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Counterproductive Adjustment? United States after the Great Recession

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The United States responded to the Great Recession with an arsenal of fiscal and monetary expansions and export promotion policies to stimulate growth, but only for temporary respite. US policies have been reactive and risked counterproductive effects. Four years after the collapse of the investment bank Lehman Brothers, economic growth is flailing, unemployment continues persistently high, and fiscal deficits have soared. Though the rules-based world economic order that the United States has built over the past seven decades has persevered, international economic policy challenges are mounting, exacerbated by the lack of US economic vitality and leadership. The purpose of this paper is to assess US adjustment policies to the global economic crisis, propose solutions to impending policy challenges, and discuss the state of the transatlantic relationship in light of the recent events and US policy priorities.

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Introduction

Four years after the collapse of the investment bank Lehman Brothers, economic growth in the United States (US) is flailing, unemployment continues persistently high compared to US historical standards, and fiscal deficits have soared. The Federal Reserve is preparing for a bond buying programme, and central banks around the world have been racing to cut interest rates. The world economy is ailing, with some nations in the European Union (EU) plunging into a depression. And instead of decoupling from the advanced economies and powering the 21st century world economy, export-dependent emerging markets remain hostage to the transatlantic economic morass. US exports have soared as the dollar has weakened, but even export growth will decelerate as China's growth cools and Asian nations set out to devalue their currencies.

The scenario is not unprecedented, but it is dire. The years after the 2008-09 global financial crisis have been difficult for the United States. The shock brought output and employment far below historical levels, and reduced inflation below 2 percent. Washington has reacted with an arsenal of fiscal and monetary expansions to stimulate growth, but only for temporary respite. Policies have been reactive and, alongside the financial regulatory overhaul, have had counterproductive effects.

Positively, the external sector has helped sustain growth and a large-scale global protectionist outbreak never occurred, and the rules-based world economic order that the United States has built over the past seven decades has largely persevered. But with global growth stagnating, new domestic and multilateral approaches are needed to reinvigorate American and world economies. The United States is critical to this process, both as the world's largest economy and a leading nation. The question is how America could and should tackle the challenges and steer the world.

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The purpose of this paper is to assess US adjustment policies to the global economic crisis, and discuss solutions to impending policy challenges. The following section sets the stage by discussing the US role in the world economy. Section three discusses the 2008-09 crash and its causes, while section four analyses US adjustment policies at home and multilateral responses abroad. The fifth section discusses prospects for a new growth model. Section six assesses the state of the transatlantic relationship in light of the recent events and US policy priorities. Section seven concludes.

World's Economic Engine

Starting with the post-World War II (WWII) creation of the Bretton Woods system, America's great contribution has been to champion an economic paradigm and set of institutions that promoted open markets and economic stability around the world. The successive Groups of Five, Seven and Eight first formed in the early 1970s helped coordinate macroeconomic policies among the world's leading economies and combat global financial imbalances that burdened US trade politics. The International Monetary Fund (IMF) spread the Washington Consensus across Asia and Latin America, and shepherded economies in transition toward capitalism. Eight multilateral trade rounds brought down barriers to global commerce, culminating in the establishment of the World Trade Organization (WTO) in 1995. The new institutions became genuinely global in their reach, claiming the loyalties of members from Asia to Africa and, in the 1990s, post-Communist Eastern Europe.

A wave of bank deregulation and financial liberalization started out in the United States and proliferated around the world, making credit more available and affordable. The US dollar became the world's reserve currency, economizing global transactions and fuelling international trade. Central bank independence spread from Washington to the world and contributed to the Great Moderation, which has produced a quarter century of low and steady inflation around the world.

National economic paradigms also shifted. As the failures of Socialism grew glaring, private enterprise was given the reins, and the state, previously the manager of entire sectors of the economy, was made more of a regulator. Efforts were made to distance economic policymaking from politics. The early 1990s Washington Consensus – aimed at defeating developing world debt crises and rampant inflation with macroeconomic discipline and economic openness – globalized the mantra of free markets and good governance.

It was the US-led order that generated prosperity unimaginable only a few decades ago. Since 1980, global gross domestic product (GDP) has quadrupled, world trade has grown more than six-fold, the stock of foreign direct investment (FDI) has shot up by twenty times, and portfolio capital flows have surged to almost 200 trillion dollar annually, roughly four times the size of the global economy. Economic reforms and global economic integration enabled previously backward developing nations to become vibrant emerging markets: the "Asian Tigers" (Hong Kong, Singapore, South Korea, and Taiwan) that boomed in the 1980s were joined in the 1990s by the awakening giants of Brazil, China, and India.

The United States was the unquestionable core of the system, the hub of global trade, finance, and investment; brokered differences among nations on the world stage; and provided the right mix of global public goods – a universal reserve currency, an open-trade regime, deep financial markets, and vigorous economic growth. Trade liberalization alone paid off, adding 1 trillion dollar annually to the post-WWII US economy (Bradford, Grieco and Hufbauer 2005). Though struggling with the oil shocks of the 1970s, stagflation of the 1980s, and the recession and Gulf War of the early-1990s, the United States rebounded time and again, making up nearly a quarter of the global economy.

In the early 2000s, the United States grew at a handsome 3-4 percent annually. Stock markets boomed and consumers gained wealth and confidence, spending and buying houses whose soaring values would back further spending. Private savings fell from some 4-5 percent of incomes in the late 1990s to 1 percent in 2005.[1] Growth would slow only in 2006 as the housing boom tapered.

Emerging markets thrived. US investment bank Goldman Sachs famously coined the term BRICs – Brazil, Russia, India, China – as a synonym for fast-growing juggernaut economies, projecting they would grow to rival the size of the G7 economies by 2035 (Goldman Sachs 2007). Growth rates across Asia were staggering. India boomed at 8-9 percent in 2003-2007 on the back of growth in manufacturing and services – hotels, banking, telecommunications, and information technology. Its output expanding at double digits, China surpassed Italy, France, and the United Kingdom (UK) in 2004-05 to become the world's fourth largest economy, followed by outpacing Germany in 2007.

East Asia grew to a good extent by trading, often with the United States. In an implicit bargain labelled "Bretton Woods II" (for the term see Dooley, Folkerts-Landau and Garber 2004), the United States stoked Asian growth by importing goods from the region in exchange for Asian investment to help sustain US consumption. In turn, Asia's insatiable demand for raw materials for manufacturing industries propelled Latin American commodity producers and Middle Eastern oil exporters. Emerging markets around the world grew and built reserves with which to invest abroad, often targeting the world's safest asset, US Treasuries. New emerging market sovereign wealth funds, government-run private investment vehicles, bought stakes in America's crown jewel companies. In 2007, the China Investment Corporation invested a total of 8 billion dollar in Morgan Stanley and the renowned US private equity firm Blackstone, and Dubai's Mubadala Development Company bought a 7.5 percent interest in the Carlyle Group. The reversal in global capital to flow "upstream" from poor to rich countries belied economic theories. Then the crisis hit.

