understanding the Crisis," World Bank, http://www.worldbank.org/html/extdr/financialcrisis/.

crisis, as many appear to believe, then the material foundations of U.S.—and, more broadly, Western—power could be at considerable risk, and that in turn would have significant consequences for the future of U.S. economic and political hegemony. The potential loss of U.S. hegemony, if capitalism was in fact fundamentally weakened, will have deleterious consequences for global order. Not only will it endanger the progressive postwar globalization that raised the standard of living for millions of people worldwide, but it could presage the return to great-power competition at the core of the global system and the power-political rivalries that force states toward autarkic solutions in the realms of both economic management and national security. The current economic crisis could, therefore, have consequences that go far beyond simply the management of yet another business cycle globally. These two core issues—the impact of the global recession on the prospects for capitalism and the impact of the economic downturn in the United States for larger U.S. hegemony—form the subject of this introductory chapter.

The rest of this volume, the ninth in the annual series, titled *Strategic Asia 2009–10: Economic Meltdown and Geopolitical Stability*, focuses on analyzing the impact of the current global economic crisis on the strategic fortunes of key Asian states and U.S. interests in Asia. Through a series of country and regional studies, the volume assesses how the global economic meltdown is affecting, and is affected by, the national economic performance of various Asian states, particularly as mediated—wherever relevant—through their financial sectors. This analytical core, which constitutes the heart of each of the chapters in this volume, forms the basis for exploring how the economic crisis could affect the strategic goals and power-political trajectories of various Asian states and, by implication, the larger balance of power in Asia and globally. (The volume also includes a special study on the future of the nonproliferation regime, which following the *Strategic Asia* tradition focuses on a different subject.) This effort at understanding strategic outcomes through the lens of economic challenges will hopefully help both scholars and policymakers appreciate the complex linkages between the evolving global recession and Asia's traditional security challenges.

Dynamic Instability and the Future of Capitalism

The causes of the current economic crisis will be debated for a long time to come. What is agreed to quite readily is that the crisis originated in the United States and that it grew out of failures in the financial sector, primarily

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imprudent mortgage lending that produced a large number of toxic loans, which ultimately became the undoing of major financial institutions. Beyond these brute facts, however, the large number of causal factors—one study has identified 26 contributing drivers[4]—that contributed in some way or another to the meltdown ensures that the debate about the origins and dynamics of the current recession will occupy economists and economic historians long after the crisis has past.

Although the global crisis was probably signaled by the increasing delinquencies in subprime mortgages that began to rise in early 2007, most economists would likely date the origins of the present problems to economic decisions made around 2004 and perhaps even earlier. The deflation of the "dot-com" bubble, which held sway from roughly 1998–2001 in the United States and came at the tail-end of a series of financial crises in emerging Asia and Latin America, led to a period of sharply falling global investment. As a consequence, the subsequent years, especially 2003–04, saw extremely low interest rates as the Federal Reserve held to a loose monetary policy in order to stimulate growth in the United States.

This development occurred at about the same time that the federal government made a concerted effort to help low-income families realize the dream of home ownership through a variety of zero-equity mortgage proposals. These home ownership loans, which could not have been offered under conventional lending standards, became possible when the Office of Federal Housing Enterprise Oversight (OFHEO) imposed stricter capital requirements and balance sheet controls on the major government-supported mortgage underwriters, Fannie Mae and Freddie Mac. These new requirements, though intended to raise financial lending standards, had the unintended consequence of constraining bank earnings. Being rational actors in a competitive environment, the commercial banks sought to remedy these revenue shortfalls by creating new financial products that permitted them to offer low-income mortgages to previously marginal customers through what were in effect miniaturized Fannie and Freddie instruments: structured investment vehicles (SIV) and collateralized debt obligation (CDO).

These new instruments enabled banks to increase income not through the older practices of maintaining a certain desirable spread on loans but rather by seeking the higher trading incomes and fees associated with collateralized debt that could be sold as complex "derivatives" to successive buyers in the financial market. What drove the attractiveness of securitization further was that these mortgage-backed securities, which frequently

[4] Mark Jickling, "Causes of the Financial Crisis," Congressional Research Service, CRS Report for Congress, R40173, January 29, 2009.

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contained both subprime loans and other worthy instruments in a single bundle, were often packaged as AAA-rated bonds by ratings agencies that either used poor economic models or were riddled by conflicts of interest. Not only did such packaging help commercial banks recover the income that would be otherwise lost if they had met the newer OFHEO constraints on Fannie- and Freddie-underwritten loans but it also improved the banks' own returns on capital and, by implication, their share prices in what was a highly competitive market.

This increased blurring of the boundaries between commercial banks and investment banks was further aided by the 2004 Basel II accord on international bank regulation, which altered the way in which returns on capital were assessed. Under the new regulation, the capital weight accorded to a bank's mortgages dropped from the original 50% to between 35% and 15%, depending on the rating system used. Since lower capital weights raise the return on capital for any given mortgage asset, the effect of the transition from the Basel I to the Basel II regulations was to create new arbitrage opportunities where mortgage securitization accelerated and was pushed into off–balance sheet vehicles, thereby allowing banks to sharply raise their return on capital. This shift in regulatory standards was so attractive that in the United States many private bankers strongly urged governmental regulators to move quickly to endorse the Basel II standards because they would permit higher leverage ratios for a given unit of capital.

These changes in international banking standards were complemented by changes in the Security and Exchange Commission's regulations within the United States. Under the 2004 Consolidated Supervised Entities (CSE) program, major global investment bank conglomerates that otherwise lacked U.S. supervisors under law could voluntarily subject themselves to consolidated capital and liquidity requirements in order to avoid becoming subject to potentially more burdensome European Union regulation. This effort at self-regulation altered the older requirements that investment banks maintain a strict 15 to 1 debt to net-equity ratio in favor of more relaxed ratios that extended to 40 to 1 in some cases. In retrospect, both the external and the internal changes in regulation proved to be dangerous. The failures at Citibank in the United States, for example, have been attributed significantly to the accelerated securitization provoked by the prospective

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changes in international bank regulation published in 2004, while the five—and only—companies that participated in the CSE program—Goldman Sachs, Morgan Stanley, Merrill Lynch, Lehman Brothers, and Bear Stearns—all became victims of the financial crisis.[5]

All these factors taken together, then, resulted in a large increase in mortgage lending centered on the offer of huge quantities of low-interest—but adjustable—housing loans to individuals who would not ordinarily qualify for such lending. So long as credit was abundant, interest rates were low, economic growth was positive, and housing prices were appreciating, the boom could be sustained because relaxed lending standards permitted individuals who could not otherwise afford houses to continue to purchase them. When interest rates began to increase, however, the adjustable-rate mortgages that looked affordable at the time of initial purchase became less so as monthly interest payments soon taxed the personal incomes of many marginal homeowners. As defaults on these loans increasingly occurred, the larger credit markets progressively began to contract and as a result the real economy began to slow as well. The progressive contraction of the real economy in turn increased unemployment, which then further slowed the housing market and added additional defaulters to an already weakened and overburdened financial sector. The housing bubble had indeed finally burst, as all such bubbles do at some point, and the collapse of this latest expansion triggered an economic crisis that expanded far beyond the original source that gave rise to it.

This chain of causation is undoubtedly complex, but its broad outlines are generally understood. Roger Kubarych's chapter in this volume details with unerring clarity the sequence of how the crisis evolved. He demonstrates how the complexity of new innovations relating to "structured finance" combined with failures in regulatory and supervisory systems to deeply disrupt the system of financial intermediation, which is critical to a smoothly running real economy. While Kubarych's analysis leaves no doubt that developments within the United States were central to originating and propagating the crisis, the causes of the global recession that followed would be fundamentally incomplete if observers were to restrict their gaze to America alone. Although events and decisions internal to the United States undoubtedly served as the efficient cause of the financial crisis, these events and decisions occurred

[5] This summary description of the subprime crisis is based largely on Adrian Blundell-Wignall and Paul Atkinson, "The Subprime Crisis: Causal Distortions and Regulatory Reform," in *Lessons from the Financial Turmoil of 2007 and 2008*, ed. Paul Bloxham and Christopher Kent (proceedings of a conference held at the H.C. Coombs Centre for Financial Studies, Kirribilli, July 14–15, 2008), http://www.rba.gov.au/PublicationsAndResearch/Conferences/2008/Blundell-Wignall_Atkinson.pdf; R. Christopher Whalen, "The Sub-Prime Crisis: Cause, Effect and Consequences," Networks Financial Institute, Policy Brief, no. 2008-PB-04, March 1, 2008, http://ssrn.com/abstract=1113888; and "The Financial Market Crisis," *Finance & Development* 45, no. 2 (June 2008).

