Last Man Standing

It's no cause for celebration, but the global financial crisis shows why the United States remains the indispensable nation.

BY TYLER COWEN

The United States has millions of homes in foreclosure, high unemployment rates, a failing General Motors, numerous insolvent banks, and unprecedented deficits. It is possibly on the brink of a second Great Depression. Yet the U.S. dollar has experienced one of its most rapid appreciations in history. Last summer, when it took about $1.66 to buy a euro, American tourists in Paris gasped at the price of a Coke. Now, a stronger dollar means that a euro can be had for something like $1.26.

What's up?

America's relative decline in global affairs has been foretold many times, but it never quite seems to happen. Today, the rest of the world is looking to the United States to pull it out of a recession (or depression), even though many countries also blame us for having started it. The truth is this: The worse things go for the world as a whole, the more the United States gains in relative power and influence. Maybe that sounds counterintuitive, but it has happened before. After the first and second world wars left many other parts of the world in devastation, the United States rose in relative stature. It fell in standing, at least arguably, during the years between 1989 and 2007, when the world as a whole was enjoying unprecedented prosperity and liberty.

Tyler Cowen, who joins the *WQ*'s Board of Editorial Advisers with this issue, is a professor of economics at George Mason University, where he is director of the Mercatus Center. He is the author most recently of *Discover Your Inner Economist: Use Incentives to Fall in Love, Survive Your Next Meeting, and Motivate Your Dentist* (2007).

In the terminology of financial economics, the United States is, relatively speaking, a countercyclical asset. It's not that America profits from bad times or war but that we have a relatively greater capacity to limit our losses and eventually bounce back. We are "built to fail," so to speak.

Its size is one reason why the United States has such a robust polity and economy. In bad times, international cooperation tends to break down, which increases the relative influence of larger economic and political units. Smaller countries, such as Belgium, are generally more dependent on international trade than the United States. And in truly dire situations, military power counts for more—and the United States accounts for almost half of the world's defense spending. Even when military power is not wielded directly, it is understood that America cannot be intimidated easily.

The United States also has a more favorable demographic position than many other nations. The populations of Japan and many European countries may be cut in half over the next 30 or 40 years, mostly because families in those places, if they form at all, have fewer children. China, with its one-child policy, is in one of the toughest positions of any country. If nothing changes, the unimaginable will happen, and within a few decades China's population will begin a rapid decline. The United States is not expected to shrink in population, in part because its immigrants are having children at relatively high rates.

Finally, while Europeans and Asians commonly think of the United States as a kind of "baby state," in reality we have one of the oldest and most durable nation-states. With the possible exception of the Civil War period, the United States has a continuous and consistent governmental history running back to 1789 or, by some accounts, to the colonial governments of the 17th century. American political and economic institutions have been time-tested in a way that few other countries can claim. If you doubt this, compare America's multicentury record with the discontinuous and tumultuous political history of France, China, or Russia.

Amid the flood of alarming commentary, it's easy to lose sight of the fact that the financial crisis has underscored the continuing strength of American global influence. Although the United States has been the epicenter of some of the economic problems, it has exhibited enviable economic and political stability, at least compared with Ireland, Spain, and most of Asia, to name just a few examples. The dollar's appeal as one of the world's safe havens has been redoubled by the recognition that the flexibility of the U.S. economy gives it a greater capacity than many others to adapt to shocks.

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It has become increasingly clear that the problems in European governance are severe—and I am referring to the wealthier nations, not Bosnia and Albania. The European nations are tied to each other through the European Union and the euro, but they don't have a good method for making collective decisions in contentious times.

Consider Germany. In January, its industrial production plummeted at an annualized rate of about 7.5 percent. Could Germany now be the financial savior of Europe? When Germany joined the Eurozone, the 16-nation bloc that embraces the euro as its sole currency, the country's politicians promised voters that they would never have to pay for the profligate policies of the "less responsible" member nations. And for almost 20 years, Germans have been paying higher taxes to reconstruct eastern Germany and ease the transition from communism. It's not a citizenry looking to fund more bailouts, especially in a major recession.

But now German citizens are told that they may have to bail out the Austrian banking system and possibly the government of Ireland, while paying additional subsidies to Hungary and perhaps to other eastern European nations as well. Further down the line, Spain, Italy, and Greece, which have all lost their premier AAA credit rating, may require some form of financial aid. The Germans might look to spread this burden around Europe, but there are few places to turn. France and the Netherlands could chip in, but the hat cannot be passed very widely. The United Kingdom had one of Europe's leading economies, but now it is one of the most financially vulnerable nations. You can think of London as a large hedge fund based on Europe, specializing in speculative financing of major European projects. After finance, the two next-biggest British exports—pharmaceuticals and tourism—are solid but hardly economically impressive.

Part of the problem for Europe is that its biggest banks are very large relative to the economies of their host nations—in other words, its component national economies are too small. The major Austrian banks, for instance, have loans to eastern Europe equal to as much as 70 percent of their country's gross domestic product. The two largest Swiss banks, taken together, have assets four times larger than Switzerland's GDP. Even in the relatively large economy of Germany, the liabilities of Deutsche Bank have been measured at 80 percent of German GDP. These banks have grown too large to be handled or bailed out by their national governments. In the United States we talk about institutions that are "too big to fail," but in many parts of Europe it might be more apt to speak of those "too big to be saved."