The Crash and Its Causes

As Lehman Brothers fell in September 2008, the world lost faith in America's capitalism and the Federal Reserve's inflation hawks. At least for a moment, the 1990s assurances about the "end of history" (Fukuyama 1989), an inevitable convergence of all nations to US-inspired capitalism and liberal democracy, seemed ludicrous. The US economy ailed more severely than at any time since the Great Depression in the 1930s.

In 2009, US GDP contracted by 2.6 percent, unemployment soared to double digits, and credit markets seized up. The US fiscal deficit rose to 13.5 percent of GDP, more than double the levels of 1983. Europe, the region most keenly connected to American financial markets, followed in close tow. The recession that began in December 2007 and ended in June 2009 resulted in the loss of more than 8.4 million jobs and unemployment levels not seen since 1982-83, and contributed to a 26 percent decline in the median home price (Homan and Harris 2010). Consumer spending, which accounts for about 70 percent of the economy, declined more than at any time since 1942.

The crisis was a financial crisis. Financial instability occurs when a large number of parties – consumers, households, companies, and/or governments – undergo financial crises that collectively amount to negative macroeconomic effects (Allen and Wood 2005). As a microeconomic event, a financial crisis impacts the economic and financial behaviours of innocent bystanders.

1 Data from Bureau of Economic Analysis, US Department of Commerce.

The causes of financial instability vary from crisis to the next, defying scholars and policymakers each time. Crises in the 19th century were largely bank failures; between the 1940s and the 1960s, crises combined bank failures and sharp devaluations; while in the 1980s, 1990s, and 2000s, the origin was real estate booms and busts, accompanied by excessive leverage (Kindleberger and Aliber 2005). But despite the differences in place and time, the build-up periods to crises share familiar features – an asset bubble followed by financial euphoria, risk taking, and accumulation of debt (Roubini and Mihm 2010).

US households and financial institutions became leveraged in the run-up to the crisis. Free cash used by consumers from home equity extraction doubled as the housing bubble grew, and home mortgage debts soared from an average of 46 percent of GDP during the 1990s to 73 percent of GDP during 2008. Household debt soared to 127 percent of annual disposable personal income at the end of 2007, as opposed to 77 percent in 1990. Private debt totalled 290 percent of GDP by the third quarter of 2008. The five main US investment banks had over 4.1 trillion dollar in debt for fiscal year 2007, almost a third of US GDP.

The hypothesized underlying drivers of the crisis are several – policies to encourage home-ownership across income strata, flawed mortgage underwriting standards, shortcomings in financial regulations and supervision, off-balance sheet finance, opaque securitization of toxic housing assets, perverse incentives facing ratings agencies, low interest rates, global financial imbalances, interconnectedness of banks, excessive leverage, among many others. The most plausible explanation is an interaction of these elements – one where cheap money in America and loosened credit constraint resulting from foreign lending combined with lax mortgage underwriting standards and federal support for subprime mortgages, producing the housing boom and mass leverage.

US Responses to the Crisis

As the crisis unfolded, US officials responded with massive fiscal and monetary policy artillery. The response was motivated by lessons from the Great Depression – whose leading drivers are believed to be inadequate government spending and money supply, and the contraction in global trade. Then Treasury Secretary Henry Paulson, seconded by Federal Reserve Chairman Ben Bernanke, convinced US Congress to release 700 billion dollar for the Troubled Assets Relief Program (TARP).[2] In a span of a few months, the Fed purchased more than 1.7 trillion dollar in Treasury and mortgage debt. Lehman Brothers was liquidated, Bear Stearns and Merrill Lynch were sold, and Goldman Sachs and Morgan Stanley became commercial banks and by so doing subjected themselves to more stringent regulation. Fannie Mae and Freddie Mac, government sponsored enterprises that at the time guaranteed 5 trillion dollar in mortgage obligations, were placed into government conservatorship. Washington raced to save banks and car companies, spending billions.

What brewed into epic bank bailouts, credit expansion, and near-zero interest rates softened the fall, but did not save the nation from the worst economic calamity since the Great Depression. Moreover, the government's responses to the crisis have also provided but temporary relief from economic doldrums.

Three main threads run through US responses to the crisis. First, the responses have been quintessentially reactive. Second, they have had unintended and possibly counterproductive effects. Third, they have raised que-

2 Bernanke's credibility encouraged Secretary Paulson to ask him to join Paulson in critical meetings with Congressional leaders and other appearances. See Wessel 2009.

stions about US leadership role in the world economy and politics. The following parts weigh the effects of monetary, fiscal, trade, regulatory, and international policy responses.

Monetary Policy: Dilemmas and Unintended Consequences

Monetary policy took centre stage in the crisis. The Fed reacted aggressively, lowering interest rates in stages from 4.25 percent in effect still through 21 January 2008 to a target range of 0-0.25 percent on 16 December of that year, the lowest in record. It also coordinated with other major central banks, such as those of the UK, China, Canada, Sweden, Japan, and Switzerland, and the European Central Bank (ECB).

However, monetary loosening proved inadequate in stopping the evaporation of credit and erosion of trust among banks. Along with some other central banks, the Fed filled the gap by opening its credit window wide open. It bought government debt to boost credit and money supply, and, most historically, set out to rescue failing banks. In March 2008, the Fed extended a 29 billion dollar loan to help bridge the J.P. Morgan Chase acquisition of Bear Stearns. Six months later in September, the Black Month of the crisis, the Fed lent 85 billion to the American International Group (AIG), one of the world's largest insurers.[3] In October, it announced 900 billion dollar in short-term cash loans to banks, made a 1.3 trillion emergency loan to non-financial companies, and bought 540 billion worth of short-term debt from money market mutual funds, which had reduced lending to banks and contributed to the credit freeze in interbank markets.

The Fed also performed a series of quantitative easing rounds – purchases of financial assets from commercial banks and other private institutions that inject a pre-determined quantity of money into the economy – to spur growth. In March 2009, the Fed bought government bonds and mortgage-related securities issued by housing finance giants Fannie Mae and Freddie Mac for a total of 1.25 trillion dollar. With unemployment at double digits, the Fed performed a second round of quantitative easing (so-called QE2) worth 600 billion dollar in November 2010. By the end of 2010, the Fed had made more than 3.3 trillion dollar in loans to financial institutions, companies, and foreign central banks during the crisis, and its balance sheet had expanded to 2.37 trillion dollar from just over 800 billion in the summer of 2007, with mortgage-backed securities making up the bulk of the total. In September 2012, Fed announced 40 billion dollar in additional monthly stimulus, and maintaining its previous programme of exchanging about 45 billion monthly in short-for-long-term securities.