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within a specific external context: the presence of persistent and widening current account imbalances between some developed economies (especially the United States but to a lesser degree Great Britain, Spain, and Ireland as well) on one hand and the emerging economies and oil-exporting countries on the other. This imbalance, which has continuously gathered steam since 1997, reached a peak in 2006 when the United States' savings deficit touched 6.25% of GDP. These imbalances represent a peculiar equilibrium arising from the fact that large emerging economies such as China, which are usually imagined to be principally recipients of foreign capital, have now become major sources of foreign capital outflows and along with the oil-exporting states are critical to financing the huge, though slowing, U.S. current account deficit. This deficit in the United States, and in other Western countries more generally, has arisen because personal, business, and governmental consumption has outstripped the national rates of household, business, and governmental saving.[6]

Such expansive consumption, especially in the United States, was sustained in the first instance mainly because of the Federal Reserve's liberal monetary policies, which by maintaining low interest rates permitted sustained credit-fuelled growth. This credit-fuelled growth, however, was tenable in the final instance only because the national budget deficits—caused by the consistent surplus of consumption over saving—could be financed by constant external borrowings from ordinarily poorer countries such as China, the other emerging or resource-exporting economies, and the outlier among wealthy countries, Japan. It is in fact a peculiar testament to the globalization of the financial system that the overconsumption by the rich can be, and in fact has been, underwritten substantially by the poor, an apparently perverse but nonetheless critical reality that has enabled the persistence and financing of existing imbalances.

While some distinguished observers such as Kishore Mahbubani have read the story thus far as vindicating "the Asian approach to capitalism,"[7] based as it is on the habits of thrift and benevolent governmental control, the fact remains that the decisions made by emerging economies to continue financing Western overconsumption may have to do more with rational necessity and internal political decisions than any moral rectitude. For starters, there is little doubt that export-led growth (whether through raw materials or manufacturing) in many emerging economies has left them with large and favorable external balances that must be recycled in some way. One sensible way of recycling these export earnings would have been

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[6] Raghuram Rajan, "Perspectives on Global Imbalances" (remarks at the Global Financial Imbalances Conference, London, January 23, 2006), http://www.imf.org/external/np/speeches/2006/012306.htm.

[7] Kishore Mahbubani, "Lessons for the West from Asian Capitalism," *Financial Times*, March 18, 2009.

by increasing domestic consumption and investment, but for a variety of political reasons many emerging economies chose to invest their export-generated incomes in financing domestic consumption in the United States. The reason for pursuing such an investment strategy, which varies in each individual case, is less germane. What is to the point is that once the decision was made not to recycle export earnings by increasing investment and consumption at home, there were perhaps few attractive choices other than subsidizing Western, and especially American, overconsumption through financing its continued appetite; this decision, in turn, further increased the export earnings of many emerging economies. Financing this consumption, especially in the United States, through the ongoing purchase of U.S. Treasuries could in fact even be justified on the grounds that the United States' developed financial markets and robust political institutions made the country the best destination for foreign investors seeking safe returns.

This logic would have been impeccable if investing in U.S. Treasuries in fact yielded better returns than investing at home or in alternative financial instruments in other countries. It is possible to argue that whereas the latter might have been more difficult—since most of the desirable alternative Western financial instruments may not have yielded better returns than their U.S. counterparts—it is hard to believe that U.S. Treasury bills could have in fact produced better returns than any responsible direct investments within the emerging economies. This conclusion is corroborated by the reality that since at least 1990 U.S. investors have earned more from external holdings—which are dominated by portfolio equity and FDI—than foreigners have earned comparably from their investments in the United States—which are dominated by portfolio debt instruments.[8]

Notwithstanding the fact that recycling export earnings through increased internal investments might have been a better strategy for most emerging economies, these states nonetheless persisted in highly conservative economic and political strategies. These strategies emphasized high rates of deferred consumption (that is, increased national savings) in favor of investments in ultra-safe, even if low-yielding, foreign financial vehicles such as U.S. Treasuries. This behavior only becomes explicable in the context of the multiple crises that enveloped Asia during the 1990s, in particular the legacy of the bursting Japanese asset bubble and the Asian financial crisis of 1997–98, which made many of the emerging market economies highly risk averse. Mahbubani is on stronger ground when he argues that "Asian culture has been honed by centuries of hard experience, which explains why Asians save more. All Asian societies have memories of

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[8] Philip R. Lane and Gian Maria Milesi-Ferretti, "A Global Perspective on External Positions," International Monetary Fund, IMF Working Paper, 05/161, 2005.

turbulent times. They know from experience the importance of preparing for the bad days that will follow the good."[9]

The policy experience in many emerging economies, especially after the Asian financial crisis, which turned out to be a painful wake-up call, bears this out abundantly: the crisis precipitated a general tightening of historically lax policies; stimulated some countries to run fiscal surpluses for the first time; induced a generalized attack on inflation through tight monetary policies; made private corporations cautious about investments and governments prudent about expenditure, especially in regard to grandiose projects; accelerated export-led growth and increased national savings rates; increased the attractiveness of running current account surpluses, in some countries for the first time; and, most conspicuously, led to a pervasive building up of international reserves.[10]

The maintenance of huge foreign currency reserves in largely dollar-denominated holdings exemplifies a reasonable response to fear. If coping with adverse economic circumstances remains a critical policy objective of crisis-scarred economies, it would be logical for state managers to acquire durable and highly liquid stores of value that can be exchanged easily in times of trouble—and what better than the dollar? Maintaining dollar-denominated holdings for this purpose becomes even more attractive if the financial markets in these emerging economies are immature, if social safety nets are absent, if national credit systems are unreliable, if fears of capital flight persist, if managed exchange-rate systems are viewed as fragile, or if a Knightian uncertainty persists about the future. Whenever such conditions persist, holding on to trustworthy foreign currencies, even if only through low-yielding instruments, becomes eminently sensible.[11]

While these behaviors arguably represent the public analog of private virtues, they also paved the way for subsidizing exactly the Western overconsumption that many in Asia have decried since the onset of the current financial crisis. Since the emerging economies' surpluses had to be invested somewhere other than at home—given the political choices many Asian governments made about their own national economic strategy—the net result was that foreign capital inexorably flooded the United States. Because the United States represented (and still represents) the most attractive foreign investment destination by far, it is not surprising that at its

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[9] Mahbubani, "Lessons for the West."

[10] Rajan, "Perspectives on Global Imbalances."

[11] Ricardo J. Caballero and Arvind Krishnamurthy, "Global Imbalances and Financial Fragility," December 16, 2008, http://econ-www.mit.edu/files/3662; and Ricardo J. Caballero, Emmanuel Farhi, and Pierre-Olivier Gourinchas, "An Equilibrium Model of Global Imbalances and Low Interest Rates," *American Economic Review* 98, no.1 (March 2008): 358–93.

peak about 70% of the rest of the world's surplus savings found its way into the United States. This persistent capital injection into American markets resulted in foreign private investors bidding up U.S. bond prices and, in the process, further lowering U.S. interest rates. Falling interest rates buttressed the American propensity to save even less in favor of continued spending (including on housing purchased through adjustable-rate mortgages that many would find later they could not afford). This behavior should not be surprising because as credit becomes cheaper, savings rates tend to decline; in the United States savings dropped from around 10% of disposable income in the 1970s to 1% and less after 2005 as foreign capital made continued overconsumption attractive and rational.

This proclivity to overspend on the part of both American consumers and the U.S. government was nonetheless simply a rational response to indulgent circumstances. The emerging economies were eager to recycle their export earnings by subsidizing further American consumption rather than by increasing investing at home—no other conclusion can be drawn from the otherwise anomalous fact that despite the progressive decline of the dollar since 2002, the U.S. current account deficit not only continued to rise but the long-term interest rate, which should have risen to reflect the falling U.S. savings rate and the steadily weakening dollar, actually began to decline even when the Federal Reserve shifted to a tighter monetary policy to stave off emerging fears of inflation.

