GLOBAL POWER REVISITED
THE UNITED STATES IN A CHANGING WORLD ORDER

Economic leadership beyond the crisis

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In the postwar period, US power and prestige, beyond the nation's military might, have been based largely on American relative economic size and success. These facts enabled the US to promote economic openness and buy-in to a set of economic institutions, formal and informal, that resulted in increasing international economic integration. With the exception of the immediate post-Bretton Woods oil-shock period (1974-85), this combination produced generally growing prosperity at home and abroad, and underpinned the idea that there were benefits to other countries of following the American model and playing by American rules.

Initially this system was most influential and successful in those countries in tight military alliance with the US, such as Canada, West Germany, Japan, South Korea, and the United Kingdom. With the collapse of Soviet communism in 1989, and the concomitant switch of important emerging economies, notably Brazil, China, India, and Mexico, to increasingly free-market capitalism, global integration on American terms through American leadership has been increasingly dominant for the last two decades.

The global financial crisis of 2008-09, however, represents a challenge to that world order. While overt financial panic has been averted, and most economic forecasts are for recovery to begin in the US and the major emerging markets well before end of 2009 (a belief I share), there remain significant risks for the US and its leadership. The global financial system, including but not limited to US-based entities, has not yet been sustainably reformed. In fact, financial stability will come under strain again when the current government financial guarantees and public ownership of financial firms and assets are unwound over the next couple of years. The growth rate of the US economy and the ability of the US government to finance responses to future crises, both military and economic, will be meaningfully curtailed for several years to come.

Furthermore, the crisis will accelerate at least temporarily two related long-term trends eroding the viability of the current international economic arrangements. First, perhaps inevitably, the economic size and importance of China, India, Brazil, and other emerging markets (including oil-exporters like Russia) has been catching up with the US, and even more so with demographically and productivity challenged Europe and northeast Asia. Second, pressure has been building over the past fifteen years or so of these developing countries' economic rise to give their governments more voice and weight in international economic decision-making. Again, this implies a transfer of relative voting share from the US, but an even greater one from over-represented Western Europe. The near certainty that Brazil, China, and India, are to be less harmed in real economic terms by the current crisis than either the US or most other advanced economies

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will only emphasise their growing strength, and their ability to claim a role in leadership. The need for capital transfers from China and oil-exporters to fund deficits and bank recapitalisation throughout the West, not just in the US, increases these rising countries' leverage and legitimacy in international economic discussions.

One aspect of this particular crisis is that American economic policymakers, both Democratic and Republican, became increasingly infatuated with financial services and innovation beginning in the mid-1990s. This reflected a number of factors, some ideological, some institutional, and some interest group driven. The key point here is that export of financial services and promotion of financial liberalisation on the US securitised model abroad came to dominate the US international economic policy agenda, and thus that of the IMF, the OECD, and the G8 as well. This came to be embodied by American multinational commercial and investment banks, in perception and in practice. That particular version of the American economic model has been widely discredited, because of the crisis' apparent origins in US lax regulation and over-consumption, as well as in excessive faith in American-style financial markets.

Thus, American global economic leadership has been eroded over the long-term by the rise of major emerging market economies, disrupted in the short-term by the nature and scope of the financial crisis, and partially discredited by the excessive reliance upon and overselling of US-led financial capitalism. This crisis therefore presents the possibility of the US model for economic development being displaced, not only deservedly tarnished, and the US having limited resources in the near-term to try to respond to that challenge. Additionally, the US' traditional allies and co-capitalists in Western Europe and Northeast Asia have been at least as damaged economically by the crisis (though less damaged reputationally).

Is there an alternative economic model?

The preceding description would seem to confirm the rise of the Rest over the West. That would be premature. The empirical record is that economic recovery from financial crises, while painful, is doable even by the poorest countries, and in advanced countries rarely leads to significant political dislocation. Even large fiscal debt burdens can be reined in over a few years where political will and institutions allow, and the US has historically fit in that category. A few years of slower growth will be costly, but also may put the US back on a sustainable growth path in terms of savings versus consumption.

Though the relative rise of the major emerging markets will be accelerated by the crisis, that acceleration will be insufficient to rapidly close the gap with the US in size, let alone in technology and well-being. None of those countries, except perhaps for China, can think in terms of rivaling the US in all the aspects of national power. These would include: a large, dynamic and open economy; favorable demographic dynamics; monetary stability and a currency with a global role; an ability to project hard power abroad; and an attractive economic model to export for wide emulation.

This last point is key. In the area of alternative economic models, one cannot beat something with nothing - communism fell not just because of its internal contradictions, or the costly military build-up, but because capitalism presented a clearly superior alternative. The Chinese model is in part the American capitalist (albeit not high church financial liberalisation) model, and is in part mercantilism. There has been concern that some developing or small countries could take the lesson from China that building up lots of hard currency reserves through undervaluation and export orientation is smart. That would erode globalisation, and lead to greater conflict with and criticism of the US-led system.

While in the abstract that is a concern, most emerging markets - and notably Brazil, India, Mexico, South Africa, and South Korea - are not pursuing that extreme line. The recent victory of the incumbent Congress Party in India is one indication, and the statements about openness of Brazilian President Lula is another. Mexico's continued orientation towards NAFTA while seeking other investment flows (outside petroleum sector, admittedly) to and from abroad is a particularly brave example. Germany's and Japan's obvious crisis-prompted difficulties emerging from their very high export dependence, despite their being wealthy, serve as cautionary examples on the other side. So unlike in the1970s, the last time that the US economic performance and leadership were seriously compromised, we will not see leading developing economies like Brazil and India going down the import substitution or other self-destructive and uncooperative paths.