The Fed's responses offered only temporary breathing space and raised questions about its ability to meet its dual mandate to ensure price stability and full employment. The Fed's moves also created two major challenges. The first was political. Monetary expansion awakened Americans' suspicions of central bankers captive to Wall Street, and subjected the Fed to allegations that it is usurping fiscal policymaking powers. In 2010, 39 percent of Americans said they believed that Fed independence should be reduced, and another 16 percent argued for abolishing the Fed altogether (Zumbrun 2010). And in October 2011, only 40 percent of Americans trusted the ideas of Bernanke to create jobs, below the 43 percent for Republicans and 44 percent for Democrats in Congress (Newport 2011).

Even though making decisions of major redistributive consequence, central bankers are at the end of the day unelected technocrats exempted from the appropriations process and have few of the immediate restraints or

3 Fed documents released in December 2010 showed that most of its loans and other aid for US institutions went to Citigroup ($2.2 trillion), Merrill Lynch ($2.1 trillion), Morgan Stanley ($2 trillion), Bear Stearns ($960 billion), Bank of America ($887 billion), Goldman Sachs ($615 billion), JPMorgan Chase ($178 billion) and Wells Fargo ($154 billion). Also foreign banks benefited, with Swiss bank UBS borrowing more than $165 billion, Deutsche Bank $97 billion, and the Royal Bank of Scotland $92 billion. See Aversa 2010.

responsibilities of politicians (Guerrera and Braithwaite 2009, Leijonhufvud 2008). But the Fed's independence is not absolute: it can be stripped by Congress. As such, the Fed's measures to stimulate growth themselves were less worrisome than its political repercussions. Some Congressmen sought to take advantage of the Fed's credit window for political ends, while others accused the Fed of overreach and sought to curb its room for manoeuvre.

These moves, however, were feared to jeopardize central bank independence, the crowning achievement of 20th century economic policymaking that has tamed inflation and safeguarded financial stability the world over. A dilemma arose: while releasing liquidity in the economy amid crises may be necessary for the Fed to forestall a depression, the implications of such a measure on independent monetary policymaking can be hugely negative and lasting. At the same time, failure to act would subject the Fed to political wrath should the economy stagnate.

The second challenge is that the Fed's dilemma is enormously consequential at the global level given US predominance in the world economy. By default devaluing the dollar, the Fed's easing risks abetting competitive currency devaluations that ricochet around the world, generating pressures for trade protectionism. More directly, the Fed's response inspired such emerging nations as Thailand, Brazil and South Korea to impose capital controls. Worried about credit bubbles and currency appreciation, Asian and Latin American governments took to shielding their economies against "hot money" from abroad as investors flee low interest rates in the EU and the United States seeking higher returns in emerging markets. These nations claim that the Fed's quantitative easing has caused a destabilizing gush of liquidity that justifies capital controls.

However, capital controls have negative effects. First, they obstruct trade that is required for reigniting the world economy. An open trade regime generally requires an open financial regime because exporters and importers need access to international financial markets to transact. Second, capital controls on hot portfolio flows tend to have a chilling effect also on the more stable foreign direct investment that emerging markets covet in order to create well-paying jobs and access new technologies. Third, there is no clear or compelling relationship between capital controls and success at avoiding crises. For example, during the economic duress in the 1970s and 1980s, Latin America was unable to contain capital outflows despite pervasive controls. In the more complex financial markets, investors are able to circumvent capital controls altogether. And fourth, at the global level, one country's controls are another country's problem. Blocked from one market, money will find its way to the next.

Fiscal Quicksand

The crisis revealed the limits of the growth model pegged to leverage. Positively, private savings rates have rebounded to 5 percent of GDP after falling from some 4-5 percent of incomes in the late 1990s to 1 percent in 2005.[4] Americans' debt loads have fallen as well. The savings rates track historical data: in the 1960s, Americans saved 7.5-10 percent of their incomes, almost the level of Germany in the past fifteen years; in the 1970s, the savings rate was at 8-12 percent range, slightly less than where France's has been the past fifteen years. Still in the boom years of 1994-2000, Americans saved 4-6 percent.[5]
However, public debt, ballooning on the back of the fiscal deficits Washington ran during the crisis, is projected

4 Data from Bureau of Economic Analysis, US Department of Commerce.

5 See Guidolin and La Jeunesse 2007. The debt to income ratio has widened particularly among those at the lowest rungs of the earning scales (Wilmot 2009). The decline in savings has been attributed to various factors, such as low interest rates, easy access to credit and the related new financial products, assumption that productivity gains will continue growing linearly, and "wealth effect" – rising capital gains and real estate values discouraging savings. Evidence cuts many ways. While some argue that the health of the stock market and financial wealth are the leading determinants of saving rates, others have found that particularly in America, government savings and demographics are key. For summaries, see Marquis 2002 and Feldstein 2009.

to rival the WWII record highs. The Congressional Budget Office (CBO) projects that under a benign scenario, deficit would be 2.3 percent in 2014 (US CBO 2012a and 2012b). With the deficit persisting through 2022, debt held by the public would rise from 73 percent of GDP in 2012 to 61 percent in 2022, the highest since the early 1950s and double the levels attained in 2001. Under an alternative scenario of significantly lower revenues and higher outlays, debt would reach 90 percent of GDP by 2022 and a stunning, Japanese-style 200 percent by 2037, while fiscal deficit would be 17 percent of GDP. The projections of the administration's Office of Management and Budget (OMB) fall in between these two scenarios. Fiscal deficit would be 3.9 percent in 2014 and debt held by the public rise to 78.1 percent of GDP by 2015, record high since 1946 (US OMB 2010). The increase in debt and interest rate hikes once the economy recovers are expected to triple interest payments between 2010 and 2022.