The existence of long-persistent global imbalances thus functioned as the permissive cause of the financial crisis that precipitated the current global recession. Viewed from this perspective, the so-called Asian virtues of thrift, living within one's means, and benevolent governmental direction may actually turn out to be systemic vices. To say so is not to rebut the Asian critique of American excesses with a new American defense of those excesses, but rather to illustrate the larger point that in an exchange economy, austerity and extravagance are simply two sides of the same coin. This reality highlights what might be considered the economic equivalent of the logician's "fallacy of composition": what is good for a part may not necessarily be good for the whole. Consequently, any assessment of American failings in the context of the current economic crisis—and there are many, particularly in the current legal and regulatory frameworks—must take into account the stark reality of what Catherine Mann has correctly described as "global co-dependency." As Mann notes,

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> That no other country faces as significant a quantitative change to their trade balance as the United States should not imply ease of adjustment. In fact, just the opposite could be the case as each [other] country, facing the policy choices and structural challenges to reorienting demand, production, and financing, could argue that someone else should 'go first.'[12]

Pieter Bottelier's chapter in this volume, which assesses China's contribution to the international crisis, accepts this fundamental proposition—that global imbalances contributed to the meltdown—yet adds that Beijing cannot be considered "co-responsible" for the crisis—which again is consistent with the characterization that global imbalances constitute a permissive rather than an efficient cause. In contrast to many in the United States, however, who believe that China's large current account surpluses have derived largely from a deliberately undervalued currency aimed at stimulating exports, Bottelier persuasively attributes these surpluses to China's exceptionally high productivity growth in manufacturing.

In any event, appreciating the nature of the microeconomic and macroeconomic interactions that led up to the current crisis underscores three conclusions that bear on the future of capitalism and its consequences for U.S. power.

First, the contemporary judgment, at least at the popular level, that greed and incompetence on the part of bankers, regulators, and policymakers were responsible for the current economic crisis must be judged as an exaggeration. While it is likely that venality and abuse characterized some of the actions contributing to the crisis, complex economic events do not lend themselves to any simplistic moral judgments. In this case particularly, moral valuations—whether of the cultural kind offered by Mahbubani or the polemical variety offered by the *New York Times*, which ascribed the economic collapse simply to "greed and an orgy of deregulation"[13]—are especially awkward because they fail to account for the ultimately rational choices made by individual agents within a specific structural context that offers certain incentives and imposes certain constraints.

The analysis thus far suggests that each of the entities contributing to the crisis acted in instrumentally rational ways: consumers and governments continued to live beyond their means so long as the opportunities for doing so existed without immediate or onerous penalties; bankers, like all other profit-seeking entities in a capitalist system, sought to maximize their share prices through new and more recondite forms of financial innovation

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[12] Catherine L. Mann, "Breaking Up is Hard to Do: Global Co-Dependency, Collective Action, and the Challenges of Global Adjustment," CESifo Forum, January 2005, 16, http://www.iie.com/publications/papers/mann0105b.pdf.

[13] "The Next President," *New York Times*, November 4, 2008.

when traditional modes of profit maximization appeared to be constrained; regulators shifted toward more lax mechanisms of oversight in many cases in order to aid national corporations that found themselves competing with others in an environment where international differences in regulation created opportunities for "regulatory arbitrage"; and suppliers of foreign capital subsidized American overconsumption despite its risks because these dangers were judged to be acceptable given the relative lack of investment opportunities at home.

In a trivial sense, then, the market did not fail—the crisis was merely an understandable outcome of various individually rational behaviors. But, in a larger and more meaningful sense, the economic crisis does represent a serious market failure in that the pursuit of individually rational behaviors still failed to produce a socially optimal outcome. This fact, however, cannot be simplistically attributed to the "failure of capitalism" because it remains merely an example of a much larger phenomenon that all social scientists are familiar with and that is pervasive in human life: the disjuncture between micro-rational choices and desirable macro-outcomes. Beneficent social outcomes often arise as the unintended consequences of private actions—the lesson conveyed by Adam Smith's metaphor of the "invisible hand." Where free markets are concerned, however, market failures can also arise just as often, *inter alia*, if there exists a divergence between the perceived and real costs (whether apparent or not) of any individual choices, especially if that difference can be shifted (either consciously or otherwise) to some entity other than the individual exercising that choice. Given this reality, the financial crisis seemed almost inevitable in retrospect because many of the innovations that triggered it distributed risks asymmetrically, with burdens shifted either to unwitting buyers or to the financial system at large while extraordinary, albeit transient, benefits were enjoyed by the smaller class of financial innovators.

Minimizing the prospects of market failure, then, requires not so much a condemnation of particular individual choices as alterations in the larger system of structural constraints, a point insistently made by Roger Kubarych's chapter in this volume. As Leszek Balcerowicz, the former Polish deputy prime minister and governor of the National Bank of Poland, has pointed out, the assertion that the current economic crisis represents "a pure market failure fails the most elementary tests" because "financial institutions and markets operate within the macroeconomic, regulatory and political framework created and maintained by public bodies, and it is empirically not difficult to point to the serious deficiencies of this framework that

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contributed to the present crisis."[14] If the larger framework of structural constraints can therefore be improved through deliberate policy decisions, it is likely that individual actions will be modified appropriately because which behavior is rationally pursued depends mainly on the incentives and costs facing the individual agent. The role of government and public policy becomes critical in this conception because, as Keynes readily understood, the role of the state essentially consists of protecting the opportunities for efficient micro-decisions in order to realize the benefits promised by Smith's invisible hand.

Second, although minimizing market failure remains the necessary task of the state, undesirable macro-outcomes must be appreciated as part and parcel of the desirable—and ultimately ineradicable—achievements of the capitalist system. As Karl Marx understood better than most, the most conspicuous characteristic of capitalism is its volcanic dynamism, which is manifested in relentless innovation and continued technical progress, all of which, however, necessarily come at the price of instability. In *The Communist Manifesto*, Marx, describing the "most revolutionary part" played by the bourgeoisie, perceptively declared that:

> The bourgeoisie cannot exist without constantly revolutionizing the instruments of production, and thereby the relations of production, and with them the whole relations of society. Conservation of the old modes of production in unaltered form, was, on the contrary, the first condition of existence for all earlier industrial classes. Constant revolutionizing of production, uninterrupted disturbance of all social conditions, everlasting uncertainty and agitation distinguish the bourgeois epoch from all earlier ones. All fixed, fast frozen relations, with their train of ancient and venerable prejudices and opinions, are swept away, all new-formed ones become antiquated before they can ossify…The need of a constantly expanding market for its products chases the bourgeoisie over the entire surface of the globe. It must nestle everywhere, settle everywhere, establish connections everywhere…In one word, it creates a world after its own image.[15]

There is no necessity to accept Marx's specific theorizing about how the internal mechanics of capitalism necessarily lead to "the contradictions in the conditions of modern production," which, in turn, produce "more extensive and more destructive crises." From outside the Marxist tradition, Joseph Alois Schumpeter amply demonstrated that the capitalist system necessarily breeds innovation through entrepreneurship and that the "perennial gale of creative destruction…incessantly revolutionizes the economic structure *from within*, incessantly destroying the old one, incessantly creating a new

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[14] Leszek Balcerowicz, "This Has Not Been a Pure Failure of Markets," *Financial Times*, May 13, 2009.

[15] Karl Marx and Friedrich Engels, *The Communist Manifesto*, vol. 50, in *Great Books of the Western World*, ed. Robert Maynard Hutchins (Chicago: Encyclopedia Britannica, Inc., 1988), 420–21.

one."[16] If every innovation in capitalism, then, contains the seeds of its own destruction, the most recent financial crisis is no different. The now much derided financial innovations, such as securitization and derivatives, were once hailed as more efficient instruments of "market completion," able to "isolate individual risk factors while simultaneously allowing investors to assume long or short positions (with leverage if desired) in these risks." Their efficiency derived from the fact that informed individual investors could "more precisely isolate the elements in the marketplace they deem[ed] to be attractive while in effect selling off or eliminating exposure to less attractive (or unwanted) characteristics. This reshuffling ultimately result[ed] in the market's risks being better matched with the investors most willing to bear them."[17] Innovations such as securitization and derivatives will not disappear simply because they have been linked to even a serious financial crisis, because after all is said and done they have increased efficiency and enabled faster economic integration. Without such innovations, capital accumulation would proceed at a slower pace, economic growth would be stymied, and the quality of life would improve only more slowly.

