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The Fall of America, Inc.

Along with some of Wall Street's most storied firms, a certain vision of capitalism has collapsed. How we restore faith in our brand.

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The implosion of America's most storied investment banks. The vanishing of more than a trillion dollars in stock-market wealth in a day. A $700 billion tab for U.S. taxpayers. The scale of the Wall Street crackup could scarcely be more gargantuan. Yet even as Americans ask why they're having to pay such mind-bending sums to prevent the economy from imploding, few are discussing a more intangible, yet potentially much greater cost to the United States—the damage that the financial meltdown is doing to America's "brand."

Ideas are one of our most important exports, and two fundamentally American ideas have dominated global thinking since the early 1980s, when Ronald Reagan was elected president. The first was a certain vision of capitalism—one that argued low taxes, light regulation and a pared-back government would be the engine for economic growth. Reaganism reversed a century-long trend toward ever-larger government. Deregulation became the order of the day not just in the United States but around the world.

The second big idea was America as a promoter of liberal democracy around the world, which was seen as the best path to a more prosperous and open international order. America's power and influence rested not just on our tanks and dollars, but on the fact that most people found the American form of self-government attractive and wanted to reshape their societies along the same lines—what political scientist Joseph Nye has labeled our "soft power."

It's hard to fathom just how badly these signature features of the American brand have been discredited. Between 2002 and 2007, while the world was enjoying an unprecedented period of growth, it was easy to ignore those European socialists and Latin American populists who denounced the U.S. economic model as "cowboy capitalism." But now the engine of that growth, the American economy, has gone off the rails and threatens to drag the rest of the world down with it. Worse, the culprit is the American model itself: under the mantra of less government, Washington failed to adequately regulate the financial sector and allowed it to do tremendous harm to the rest of the society.

Democracy was tarnished even earlier. Once Saddam was proved not to have WMD, the Bush administration sought to justify the Iraq War by linking it to a broader "freedom agenda"; suddenly the promotion of democracy was a chief weapon in the war against terrorism. To many people around the world, America's rhetoric about democracy sounds a lot like an excuse for furthering U.S. hegemony.

The choice we face now goes well beyond the bailout, or the presidential campaign. The American brand is being sorely tested at a time when other models—whether China's or Russia's—are looking more and more attractive. Restoring our good name and reviving the appeal of our brand is in many ways as great a challenge as stabilizing the financial sector. Barack Obama and John McCain would each bring different strengths to the task. But for either it will be an uphill, years-long struggle. And we cannot even begin until we clearly understand what went wrong—which aspects of the American model are sound, which were poorly implemented, and which need to be discarded altogether.

Many commentators have noted that the Wall Street meltdown marks the end of the Reagan era. In this they are doubtless right, even if McCain manages to get elected president in November. Big ideas are born in the context of a particular historical era. Few survive when the context changes dramatically, which is why politics tends to shift from left to right and back again in generation-long cycles.

Reaganism (or, in its British form, Thatcherism) was right for its time. Since Franklin Roosevelt's New Deal in the 1930s, governments all over the world had only grown bigger and bigger. By the 1970s large welfare states and economies choked by red tape were proving highly dysfunctional. Back then, telephones were expensive and hard to get, air travel was a luxury of the rich, and most people put their savings in bank accounts paying low, regulated rates of interest. Programs like Aid to Families With Dependent Children created disincentives for poor families to work and stay married, and families broke down. The Reagan-Thatcher revolution made it easier to hire and fire workers, causing a huge amount of pain as traditional industries shrank or shut down. But it also laid the groundwork for nearly three decades of growth and the emergence of new sectors like information technology and biotech.

Internationally, the Reagan revolution translated into the "Washington Consensus," under which Washington—and institutions under its influence, like the International Monetary Fund and the World Bank—pushed developing countries to open up their economies. While the Washington Consensus is routinely trashed by populists like Venezuela's Hugo Chávez, it successfully eased the pain of the Latin American debt crisis of the early 1980s, when hyperinflation plagued countries such as Argentina and Brazil. Similar market-friendly policies are what turned China and India into the economic powerhouses they are today.

And if anyone needed more proof, they could look at the world's most extreme examples of big government—the centrally planned economies of the former Soviet Union and other communist states. By the 1970s they were falling behind their capitalist rivals in virtually all respects. Their implosion after the fall of the Berlin Wall confirmed that such welfare states on steroids were an historical dead end.

Like all transformative movements, the Reagan revolution lost its way because for many followers it became an unimpeachable ideology, not a pragmatic response to the excesses of the welfare state. Two concepts were sacrosanct: first, that tax cuts would be self-financing, and second, that financial markets could be self-regulating.

