Aftershocks

Rough Week, But America's Era Goes On

washingtonpost.com
Sunday, September 21, 2008; Page B01

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http://www.washingtonpost.com/wp-dyn/content/article/2008/09/19/AR2008091902804.html

Does Wall Street's meltdown presage the end of the American century? Many commentators have warned that the past week's financial mayhem signaled a major political setback for the United States as well as an economic one. "Why should the rest of the world ever again take seriously the American free-market model after this debacle?" a leading British journalist asked me last Thursday. This crisis, he argued, was to economics what the Iraq war was to U.S. foreign policy: a fatal blow to the credibility of American claims to global primacy.

Certainly, if the talk of a "unipolar moment" after the collapse of the Soviet empire was hubris, then the credit crunch has been a very American nemesis. Ten years ago, there was a strange competition in the United States to see who could be more arrogant. Neoconservatives argued that the rest of the world should hurry up and embrace the American political way or prepare to be bombed into the democratic age. But equally smug were the neoliberal economists, who argued that the rest of the world should hurry up and embrace the so-called Washington consensus of expanding trade, attacking inflation and encouraging foreign investment, or prepare to be sold short. One lot derided the political failure of the Muslim world; the other lot heaped scorn on Asian "crony capitalism," supposedly the root cause of the 1997-98 Asian financial crisis.

The neocons got their comeuppance in Iraq, where American forces were not, after all, ultimately embraced as liberators. The neolibs got theirs this month, as a Republican Treasury Department, headed by the former CEO of Goldman Sachs, effectively nationalized first the country's biggest mortgage lenders and then its biggest insurance company. As the presidential candidates, in rare unison, heap opprobrium on Wall Street gamblers and slumbering regulators, the stage seems set for the demise of "market fundamentalism," in George Soros's phrase.

That policy paradigms are shifting is clear. But is the global balance of power shifting too? To answer that question, we need to reflect more deeply on the true nature of this crisis.

We are living through the end of a phenomenon that Moritz Schularick of Berlin's Free University and I christened "Chimerica." In this view, the most important thing to understand about the world economy over the past 10 years has been the relationship between China and America. If you think of it as one economy called Chimerica, that relationship accounts for around 13 percent of the world's land surface, a quarter of its population, about a third of its gross domestic product and somewhere more than half of global economic growth in the past six years.

For a time, this symbiotic relationship seemed almost perfect: One half did the saving, and the other half did the spending. Comparing net national savings as a proportion of gross national income, U.S. savings declined from more than 5 percent in the mid-1990s to virtually zero by 2005, while Chinese savings surged from less than 30 percent to nearly 45 percent in the same time frame. This divergence in savings allowed a tremendous explosion of debt in the United States, because the Asian "savings glut" made it much cheaper for households to borrow money. Meanwhile, cheap Chinese labor helped hold down inflation.

Needless to say, it was not just the United States that was borrowing, and it was not just the Chinese who were lending. All over the English-speaking world, as well as in countries such as Spain, household indebtedness increased, and conventional forms of saving were abandoned in favor of leveraged plays on real estate markets. Meanwhile, not only China but other Asian economies adopted currency pegs and accumulated international reserves, thereby financing Western current-account deficits, as well as keeping their exports affordable. Energy exporters in the Middle East and elsewhere also found themselves running surpluses and recycling petrodollars to the Anglosphere and its satellites. But Chimerica was the real engine of the world economy.

As this tremendous expansion in borrowing -- and lending -- was taking place, some economists tried to rationalize what was going on. Some argued that this was "Bretton Woods II," a system of international exchange-rate management akin to the one that linked Western Europe to the United States after World War II. Others called it a "stable disequilibrium" that could be counted on to continue for some time. But then a wave of defaults in the subprime-mortgage market revealed just how unstable Chimerica was.