The task before governments in this context, then, is not to eliminate the dynamic instability in capitalist economies. Such instability will necessarily arise so long as the economic system is capable of engendering innovation and inciting rapid, even if always disruptive, technical change. Episodically, this change will materialize not in the form of a durable transformation of the underlying fundamentals of the economy but as volatile short-term movements in asset prices precipitated mainly, as Alan Greenspan characterized it, "by perceptions of real improvements in the productivity and underlying profitability of the corporate economy."[18] Because investors' expectations of future earnings are inextricably tied to the relentless competition and innovation that occurs in a free market, high long-term growth without occasional volatility in the real and monetary sectors is simply impossible. It is in fact the possibility of claiming super-normal profits accruing from various innovations, both those that last and those that turn out to be evanescent, that makes capitalism the most productive form of economic organization known to man—as Marx himself readily understood and appreciated.

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[16] Joseph Alois Schumpeter, *Capitalism, Socialism and Democracy* (New York: Harper, 1942, repr. 1975), 82–85.

[17] Glenn E. Baker, "Market Completion and the Growing Derivatives Markets," Brown Brothers Harriman, 2007, 2.

[18] Alan Greenspan, "Economic Volatility" (remarks at a symposium sponsored by the Federal Reserve Bank of Kansas City, Jackson Hole, Wyoming, August 30, 2002), http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20020830/default.htm.

Seeking to replace the currently energetic arrangements known as capitalism with some ultra-stable alternative would require either a revolutionary form of new social organization or a willingness to accept some Ricardian asymptotes of a "stationary state" economy. Marx clearly championed the former and while it is possible to argue that his own vision was never truly incarnated in any of the economic systems that bore his name, the classical Soviet and Chinese revolutionary experiments came at such high political, economic, and social costs—with little by way of compensatory remediation—that even the citizens of these states today recoil from the prospect of returning to such experimentation. The second alternative too finds no votaries today either in the developed or the developing world. In the former, the citizenry, having tasted enough of the good life, appears reluctant to trade the material benefits of the dynamic instability inherent in capitalism for the solitude and beauties of nature that John Stuart Mill imagined could best be enjoyed when incomes suffice primarily to maintain accumulation. In the developing world, particularly in the emerging economies, the willingness to accept the dynamic instability of capitalism is even stronger. To be sure, these states, just like their more developed counterparts, seek to dampen the most violent oscillations of the business cycle to the degree possible; they recognize clearly, however, that the innovativeness of capitalism is what provides the fastest way out of defeating poverty, increases economic growth, and cements their status as rising powers.

If the two polar alternatives represented by the ideal-types of egalitarian socialism on the one hand and orderly variations of a "stationary state" on the other are both unacceptable as solutions to mitigating the dynamic instability of capitalism, then the role of governments boils down to a very important but nonetheless still relatively narrow task: creating an institutional and policy framework that permits the freest possibilities for innovation—which means permitting firms and organizations to fail according to market conditions—by defining fair, transparent, and neutral rules of conduct; erecting appropriate standards; and enforcing appropriate market behavior. Because businesses and firms are permitted to fail in this regime, the role of government also extends to providing effective safety nets for individuals who are at risk because of changes in the business cycle. The government's role also includes, of course, the traditional tasks of compensating for market failures in regard to the provision of public goods as well as the undertaking of other socially necessary redistribution. While all these principles are easy to accept in the abstract, they become sources of deep contention in practice because, when implementing them in detail, there is enormous room for veering in the direction of either inadequate or

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excessive governmental intervention. As previous historical experience has demonstrated, even when an optimum level of intervention can be agreed to conceptually, it is hard to get consensus on whether specific policy initiatives comport with that optimum or not. Moreover, because these initiatives are usually developed and implemented through the political process, it is harder than usual to institutionalize truly optimum interventions—that is, interventions that are fair, transparent, and neutral.

The issue of governmental intervention boils down then to maintaining a fine balance. An excess of intervention might enhance stability but comes at the cost of increased efficiency and reduced incomes; a deficit of intervention, on the other hand, could provoke the "animal spirits" to great achievements that come frequently at high social cost. Consequently, the key to achieving the right balance of intervention is to recognize the insight—affirmed by Marx, Schumpeter, and Keynes in different ways—that the recurrent creative destruction flowing from innovation and all the inconveniences produced thereby are essentially inextirpable features of capitalism that must be accepted for the sake of those larger benefits in efficiency and growth deriving from such an economic system. In other words, any attempt to produce a truly stable "capitalism" through government intervention will only kill the goose that lays the golden eggs.

Third, although good regulation is necessary, even theoretically, to enable free markets to operate effectively—that is, to generate the highest levels of innovation possible in order to accelerate capital accumulation—it is unlikely that even the best institutional systems will be able to keep pace with the activities of all entrepreneurs. Any regulatory framework that can consistently anticipate future innovations and "proactively" manage the disorder that comes with its "gales of creative destruction" would by definition have to be omniscient in a way that is not characteristic of any human institution. This pessimistic conclusion should undermine the hopes of all those who see more effective regulation as the real solution to mitigating future crises within capitalism—but there is no reason to believe that any alternative inference is true.

If the dynamism of capitalism ultimately derives from innumerable atomistic actions—actions aimed at introducing new goods, services, and resources to the marketplace and improving the processes by which existing goods, services, and resources are already produced—there will be almost by definition at least some kinds of technical change that cannot be foreseen by existing institutions. This constraint is not only natural to all social institutions but is actually engendered by the competitive dynamics of capitalism itself. Because capitalism places extreme demands on survival, innovations that can circumvent existing modes of production or the organizational systems

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that control them are especially prized as they offer their creators the prospects of securing supernormal profits at least until such time as they either fail, spawn emulators, or force regulators to respond. This lag between innovation and regulation will be most conspicuous in the case of radical improvements; it is possible, however, that all innovations—both those that are "nominal" and those that are "real"[19]—would test preexisting regulations in some measure. Precisely because all innovations in the Schumpeterian sense necessarily lead, rather than lag behind, extant regulations, it is simply unclear whether even the best supervisory systems would be able to control innovations in a capitalist society. This is in part due to the fact that the competitive constraints that bear on survival in a capitalist society place a premium on harvesting the supernormal profits, however temporary, that come from the dramatic technical change that shatters existing production, organizational, ideational, and regulatory arrangements.

Other considerations reinforce this conclusion as well. Many innovations today, both at a technical and at a social level, can be so complex that it is often difficult for physical and social scientists, regulators, and even governments writ large to assess the challenges they pose in real time, let alone their longer-term consequences. The inherent difficulties posed by technical and social complexity then have the effect of obscuring risks, which may only become progressively transparent in retrospect. Robert Merton's concept, "unanticipated consequences," describes a permanent feature of human life that derives partly from the inherent complexity of physical and social systems; the permanently incomplete state of human knowledge; the presence of some perverse incentives in all social structures; the intrinsic human capacity for error, self-deception, and bias; and finally the permanent possibility of "Oedipus effects" that create self-fulfilling prophecies.[20] These elements ensure that even an apparently perfect regulatory regime will be unable to anticipate and control many, if not most, of the complex innovations that are routinely spurred by a dynamic capitalist system, especially one that provides extraordinary rewards for radical innovations that have the effect of making obsolete existing physical and organizational frameworks.

On a more prosaic level, this reality of regulation inevitably lagging innovation in a capitalist system is reinforced by the asymmetry of capabilities within governments and markets. Although governments may be strong

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[19] These terms have been used in an excellent paper by Joseph R. Mason to distinguish between superficial and lasting financial innovations. See Joseph R. Mason, "The Summer of '07 and the Shortcomings of Financial Innovation," *Journal of Applied Finance* 18 (Spring 2008): 7–15. While this distinction is eminently sensible for purposes of assessing the quality of innovations, both types of change unfortunately are capable of stymieing effective regulation, at least *a priori*.

[20] Robert K. Merton, "The Unanticipated Consequences of Purposive Social Action," *American Sociological Review* 1, no. 6 (December 1936): 894–904.

and have access to considerable pools of trained and secure administrators, the wealth, diversity, and size of the human and material resources resident in firms operating in a free market ensures that the latter will always be more creative, in effect always producing more sophisticated and complex innovations than regulators will be able to anticipate and control. Given these realities—that markets will always innovate faster than regulators can direct; that the complexity of many innovations may in fact befuddle regulators at least for a time; and that the resource pools driving innovative activities will always be larger than the resources available for regulation—the idea that instability caused by innovation can be averted through better regulation must be judged a chimera.

