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End of the ‘American Century’

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The “American Century” is ending. After World War II, American power, inventiveness, creativity, and economic, military, and financial strength was unchallenged in a class by themselves. The United States proposed military and economic strategies to avoid war, contain the Soviet Union, and prevent a return to the destructive economic policies of the interwar years. The institutions that embodied and carried out these policies succeeded. They prevented a major war in Europe, ended the threat from the Soviet Union, opened most of the world economy to trade, fostered prosperity, expansion of economic activity, reductions in poverty, and increased economic and financial stability. More people in more places increased living standards, health, educational attainment, and longevity.

That period is ending. The international institutions that sustained the successful policy no longer enjoy general acceptance. A large part of the U.S. electorate no longer supports the policy consensus that sustained the policies and contributed to its success.

Much has been written about international disagreements and reduced U.S. influence on international political decisions. Much of this commentary seems overstated. The United States remains strong militarily but divided about how to translate power into influence. And many critics at home and abroad want to require approval by the United Nations Security Council to use American military power. NATO is unable to adopt an effective response to a common problem in Afghanistan or Darfur. Why should they be permitted to hobble the principal power?

Economic changes are much less discussed but no less important. I will concentrate on those changes and the effect on our international position. There are two points. One is the weakening of international economic institutions. The other is domestic policy and politics.

International Economic Institutions

At Bretton Woods and Havana, representatives of most of the world's market economies committed their governments to follow rules for trade and finance. The General Agreement on Tariffs and Trade (GATT) followed by the World Trade Organization (WTO) monitored trading practices and settled trade disputes. A series of agreements or "rounds" lowered remaining tariffs except in agriculture. The United States led the way forward.

Lower tariffs and trade barriers worked as expected. Countries found their comparative advantage, opened their economies, and raised their incomes. The success stories in Asia especially are well-known.

The GATT and WTO permitted regional agreements that lowered internal barriers. The European Union is a successful example as is the North American Free Trade Agreement (NAFTA). But NAFTA was opposed by organized labor and is unpopular with large groups in Mexico and the United States. Despite much evidence of NAFTA's benefits to all signatories, politicians pander to the disaffected. Instead of recognizing that the education system does not provide job skills, they blame freer trade for the decline in real income experienced by those who are displaced.

The Doha negotiations show an inability to reach a compromise that would lower barriers affecting agriculture in the developed countries and services in some of the principal developing countries. The United States (and others) turned to bilateral agreements. Many of these have proved contentious. The high tide of multilateral trade agreements to reduce barriers is probably past. Currently the best future hope is that we will not adopt increased trade restrictions to compensate for foreign labor and environmental practices. This seems a false hope. Protectionists seem eager to end the regime that brought sixty years of global expansion and rising living standards. This is a major change in the international landscape. It threatens a main source of higher living standards at home and abroad. And it comes at a time when the unemployment rate is below the postwar average. What might happen if unemployment increased?

One of the oldest economic principles explains that reducing trade barriers benefits all parties to the agreement. It does not say that everyone gains. As in many political issues, those who lose are more determined to make their grievances known.

Their representatives emphasize the losses and neglect the gains. Using misstatement and overstatement they have been able to prevent new trade agreements.

The United States took the lead in promoting open trading arrangements. All countries that participated gained. Several adopted policies of export-led growth, encouraging exports and production for the international market. Japan's success was a beacon for other Asian countries—Korea, Taiwan, Hong Kong, Singapore and others followed Japan. Eventually China abandoned autarchy and began export-led growth.

The negotiators that allowed China into the WTO neglected requiring exchange rate adjustment. China was able to promote low cost exports by exchange rate management and exchange controls. Exchange controls and credit controls limited the rise in Chinese prices that would have reduced their advantage by adjusting the real exchange rate.

Export-led growth had import-led consumption or investment elsewhere as a companion policy. Policymakers in the United States recognized that U.S. consumers receive desirable goods and services in exchange for pieces of paper, produced at little cost, that China and others accumulate. As always in trade arrangements, both countries gained. China reduced unemployment and poverty. It increased output and improved living standards and global influence. The United States gained from low prices, but those who lost jobs for whatever reason complained that the trading system harmed the economy.

The WTO system will survive in some form, but it will have a lesser role. Many in the United States and the European Union are willing, perhaps eager, to restrict imports. Those who expect international trade to increase in the next 25 years at a pace similar to the past 25 years are likely to be disappointed. This will affect GDP growth rates in China, India, and other developing countries that depend on export led growth. It is one among many reasons for doubting the more optimistic estimates of China's future growth. It is a reason for believing that a major support for world growth and economic progress will be weaker.