There have been several attempts to deal with the fiscal challenges, but political gridlock has hampered fixes. While the so-called fiscal cliff was averted, tall fiscal challenges remain. Moreover, fiscal spending is only a short-term fix, and ultimately counterproductive. For one, there are certain thresholds where fiscal policy starts to lose its impact. When GDP growth is low, there are some multiplier effects from fiscal loosening, but these are short-lived (IMF 2012). Moreover, growing debt loads stunt growth and competitiveness. Research shows that there is a two-way inverse relationship between debt and growth: higher debts tend to lead to less growth, and more growth leads to lower debts (Alesina and Ardagna 2009, Thornton 2009, Mankiw, Weinzierl and Yagan 2009). When growth increases, tax revenues increase and so do unemployment benefits. A large body of literature finds that at least beyond a certain threshold, higher public debt lowers potential growth. The IMF finds that, a rise in debt from 60% of GDP to 120% of GDP would lower US economic growth by one full percentage point a year (IMF 2012).

Besides undermining growth, debt at current levels hurts US competitiveness in at least three ways. The first is if it entails spending cuts and revenue increases that discourage productive activities and investments.

Second, public debt crowds out the private sector: once the cost of borrowing rises for the US government, it will rise for private-sector borrowers, undermining investment. The CBO projects that the US government's budget deficit will average 5.2 percent of GDP over the next decade, and be 5.5 percent of GDP a decade from now. If that high level of government borrowing occurs, it will absorb all of the available household savings even at the current elevated level.

Third, high external borrowing means that the US will have to continue to need substantial inflows of foreign capital to fund business investment and housing construction. However, when entailing borrowing from overseas, the debt burden can have dramatic implications on the US current account deficits, which entail a less competitive dollar and protectionist sentiments.[6] Economist William Cline (2009) estimates that in a benign scenario where growth was a decent 2.75 percent annually and fiscal deficit only 2 percent of GDP through 2030, US current account deficit would still be a notable 4-5 percent of GDP. However, in a scenario where the fiscal deficit escalated to 10 percent in 2030, America's debt would be 140 percent of GDP and more than 700 percent of exports, and US current account deficit would soar to 5.2 percent in 2015, 7.5 percent in 2020, and 16 percent in 2030, two and a half times the historic levels reached in 2006.[7] The value of the dollar would surge more than 20 percent, undermining America's export competitiveness and fuelling global imbalances, which in turn give rise to protectionist sentiments and currency wars.

6 There is no necessary link between budget deficit and current account deficits: the United States had a moderately deepening current account deficit while reducing the fiscal deficit in 1996-2000, and some other indebted countries like Japan run current account surpluses. However, most of recent American and international economic history has shown that by causing total national savings to decline, budget deficits tend to increase borrowing from abroad.

7 In 2005, Cline called for Plaza II, a coordinated policy adjustment among the major industrial economies aimed at unwinding the imbalances (Cline 2005).

Trade Policy: Growth through Exports

Catering to trade union supporters, the Barack Obama administration came to office as a trade-sceptic, wowing in particular to enforce US trade rules to prevent unfair foreign competition. US trade policy did not change much in response to the crisis; only its anti-import tenor amplified and export promotion gained centre stage as a means to propel growth in the insipid economy. In January 2010, the administration launched an export promotion campaign, pledging to double US exports by 2015.

The goal was ambitious – US exports have doubled only twice during a five year period in the post-WWII era – but it also promised easy political victories: the slump in world trade in 2009 was so deep that the mere rebound of trade would help administration claim its efforts worked. The export drive became widely adopted by governors and mayors across the United States. The administration also broke with its opposition to free trade agreements (FTAs) and took to a receptive Congress free trade accords negotiated by the George W. Bush administration with Panama, Colombia, and South Korea. The action came only after unemployment persisted in near double digits and the administration wanted to expand the Trade Adjustment Assistance (TAA) benefits for workers laid off due to foreign competition. For congressional Republicans, the TAA was made as a quid pro quo for the FTAs. The administration also stepped up negotiations with Pacific Rim countries on the Trans-Pacific Partnership FTA.

Besides playing offense, Washington has undertaken numerous defensive trade policy measures. In February 2009, Congress passed and President Obama promptly signed the "Buy American" provisions in the US economic stimulus plan – designed to make recipients of stimulus money source their inputs solely from US suppliers. Protectionist sentiments spilled over to seemingly non-trade policy areas. The Lieberman–Warner–Boxer bill, among the more ambitious US efforts at climate legislation to reach a Senate vote in 2008, is indicative. Even though it did not prosper at the end, the bill would have required foreign suppliers, based in countries that had not taken "comparable action" to US control measures, to purchase greenhouse gas allowances before their exports would be allowed into the US market.

Washington hardened its stance toward Chinese currency manipulation. The 110th Congress (2007-2009) put forth some dozen China bills, many of which aimed to force an overhaul of China's exchange rate regime. In September 2010, the US House of Representatives approved by an overwhelming margin a bill that is interpreted to open the door for an imposition of trade remedies against alleged currency manipulation; the Senate followed suit in October 2011.[8] The administration also hardened its stance toward China, even though keeping from signing laws or pursuing actions that would explicitly naming China a currency manipulator. This balancing act reflects an effort not to antagonize the Sino-US relationship, and it in part is positive, as US tariff retaliation would have counterproductive effects for the US economy. For example, Hufbauer and Schott (2009) estimated that retaliation by other nations against the Buy American provision that were to affect just 1 per cent of US exports would erase 6,500 American jobs. A blanket tariff against China would also cancel out the benefits, for three reasons. First, a unilateral tariff may make China counter-retaliate with trade barriers. Second, a tariff on China would only raise the cost for US consumers and companies that either pay tariff on Chinese imports or shift to goods from higher-cost nations. A tariff would hurt US multinationals in China. Third, a tariff on goods imported from China that are produced in a global supply chain could also hurt American jobs in such areas

8 Specifically, the bill narrows the Commerce Department's discretion to refuse to initiate a countervailing duty investigation on an allegation of export contingency and specifies how the Department must calculate the subsidy benefit.

as engineering, design, finance, marketing, and retail, while not hurting China to the same extent: on average, 50-61 percent of the value of goods exported from China is added in countries other than China, including in the United States (Lau et al. 2006, Ikenson 2010, Koopman, Wang and Wei 2008).

Regulatory Clampdown

US monetary, fiscal, and trade policy responses have been aimed at stimulating growth in the short-term. Another response to the crisis was the greatest financial regulatory reform since the Great Depression, aimed in theory to position the United States on a growth path. However, with Washington eagerly painting Wall Street as the culprit for the crisis, the regulatory response was quintessentially political and massive. The 2,319-page Dodd-Frank Act finalized in 2010 creates an oversight council to monitor the entire financial sector and consumer protection agency to counteract predatory practices, raises bank capital requirements, regulates more speculative players such as hedge funds and private equity firms, and establishes a process for unwinding foundering banks in a more orderly fashion. It also seeks to tame "too big to fail" institutions, curb bankers' bonuses, and bar credit-default swaps.