Recognizing just this fact, Alan Greenspan once argued that it was perhaps easier to deal with the disruptions caused by innovations, including the bubbles that could sometimes accompany them, after the fact than to manage them prior to or soon after the emergence of instability.[21] Other policy managers have cautiously expressed the opposite view, though with the full recognition that such action may be beyond the capacity of even the most prescient institutions. Still others have proposed more middling solutions. Given the difficulties of regulating innovation, much less anticipating them, some policy managers (such as Kubarych in this volume) have suggested that, at the very least, new financial instruments should be quality- or stress-tested; others, such as Mason, have suggested that financial instruments should be given time to mature before they are permitted to attain any systemically significant size.[22] While these solutions ought to be considered seriously, it is still an open question whether they can be implemented in a globalized economy where differences in national regulation systems not only create opportunities for arbitrage but could also provoke resistance on the part of a country's citizens if national regulations are viewed as placing these citizens at a competitive disadvantage.

All these considerations suggest that because crises are endemic to capitalism (there has been a succession of economic shocks over the past three decades alone), it will take more than even the current global recession, bad as it is, to kill capitalism irrevocably. Capitalism as a system of economic organization was not born by fiat, not brought into being through a single deliberate act. Rather, it evolved, sometimes haphazardly, over centuries and its capacity to evolve further is in fact its greatest strength. All of its permutations have progressed around one core characteristic: individual agents, whether personal or corporate, relying on open, albeit

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[21] Alan Greenspan, "Risk and Uncertainty in Monetary Policy" (remarks at the meetings of the American Economic Association, San Diego, California, January 3, 2004).

[22] Mason, "The Summer of '07."

regulated, markets to conduct a variety of economic transactions. Because this arrangement has proven to be the worst way of organizing production and distribution save all others, capitalism is certain to survive but in further modified form. The trends thus far suggest that the financial sector in the advanced market economies will be regulated further, though whether these regulations will be either effective or optimal still remains to be seen.

To date, there appears to be little appetite for further regulation of the real economy—despite the frequent claims that "the magnitude of the global economic crisis means that we have to change completely the way we live."[23] Even if more comprehensive and burdening regulation can be avoided, however, increasing governmental intervention in the market seems to be inevitable and the increase in state control of private firms since the advent of the Obama administration has been breathtaking. Although such control has undoubtedly been precipitated as a response to the crisis and may not last indefinitely, the likelihood that these interventions will introduce "inefficiencies into global markets" and inject "populist politics into economic decision-making"[24] implies that they too contain the seeds of their own undoing. As recent economic history, at least in the United States, suggests, waves of excessive governmental intervention have invariably spawned forces of reaction that compel retrenchment. Thus, the advent of Ronald Reagan and the triumphalism of the free market that dominated the last three decades remains a good example of the corrective response to the perceived failures of excessive governmental intervention of the three earlier decades. Through such a persistent, but cyclic, struggle between states and markets, capitalism will continue to survive. Such success is ultimately attributable to capitalism's capacity to produce and distribute resources far more efficiently in comparison to its competitors; its imposition of relatively lower burdens on personal, associational, and political freedoms; and its ability to evolve in ways that respond to the necessities of history at any given point in time.

The Economic Crisis and the Future of U.S. Power

The current economic crisis will thus not likely suffice to dethrone capitalism as an economic system. The crisis could, however, undermine its present configuration—which is shaped fundamentally by the economic and political hegemony of the United States—were it to result in a fundamental

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[23] Neal Lawson and John Harris, "No Turning Back," *New Statesman*, March 5, 2009.

[24] Ian Bremmer, "State Capitalism Comes of Age: The End of the Free Market?" *Foreign Affairs* 88, no. 3, (May/June 2009): 40–55.

erosion of U.S. power, both in absolute terms and relative to other major countries such as China and India. Hegemony in international politics derives in the first instance from the military capabilities of a state. By any measure, U.S. military capabilities today and for the foreseeable future will remain unparalleled. But, in the final instance, the capacity to procure and field sophisticated military power depends fundamentally on the health of a nation's economy, understood in terms of both its real and monetary sectors.

The important immediate issue raised by the economic crisis for the future of U.S. power, then, is the character and length of the recession insofar as it affects the United States both absolutely and relatively. A recession by definition is a period of sustained economic slowdown when the gross domestic product of a country contracts, thereby causing reductions in production, investment, employment, profits, and incomes. These falling values in economic activity by extension imply reduced government revenues, which in turn inhibit the state from being able to freely engage in important power enhancing endeavors such as expanding research and development, improving education and infrastructure, and procuring revolutionary weaponry.

If the downturn in the business cycle turns out to be short-lived in duration and the cycle takes the form of a "V," the risks to U.S. power would be considerably mitigated irrespective of what happens to competitors such as China. A V-shaped recession is one where the downturn lasts for only a few quarters and is succeeded by a sharp upturn where the economy recoups (or more than recoups) its previous losses. The recession and recovery that occurred in the aftermath of the bursting of the dot-com bubble earlier in this decade could be characterized as V-shaped because growth picked up in a matter of months rather than years.[25] A U-shaped business cycle, in contrast, is one where recovery also occurs, but much more slowly and at much greater disruption to the economy at large. Simon Johnson, formerly chief economist at the International Monetary Fund (IMF) and now at the Massachusetts Institute of Technology, has described a U-shaped recession as akin to a bathtub with slippery sides that make it difficult for the global economy to easily climb out.[26] The recessions witnessed in the United States between November 1973 and March 1975 and between July 1981 and November 1982 were both U-shaped cycles that spanned sixteen months each and could only be characterized as severe.

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[25] A W-shaped business cycle is a special case of a V-shaped downturn, where sharp contractions and recoveries occur in quick, roller-coaster succession.

[26] William L. Watts and Greg Robb, "Global Economic Downturn Is Picking Up Speed," *MarketWatch*, December 19, 2008, http://www.marketwatch.com/m/story/6ba1a339-95e4-4ada-a519-13377d66b9e1/0.

An L-shaped cycle is the worst of all in that the steep decline captured by the vertical stroke of the letter is followed by a long—and what looks like an interminable—period of slow, unsteady, and precarious growth that is often hard to distinguish from stagnation. The Great Depression and the "lost decade" in Japan represent the only true examples of an L-shaped business cycle in this century, something the United States has been lucky to avoid since 1945. The closest the United States has come to an L-shaped cycle in the postwar period was in 1945–46, when real GDP dropped 13% (measured in 1962 dollars) and then remained essentially flat for a period of two years. This episode, however, is generally viewed as anomalous because it marked the end of World War II, when federal spending dropped suddenly from over 40% of GDP to less than 10%, a drop that overwhelmed private consumption and private investment, which despite soaring in this period could not offset the cutbacks in wartime governmental spending. If the current crisis is excluded, the United States has thus gone through six U-shaped contractions and four V-shaped contractions since 1945 (with possibly one W-shaped contraction if the January–July 1980 and the July 1981–November 1982 recessions are treated as a compound phenomenon).[27]

Nobody quite knows yet what the profile of the current downturn will eventually be.[28] What can be safely said, however, is that it cannot be a V-shaped affair because its duration has already exceeded the longest previous contractions since the Great Depression (November 1973–March 1975 and July 1981–November 1982). Michael Mussa, citing the late Victor Zarnowitz, has persuasively argued that forecasting the turning points of a business cycle has never been a successful profession, but that there has been "one reliable regularity about business cycles and business cycle forecasts: Deep recessions are almost always followed by steep recoveries, and forecasts generally fail to take account of this regularity in consistently underpredicting the initial strength of many economic expansions."[29] Since the current recession is indeed deep by any measure, Mussa argues with some persuasion that the prevailing downturn is also likely to be succeeded by a steep recovery if the historical record is any indicator.

Sustaining the preconditions for recovery, however, will require the United States, and the international community more generally, to preserve

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[27] For a survey of the various types of business cycles, see "Alphabet Debate? Economists Mull Shape of Recession," Agence France-Press, April 25, 2008, http://rawstory.com/news/afp/Alphabet_debate_Economists_mull_sha_04252008.html.

[28] For a useful discussion, see Nouriel Roubini, "The US Recession: V or U or W or L-Shaped?" RGE Monitor, April 7, 2008, http://www.rgemonitor.com/blog/roubini/252460/.