In the United States, with its relatively unified system of governance, the Federal Reserve can simply print money to fund bailouts, and even if that is an ugly alternative, the government's ability to act underpins the credibility of the sys-

Concerns about unrest and political instability in China are growing as economic woes cost more workers like this man in Shaanxi Province their jobs.

tem as a whole. The European Central Bank (ECB) is explicitly banned from creating more euros for the purpose of bailing out national banks. The Swiss central bank could print money for financial bailouts, but the prospect of the resulting inflation and rapid depreciation of the Swiss franc makes this a very unappealing choice, especially for a country that has marketed itself as a haven of financial solidity. And a weaker franc would only make it harder for Switzerland's big banks to meet their obligations, many of which they must pay in other currencies.

Ideally, the ECB should take on a stronger role as lender of last resort in Europe, but the EU does not make such decisions easily. Fundamental alterations would be needed in the bank's charter, which was written precisely to make change very difficult, in part because Germany, with its historically rooted dread of inflation, insisted on biasing the ECB toward conservatism and inaction. Even if the bank's charter were amended, the member countries would surely impede any action by bickering over who would pay the bills for new initiatives. If the ECB is going to run bailouts, decision making will have to become a lot more fluid, and that would require Germany to give up control and the bank to move away from price stability as its sole objective. Since the EU member states have not been able to agree on a reform of the Union constitution, it's not obvious they will be able to agree on changing the bank's charter. They've had time—and good reason—to do so, yet have taken no serious action.

It's not impossible that the ECB could at some point simply assume emergency powers and run a bailout on very short notice and without legal authorization. Recall that the Bear Stearns and AIG emergency deals were done by the Fed over weekends. At that point the question would be whether other EU procedural safeguards would maintain their credibility, or whether skeptics within the EU, such as Denmark, would feel that their precious veto rights were no longer being protected.

The relatively weak nature of the ECB reflects some of the problems of coordinating the actions of a number of smaller countries in difficult times. In the United States, coordination between the Fed and the Treasury Department is taken for granted, and Congress is usually willing to back up those institutions. The Troubled Assets Relief Program bailouts passed in 2008 not because Congress thought they were a good idea, but because Treasury secretary Henry Paulson and Fed chairman Ben Bernanke told the legislators that they had better sign on or the sky would fall. This sort of bossiness won't solve every problem, but the European nations have no comparable process, and no comparable centralized power base capable of responding quickly and effectively to crises. In the final analysis, no one knows who is responsible for the European economies. If the Chinese are investing in the United States and they have a concern, they can pick up the phone and call Bernanke or the current Treasury secretary, Timothy Geithner, and receive a consistent answer, backed by a single national executive, a single legislature, and, ultimately, the world's most powerful military. You could say that when it comes to major foreign investors, the United States has a better "customer service department" (we at home call them politicians) than Europe or, for that matter, Asia.

It's not widely recognized that Europe, because of its systemic weaknesses, already has required implicit bailouts by the United States. European financial institutions are prominent on the list of the bailed-out creditors of AIG, the insurance company that, in effect, was nationalized by the Fed in 2008. Few U.S. financial regulators wish to stress this point, but one reason why the Fed rescued AIG was that it knew that European regulators could not handle the fallout from an AIG collapse.

It's commonly claimed that the economic future of the world lies in Asia, but that vision too has taken a beating lately. The export-based economies of Japan and Taiwan are contracting more rapidly than those of the United States and Europe. The two countries have not suffered banking crises, but their economies are dependent upon the expectation that global consumers will have more money to spend every year. Their economies are in this manner implicitly leveraged—arguably, more leveraged than the U.S. economy—even apart from whatever explicit levels of debt they hold. The value of Japanese and Taiwanese commercial investments depends on the ability of customers overseas to continue borrowing and spending money—and that doesn't look like a very good bet right now.

One of the most important economic questions is what will happen with China. The Great Depression of the 1930s came to China last, and that pattern could be repeated today. So far, the country's economic growth rate has dropped from 12 or 13 percent annually to a measured rate of about six percent. But given that there are doubts about the honesty of the Chinese government in reporting economic data, the true growth rate may be much lower than that. In any case, the Chinese real estate boom has ended, and massive layoffs are occurring in the export sector. Chinese financial and commercial enterprises are not very transparent, double-digit growth allowed many unsound or speculative enterprises to stay afloat ("The recession reveals what the auditor missed" is one version of an old saying), and the economic expectations of the Chinese citizenry have become high. The nation's leaders fear social unrest. No one knows if Chinese economic and political institutions will hold together in tougher times.

On the positive side, China has the luxury of high savings rates and an immense stock of accumulated foreign assets, especially U.S. government securities. If China survives the current crisis more or less intact, like the United States it will emerge as a large nation with its status and influence enhanced.

In the long run, the fortunes of nations depend on many factors, not just their response to a single financial crisis. Nonetheless, such reactions reflect strengths and weaknesses that show up in other areas of economic and social policy. Despite the separation of powers built into the American political system, U.S. political institutions have, by global standards, proven themselves unusually decisive and effective at critical times. The ability to react swiftly to new challenges is an underlying theme in American history, whether we consider the early missions to the moon, the breakthroughs of the civil rights movement, the pioneering of environmental regulation, or the pro-market Reagan reforms of the 1980s.

It's a paradox that it's the large, diverse nations such as the United States that have the greatest ability to maneuver in a crisis and turn on the proverbial dime. That's good for us, of course, but if a new American Century is about to be born, it's another sign that the world faces very serious challenges. And that's not a cause for anyone to cheer. ■