The Future of America's Financial Dominance

Consider four factors.

By Robert D. Hormats

It appears to be accepted wisdom that the current global financial crisis, because it had its origins in the United States, marks the end of American financial leadership. That is not, however, a foregone conclusion. Whether and how much this crisis will weaken U.S. leadership will depend heavily on four factors:

■ First, how well America's financial and monetary authorities, markets, and economy respond to this crisis and how quickly the country rebounds;

■ Second, what changes are made to avoid the recurrence of anything of similar magnitude in the future;

■ Third, whether American leaders, in crafting a new stimulus and job creating package, do so through programs that also address underlying structural problems such as investment in infrastructure and support for the development of new sources of clean energy;

■ Finally, how quickly after the crisis and recession Washington reverses the sharp rise in the government's debt-to-GDP ratio that will take place during this period, begins

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to engage in more rigorous budgetary practices than it did earlier in this decade, and puts entitlement programs on a sustainable basis.

I will focus primarily on the last of these.

LONGER-TERM THREATS TO U.S. LEADERSHIP

The current financial crisis presents the greatest immediate threat to America's prosperity and financial leadership in many decades. But the greatest long-term threat is complacency—complacency about the enormous financial imbalances that will emerge rapidly in coming decades as baby-boomers retire in growing numbers and their health requirements increase. These imbalances, coupled with large budget deficits resulting from a tendency in Washington to give Americans more government than it asks them to pay for, loom large on the horizon. They could pose serious dangers for the U.S. economy and financial system in coming decades, unless corrective measures are undertaken in coming years.

For the last two decades, the United States has sidestepped a series of tough economic, financial, and energy issues. The American political system appears to suffer from chronic shortsightedness. Too often, its leaders have engaged in wishful thinking, believing that impending financial problems will go away on their own, with no need to take corrective action.

Difficult decisions have been avoided on how best to pay for current wars and homeland security (all of the added costs have been borrowed), reduce energy dependence, ensure the sustainability of Social Security, Medicare, and Medicaid, and bring long-term revenues and spending into balance. For years, the default position has been "do nothing" or, at least, nothing that would involve any real sacrifice or political pain. We collectively have ignored the serious implications of inertia.

Polarization of the American political system has blocked the bold measures and the political compromises required to overcome this inertia. By ducking these issues, Washington has shifted a heavy financial burden to future taxpayers. It has also jeopardized the nation's future economic well-being and security, its resilience if faced with new internal or external crises, and its capacity to play a robust long-term global leadership role.

Effect on the United States: Too Soon to Tell

Several decades ago, China's premier Zhou Enlai was asked to assess the impact of the French Revolution. Responded the premier, "It is too soon to tell." There is little doubt that the current crisis will have a profound impact on many aspects of the American and global financial system—on regulatory policy, the conduct of financial institutions, public attitudes toward the financial sector, and the role of governments in economies. Even smaller upheavals have had important effects in all of these areas. It is too early to determine the long-term affect of the current crisis on America's standing in the global financial system or its overall leadership. That will turn less on this crisis itself and more on whether the United States responds effectively to it and to other financial challenges that have been left unaddressed for decades.

—R. Hormats

China's former premier **Zhou Enlai.**

THE CURRENT CRISIS AND THE GLOBAL ECONOMY

Although the United States is the epicenter of the current crisis, the turmoil has rapidly become global. As this crisis vividly demonstrates, economies and financial markets are extremely closely integrated. This crisis, like a virulent virus, has spread throughout the world. No area has escaped contagion. Troubled securities that originated in the United States were sold in large amounts to foreign institutions. And weakening economic activity in the United States has curtailed the exports and thus the weakened the economies of America's trading partners.

But financial excesses—including runaway housing speculation—have also occurred independently in countries other than the United States. And in many emerging economies, stock prices rose dramatically through the early years of this decade; recently they have fallen back sharply, in some cases far more sharply than in the United States.

Every nation that depends heavily on global trade and finance, has large investments abroad, or sells its commodities in the world market—which means basically every nation—has an interest in resolving this problem. The management of the current crisis reflects the fact that virtually all major economies see themselves as vulnerable and most are playing a role in the management of the crisis.

The G7 and G20 finance ministers, the International Monetary Fund, the Basel Group of central bankers, and the G20 heads of state have all been engaged in an effort to restore stability and reverse the spiraling downturn in global economic activity. Several weeks ago the Federal Reserve and a number of foreign central banks—including the People's Bank of China—took the extraordinary step of jointly reducing interest rates. This crisis has, in fact, led to unprecedented cooperation among global financial and monetary authorities. Lest we take this for granted, this did not happen in the 1930s, which is one reason for the Great Depression.