Implementation will continue for years. Much of energy in the implementation process since the adoption of the Dodd-Frank Act has been aimed at the too-big-to-fail problem. It has also aimed at raising capital requirements for banking firms, both domestically as well as internationally at the Basel Committee on Banking Supervision, the international forum in which banking supervisory issues are discussed. What are the effects?

Ultimately, the reforms are to be judged both by the degree to which they meet their objectives – prevent future crises and extricate the taxpayer from the burden to bail out banks when crises occur – and by their potential for promoting open, competitive, and globalized financial markets, something the United States has championed for decades. But by both standards, the reforms have flaws. Many of the initiatives, such as the consumer agency, are good politics – grand and visible organizational innovations that are easy to explain to the public – but can ultimately create perverse incentives and, ultimately, undercut competition and raise costs of financial services in America (Wallison 2010, Posner 2010).

For example, the regulations are fared to only increase moral hazard among the largest banks: the new Financial Stability Oversight Council's expansive mandate means that the council will be able and encouraged not only to clamp down on banks, but also to promptly pre-empt the failure of any major financial institution. If large financial companies believe this to be the case, moral hazard could only increase, not decrease as intended.

Similar problems arise from the government's new authority to resolve a failing financial institution. A resolution authority is positive in that it ends the regulators' dilemma to either bail out a company and its creditors or let it go bankrupt. The authority also strives to make institutions internalize costs of failure: the government can impose losses on a failed institution's shareholders and creditors and replace its management. At the same time, it is not clear how severe those losses would be. And a rule that provides for an orderly unwinding can create an expectation that unwinding will be effected. If institutions believe that a bailout is likely – an impression that the repeated bailouts in the past few years have only cemented – they will have fewer incentives to assess their risks or insure against counterparty failure.

Capital ratios can also produce perverse incentives. They can drive institutions to take greater risk in order to compensate for the investments they could have made with the now-latent capital. High capital requirements can also make short-term debt undesirable – although short-term debt can help discipline bank management and make banks more productive (Squam Lake Group 2009).

The most immediate further implication of moral hazard is financial Darwinism: if large institutions enjoy an implicit government guarantee to bail them out, they can borrow more cheaply than their smaller competitors and thus crowd out the latter (Wallison 2009). A recent study shows that the borrowing costs for larger banks have become 0.78 percent less than those for small ones, up from 0.29 percent in 2000–2007 (Johnson and Kwak 2011). Smaller banks are also expected to be hurt by the new capital ratios, as they are harder-pressed to raise the capital required to comply with the new rules than large firms are.[9]

If and when stifling competition in America's financial markets, the regulations ultimately raise the costs of financial services to consumers (Wallison 2010, Posner 2010). Consulting firm McKinsey argues that the new rules entail an "increase in [the] cost of liquidity and net reduction in liquidity credit lines," and "higher rates and reduced access to credit" (Anderson et al. 2011: 9). Indeed, both banks and businesses now see regulatory pressures as the leading cause of banks' risk-aversion and declined small business loans (Robb and Reedy 2012, Paglia 2011). In a 2011 survey, nearly 80 percent of banks argued that pressure from regulators had caused them to avoid making risky loans, and 60 percent agreed that regulatory pressure was the cause of declined small business loans (Paglia 2011: 122-123). One of the law's most controversial parts, the so-called Volcker rule, curtails banks' proprietary trading and echoes the limits imposed in the 1930s by the Glass-Steagall legislation on bank operations that elevated Americans' cost of credit and limited banking services for more than five decades (on cost analysis, see Ramírez 1999, Kroszner and Rajan 1994, Calomiris 2000).

Withering International Leadership

US responses to the crisis are rooted in America's pressing domestic political imperatives to promote growth, propel exports and jobs, and pre-empt discrimination against US economic interests. They also have not been particularly novel. For example, in 1982-83, as unemployment soared to above 9 percent, the Ronald Reagan administration embarked on policies aimed at sharpening the edge of American firms in global markets and ensuring reciprocity with US trade partners through import relief and export promotion. Washington's stance toward China too echoed the Reagan administration's drive at currency realignments especially with Japan through the 1985 Plaza Accord.

The United States played a central role in the initial international crisis response. The thrust of US actions mirrored that of the United States since the mid-20th century: to further America's interest in global economic growth and stability by creating, fostering, and, when necessary, reforming global economic institutions. The measures were not altruistic, but geared to driving the interests of an inherently global economic power each day more dependent on the fortunes of the world economy for its prosperity.[10]

In November 2008, the US assembled the leaders of the G20 nations to their first-ever summit in Washington, and a year later it originated its leitmotif, the "Framework for strong, sustainable and balanced growth" aimed at taming global financial imbalances. Washington also took the lead in the tripling of IMF's resources to better respond to the spreading crisis, and that subsequently persuaded a reluctant EU to expand the powers of

9 "Basel III Will Cause 'Financial Darwinism': BaFin's Sanio", *Risk Magazine*, 17 January 2011, http://www.risk.net/risk-magazine/news/1937473/basel-iii-cause-financial-darwinism-bafin-s-sanio.

10 For example, the ratio of merchandise trade (imports plus exports) to US GDP grew from 17.4 percent in 1980 and 24.6 percent by 2008.

emerging nations in the world body. It was also the United States that first drove for an overhaul of financial regulations and envisioned the Financial Stability Board (FSB) as the global regulatory coordinator of the stature of the IMF, World Bank, and World Trade Organization (WTO).

Despite the talk about American decline and end of the American order, the US-made world economic order has persevered. The new institutions, the G20 and FSB, are but US-conceived sequels to US-created entities. The dollar continues as the world's anchor currency as investors deemed America the world's safe haven. The mission and capacities of the Bretton Woods twins, the IMF and the World Bank, have only been expanded, and no country has resigned from these institutions – rather, nations have coveted for a seat at the table. Open markets have survived, and 1930s-style protectionist avalanche has not materialized. The WTO continues to resolve trade disputes and recently welcomed Russia as its 154th member. Countries have continued opting in, not out, of the American-led order, reflecting a reality of global governance: there are no rival orders that can yet match this one's promise of mutual economic gains.

However, there are mounting challenges that undermine the legitimacy of the existing economic order in managing 21st century challenges, including the deepening EU debt crisis, discord over national policies to restore growth, and the all-but-dead Doha Development Round of WTO negotiations. Old tensions simmer over issues such as financial nationalism, exchange-rate manipulation, and capital controls, that are bound to raise their head when domestic and overseas demand cools. Indeed, rather than decoupling from advanced nations, the fortunes of emerging markets continue fluctuating with demand in the United States, the world's largest importer. Complaints from countries like Brazil and China about the Fed's quantitative easing, attest to global economic interdependences.

