OPINION

A Slow-Growth America Can't Lead the World

By John B. Taylor

When President Obama meets with his counterparts from other G-20 countries in Cannes later this week, American economic leadership will, unfortunately, largely be absent.

At the most recent meeting a year ago in Seoul, the G-20 rejected the president's pleas for a deficit-increasing Keynesian stimulus and instead urged credible budget-deficit reduction and a return to sound fiscal policy. And on that trip he had to defend the activist monetary policy of the Federal Reserve against widespread criticism that its easy money was damaging to emerging-market countries, causing volatile capital flows and inflationary pressures.

With a weak recovery—retarded by new health-care legislation and financial regulations, an exploding debt, and threats of higher taxes—the U.S. is in no position to lead as it has in the past.

By contrast, in the years after World War II, the U.S. led the world in promoting economic growth through reliance on the market and the incentives it provides, the rule of law, limited government, and more predictable fiscal and monetary policy. It created a rules-based, open trading system by helping to found the General Agreement on Tariffs and Trade, which slashed tariffs multilaterally. The miraculous postwar European and Japanese recoveries came from greater adherence to these principles of economic freedom and direct support from the U.S.

After getting off track with interventionist policies in the 1970s, the U.S. put its economic house in order in the 1980s, adopting pro-growth policies and creating a long boom that lasted through the 1990s. Again its economic ideas were contagious, not just in Britain under Margaret Thatcher but in the developing world. Seeing the advantages of American-style economic liberty over state intervention and control, Deng Xiaoping expanded his initial and tentative market-based reforms in China and created an economic renaissance. The U.S. helped the countries in Central and Eastern Europe implement market-based reforms, and it encouraged other countries and the international financial institutions to do the same in Africa and Latin America.

> After World War II, the U.S. promoted international economic growth through reliance on the market and the incentives it provides. Times have changed.

As the U.S. has moved away from the principles of economic freedom—instead promoting short-term fiscal and monetary interventionism with more federal government regulations—its leadership has declined. Some, even in the U.S., may cheer the decline, but it is not good for the world or for the U.S.

Economic policies in America affect the world in ways that are often subtle. In the case of monetary policy, for example, decisions on interest rates by foreign central banks are influenced by interest-rate decisions at the Federal Reserve because of the large size of the U.S. economy. If the Fed holds its interest rate too low for too long, then central banks in other countries will have to hold rates low too, creating inflation risks. If they resist, capital flows into their countries seeking higher yields, thereby suddenly jacking up the value of their currencies and the prices of their exports.

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Due to the Fed's low rates, the European Central Bank held short-term interest rates low in the euro zone in 2003-05. Economists at the Organization for Economic Cooperation and Development found that these low rates in Europe were the cause of the housing booms in Greece, Ireland and Spain. As with all unsustainable booms, these were associated with undue risk taking, bad bank loans, busts, and huge government borrowing to bail out banks or to finance spending when revenues fell during the ensuing recession. Excessive government borrowing and problem banks are the source of the current crisis in Europe, which has in turn increased economic and financial risks for the U.S.

Some countries, including Mexico and Brazil, are complaining that the Fed is exporting inflation with its near-zero interest rate and massive purchases of long-term government debt, which is rapidly growing due to U.S. fiscal deficits. And when global inflation picks up, as it has started to do in many emerging markets, it feeds back into more inflation in the U.S. through higher prices of globally traded commodities. With unemployment already high, the result would be stagflation—slow growth, high inflation, steady unemployment—as we saw in the 1970s. For the good of the world and for its own good, America needs to show some leadership and better adhere to sound monetary and fiscal policy.

American economic leadership is also essential for defining the appropriate role of government in a global economy in which China plays an increasingly important role. Despite the enormous success of Deng Xiaoping's reforms, the Chinese economic system still fails to meet some key principles of economic freedom. While relying on markets and incentives, it has a weak rule of law and still imposes many barriers to free trade. The Chinese government favors some firms over others, crony-capitalism style, in its procurement procedures, and it requires that foreign technology firms partner with government-owned Chinese firms, thereby transferring technology to potential competitors.

The U.S. government should work to prevent interventionist trade and other policies abroad. But this is hard to do if America is moving in an interventionist direction internally. And it will have less and less influence if it continues to depart from sound fiscal policy, becoming more indebted to the negotiators on the other side of the table.

The next meeting of the G-20 leaders will be in Mexico in 2012, though the exact date is undecided. In the meantime, the 2012 election in America promises to be a referendum on the role of government in the economy. If, as a result, the U.S. starts to return to the principles of economic freedom—the best route to improving its own economy—then perhaps it will be able to reassert its economic leadership, benefit the world economy, and in turn create an even more prosperous American economy in a grand virtuous circle.

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