In essence, the rest of the world's savings had helped inflate a real estate bubble in the United States. Easy money was (as is nearly always the case in asset bubbles) accompanied by lax lending standards and downright fraud. Euphoria eventually gave way to distress and then to panic. The trouble began in the subprime market because it was there that defaults were most likely to happen. But it soon became clear that the entire U.S.

property market was going to be affected. Not since the Great Depression have we seen house prices declining at annual rates of more than 10 percent.

This has had three distinct consequences. First, it has exposed the weaker banks (particularly the investment banks, which cannot fall back on the cushion of savers' deposits) to savage and self-perpetuating share-price declines. Second, the failure of financial firms has triggered a further crisis in the vast but opaque market for derivatives -- especially credit-default swaps. Third and most important, the contraction of bank balance sheets almost certainly condemns the rest of the U.S. economy to a recession. Main Street is only now beginning to feel the pain that will be caused by Wall Street's credit crunch.

What are the geopolitical implications of all this? One possibility is that the "great reconvergence" between East and West is speeding up. If you go back to the very first report that Goldman Sachs produced about the "BRICs economies" (Brazil, Russia, India and China), China was projected to overtake the United States in gross domestic product in 2040. But in more recent reports, that has been brought forward to 2027. Maybe it will be even sooner. For one inevitable consequence of the credit crunch is that the United States will grow more slowly for the foreseeable future -- at closer to 1 or 2 percent per year, rather than the 3 or 4 percent it has grown used to. By contrast, China's semi-planned economy can comfortably maintain growth of 8 percent or more per year, propelled forward by state-led investment in infrastructure and growing consumer demand. Because net exports are no longer the key driver of China's growth, an American sneeze need not necessarily cause an Asian cold.

The days when the dollar was the sole international reserve currency may also be coming to an end. Reserve currencies do not last forever, as the British pound makes clear. Once upon a time, sterling was the world's No. 1 currency, the unit of account in which most financial transactions were done. It died a long, lingering death, sliding from $4.86 in 1930 to very near par with the dollar at the pound's nadir in the early 1980s. The principal reason were the huge debts that Britain had run up to fight the world wars. The second reason was slower growth: Britain's economy was the underperformer of the developed world in the postwar decades, right down to the early 1980s

If the main fiscal consequence of the credit crunch is a huge increase in the liabilities of the federal government -- already substantially increased by the nationalization of Fannie Mae and Freddie Mac -- the United States could find itself in a similar situation. The dollar could follow the pound into the category of former reserve currencies. And the United States would lose the convenient facility of being able to borrow from foreigners at low interest rates in its own currency.

With China decoupled from the United States -- relying less on exports to America, caring less about the yuan's peg to the dollar -- the end of Chimerica seems nigh. And with the end of Chimerica, the balance of global power is bound to shift. No longer so committed to the Sino-American friendship established back in 1972, China can explore other spheres of global influence, from the Shanghai Cooperation Organization that groups together China, Russia and four Central Asian nations to China's own nascent empire in commodity-rich Africa.

But commentators should always hesitate before they prophesy the decline and fall of the United States. America has come through disastrous financial crises before -- not just the Great Depression but also the Great Stagflation of the 1970s -- and emerged with its geopolitical position enhanced. Such crises, bad as they are at home, always have worse effects on America's rivals.

The same is proving to be true today. According to the Morgan Stanley Capital International index, the U.S. stock market is down around 18 percent to date this year. The equivalent figure for China is 48 percent, and for Russia -- the worst affected of the world's emerging markets -- it is 55 percent. These figures are not very good advertisements for the more regulated, state-led economic models favored in Beijing and Moscow.

Moreover, because investors continue to regard the U.S. government's debt as a "safe haven" in uncertain times, the latest phase of the financial crisis has seen the dollar rally, rather than sag further.

Of course, this could yet prove to be the safe haven's last gasp, especially if U.S. authorities are unable to avert a fresh wave of bank failures in the days ahead. Nevertheless, the caveat is clear. The hubris of recent years has certainly been followed by a terrible financial nemesis. But it is much too early to conclude that the American century is over. Like so much else made in the United States, this nemesis is proving an all-too-successful export.

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