Even though these challenges hurt US economic interests, America's responses have fallen short. The EU's travails are reducing US companies' exports and overseas profits, threatening America's recovery: about a fifth of US exports go to the EU and some half of US corporations' foreign sales arise in the EU. Growth has slowed in a number of major emerging economies that are also US export markets, especially Brazil, China, and India. And yet Congress has balked at boosting the IMF's resources to fight the Eurozone crisis while the Obama administration has deflected responsibility, framing the crisis as Europe's to manage and calling on Europeans to stimulate their economies – which has soured relations with Germany that advocates austerity. It has been emerging nations like Brazil, China, India, Mexico, and Russia that have contributed to the IMF's firewall aimed to shield the rest of the world from the EU.

In the realm of trade, while muted, protectionism has not been absent. According to data by the Global Trade Alert, by October 2011, the G20 members alone had implemented nearly 800 protective measures since the first G20 pledge in November 2008. Worse, the protectionist trend continued rather than reversing as the global recovery commenced. The bulk of this new protectionism takes the form of obscure discrimination through barriers aimed at skirting the General Agreement on Tariffs and Trade (GATT)/WTO system of tariff bindings. As in the United States, fiscal stimulus packages enacted around the world often contained industrial subsidies that can distort the patterns of global commerce and trigger WTO disputes over "illegal state aids".

Multilateral trade liberalization is the first-best trade policy, but the global Doha Round is dormant. The fault is to a large extent in emerging economies such as India and Brazil that hold on to their barriers against foreign manufactures and services and fear that further opening would flood their markets with cheap Chinese goods. But it is also the case that the United States does not appear committed to the talks, which, in turn, dampens other nations' enthusiasm for the talks and gives them license to cut corners on their policies. Moreover, America's languishing trade agenda hurts US relations with key allies in Asia and the Americas, undermines the world trading system that America has built and that has opened markets for US industries around the world, and weakens Washington's hand in dealing with US trade deficits and global imbalances.

More positively, the United States moved increasingly to liberalize trade in the Asia-Pacific through the Trans-Pacific Partnership, and also announced a launch, potentially in 2013, of free trade agreement negotiations with the EU. Once complete, these two historic agreements comprise several of the world's largest trading nations and could, as such, open new pathways for multilateralism. For example, some of the FTA disciplines could be multilateralized, while the overall regional momentum could compel the outsiders, Brazil, India, and China, to get back to the Doha table. Positively as well, the United States also has paid increased attention to plurilateral deals at the WTO among coalitions of the willing, and commenced the negotiations for a plurilateral services agreement at the WTO.

In short, America's international economic leadership and resolve have withered since the positive, immediate responses to the crisis. A large reason is domestic policy challenges, which deviate attention and undermine US leadership. For example, gaping fiscal deficits in the United States are undercutting the dollar, trade balance, and US economic dynamism and credibility in world affairs. American companies claim being stifled by taxes, regulations, and policy uncertainty. There are also uncertainties surrounding trade policy, including worries expressed by other nations about a protectionist America, that hold world trade back.

Toward a New Growth Model? Challenges to US Growth in the Post-Crisis World

The driver and legacy of the crisis is excessive leverage. Deleveraging is critical. However, it also means that consumers are reducing purchases especially of durable goods to build their savings and businesses are cancelling planned investments and laying off workers to preserve cash. This pattern is the so-called "paradox of deleveraging", whereby what may be smart for individuals and firms and essential for the economy in the long-term also magnifies the immediate distress of the economy (Minsky 1992).

Today, the US economy is amid the paradox. Three years after the US economy turned from contracting to expanding, unemployment rates are at 28-year highs. The Federal Reserve has cut growth forecasts, expecting the economy to grow 2.4-2.5 percent in 2012, compared to an earlier forecast of 3-3.5 percent. Incomes have stagnated and inequality has deepened, feeding deep unease among the America's vast middle class.

The hallmark of today's US economy is uncertainty. Whether the economy is trending toward the historic normal is also unclear. The long adjustment period means that there are several intermittent shocks and events that complicate forecasting. There are still also questions as to whether the housing shock was so profound that today's mediocre growth rate does in fact reflect potential growth rate. What is clear is that the old drivers will not power America's economy going forward: the US and global growth model relying on leverage has to come to an end. A new growth model requires fiscal discipline, productivity increases, and international leadership. The following will examine these in turn.

Fiscal Policy Dilemma

On the basis of data starting from year 1800, Harvard's Kenneth Rogoff and University of Maryland's Carmen Reinhart calculate that the total costs of responses to banking crises – bailout of the financial sector, shortfall in revenue, and fiscal stimulus packages – have increased central government debts by an average of 86 percent in the three years after a financial crisis (Reinhart and Rogiff 2008). Today's crisis is not different. America's main challenge going forward is reducing the high debt loads that now undermine investment, growth, and competitiveness.

Historically, robust investment and economic growth have been sustainable only at the back of domestic saving. In a study of 107 adjustments in Organization for Economic Cooperation and Development (OECD) nations' fiscal policies in 1970-2007, Alberto Alesina and Silvia Ardagna (2009) find that cutting spending and cutting taxes is an effective way to propel growth and reduce deficits, while increasing spending is ineffective – the promised multiplier effect of stimulus dollars is scant – and increasing taxes is recessionary. Several rigorous empirical studies echo these findings. The IMF (2012) finds that on average for advanced countries, a one percentage point of GDP reduction in discretionary spending leads to 0.7 percentage point reduction in the deficit. Spending cuts are expansionary because they signal that tax increases will not occur in the future, or that if they do they will be smaller. This, in turn, leads to adjustments in expectations: consumers and investors are more willing to spend if they believe that spending and taxes will remain low for an extended period of time. Lowering the fiscal deficit will also reduce current account deficits – a 2 percentage point reduction in the fiscal deficit is estimated to lower current account deficit by 0.6 percentage points of GDP (Bartolini and Lahiri 2006).[11]

The federal deficits and accumulating debt must be stabilized so that US national debt grows more slowly than future GDP. Robust GDP growth in turn drives tax revenues, resulting in a virtuous cycle. However, fiscal policy adjustment will take time. The setting is complicated, given the risks of excessive fiscal tightening. Going forward, containing the rising cost of medical care and reforming Social Security are critical for curbing spending.[12]

Tax policy is also critical. Taxes too must be held at bay when growth hangs on balance, despite political calls to tax the wealthy, not least because growth increases tax revenues.[13] In addition, corporate taxes need to be reduced and the tax regime simplified. Policies are also need to alleviate households' mortgage debt burden, such as through write-downs of underwater mortgages and expanded access to refinancing. This, in turn, will lower foreclosures and thereby support the housing sector and the broader economy.