The Bretton Woods agreement was part of an international effort to increase postwar stability by avoiding competitive devaluation and facilitating economic growth and development. Between 1958 and 1971 the International Monetary Fund (IMF), worked to maintain fixed but adjustable nominal exchange rates. Britain and the United States negotiated the agreement and others signed on. The final plan was mainly a U.S. plan. The United States agreed to maintain the dollar price of gold at $35 an ounce. Other countries set their exchange rates in terms of the dollar or gold.

The system did not work as intended and did not survive. In practice, the United States did not maintain policies consistent with its obligations under the Bretton Woods system. In 1971 the dollar floated and in 1973 the Bretton Woods system ended. Countries gave most attention to employment, less attention to currency values. The United States would not devalue the dollar against gold; other major countries were reluctant to revalue their currencies against the dollar. The dollar, the British pound and the Japanese yen adopted floating exchange rates. Most western European countries experimented for a time and later adopted a single currency, the Euro.

The IMF took on a number of tasks such as recycling oil revenues, reforming the former Soviet Union and its satellites, and managing the Asian currency problems in the late 1990s. Its role and influence have now declined. Most of its former borrowers have repaid, reducing the IMF's income. Facing budget deficits for a long future, it has promised to reduce its spending. It will have to make additional reductions, so it will shrink.

No less important, its role is limited. Growth of international reserves in Asia and to a lesser extent in Latin America frees these countries from seeking IMF assistance. The original IMF design and resources enabled it to help countries with temporary trade deficits. By the 1980s, international imbalances mainly came from the capital account. When lenders anticipated problems, they withdrew their loans or did not renew them. IMF lending increased substantially requiring members to increase IMF capital by $100 billion.

The IMFs more limited role is another reason the future will differ from the past. The Argentine default showed that the market can resolve problems with defaulted debt. Argentina's was the largest default ever recorded. Bondholders were dispersed geographically, and there were many individual debt holders. Agreement was achieved, and more than three-quarters of the bondholders accepted the terms. No public money or lending by international organizations was needed.

This change is desirable, I believe, but it also increases risk in international lending. Previously many countries kept exchange rates fixed when lenders withdrew their loans. Often lenders received risk premiums to cover the risk. By allowing them to withdraw at a fixed exchange rate, the country absorbed the losses, shifting them to its taxpayers and wealth owners. Lenders were spared losses. The IMF lent reserves to help the country maintain its exchange rate. The main burden fell on the citizens of the troubled country.

Hereafter, lenders will become more aware of the risks. All risks cannot be avoided. But countries can reduce risk by following stable policies. Instead of having policies dictated by some IMF consensus reached in Washington, governments can adopt stabilizing policies that are in their interest. Those that do will obtain more foreign capital at lower interest rates. Those that don't will get less investment and will pay higher interest rates.

I believe that is a major change. If lenders to countries that do not reform are made to accept the losses that risky lending entails, the new system will become more stable. The IMFs role will diminish.

The IMFs most valuable contribution will be collection and distribution of timely information about borrowing countries. Better information improves the operation of markets.

Some see in the present difficulties a reason for more rules and increased international regulation. They neglect to mention that a major cause of current financial problems was international regulation. The Basel agreement required banks everywhere to adopt common standards including a rule that required banks to increase their reserves as they increased their risk position. Banks responded by taking risk off their balance sheets. New instruments distributed the risk, but bank reserves did not increase. Instead of leaving the risk on the banks' balance sheets where regulators monitored transactions and holdings, risk became unobserved.

Recent experience illustrates again that lawyers set regulations but markets circumvent them without violating the law. The crisis in home finance is another example of this principle. Successful regulation is difficult because lawyers do not usually think about the incentives that the regulation will create. Admittedly this is difficult to do. Markets devote considerable resources to circumvention, when it seems profitable to do so.

Regulation adopted hastily is usually bad regulation. The central problem in financial markets, I believe, is that traders' incentives increase risk. How else to explain the purchase and sales of almost worthless securities by traders with MBAs from the world's best business schools. They were rewarded for these transactions and often fired if they did not participate. The incentives have to change, not by regulation but by industry and firm actions. Only if top management refused to participate did the bank avoid large losses when markets closed.

The United States no longer is able to develop plans that others accept. It retains an important role, but it has less power and influence than in the past. Part of the change results from the success of America's postwar policies that encouraged many countries to develop. Part results from domestic political weakness, to which I now turn.