Prior to the 1980s, conservatives were fiscally conservative— that is, they were unwilling to spend more than they took in in taxes. But Reaganomics introduced the idea that virtually any tax cut would so stimulate growth that the government would end up taking in more revenue in the end (the so-called Laffer curve). In fact, the traditional view was correct: if you cut taxes without cutting spending, you end up with a damaging deficit. Thus the Reagan tax cuts of the 1980s produced a big deficit; the Clinton tax increases of the 1990s produced a surplus; and the Bush tax cuts of the early 21st century produced an even larger deficit. The fact that the American economy grew just as fast in the Clinton years as in the Reagan ones somehow didn't shake the conservative faith in tax cuts as the surefire key to growth.

More important, globalization masked the flaws in this reasoning for several decades. Foreigners seemed endlessly willing to hold American dollars, which allowed the U.S. government to run deficits while still enjoying high growth, something that no developing country could get away with. That's why Vice President Dick Cheney reportedly told President Bush early on that the lesson of the 1980s was that "deficits don't matter."

The second Reagan-era article of faith—financial deregulation—was pushed by an unholy alliance of true believers and Wall Street firms, and by the 1990s had been accepted as gospel by the Democrats as well. They argued that long-standing regulations like the Depression-era Glass-Steagall Act (which split up commercial and investment banking) were stifling innovation and undermining the competitiveness of U.S. financial institutions. They were right—only, deregulation produced a flood of innovative new products like collateralized debt obligations, which are at the core of the current crisis. Some Republicans still haven't come to grips with this, as evidenced by their proposed alternative to the bailout bill, which involved yet bigger tax cuts for hedge funds.

The problem is that Wall Street is very different from, say, Silicon Valley, where a light regulatory hand is genuinely beneficial. Financial institutions are based on trust, which can only flourish if governments ensure they are transparent and constrained in the risks they can take with other people's money. The sector is also different because the collapse of a financial institution harms not just its shareholders and employees, but a host of innocent bystanders as well (what economists soberly call "negative externalities").

Signs that the Reagan revolution had drifted dangerously have been clear over the past decade. An early warning was the Asian financial crisis of 1997-98. Countries like Thailand and South Korea, following American advice and pressure, liberalized their capital markets in the early 1990s. A lot of hot money started flowing into their economies, creating a speculative bubble, and then rushed out again at the first sign of trouble. Sound familiar? Meanwhile, countries like China and Malaysia that didn't follow American advice and kept their financial markets closed or strictly regulated found themselves much less vulnerable.

A second warning sign lay in America's accumulating structural deficits. China and a number of other countries began buying U.S. dollars after 1997 as part of a deliberate strategy to undervalue their currencies, keep their factories humming and protect themselves from financial shocks. This suited a post-9/11 America just fine; it meant that we could cut taxes, finance a consumption binge, pay for two expensive wars and run a fiscal deficit at the same time. The staggering and mounting trade deficits this produced—$700 billion a year by 2007—were clearly unsustainable; sooner or later the foreigners would decide that America wasn't such a great place to bank their money. The falling U.S. dollar indicates that we have arrived at that point. Clearly, and contrary to Cheney, deficits do matter.

Even at home, the downside of deregulation were clear well before the Wall Street collapse. In California, electricity prices spiraled out of control in 2000-2001 as a result of deregulation in the state energy market, which unscrupulous companies like Enron gamed to their advantage. Enron itself, along with a host of other firms, collapsed in 2004 because accounting standards had not been enforced adequately. Inequality in the United States rose throughout the past decade, because the gains from economic growth went disproportionately to wealthier and better-educated Americans, while the incomes of working-class people stagnated. And finally, the bungled occupation of Iraq and the response to Hurricane Katrina exposed the top-to-bottom weakness of the public sector, a result of decades of underfunding and the low prestige accorded civil servants from the Reagan years on.

All this suggests that the Reagan era should have ended some time ago. It didn't partly because the Democratic Party failed to come up with convincing candidates and arguments, but also because of a particular aspect of America that makes our country very different from Europe. There, less-educated, working-class citizens vote reliably for socialist, communist and other left-learning parties, based on their economic interests. In the United States, they can swing either left or right. They were part of Roosevelt's grand Democratic coalition during the New Deal, a coalition that held through Lyndon Johnson's Great Society in the 1960s. But they started voting Republican during the Nixon and Reagan years, swung to Clinton in the 1990s, and returned to the Republican fold under George W. Bush. When they vote Republican, it's because cultural issues like religion, patriotism, family values and gun ownership trump economic ones.

This group of voters will decide November's election, not least because of their concentration in a handful of swing states like Ohio and Pennsylvania. Will they tilt toward the more distant, Harvard-educated Obama, who more accurately reflects their economic interests? Or will they stick with people they can better identify with, like McCain and Sarah Palin? It took an economic crisis of massive proportions from 1929 to 1931 to bring a Democratic administration to power. Polls indicate we may have arrived again at that point in October 2008.