Productivity Gap

A more sustainable way to grow than fiscal spending is increases in productivity. Growth is a function of productivity. There are more and less pessimistic scenarios. Projecting on the basis of figures dating back to 1891, Gordon (2010) argues that in 2007-2027, labour productivity in the US economy is bound to grow 1.7 percent per year, slower than 2.02 percent in 2000-2007 or 1.79 percent for 1987-2007, even if faster than 1.25 percent

11 The authors find that even if the federal fiscal deficit (in 2006 at 2 percent of GDP) were fully erased, US current account deficit would improve by only a fraction of its current 7 percent of GDP.

12 For projections on costs through 2032, see Walker 2008.

13 For a discussion on optimal taxation, see Mankiw, Weinzierl and Yagan 2009.

for 1972-95. That entails 2.4 percent annual GDP growth for 2007-2027, same as in 2000-07 and at a par with other projections. GDP growth in turn translates into a per capita income gain of 1.5 percent per annum, much below the 2.17 percent attained in 1929-2007. McKinsey Global Institute finds that in order to match the GDP growth of the past 20 years and the rising living standards of past generations, the United States needs to boost labour productivity growth from 1.7 to 2.3 percent a year – 34 percent acceleration to a rate not seen since the 1960s (Manyika et al. 2011: 3).

Productivity increases come both from efficiency gains and from increasing the volume and value of outputs for any given input. These have many drivers. New technologies and innovation, infrastructures and education, specialization and division of labour, openness to trade, good institutions, and such hard-to-quantify variables as trust among people, have all been argued to affect it.[14] America's productivity challenges – primary and secondary education, physical infrastructure, wasteful government spending, suboptimal research and development (R&D) spending – have been catalogued extensively.[15]

To be sure, there is much more to these select drivers of productivity. The quality of education is not the only factor behind labour productivity; on-the-job training is another. Physical infrastructure is only one part of productivity in the information technology era. Innovation transcends borders: new technologies abroad can be imported to America just as R&D can be outsourced overseas and used by US companies operating in and outside America. R&D spending by US companies from Google to GE produce positive externalities that benefit not only them and their customers, but also the public at large. Moreover, spending more is not the only or necessarily even the best solution. But the basics will have to be met: investments, public and especially private, in the economy's backbones are necessary for fuelling US productivity. If stemming from enhanced quality of education across the board, productivity increases can also help alleviate the politically divisive income gaps.

Upholding the Global Order

The United States also faces a challenging global economic setting. The US economy is intimately dependent on the performance of other leading nations, and it is critical for global growth. A thriving world economy requires a thriving America, as well as vice versa. This linkage has not been articulated clearly by US policymakers. Instead, high unemployment, a strong dollar and a huge trade deficit are feeding protectionist and isolationist sentiments.

Pressed by domestic challenges, the United States has retreated from the global economic leadership role it has played for seven decades. Other nations have failed to fill the gap. The setting is one of global economic instability, divisions among leading powers, and a global leadership vacuum. A perfect storm of these elements would produce a world disorder of mercurial financial markets, widening global imbalances, and beggar-thy-neighbour protectionism – a scenario with a sorry past.

US foreign economic policy needs to focus on pre-empting instability and integrating the global economy. The United States needs to turn the IMF's business model to one that addresses financial risks before they mushroom into catastrophes, as well as to revise the multilateral trade regime to allow for fast agreements among a

14 International differences in productivity are also affected by such variables as openness to trade, rule of law and good institutions, private ownership, and even geographic latitude, with nations in temperate zones having greater productivity. See Hall and Jones 1996. Political scientists take a one further step back, arguing that the public policies that propel productivity in turn hinge on political and social factors, such as electoral systems and ethnic fragmentation.

15 See, for example, World Economic Forum 2012.

critical mass of members rather than requiring agonizing, decade-long talks requiring the consent of the full membership. Instead of stifling financial markets, the United States needs to champion global financial liberalization – all the while deepening access to US goods, services, and investment around the world. A Trans-Pacific Partnership agreement and a transatlantic free trade pact are low-hanging fruits that can jump-start global growth without any new stimulus dollars.

The quintessential challenge facing US policymakers is to convince other nations to buy into a rules-based international economic order rather than waging currency wars and instituting capital controls. For example, with most emerging economies uneasy about Beijing's trade and foreign policies, Washington has an opportunity to persuade these nations to take the high ground and strengthen investor protections, enforce intellectual property rights, and adhere to trade rules. With others playing by the rules of the game, a misbehaving China would be relegated into a pariah.

Not All Is Wrong: Strong Fundamentals

All too often the focus on America's challenges eclipses attention to its many strengths. The United States is the home of a larger share (133) of the world's leading companies on the Fortune Global 500 list than any other country, thrice as many as Germany and also more than China and Japan *combined*. The US military is still overwhelming in reach and has multiples of the equipment, sophistication, and projection of those of the closest competitors. US universities are still unquestionable global leaders.

The United States also has fundamentals. The United States is seventh in the World Economic Forum's perceptions-based ranking of most competitive nations in 2012 (World Economic Forum 2012: 13), behind Switzerland, Singapore, Finland, Sweden, Netherlands and Germany and far above China and Korea (at 29th and 19th). Reported US competitive advantages range from technological readiness to labour and goods market efficiencies, innovation, strength of investor protections, and certain aspects of higher education, such as use of information technology (IT) and tertiary enrolment. The United States also has the greatest potential for pushing the frontiers of innovation. The *2013 Global R&D Funding Forecast* (Battelle 2012) expects the United States, which makes up over a third of global R&D spending, to maintain technology leadership in specific, high-growth areas over the next years,[16] including health care and medicine, basic energy research, carbon dioxide sequestration, and security and defence.

The United States is also by global standards hospitable to business. It is fourth in World Bank's *Doing Business* rankings,[17] along with Singapore, New Zealand, and Hong Kong, while Germany is 20th, China is 91st, and is India 132nd. It is fourth on availability of credit and sixth in investor protections. In a world where garage entrepreneurs have a chance to build global companies with a fraction of the cash needed for a start-up just a decade ago, America outperforms most nations: starting a company in the United States takes only six days, as opposed to fifteen days in Germany, twenty-seven in India, thirty-three in China, and 119 in Brazil. Trading goods across borders in the United States takes five-six days, compared to seven days in Germany and between twenty-one and twenty-four days in China.