[29] Michael Mussa, "World Recession and Recovery: A V or an L?" (paper presented at the fifteenth semiannual meeting on Global Economic Prospects, April 7, 2009), 9, http://www.iie.com/publications/papers/mussa0409.pdf.

the previous gains of globalization, namely the free flows of trade in goods, services, and capital even in what may be transiently difficult circumstances. It is worth remembering that what contributed mightily to making the Great Depression a "great" depression was not the stock market crash per se but the "beggar thy neighbor" trade policies that followed in conjunction with a national fiscal and monetary contraction. The United States, or at least the executive branch of government, seems intent on avoiding a repetition of the mistakes made during the early 1930s. It remains to be seen, however, whether Washington can stay steadfast in its resolve against emerging protectionist pressures building up in the political arena and in Congress.

How the current U.S. governmental response to the recession has created both opportunities and problems for maintaining U.S. power will be commented on later in this section. The foregoing discussion about the eidetic profiles of different business cycles is important because it provides a simple methodological device for exploring the implications of the economic crisis for U.S. power both in absolute and in relative terms across certain relevant comparisons. If the United States is faced with a difficult U-shaped recession, its capacity to generate the output necessary to maintain its preeminence will be hobbled, depending on how long the recovery takes to materialize and consolidate. If the business cycle in the United States follows a U-shaped pattern, whereas China's recovery in contrast follows a V-shaped trajectory, Beijing's growth in power will be hastened relative to the United States, other things being equal. Obviously, the existing gap in national power between Washington and Beijing is still considerable. Thus, China's ability to force a V-shaped recovery through massive internal spending will still be insufficient to fundamentally alter the existing global balance of power—unless the U-shaped recovery in the United States takes an extremely long time.

Even if this were the case, however, the structural constraints in the Chinese economy, among other things, would still prevent any genuine power transition in the international system in the near-term. Yet any situation where there is both a quick return to high rates of economic growth in China and a stagnating U.S. economy will become dangerous for Washington depending on how long such divergence in performance continues to persist. Such a projection, however, also has to take into account the fact that as China's economy matures, its own growth rates will naturally fall as diminishing returns set in. Moreover, China's strategic prospects over the secular period will in any case be constrained, relative to the United States, by its limitations in regard to labor force growth, science, technology and innovation, and ultimately possibly even capital formation. The worst outcome, in any event, from a U.S. power-political perspective is one in which the U.S. economy is

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confronted by a lengthy L-shaped business cycle, while China continues to make a quick and sustained V-shaped recovery. If such a divergence obtains over a lengthy period of time, the risks to U.S. geopolitical preeminence are indeed grave. The evidence right now, however, provides some reason for hope that a return to positive growth in the United States, at something resembling the traditional rate, will likely occur sometime in 2010, whereas the shape of the current Chinese stimulus package suggests that even though China's own prospective recovery is likely to be faster than that of the United States, Beijing's strategy of boosting production rather than increasing domestic net consumption will actually undermine its ability to sustain long-term growth when export-led opportunities eventually diminish.[30]

In short, therefore, while countries such as China (and to a lesser degree India) will continue to grow in relative power in comparison to the United States, the current global recession is unlikely to catapult them into becoming serious geopolitical (or even economic) challengers anytime soon. To be sure, the recession will have—in fact already has had—a humbling effect on U.S. diplomacy in that policymakers will find it more difficult to lecture other nations on how to manage their economic affairs. But this is, at the end of the day, a somewhat trivial consequence. What is more important is that the crisis will not result in any sudden forfeiture of American primacy, either to China or to anyone else in Asia or globally, simply because the much derided U.S. consumption binge was exactly what permitted China to build its current account surpluses and foreign exchange reserves, both of which are now likely to decline as U.S. spending contracts and national savings increases in the aftermath of the current recession. None of the other major global economies—Japan, Western Europe, or India—can substitute for the United States where absorbing China's production surpluses are concerned. Nor can Beijing's own increased internal investments serve to compensate. Thus, there is no simple way in which the current global crisis can elevate China to geopolitical importance at the expense of the United States.

Nouriel Roubini explained China's predicament succinctly when he noted that,

> Chinese fiscal stimulus will also provide much less bang for the headline buck ($480 billion). For one thing, you have an economy radically dependent on trade: a trade surplus of 12% of GDP, exports above 40% of GDP, and most investment (that is almost 50% of GDP) going to the production of more capacity/machinery to produce more exportable goods. The rest of investment is in residential construction (now falling sharply following the bursting of the Chinese housing bubble) and infrastructure investment (the only component of investment that is rising).

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[30] Michael Pettis, "Asia Needs to Ditch Its Growth Model," *Financial Times*, May 19, 2009.

> With massive excess capacity in the industrial/manufacturing sector and thousands of firms shutting down, why would private and state-owned firms invest more, even if interest rates are lower and credit is cheaper? Forcing state-owned banks and firms to, respectively, lend and spend/invest more will only increase the size of nonperforming loans and the amount of excess capacity. And with most economic activity and fiscal stimulus being capital- rather than labor-intensive, the drag on job creation will continue.
>
> So without a recovery in the U.S. and global economy, there cannot be a sustainable recovery of Chinese growth. And with the U.S., recovery requiring lower consumption, higher private savings and lower trade deficits, a U.S. recovery requires China's and other surplus countries' (Japan, Germany, etc.) growth to depend more on domestic demand and less on net exports. But domestic-demand growth is anemic in surplus countries for cyclical and structural reasons.[31]

If anything, the present international recession therefore highlights the pivotal economic position of the United States: as Martin Wolf summarized, "when the US catches pneumonia, everybody falls seriously ill."[32] And when the global economy recovers, it will be in large part because the U.S. economy, with its consumptive capacity, leads the way. The bottom line, therefore, is that the current economic downturn, severe as it is, will not be some epochal watershed that marks the passing of the hegemonic torch from the United States to its chief emerging Asian rival, China.

While this conclusion may be reassuring in the near term, the medium term is fraught with greater dangers. These dangers arise not from the recession per se but from some of the trends leading up to it and, equally importantly, some of the means Washington employed to combat it. Based on an understanding, first, that what made the current economic meltdown particularly dangerous was the threat to the financial (and, in particular, the banking) system and, second, that a collapse in the banking sector accompanied by a parallel contraction in the money supply was what led to the severe retrenchment in economic activity that created the Great Depression, U.S. policymakers this time around moved with alacrity on five fronts simultaneously: the Federal Reserve embarked on an unprecedented easing of monetary policy to offset the contracting credit market and the broader economy; the Federal Reserve also sharply increased the liquidity in the private sector by a large-scale exchange of cash or its equivalent for various relatively illiquid banking assets; in collaboration with the Department of the Treasury, the Federal Reserve propped up several major investment and commercial banks either though acquisitions, conservatorships, guarantees,

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[31] Nouriel Roubini, "The U.S. Financial System Is Effectively Insolvent," Forbes.com, March 5, 2009, http://www.forbes.com/2009/03/04/global-recession-insolvent-opinions-columnists-roubini-economy.html.

[32] Martin Wolf, "This Crisis Is a Moment, but Is It a Defining One?" *Financial Times*, May 19, 2009.

or increased access to liquidity and capital; Congress, at the behest of the Obama administration, authorized a massive stimulus package of close to $800 billion in a Keynesian effort to jumpstart the contracting economy; and finally, a series of regulatory changes have begun in the hope of preventing financial meltdowns of the sort that occurred from reappearing.[33]

The net result of this massive burst of government spending, though necessary to combat the present recession, is that the huge U.S. current account deficit (which has been largely negative since the early 1980s with one correction that peaked in 1991) has now been complemented by a gigantic budget deficit (which in 2009 closed in on $1 trillion just halfway through the fiscal year). As a result the total U.S. federal debt has reached over $11 trillion in 2009. The return of these "twin deficits" and their growing size should be a source of consternation to all concerned about the future of U.S. hegemony because, if not arrested, they could lead to a consequential erosion of U.S. power. If the budget deficits in the United States continue to grow indefinitely, the result will soon be "upward pressure on interest rates, a crowding out of private investment, and an erosion of longer-term U.S. productivity growth," which would seriously undermine the objective of preserving the robust U.S. economic capabilities necessary for the maintenance of global hegemony.[34] These threats are of particular significance because much of the current U.S. budgetary deficits have not arisen from overspending on education, technology, or infrastructure—investments that would bear great dividends in the future. Instead, the current deficits derive primarily from overconsumption (and rising mandatory expenditures), which do little to expand future American productivity or innovation and as a result contribute to the weakening of U.S. competitiveness over time.