Political Stalemate

Politics in the United States remains in a stalemate. Most observers recognize that healthcare; energy prices and educational failures are old problems that government has not solved and will not permit private solutions to apply when they can. Nearly continuous large budget deficits, enormous international debt, and crime continue. Congress is unable to adopt solutions. Deficits in social security and Medicare are discussed endlessly without any action. Medicare's trustees estimate the present value of future Medicare net payments at $85 trillion dollars. This is a $10 trillion increase in one year.

This large increase reflects the main actions taken in recent years; adding a drug benefit increased the unfunded liability. Presidential candidates argue over who can promise more. Rival plans for so-called reform add much more to the benefits than to revenues. Healthcare policy and promises are an extreme example of the absence of discipline in the political process.

During part of the Reagan years, I served on PEPAB—the President's Economic Policy Advisory Board. We met a few times a year with the president to discuss his policies and counteract some of the opposition found in the press and parts of the bureaucracy.

At one meeting, President Reagan announced that he favored a program to insure against catastrophic healthcare payments. Congress promptly approved a bill. The bill required all senior citizens to enroll and pay an insurance premium. That requirement recognized an insurance principle called adverse selection. A voluntary program would enroll only those who believed they were likely to develop a long-lasting, catastrophic illness. Others, who did not believe they would suffer, would not enroll. That would raise the cost of the program and put it beyond the reach of many. Hence participation was mandatory.

The outcry was loud and sustained. Those who believed they would not need it demanded repeal. Within a year, Congress repealed the program. It never went into effect.

The lesson I draw from that experience is that many more citizens desire better healthcare than are willing to pay for healthcare. A recent attempt to mandate comprehensive healthcare in California failed for this reason. The political process facilitates the belief that today's consumers can get the benefits by shifting the cost elsewhere.

Elsewhere turns out to be future generations. We have two political parties. One wants to spend more and tax the rich. The other is willing to spend more but wants to tax less. The usual compromise is more spending but lower or not higher tax rates. The result is an outstanding publicly held debt of about $4.5 trillion dollars, about half owned by foreigners and even larger—much larger—unfunded liabilities.

When Vice President Cheney told Paul O'Neill that Ronald Reagan showed that the deficit did not matter, he forgot to add "as long as foreigners finance most of it." It is true that $4.5 trillion is not an alarming percentage of GDP. Our children will be wealthier than we are, so they can manage to pay the cost of our healthcare and much else by servicing the debt we leave to them. We also leave a large capital stock and an extraordinary educational system at the graduate and research level.

The bigger problem is that we have put our country in a risky position. Current policy is unsustainable. We all know that unsustainable policies end. The problem is we cannot know how it ends. We can hope, against experience, that we will stop spending more than we produce and stop borrowing from abroad. The debt levels off or even declines. To complete that picture, we have to conjecture about why that will happen. We have rarely slowed spending growth below income growth for very long.

A benign outcome is not impossible, but perhaps too much to expect because the public's desire for increased spending has not slowed. The alternative is that we will have a crisis of one kind or another. The dollar which once traded at 360 yen and 4.25 Swiss francs is now about 100 yen and 1 Swiss franc. As long as saving rates remain lower than investment, the declining trend is likely to continue. The political reaction is to blame foreigners for our current account deficits. The truth is that we save too little and spend too much relative to our income.

More than forty years ago, a government commission published *A Nation at Risk* warning of the decline in the quality of education for large parts of our population. The government has not failed to introduce educational programs, but the problem remains. We fail to train our children for 21st century jobs. In our 50 largest cities, about half the children do not earn a high school diploma from a public high school. This restricts many of them to unskilled jobs. That affects our ability to compete in the world economy and threatens the global trading system.

Research shows that family structure gives students the incentive to study and learn. A nation that educated millions of immigrants and their children over more than 100 years relied on parental discipline and self discipline. We do not seem able to do much about family structure and discipline. Some schools experiment with payments to students for mastering material. Monetary rewards increase incentives and may develop useful work habits.

The oil price increased in 1973-74. In the more than forty years that followed, seven presidents and many Congresses discussed the problem, talked loosely about energy independence and changed little. For a time, they controlled the price, encouraging consumption. Businesses have responded by reducing use of energy, and government has mandated increases in mileage per gallon for autos and trucks. However, a leading political candidate thinks the solution is higher taxes on oil companies, a policy that failed during the Carter years.

The billions we pay to import oil goes to our adversaries. Because we are politically unable to agree on a policy to reduce oil imports, we furnish Saudi Arabia with the funds to build mosques and employ preachers to teach hate of us. Iran can use our money to build nuclear weapons. Russia and Venezuela pursue hostile policies.