In contrast to the EU, Japan, China, or even India, the United States has a wealthy resource base. It has not only

16 Nevertheless, the report affirms that "China's economy is already set to surpass that of the U.S. within the next three years, and its R&D investments will do the same in less than 10 years" (Battelle 2012: 24).

17 World Bank, *Doing Business* database, http://www.doingbusiness.org/rankings.

the most arable land and is the largest food exporter in the world, but also has extensive domestic sources of energy. The Great Plains and Appalachian regions hold massive reservoirs of natural gas, and America's Midwest is famously labelled the Saudi Arabia of wind power (Oxford Analytica 2009, Kotkin 2009, Kennedy 2009). According to the US Department of Energy, America's net imports of energy will decline as a share of US energy consumption from 19 percent in 2011 to 9 percent in 2040[18] owing to increased use of biofuels and shale gas produced in the United States, rapid improvements in the efficiency of appliances, and higher energy prices (US Energy Information Administration 2013: 9).

Demographically, the United States is aging like the other main economies, but it is also the only major advanced country with a persistent population increase, thus more likely to produce, build businesses, contribute tax revenues, and sustain aging retirees than the EU or Japan are (UN Dept. of Economic and Social Affairs 2011). The US median age will be 40 in 2050, only slightly above the 37 in 2011. Americans 60 and over will make up 26.6 percent of the US population in 2050, above the 18.8 percent in 2011, but far below figures in many other leading economies. European, Japanese, and Korean median age is in the 50s by 2050, and a third of these nations' populations will be 65 or older. China is also aging rapidly. Its population growth will turn negative by 2035, and, at 48.7 years in 2050, its median age will be higher than that of the United States and well above the 34.9 in 2011. And entitlement reforms as well as innovations in health care, labour market, and migration regime can reduce the pressure that aging populations have on US budget.

Transatlantic Relationship in the Post-Crisis World

The transatlantic relationship has been turbulent amid the global economic convulsions. At first blush, the United States and the EU appear to be drifting apart: the US response to European crisis has been rather meek, while Europeans keep pointing fingers at the United States as the culprit for the global crisis. The EU crisis is an economic crisis that has major political and geoeconomic implications, yet there have been clear gaps in the US policymaking apparatus when it comes to the EU – the Treasury has focused keenly and solely on the economic issues at stake, ignoring the political implications, while the State Department has centred on strategic aspects of the relationship, practically omitting the economic issues.

At the same time, the crisis has also focused probably more US attention to the EU than would otherwise been the case. Moreover, business lobbies on both side of the Atlantic have been pressing for crisis resolution and stronger common responses, a drive that in late 2012 culminated in the decision to launch a transatlantic free trade agreement (TAFTA). This is a very positive development: the FTA negotiations will bring more strategic focus to the bilateral relationship after years of piecemeal sectoral and regulatory negotiations. Trade is also a low-hanging fruit: while not immediate and while requiring much work on service liberalization and regulatory harmonization, the FTA talks will also give a jolt of energy and confidence to the bilateral relationship and US and EU economies. Even though tariffs are low on both sides of the Atlantic, even small liberalization will deliver large gains, due to the size of the two economies. Former Secretary of State Hillary Clinton has framed the deal as a focal point for transatlantic economic relations and envisions an "economic NATO", a comprehensive agreement covering trade in goods, services, investment and agriculture (Clinton 2012, Ignatius 2012).

Such an ambitious effort would have important strategic benefits. It can pressure the largest emerging markets such as India, China, and Brazil to adopt more lenient trade policy stances at the multilateral level. This is particularly the case as the US and EU have several FTA partners such as Canada, Mexico, South Korea, and possibly also Japan in common, and could ultimately dock all these parties to the US-EU zone.

18 The share was 30 percent in 2005.

In addition to the FTA, the re-elected President Obama may focus his personal attention more on international matters during the second term, which could also augur well for the transatlantic relationship and mending some of the fences, after discord over fiscal stimulus policies between Germany and the United States in the course of 2012. In short, the crisis may have pulled the EU and the United States apart, but it is the crisis resolution and common challenges that are pulling them together.

Conclusion

The global financial crisis and the Great Recession dealt a devastating blow to the US economy and resulted in numerous monetary, fiscal, regulatory, and trade policy responses aimed at stimulating growth and preempting future crises. However, several of these policies have also had unintended, counterproductive effects – public debt, politicization of central banking, international currency wars and capital controls. The adjustment is protracted, and economists tend to agree that the US economy is poised for a slower trend rate of growth and higher natural rate of unemployment than in the pre-crisis years.

However, the United States also has countless advantages, from a flexible, entrepreneurial economy to world class companies, technologies, and management practices. To unlock these productivity drivers, needed are fiscal discipline, ironclad central bank independence, education overhaul that challenges the smartest and rewards excellence in teaching, end to taxes and regulations stifling US companies, migration reforms to encourage the world's brightest to join forces in America, a bipartisan commitment to hone institutions, and incentives for the private sector to innovate, turn around schools, and assume the lead in rebuilding infrastructures.

At the international level, arguments that the crisis will accelerate the demise of the West and the rise of the East are premature. The crisis may not even signal an inflexion point in the distribution of global power. The paradox is that while the United States has been blamed for the crisis, it is also America that is asked to deliver the world to a path of growth and stability. In part this call reflects economic reality; in part it shows the absence of contending leaders. China may be waiting in the wings, but China's economy is still less than half the size of United States. The European Union, for all its size and heft, cannot yet speak with a single voice on fiscal affairs or exchange rates. The United States will remain essential for getting the world economy back on track, and American must resume stauncher leadership role – be a superpower it used to be rather than a "superpartner" it has arguably been in the past few years. However, America can only continue leading by the strength of its economy. At the same time, the transatlantic relationship is critical for America. Working with Europe, the United States can inject new energy to its economy, power America's trade and investment, and deliver important strategic gains in global affairs.

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The Project

In an era of global flux, emerging powers and growing interconnectedness, transatlantic relations appear to have lost their bearings. As the international system fragments into different constellations of state and non-state powers across different policy domains, the US and the EU can no longer claim exclusive leadership in global governance. Traditional paradigms to understand the transatlantic relationship are thus wanting. A new approach is needed to pinpoint the direction transatlantic relations are taking. TRANSWORLD provides such an approach by a) ascertaining, differentiating among four policy domains (economic, security, environment, and human rights/democracy), whether transatlantic relations are drifting apart, adapting along an ad hoc cooperation-based pattern, or evolving into a different but resilient special partnership; b) assessing the role of a re-defined transatlantic relationship in the global governance architecture; c) providing tested policy recommendations on how the US and the EU could best cooperate to enhance the viability, effectiveness, and accountability of governance structures.

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