Whether the United States can devise a non-inflationary exit from its vastly expanded deficit spending, therefore, remains a key challenge. One minority but often influential view holds that U.S. fiscal deficits do not matter because continuing economic growth will permit the nation to "grow its way" out of these constraints. In other words, sustained economic expansion of the real economy—if driven by tax cuts, productivity growth, and even borrowing—will in time generate sufficient tax revenue to pay off the deficit. Such a claim makes sense in principle if the budget deficits derive from overspending on productive

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[33] Ben S. Bernanke, "The Crisis and the Policy Response" (the Stamp Lecture, London School of Economics, London, January 13, 2009), http://www.federalreserve.gov/newsevents/speech/bernanke20090113a.htm; and Allen P. Webb, "Weighing the US Government's Response to the Crisis: A Dialogue," *McKinsey Quarterly* (June 2009): 1–5.

[34] Martin Mühleisen, "Overview: Returning Deficits and the Need for Fiscal Reform," in *U.S. Fiscal Policies and Priorities for Long-Run Sustainability*, eds. Martin Mühleisen and Christopher Towe, International Monetary Fund, Occasional Paper No. 227, January 7, 2004, 1.

activities that yield high rates of return over time; much of the U.S. budget deficit, however, derives from growing entitlement spending, and although the recent stimulus package makes a bow in the direction of increased real investments, it is simply unclear whether they will yield the long-term returns that the Obama administration has touted. In any event, the evidence suggests that increased economic growth alone will not compensate to offset the deficit if both economic growth rates and the rate of mandatory spending increases stay within traditional norms. The U.S. Government Accountability Office (GAO), for example, has estimated, that "closing the current long-term fiscal gap based on reasonable assumptions would require real average annual economic growth in the double digit range every year for the next 75 years." Given the average 3.2% economic growth rate in the United States throughout the 1990s, it is reasonable to conclude, as the GAO does, that "tough choices will be required" because the country "cannot simply grow [its] way out of this problem."[35]

If a situation of national bankruptcy is to be avoided, these choices ultimately boil down to some combination of raising taxes and cutting spending. If the large and growing structural deficits are not arrested by actions taken today, balancing the budget in 2040 might require such radical actions as cutting the total federal spending by 60% or raising federal taxes to twice the current level.[36] Washington has, of course, managed to avoid making these difficult decisions thus far because the country has benefited from large injections of foreign capital. The current economic crisis suggests that such an approach will not be sustainable indefinitely. If U.S. national deficits have to be continuously financed in the face of low domestic savings by foreign investors, there could come a point when bondholders abroad, fearing the dollar's loss of value, choose to jettison the currency in favor of other alternatives, thus resulting in a significant plunge in dollar prices.

This is a serious and growing risk for three reasons. First, the majority of U.S. assets held abroad reside primarily in the private sector and not in central banks. This implies that foreign investors, who hold these assets either because they promise superior profits or superior safety, are likely to dump them the moment they sense a threat of falling currency values.[37] Second, even the foreign central banks, who are smaller holders of U.S. assets and who are in principle less likely than private asset holders to dump their dollars merely to realize transient financial gains, could increasingly be tempted to slowly diversify their currency baskets by investing in other legal tender. This reduced demand for dollars would make deficit financing in the

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[35] David M. Walker, "U.S. Financial Condition and Fiscal Future Briefing," GAO-08-446CG, National Press Foundation, January 17, 2008, 27.

[36] Ibid.

[37] Rajan, "Perspectives on Global Imbalances."

United States more complicated and may have to be compensated for, once again, over the long term by increasing interest rates.[38] Third, unlike the situation obtaining for most of the postwar period when there was no other alternative to the U.S. dollar as the international reserve currency, the rise of the euro now provides both foreign private investors and foreign central banks an alternative store of value. Although there are not enough euros currently to fully substitute for the dollar as a reserve currency, the steady growth of the European market will increasingly provide alternatives to the U.S. dollar.[39]

Any major downward shift in foreign preferences in regard to holding dollars over time would then undermine the current U.S. approach of funding deficits through external financing. While such a shift would undoubtedly cause interest rates in the United States to rise—precipitating declines in the domestic bond market, increasing the difficulties in raising capital for productive ventures, and potentially depressing global growth rates—the larger and more consequential danger is the potential erosion of the dollar as the international reserve currency. The demise of this asset would, as Jeffrey Frankel summarized so well, "probably extend beyond the simple loss of seignorage narrowly defined." Rather, the United States would surrender what Charles de Gaulle once called the "exorbitant privilege" of being the banker to the world, where it enjoys the benefits of "accepting short-term deposits at low interest rates in return for long-term investments at high average rates of return."[40] Seeking to protect this exorbitant privilege should, therefore, be a key goal of U.S. grand strategy because it is fundamentally related to the preservation of Washington's political hegemony globally. As the earlier example of Great Britain amply attests, the transformation of the pound sterling from the international reserve currency of the nineteenth and early twentieth centuries to just another national currency by the end of World War II marked the power transition from British to U.S. hegemony. The loss of the dollar's status as the international reserve currency could be the fateful marker that heralds a similar transition in the future.

Such an outcome is, of course, not inevitable. Although present American difficulties are formidable, they can be managed and the negative trends reversed through a wise public policy. The great advantage of American

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[38] The short-term costs, however, are likely to be related more to the risks and rewards of treasury borrowing under currency swap facilities. For a useful discussion, see Bruce Krasting, "China's Threat to Diversify Currency Holdings Is Real, but Manageable," *Seeking Alpha*, March 26, 2009, http://seekingalpha.com/article/127909-china-s-threat-to-diversify-currency-holdings-is-real-but-manageable.

[39] Menzie Chinn and Jeffrey Frankel, "The Euro May Over the Next 15 Years Surpass the Dollar as Leading International Currency," *International Finance* 11, no. 1 (2008): 49–73.

[40] Jeffrey Frankel, "Could the Twin Deficits Jeopardize U.S. Hegemony?" *Journal of Policy Modeling* 28 (2006): 660.

capitalism is that individual agents do respond appropriately to structural incentives—if these incentives can be supplied by conscientious policy change. The current recession, for example, has already demonstrated that U.S. savings rates can shift upward: under pressures of necessity, American household debt in 2009 decreased for the first time since 1952 and savings rates, which had been declining since the 1980s, are expected to rise to somewhere between 5–10% this year. Attacking the twin deficits, therefore, is possible but will require a combination of reduced spending and steady dollar depreciation. Ideally, this effort would proceed in coordination with other countries so that no single nation has to bear the burdens of suffering asymmetric losses. There is considerable room for pessimism on this score, however, because the current recession suggests that countries are more willing to trade charges about who is to blame than they are managing adjustments through coordinated action. This is not to say that harmonized action is impossible, as coordination between central banks has already occurred during the crisis. Yet orchestrating a rapid and orderly adjustment of global current account imbalances—which will be necessary if a new, more stable equilibrium is to be restored—will require a political agreement between the major trading states that at the moment seems unlikely. If the United States, however, makes the effort unilaterally to get its own economic house in order, other countries may not have any choice but to engage Washington in a serious discussion about managed collective action. Not to do so would open these countries to the vulnerabilities that will otherwise descend upon them haphazardly on account of both diminishing U.S. consumption (and, by implication, U.S. imports) and capital losses suffered on their dollar-denominated assets.

The chapters in this volume implicitly clarify why such a readjustment of global current account balances will be necessary and why it is also likely to be difficult. Pieter Bottelier's chapter details how China, more than say India in comparison, has been deeply integrated into the global trading system and, accordingly, has suffered greatly because of the contracting U.S. market. Beijing is now valiantly striving to stimulate the country's economy through increased domestic spending. Although it has the resources to sustain an aggressive fiscal and monetary stimulus domestically, such actions may still be an insufficient substitute for the loss of U.S. markets if the Asian and European alternatives that China is consciously pursuing turn out to be inadequate—as is mostly likely.

As Chung Lee and Joon-Kyung Kim detail in their chapter, the South Korean economy has suffered grievously as well; in fact the burdens here have been doubled because the real economy has been forced into a recession at the same time that Korean financial markets have been undermined by the

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collapse of the U.S. financial system. To complicate things further, South Korea's links to the Chinese economy now exceed those of the United States, and while this may help mitigate the U.S.-South Korean foreign imbalances some, it creates unhelpful geopolitical dependencies on China.