AMERICA'S CHANGING ROLE

Inevitably, the United States will not play as dominant a role in the global economy and international finance going forward as it did during most of the twentieth century. This change in America's role is not so much because of the current crisis. It reflects, to a greater degree, the rise of emerging economies such as China, India, Brazil, and Russia, as well as key Middle Eastern oil exporters. They have become major financial and trading powers. They also are gaining great political influence in their regions and globally.

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As the result of this crisis, many of these nations are questioning the merits of the U.S. financial system and its applicability as a model for them. Skepticism also has increased about the wisdom or validity of what came to be known as the "Washington Consensus"—which was predicated on the principle of market-oriented and decreasingly regulated trade and finance.

However, important aspects of America's brand of market capitalism, with its emphasis on entrepreneurialism, innovation, close collaboration between business and academia, the rule of law, and flexibility, are likely to remain attractive to other nations. Moreover, if the American economy and financial system prove as resilient as they have throughout history, and the United States makes the kinds of policy and regulatory corrections that have enabled it to recover from market crises going back to Alexander Hamilton and the founding of the nation, that could well reinforce global respect for the United States as a financial leader.

In almost any foreseeable case, even if recovery does not proceed smoothly, the United States is likely to continue to be the most significant participant in the global financial system for a long time. By necessity, it must play the central role in forging solutions to the current crisis—and in the period that follows to ensure that a similar event does not occur again.

One reason the United States will continue to play a pivotal role in the global financial system is the pivotal role of the dollar. This crisis has demonstrated the centrality of that currency in global financial activity, as risk-adverse investors around the world have fled into U.S. Treasury securities.

But the United States will have to play its leadership role differently in this decade than it did in the past. In the current crisis, highly constructive initiatives have come from abroad, particularly from the leaders of Britain and France. Solutions to global problems now require the efforts of a wide range of nations—as financial turmoil in one part of the world immediately affects all others. And if one country protects its banks and financial system, money will move there unless others take similar measures to restore confidence.

Moreover, unprecedented financial and commercial multipolarity means that virtually no progress can be made on any major international financial problem (or, for that matter, multilateral trade negotiation, environmental issue, energy matter, or effort to contain a pandemic) with only the major industrialized nations. The major emerging nations must play an integral part in the process of finding solutions; forums that lack their presence will also lack the capacity and legitimacy to address many such issues on a broad enough scale. Finding forums and processes of consultation and coordination that include the major new players, and devising ways to enable them to work efficiently to produce concrete results on such subjects, will pose a leadership challenge for the United States in coming years.

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THE CRITICAL ROLE OF SOUND AMERICAN FISCAL POLICY

The enormous amounts of borrowing and the large deficits that will be accrued by the U.S. government during this crisis will inevitably constrain America's capacity to pursue a wide range—although not all—of its international objectives. Budgetary requests for the military, homeland defense, and foreign aid will encounter public and Congressional resistance as the country devotes more resources to overcoming serious problems at home. In recognition of budgetary constraints, rigorous prioritization of the entire national security and foreign policy budget will be needed.

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Climbing unemployment in the United States, coupled with already-strong popular resentments about globalization and international trade agreements, will raise the threshold for those advocating new trade liberalizing agreements and lower it for those demanding additional protection for American jobs and businesses. The new populism in America has been driven in significant part by resentment in some quarters of the country's business and financial community. Traditionally those communities have been among the most vocal advocates of more open trade, but in the future their advocacy may carry less weight in the eyes on the public.

An important way to increase the receptivity of American workers to future trade liberalization is to enhance their skills, insure their access to affordable healthcare, and provide adequate benefits when they lose their jobs. But such measures will cost more money—which will be in short supply for a period of time. Yet finding ways to restore the confidence of middle-income families in their financial futures, ability to obtain health care and send their kids to school will be a key factor in America's future prosperity and the government's ability to conduct an internationalist trade and economic policy.

For a while, depending on the duration of this downturn, Washington will be forced to play a more limited role in global affairs. It will have fewer resources available to bring American power and influence to bear on global events and less domestic support for many kinds of international activities. Americans will insist that government funds be used to address domestic problems, and as the deficit widens, funds will be limited for international purposes.