If this assessment is correct, the policy challenge is to deal with relative US economic decline, but not outright hostility to the US model or displacement of the current international economic system. That is reassuring, for it leaves us in the realm of normal economic diplomacy, perhaps to be pursued more multilaterally and less high-handedly than the US has done over the past 20 years. It also suggests that adjustment of current international economic institutions is all that is required, rather than desperately defending economic globalisation itself.

For all of that reassurance, however, the need to get buy-in from the rising new players to the current system is more pressing on the economic front than it ever has been before. Due to the crisis, the ability of the US and the other advanced industrial democracies to put up money and markets for rewards and side-payments to those new players is also more limited than it has been in the past, and will remain so for at least the next few years. The need for the US to avoid excessive domestic self-absorption is a real concern as well, given the combination of foreign policy fatigue from the Bush foreign policy agenda and economic insecurity from the financial crisis.

Managing the post-crisis global economy

Thus, the US faces a challenging but not truly threatening global economic situation as a result of the crisis and longer-term financial trends. Failure to act affirmatively to manage the situation, however, bears two significant and related risks: first, that China and perhaps some other rising economic powers will opportunistically divert countries in US-oriented integrated relationships to their economic sphere(s); second, that a leadership vacuum will arise in international financial affairs and in multilateral trade efforts, which will over time erode support for a globally integrated economy. Both of these risks if realised would diminish US foreign policy influence, make the economic system less resilient in response to future shocks (to every country's detriment), reduce economic growth and thus the rate of reduction in global poverty, and conflict with other foreign policy goals like controlling climate change or managing migration and demographic shifts. If the US is to rise to the challenge, it should concentrate on the following priority measures.

Firstly, it should focus its economic diplomacy on Brazil, India and South Korea. The widely held instinct these days is to pursue China's attention and good graces obsessively if not exclusively. While good relations with China are of course important, that will not be enough, and excessive pursuit of that may be counter-productive. For the primary goals of keeping a multilateral system open in finance and trade, and making sure the world does not adhere to a truly competing alternative to the (properly chastened) US economic model, it is better to focus on the swing voters among the major emerging markets. These three countries combined have at least comparable economic weight and population to China's, and as three countries of noted independence and accomplishment, they have real legitimacy as alternative voices at the table to China's. Furthermore, these are the success stories in recent years of emerging markets that have by and large played by the US-promoted rules, and benefitted from so doing. So they are important for their own opinions and for their resonance as examples, as well as counterweights to China in the normal sense of diplomacy. They also give opportunities in various ways for US allies in Western Europe and Japan to be constructively involved.

The US should also pro-actively seek a massive shift in voting and voice at the World Bank and IMF. The expansion of resources provided to the IMF, with a surprising absence of demands for near-term reallocation of shares and chairs, at the March 2009 G20 Summit has given a false sense of confidence. Actually, what is still happening is the major emerging markets self-insuring and removing themselves from the Fund's activities - which both leads to mercantilist tendencies and a power vacuum. The US and EU must offer up several percentage points of voting directly to China, Brazil, and India out of their current voting allocations. This should include going to just below the voting shares needed for unilateral veto power on behalf of both the EU and the US - if these voting blocs cannot get one other representative to side with them, they should not have a veto. The symbolism will be very important, especially if done ‘voluntarily' ahead of the current piddling agreements on IMF share changes, even though in practice the US would retain a veto. This, of course, would require consolidation of the European seats into one euro area representative and a reorganised constituency for non-euro EU members. Promising that no European or American candidates would be nominated for the Managing Director (IMF) / President (World Bank) jobs when they next become vacant would be a nice touch.

In addition, the US needs to move quickly to adopt new coordinated or global financial regulations. This priority sounds either banal or hopelessly idealistic, depending upon who would hear it. But the US, UK, and the eurozone countries are all moving surprisingly quickly towards new financial regulatory and bank supervisory frameworks. They are doing so, however, on a strictly domestic basis. For all the talk about the new Financial Stability Board, including the G20 countries not normally part of the Basel financial committees, not much is being pursued at that level. Since the financial regulatory agenda being pursued in each of these regions is in many ways the same, it is only a matter of political will and effort to make it coordinated if not international - there is nothing really to be given up by so doing except bureaucratic interests parochial even within countries, and arguably many of the regulations would be more effective if done globally. This is a very different situation than that which pertains in many international economic institutions where there are issues of economic burdens to share or particular sectors in one or another country being displaced. We know the sector to be displaced, it is the same in all countries, and there are no fiscal commitments required in reaching agreement.

Finally, the US should pursue a stand-down agreement on ‘beggar they neighbour' policies among the major economies. This would encompass both exchange rates and trade protections (including subsidies as well as tariffs). The G20 has paid lip service to this on the trade side, and the WTO has compiled lists of violations and violators, but they are too narrowly defined. On exchange rates, watchful deterrence seems to be the order of the day. After the crisis, exchange rates have undergone a major realignment for many countries but the Chinese, Japanese, European, and American bilateral exchange rates are all within striking distance of broadly acceptable rates. After the crisis, any hope for a positive Doha agenda of more than trivial size is dead. Let us aim for a mutual cease and desist order on unilateral exchange rate and trade intervention. This is the one place where China would indeed be asked to give up its current practices in an important area, that of pegging the remnibi unilaterally. This is also a place, however, where the US can offer something valuable to China without having to put up money, by assuring market access. Meanwhile, an assurance from the US on fiscal probity could remove the downside fears of China and other dollar reserve holders, while being in the US' own self-interest.

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