We arm in part to defend ourselves against these possible threats. If we had heavily taxed carbon forty years ago, we would pay ourselves instead of foreigners. We could not summon the self-discipline to do that and our government did not call upon us to make the adjustment. Instead we pay others to induce us to consume less. Several use the money for unfriendly purposes.

A country that cannot solve its domestic problems does not inspire confidence in its leadership. Inability to solve major problems hastens the end of the American century. To outsiders, our failure must be puzzling since some of the problems have obvious solutions. A tax increase and benefit reduction are certain to be a large part of any solution to budget deficits. Some type of carbon tax will be part of any program to reduce oil imports.

Why Now?

Through much of our history, the United States government maintained fiscal balance. Budget deficits rose during wars, but surpluses followed. Budget surpluses in every year from 1866 through 1893 paid down two-thirds of the government debt outstanding after the Civil War. By 1930, government surpluses had reduced by one-third the debt outstanding at the end of World War I. In the 1920s, Treasury Secretary Andrew Mellon reduced both tax rates and debt by running an annual budget surplus.

One can debate whether these were desirable policies. They were different. Spending and tax policy remained disciplined except in wartime. This is no longer so.

Until World War II, or thereabouts, a majority accepted the international gold standard as the proper international system. I have not been an advocate of the gold standard, and I have not changed my mind. The gold standard requires acceptance at times of unemployment rates that the public does not accept. We do not have the gold standard because we know its consequences.

That said, belief in the gold standard protected the economy from continued, large budget deficits. As long as the public supported the rule, governments were unable to run large continuous budget deficits. Along with belief in the gold standard, the public accepted a balanced budget as evidence of correct policy.

Continental European countries substituted a single currency, thus a permanently fixed exchange rate. Although Italy maintains a large outstanding debt, the common currency and the rules of the European system have functioned as an effective budget restriction.

The United States currency is a world currency. Its debt is a standard for safety of nominal values. Policies abroad favoring export-led growth and a domestic policy of import-led consumption permitted publicly held debt to grow without any noticeable effect on real interest rates. Real interest rates on U.S. debt were not different during the budget surplus years in the 1990s or the budget deficit years after 2001. Foreigner's accumulated dollar denominated debt to finance our spending.

Once again, the solution is not difficult to see. Either the United States voluntarily adopts fiscal discipline or eventually it will face a crisis with rising interest rates and a falling currency. The crisis solution will impose large costs on holders of dollar denominated debt, but it will force policy adjustment. If a voluntary solution is unlikely, the mystery is when the crisis will occur.

Voluntary solutions are rare. Several countries in Asia faced fiscal and exchange rate crises in the 1990s. Korea and Indonesia made durable reforms. Crises forced political changes that in most cases were overdue. Argentina, Brazil and Mexico suffered through several crises. Brazil and Mexico made lasting reforms. The United Kingdom had repeated exchange rate crises from the 1950s to the 1980s that ended with fiscal tightening. The Thatcher government reforms put the country on a different path that successor governments maintained.

Japan also has a large debt outstanding in absolute terms and relative to GDP. Unlike the United States, Japan has a relatively high saving rate. Domestic owners hold most of the debt. Debt financed public projects that made little contribution to productivity. This cost was borne internally. The risk to Japan, however, is much less than the risk to the United States.

Political changes in the United States make voluntary change difficult. We are long past the Eisenhower era of fiscal responsibility when President Eisenhower could enlist the cooperation of the Senate majority leader, Lyndon Johnson, to prevent permanent tax rate reduction during the 1958 recession. The two parties have become less cooperative, even uncooperative on major issues.

The political parties formerly were coalitions that resolved disputes internally. This is less true now. Campaign funding legislation weakened the parties by reducing their funding. Interest groups gained influence because they gained resources. Most of these groups had no interest in political compromise. They support candidates who commit to support their position, often an extreme position.

Conclusion

Our country cannot agree on a long-range program to solve its main problems. It does not have a shared vision of the way to maintain domestic and world growth. Leadership requires such a vision. A country that cannot agree on solutions to its domestic problems is an unlikely leader.

The future position of the United States is not entirely a negative tale. The United States has a more flexible economic system than most. It leads often in innovation and technological change. These are advantages in adapting to global changes.

An additional advantage is that there is no obvious leader who can replace the United States. As our influence and position wane, the world will be more dependent on willing cooperation by many countries to agree on rules for trade, economic and political agreement. This outcome is not likely to be more stable than the American century. Nor is it as likely as the American Century to support institutions that benefit nations that choose peaceful economic development and higher living standards.