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For example, Washington will be constrained in its ability to provide financial support to other nations—as it did, for instance, in the case of the Mexican crisis. Iceland, a NATO ally, sought the assistance of Moscow, not Washington, to address its financial crisis.

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But, although this may be small consolation, many other nations, including some with which the United States has had substantial policy differences, will face even greater resource constraints, including Iran and Venezuela.

This crisis could affect the U.S. role in the world in another way: it makes this country more economically vulnerable in the event of another terrorist attack. One of Osama Bin Laden's avowed objectives in 2001 was to inflict major damage on the American economy. A terrorist attack takes years to plan, and thus it cannot easily be triggered in a narrow window of a limited financial crisis. However, the risk grows the longer the financial turmoil and the recession last—and potential terrorists might be tempted to strike in order to cause even more economic and financial disruption.

In 2001, the United States was in a strong financial position to respond to the September 11 attacks because it had enjoyed several years of budget surpluses. These increased its fiscal resiliency—enabling Washington with relative ease to devote substantial funds to recovery at home and to a powerful response abroad. The United States no longer has such a margin. The budget is stretched and will be even more so in the next couple of years. In the financial sphere as well as in the military, perceived weakness is a source of vulnerability. This risk is yet one more powerful incentive to address and resolve this problem as quickly as possible.

This crisis also substantially increases U.S. dependence on foreign capital. The Treasury will need to borrow enormous sums—perhaps up to $2 trillion on a gross basis in 2009—to pay for programs that shore up the U.S. financial system, replace maturing securities, and cover a widening budget deficit caused by a drop in revenues and new stimulus measures. Although household savings are rising in the United States as consumers become more cautious and spend less money, a large portion of this borrowing will need to come from abroad.

Ensuring the steady flow of foreign capital during this period will be vitally important. The need for such capital places a high premium on working with authorities in other nations not only on financial market issues but also on trade and investment matters to avoid conflicts, or nationalistic policies in the United States and abroad, that could jeopardize these flows.

Maintaining a well-functioning U.S. domestic and global capital market also will be essential to ensuring a smooth inflow of funds at a reasonable cost. It will become a national imperative to pay down the enormous debt the government will incur during the recession as soon as possible after the emergency requirements for financial stabilization and growth stimulus have passed.

Large debt pay-downs have been accomplished in the past after periods when the Treasury was forced to engage in extraordinary amounts of borrowing. At the end of World War II, for instance, government debt had risen to an unprecedented 110 percent of GDP. But a period of fiscal discipline cut that figure in half a decade later. This reduction established a sound financial basis for paying for the added costs of the early Cold War.

Failure to reduce the debt as a portion of GDP after the current stimulus and financial stability programs have done their work could lead to serious fiscal problems, particularly in view of the expanded borrowing for entitlement programs that will occur in coming years. It will certainly limit the government's flexibility to address new emergencies at home or abroad in the future.

Substantial debt reduction when growth resumes, on the other hand, will improve the confidence of capital markets and enable the United States to retain its good standing in the eyes of foreign investors. It will also, if coupled with increased household saving, reduce U.S. dependence on foreign capital.

Until U.S. savings rise substantially, this country will continue to depend heavily on foreign capital. That dependence can be a vulnerability if flows are interrupted. It imposes a requirement on Washington to ensure they are not. But it is equally true that few nations have an interest in a deliberate disruption of capital flows into the United States. That would curb American growth, push up the value of many foreign currencies, damage exports, and cause the enormous holdings of dollar-denominated assets held by foreign governments and private investors to plunge in value.

So there will be strong incentives for other nations to work with American officials to ensure that this dire scenario does not occur. In the longer term, however, if foreign holders of capital do not have confidence in U.S. fiscal policy or U.S. markets, the risk grows that they will accelerate their efforts to reduce the portion of dollars in their portfolios or reserves.

The reserve currency role of the dollar, and its status as the world's preeminent transaction currency, continue to be a major benefit to the United States. A significant diminishment of these roles would impose a severe financial constraint on this country.

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If the current crisis serves any purpose, it is as a wake-up call for the United States to tackle underlying long-term threats to its financial soundness—especially budgetary excesses, large prospective imbalances in entitlement programs, and growing oil dependence. If left unaddressed, like the problems that led to the current crisis, they will bring enormous harm to the United States in the future.

If, however, U.S. leaders do take on these issues and make needed changes, and the country demonstrates its characteristic resilience, it may turn out that this crisis actually strengthens its leadership in the longer term. As Zhou Enlai said, "It is too soon to tell." ◆