Dwight Perkins, in his chapter on Southeast Asia, shows that comparable challenges afflict this critical region as well. Thanks to the reforms undertaken in the aftermath of the Asian financial crisis of 1997–98, the financial sector in Southeast Asia has largely avoided being hit, but the recession in the United States has precipitated a large decline in Southeast Asian exports. The Southeast Asian states, like China, have also increased domestic spending, but here again such a stimulus will not suffice unless the contraction in U.S. markets is picked up by China or Japan.

Similar challenges are manifested in Tokyo. As William Grimes details in his chapter, Japan's responses to the domestic financial crisis and economic stagnation since the mid-1990s has enabled the country to mitigate the threats of financial contagion. Sclerotic Japanese politics and now a slowing U.S. economy have, however, limited Japan's ability to jumpstart its productive machine despite what has been a very vigorous effort to stimulate domestic consumption and international exports.

In four major trading centers in Asia—China, Japan, South Korea, and Southeast Asia—renewed economic growth therefore depends on expanded exports to the United States. Yet, the contraction in American consumption brought about by the recession makes the prospects of dramatically increased imports from Pacific Asia precarious, at least in the short term. When the demand for these imports finally increases, it may be accompanied once again by a commensurate demand for Asian financing, if Washington is unable to expand its savings rate in the interim—with all the same risks created by the erstwhile global imbalances to begin with. This disequilibrium can be partly circumvented if the Pacific Asian states either increase domestic consumption or increase intraregional trade to compensate for lost exports to the United States. Although both alternatives are being explored more concertedly today than before, it is unclear whether either of these solutions will be sufficient because the lower incomes in the Asian region may not permit the large-scale consumption increases that will be required to offset reduced U.S. imports. Even if such expanded regional demand could be sustained, however, the geopolitical consequences may turn out to be unpalatable for the United States if they were to involve either a political "decoupling" between Washington and its Asian allies or a greater Asian economic integration with, and dependency on, China at a time when Beijing is gradually emerging as a major global power. Given that this issue will become salient henceforth until the medium term, engineering

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an orderly global adjustment that does not unduly disadvantage the United States in both economic and geopolitical terms must become a critical policy priority in Washington if U.S. hegemony is to be sustained over the long run.

This volume also contains two other chapters pertaining to a pair of interesting outliers—from the perspective of world trade—in Asia. Steven Halliwell's superb survey of Russian responses to the global crisis underscores the fragility of Russian power and how this once-mighty political titan not only barely survived a financial collapse but also is now squarely at the mercy of foreign effective demand to sustain the natural resource prices that provide the country with revenue and by implication solvency. Were it not for Moscow's large foreign currency reserves, derived from previously high energy prices, Russia's collapse might have been inevitable given its quintuple maladies of heavy reliance on energy exports, overbearing state presence in the economy, pervasive corruption, fragile market institutions, and underdeveloped financial system. Even though Russia is weakly integrated into the Asian trading system, the country's recovery will depend—just like other key Asian powers—on a global economic recovery that bids up energy prices. However this unfolds, Halliwell warns that "Russia will look to maximize its export revenues, attract foreign capital, and undermine the global influence of the U.S. dollar" by seeking, if necessary, what may be problematic bargains with U.S. regional challengers such as Iran and China.

Of all the countries and regions surveyed in this volume, India represents an interesting exception because relatively lower integration with the global trading system rendered it more immune to the effects of the global crisis. Sanjaya Baru's chapter details how India's external sector liberalization—which has occurred in the context of a cautious reform program domestically and has been shaped by previous responses to fiscal, balance of payments, and financial crises—resulted in the adoption of currency convertibility only on the current (and not on the capital) account. This fact has made the Indian economy more resilient to external shocks, but Baru notes that sustaining high rates of long-term economic growth will require continued reform at home and deeper integration with the trading system abroad. New Delhi's interest in the critical problem of "global rebalancing" derives fundamentally from fears that the major developed economies might choose to rely on protectionist strategies to manage their current account deficits, which would threaten India's growing exports of both services and merchandise. In that sense, India's predicaments are similar to China's and the other Asian trading states, though on a reduced scale. The U.S. interest in strengthening Indian power geopolitically—in order to preserve a balance in Asia—would require Washington to continue to afford India easy access

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to U.S. markets, but this in turn exacerbates the global imbalances that have been the cause of the current recession.

This volume of *Strategic Asia* continues the tradition of commissioning a special study on a subject not related to the book's main theme, and this year's focus centers on an issue that is also critical to the maintenance of both U.S. hegemony and global order though not from an economic perspective: nuclear nonproliferation. The chapter authored by Christopher Ford examines a difficult subject, namely, whether the nonproliferation regime can survive the many challenges that confront it in Asia and beyond. Through a careful examination of the attitudes toward proliferation held by various protagonists, Ford demonstrates that the current nonproliferation equilibrium is indeed precarious because many of the regime's strongest state advocates are either ambivalent about their own status or are constrained by a necessary duplicity pertaining to their own choices. Despite the problems affecting the regime, Ford nonetheless—and correctly—argues that neither wholesale repair nor renewal may be possible, leaving states mainly with a set of complementary elements to advance the regime's nonproliferation goals.

Because Ford's chapter raises a larger and more unsettling question—that of whether any treaty, no matter how noble, can survive the circumstances that engendered it—the economic issues addressed by the other chapters in this volume become even more important: for some non-nuclear states today, such as Japan, South Korea, and possibly Taiwan, their long-term economic performance will have a significant bearing on whether nuclear weapons are viewed as necessary for their security; a similar calculation also affects the degree of dependence on nuclear weapons as far as some other current nuclear powers are concerned, such as Russia, China, India, Pakistan, and North Korea; and, finally, the extent and durability of U.S. economic and political hegemony will not only affect the shape of future nuclear proliferation but will also determine the capacity with which the United States will be able to cope with emerging nuclear threats in the years to come.

This year's volume as a whole, therefore, underscores the importance of the United States successfully managing the challenge of global rebalancing if U.S. hegemony is to be sustained durably into the future. While the near-term threats to this hegemony are not likely to be significant, the medium-term problems could be serious. This danger comes about because there are strong structural disincentives within the United States to avoid reducing budget deficits even as there are equally strong disincentives in many foreign nations to avoid their currencies from appreciating and shifting toward increased domestic consumption. The temptation to sustain the prevailing global imbalances will thus remain strong because codependency is both less

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painful in the short term and serves multiple interests, even if it increases the medium-term risks to the United States.[41]

If the United States can therefore manage the treacherous intervening dangers to its hegemony, the long-term future of American preeminence is much brighter than is often supposed. This is not simply because fixing the medium-term problems will inevitably make things better in the secular future—though it certainly will—but because the social foundations of U.S. power are in fact highly robust in comparison to all other major powers and especially the United States' rivals. As previous volumes of *Strategic Asia* have elaborated more fully, if economic dominance over the long term depends on high levels of capital accumulation, labor-force growth, and technological innovation, the United States is favorably positioned relative to most other countries because of its size and natural resources, its demographic profile and access to immigration, its wealth and material well-being, its open economic and political systems, and its social and institutional adaptability.[42] In fact, no other national competitor comes close to the United States when assessed compositely along all these dimensions. Barring some extraordinary wild cards—what insurance salesmen conveniently label "acts of God"—the long-term future of U.S. hegemony, both economic and political, is extraordinarily bright. If the United States' medium-term maladies, most of which revolve around its model of capital formation, can therefore be treated, the current economic crisis too will have turned out to be just another blip in the convulsive upward trajectory of what is the world's most vibrant capitalist economy and for that very reason also history's mightiest hegemonic power.

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[41] Catherine L. Mann, "Managing Exchange Rates: Achievement of Global Re-balancing or Evidence of Global Co-dependency," *Business Economics* 39, no. 3 (July 2004): 20–29.

[42] See, in particular, Ashley J. Tellis, "Preserving Hegemony: The Strategic Choices Facing the United States," in *Strategic Asia 2008–09: Challenges and Choices*, eds. Ashley J. Tellis, Mercy Kuo, and Andrew Marble (Seattle: National Bureau of Asian Research, 2008), 3–37; and Ashley J. Tellis, "India in Asian Geopolitics," in *Rising India: Friends and Foes*, ed. Prakash Nanda (New Delhi: Lancer, 2007), 118–30.