

**Newsweek**

# The Making Of America 2.0

**No, even \$700 billion won't be enough. But despite the size of the bailout, the United States still rules the markets.**

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NEWSWEEK

When it comes to predicting the financial crisis, Harvard's Kenneth Rogoff, the former chief economist of the International Monetary Fund and a chess grandmaster to boot, has been right on the money. Last March, after the markets stabilized in the wake of the collapse of Bear Stearns, I asked Rogoff if he thought that would be pretty much it: were we in the clear? No way, Rogoff replied without hesitation. "This is going to end up in Congress's and the president's lap. It's not going to wait until the next administration." Rogoff forecast another big fallout from the devastation caused by failing subprime loans and mortgage-backed securities—and a giant government bailout. "Home prices are continuing to fall. The credit markets are stressed. This is a multi-trillion-dollar problem. It's beyond the Fed's balance sheet to handle it."

With a track record like that, I figured it would be worth another chat with Rogoff. How about this time? I asked him Thursday after the Senate approved a modified \$700 billion rescue plan. If the House goes along, will it be enough? "It definitely will not," he replied. "This is going to be a first step. We're going to end up with far more expansive and extensive measures. What has been accomplished already is incredible, but I suspect that we're going to end up intervening much more directly in the mortgage market, propping up housing prices ... I think this will cost us one to two trillion dollars by the end. That's a typical 6 to 10 percent of GDP [gross domestic product] for a crisis of this size."

Given such a grim prognosis, you might think that Rogoff has joined the growing throng of pessimists who are predicting yet again (as they did in the 1930s, '50s, '70s and '80s) the end of American financial hegemony and the eclipsing of American power. Even a gibbering lunatic like Iranian President Mahmoud Ahmadinejad sounded almost credible the other week when he declared, in his U.N. General Assembly speech, that "the American empire, in the world, is reaching the end of the road."

Instead, Rogoff sees great opportunities ahead for America, and the more I think about it, the more I tend to agree with him (I should also point out that Rogoff held these same views *before* he became an adviser to John McCain). Yes, the current crisis signals an end to the remarkable free ride we Americans have had for decades, when we financed our rampant, zero-savings consumerism with boatloads of borrowed investment money from abroad. "I think this is the end of that era of a 6 to 7 percent current-account deficit," says Rogoff. "The financial sector was key to that dynamic. For sure it's going to drop to half that level. [The current-account deficit] might even go back to 1 percent."

So consumption will decline. There will be an economic slowdown of unknown severity. But overall that's a healthy deflation of an economic bubble that the subprime disaster was only a symptom of: as a country, we need to stop buying things we can't afford. And Washington—the next president *and* Congress—will have to make some very responsible choices about how to regulate the new landscape that has emerged on Wall Street without overdoing it (the impulse will be to place a regulatory chokehold on banking since it's now clear to everyone that underregulation got us into this mess). "There's no doubt that the U.S. financial model has been undermined," says Rogoff. "The question is, are we going to come up with better regulation and produce an American finance 2.0 that's more robust and better than the first one and keeps the financial sector as the flagship of the American economy? Or we going to regulate it into a

coma?"

There is ample time to get that balance right. Even amid the current worldwide crisis of confidence in America—which extends not just to the subprime fallout but to the widespread mistrust of the Bush administration over its foreign policy and fiscal irresponsibility—interest rates have remained low and [the dollar strong](#). Those are sure signs that other countries simply have no choice but to continue to invest here and depend on the dollar. If the world really felt that America's time was passing, "the dollar would be tanking and our interest rates would be soaring," says Rogoff. "Whatever the newspapers are saying, foreign investors have not given up on us."

True enough. It's also true that other financial-market centers, like London, Hong Kong and Singapore, are looking to grab as much new business for themselves as they can while the former titans that ruled Wall Street—like Goldman Sachs and Morgan Stanley—are focused inward in cleaning up their balance sheets and remaking themselves into more conservative commercial banks.

But let's be blunt: there is no other country or market that is even within sight of replacing the United States and the money masters of Manhattan island. The rising power of China or Russia or the European Union has always been more alleged than real. The EU actually has bigger banking and financial problems than we do—one reason the euro hit its lowest point against the dollar in 13 months on Thursday—and Europe remains a hopelessly fractious cacophony of voices.

As for China, the never-remitting hype about its imminent rise to superpowerdom would make P. T. Barnum blush. The Beijing Olympics in August were an impressive shout to the world: we're ready! But as Washington Post editor John Pomfret, one of the journalism world's most astute observers of China, wrote last July, [the Chinese really aren't ready](#). "For four big reasons—dire demographics, an overrated economy, an environment under siege and an ideology that doesn't travel well—China is more likely to remain the muscle-bound adolescent of the international system than to become the master of the world."

To the north, Russia is riding high now thanks to soaring energy prices. But with Vladimir Putin's KGB pals in charge of increasingly powerful state companies, Russia is scarcely even an open-market economy any longer. Fascism, anyone? As for Singapore—yes, it's a very impressive little place. But it's a city-state that owes its calm prosperity to the U.S. defense umbrella in Asia, as does Japan.

Let's reiterate that latter point, because it's an important one. When times really get tough, when there are belligerent rising powers or threats, the dollar is still the world's safe haven because America is still the only reliable great power out there. Set aside for the moment the deeply unpopular invasion of Iraq. Every foreign government knows that America is still the main stabilizer of the international system—American power overlays every region of the planet and supplies the control rods that restrain rogues, hostile states and arms races from East Asia to Latin America, enabling globalization to proceed apace. This status quo is unlikely to change over our lifetimes.

Sure, we've suffered a lot of self-inflicted damage over the last eight years. Conan O'Brien didn't have to explain himself when he joked the other day, after the Dow's record one-day 778-point drop, that "as a result, President Bush was able to cross off the 10th and final item on his administration's bucket list." So devoid of credibility and influence is Bush today that the bailout package seemed to move forward *in spite of*, rather because of, his support. So, yes, as a country we've slowed to a crawl in the great global race. But we're still lapping everyone else. We've got time. And there's no reason we can't start to get it right come Jan. 20.

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