The other critical component of the American brand is democracy, and the willingness of the United States to support other democracies around the world. This idealistic streak in U.S. foreign policy has been constant over the past century, from Woodrow Wilson's League of Nations through Roosevelt's Four Freedoms to Reagan's call for Mikhail Gorbachev to "tear down this wall."

Promoting democracy—through diplomacy, aid to civil society groups, free media and the like—has never been controversial. The problem now is that by using democracy to justify the Iraq War, the Bush administration suggested to many that "democracy" was a code word for military intervention and regime change. (The chaos that ensued in Iraq didn't exactly help democracy's image either.) The Middle East in particular is a minefield for any U.S. administration, since America supports nondemocratic allies like the Saudis, and refuses to work with groups like Hamas and Hizbullah that came to power through elections. We don't have much credibility when we champion a "freedom agenda."

The American model has also been seriously tarnished by the Bush administration's use of torture. After 9/11 Americans proved distressingly ready to give up constitutional protections for the sake of security. Guantánamo Bay and the hooded prisoner at Abu Ghraib have since replaced the Statue of Liberty as symbols of America in the eyes of many non-Americans.

No matter who wins the presidency a month from now, the shift into a new cycle of American and world politics will have begun. The Democrats are likely to increase their majorities in the House and Senate. A huge amount of populist anger is brewing as the Wall Street meltdown spreads to Main Street. Already there is a growing consensus on the need to re-regulate many parts of the economy.

Globally the United States will not enjoy the hegemonic position it has occupied until now, something underscored by Russia's Aug. 7 invasion of Georgia. America's ability to shape the global economy through trade pacts and the IMF and World Bank will be diminished, as will our financial resources. And in many parts of the world, American ideas, advice and even aid will be less welcome than they are now.

Under such circumstances, which candidate is better positioned to rebrand America? Barack Obama obviously carries the least baggage from the recent past, and his postpartisan style seeks to move beyond today's political divisions. At heart he seems a pragmatist, not an ideologue. But his consensus-forming skills will be sorely tested when he has to make tough choices, bringing not just Republicans but unruly Democrats into the fold. McCain, for his part, has talked like Teddy Roosevelt in recent weeks, railing against Wall Street and calling for SEC chairman Chris Cox's head. He may be the only Republican who can bring his party, kicking and screaming, into a post-Reagan era. But one gets the sense that he hasn't fully made up his mind what kind of Republican he really is, or what principles should define the new America.

American influence can and will eventually be restored. Since the world as a whole is likely to suffer an economic downturn, it is not clear that the Chinese or Russian models will fare appreciably better than the American version. The United States has come back from serious setbacks during the 1930s and 1970s, due to the adaptability of our system and the resilience of our people.

Still, another comeback rests on our ability to make some fundamental changes. First, we must break out of the Reagan-era straitjacket concerning taxes and regulation. Tax cuts feel good but do not necessarily stimulate growth or pay for themselves; given our long-term fiscal situation Americans are going to have to be told honestly that they will have to pay their own way in the future. Deregulation, or the failure of regulators to keep up with fast-moving markets, can become unbelievably costly, as we have seen. The entire American public sector—underfunded, deprofessionalized and demoralized—needs to be rebuilt and be given a new sense of pride. There are certain jobs that only the government can fulfill.

As we undertake these changes, of course, there's a danger of overcorrecting. Financial institutions need strong supervision, but it isn't clear that other sectors of the economy do. Free trade remains a powerful motor for economic growth, as well as an instrument of U.S. diplomacy. We should provide better assistance to workers adjusting to changing global conditions, rather than defend their existing jobs. If tax cutting is not a path to automatic prosperity, neither is unconstrained social spending. The cost of the bailouts and the long-term weakness of the dollar mean that inflation will be a serious threat in the future. An irresponsible fiscal policy could easily add to the problem.

And while fewer non-Americans are likely to listen to our advice, many would still benefit from emulating certain aspects of the Reagan model. Not, certainly, financial-market deregulation. But in continental Europe, workers are still treated to long vacations, short working weeks, job guarantees and a host of other benefits that weaken their productivity and will not be financially sustainable.

The unedifying response to the Wall Street crisis shows that the biggest change we need to make is in our politics. The Reagan revolution broke the 50-year dominance of liberals and Democrats in American politics and opened up room for different approaches to the problems of the time. But as the years have passed, what were once fresh ideas have hardened into hoary dogmas. The quality of political debate has been coarsened by partisans who question not just the ideas but the motives of their opponents. All this makes it harder to adjust to the new and difficult reality we face. So the ultimate test for the American model will be its capacity to reinvent itself once again. Good branding is not, to quote a presidential candidate, a matter of putting lipstick on a pig. It's about having the right product to sell in the first place. American democracy has its work cut out for it.

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