Surviving the slump

America's non-financial businesses are suffering. But they will emerge from the recession leaner and stronger than ever, says Robert Guest.

Reuters

The crisis began on Wall Street. Financial conjurors suddenly discovered that their tricks for making risk vanish had only disguised it. Their leveraged bets went sour, and the derivatives they thought insured them against any shock turned out to be worse than worthless. Trillions of dollars disappeared. Credit markets froze, and the pain spread to Main Street. This special report looks at how American business will cope with that pain and with the big policy issues that the country will face in the aftermath of the crash.

America's recession began quietly at the end of 2007 (see chart 1). Since then it has mutated into a global crisis. Reasonable people may disagree about whom to blame. Financiers who were not as clever as they thought they were? Regulators dozing Homer Simpson-like at the switch? Consumers who borrowed too much? Politicians who recklessly promoted home-ownership for those who could not afford it? All are guilty; and what a mess they have created.

Since 2007 America has shed 5m jobs. More than 15% of the workforce are jobless or underemployed—roughly 25m workers. The only industries swelling their payrolls are health care, utilities and the federal government. The value of listed shares in American firms collapsed by 57% from its peak in October 2007 to a trough in March this year, though it has since rebounded somewhat. Industrial production fell by 12.8% in the year to March, the worst slide since the second world war. Mark Zandi, an economist at Moody's Economy.com, predicts that the recession will shrink America's economy by 3.5% in total. "For most executives, this is the worst business environment they've ever seen," says Lenny Mendonca, chairman of the McKinsey Global Institute, a research group.

Times are so tough that even bosses are taking pay cuts. Median pay for chief executives of S&P 500 companies fell 6.8% in 2008, according to Equilar, a data provider. The overthrown titans of Wall Street took the biggest knock, with average pay cuts of 38% and median bonuses of zero. But there was some pain for everyone: median pay for chief executives of non-financial firms in the S&P 500 fell by 2.7%.

Nearly every business has a woeful tale to tell. For example, Arne Sorenson, the president of Marriott hotels, likens the crisis to the downturn that hit his business after September 11th 2001. When the twin towers fell, Americans stopped travelling. Marriott had its worst quarter ever, with revenues per room falling by 25%. This year, without a terrorist attack, the hotel industry is “putting the same numbers on the board”, laments Mr Sorenson.

The hotel bust, like most busts, was preceded by a breathtaking boom. Although many other big firms resisted the temptation to over-borrow, developers gorged on cheap debt and built bigger and swankier hotels as if the whole world were planning a holiday in Las Vegas. When the bubble burst, demand collapsed. Hoteliers found themselves with a multitude of empty rooms even as a gaggle of unnecessary new hotels was poised to open.

Other industries have suffered even more. Hordes of builders, property firms and retailers have gone bust. And a “carpocalypse” has hit Detroit. Last year the American car industry had the capacity to make 17m vehicles. Sales in 2009 could be barely half of that. The Big Three American carmakers—General Motors, Ford and Chrysler—accumulated ruinous costs over the post-war years, such as gold-plated health plans and pensions for workers who retired as young as 48. All three are desperately restructuring. Only Ford may survive in its current form.

Hard times breed hard feelings. Few Americans understand what caused the recession. Some are seeking scapegoats. Politicians are happy to pander. Bosses have been summoned to Washington to be scolded on live television. The president berates their greed. The House of Representatives passed a retroactive 90% tax on bonuses at AIG, a bailed-out insurer. (The bill died in the Senate.) The attorney-general of New York threatened to release the bonus recipients’ names unless they returned the cash.

Extravagance is out

Retroactive taxes and personal threats? Businessfolk pray such habits do not spread. Meanwhile, they are bending over backwards to avoid seeming extravagant. Meetings at resorts are suddenly taboo. Goldman Sachs, an investment bank, cancelled a conference in Las Vegas at the last minute and rebooked it in San Francisco, which cost more but sounded less fun.

This special report will make several arguments. The pain will eventually end. American business will regain its shine. Many firms will die, but the survivors will emerge leaner and stronger than before. The financial sector’s share of the economy will shrink, and stay shrunk for years to come. The importance of non-financial firms will accordingly rise, along with their ability to attract the best talent. America will remain the best place on earth to do business, so long as Barack Obama and the Democrats in Congress resist the temptation to meddle too much, and so long as organised labour does not overplay its hand.

The crisis will prove hugely disruptive, however. Bad management techniques will be exposed. Necessity will force the swift adoption of more efficient ones. At the same time, technological innovation will barely pause for breath, and two big political changes loom.

Mr Obama’s plan to curb carbon dioxide emissions, though necessary, will be far from cost-free, whatever his sunny speeches on the subject might suggest. The shift to a low-carbon

economy will help some firms, hurt others and require every organisation that uses much energy to rethink how it operates. It is harder to predict how Mr Obama's proposed reforms to the ailing health-care system will pan out. If he succeeds in curbing costs—a big if—it would be a colossal boon for America. Some businesses will benefit but the vast bulk of the savings will be captured by workers, not their employers.

In the next couple of years the businesses that thrive will be those that are miserly with costs, wary of debt, cautious with cashflow and obsessively attentive to what customers want. They will include plenty of names no one has yet heard of.

Times change, and corporations change with them. In 1955 Time's man of the year was Harlow Curtice, the boss of GM. His firm was leading America towards "a new economic order", the magazine gushed. Thanks to men like Curtice, "the bonds of scarcity" had been broken and America was rolling "in two-toned splendour to an all-time crest of prosperity". Soon, Americans would need to spend "comparatively little time earning a living".

Half a century later GM is a byword for poor management. In March its chief executive was fired by Time's current man of the year, Mr Obama. The government now props up the domestic car industry, lending it money, backing its warranties and overseeing its turnaround plans. With luck, this will be short-lived. But there is a danger that Washington will end up micromanaging not only Detroit but also other parts of the economy. And clever though Mr Obama's advisers are, history suggests they will be bad at this.

Trading down

From decadence to discounts.

Five years ago Michael Silverstein and Neil Fiske wrote a book, "Trading Up: The New American Luxury". They argued that Americans, even those of modest means, were abandoning merely adequate products for luxurious ones. Jake the construction worker, for example, splurged $3,000 on Callaway golf clubs, though he could have bought a set nearly as good for a third as much. ("They make me feel rich," he said.) A shipping clerk on $25,000 a year bought silk pyjamas from Victoria's Secret. A couple making $125,000 ordered a $4,000 brand-name cooking range, even though their kitchen came with a free generic one.

If you read the book backwards, it describes what is going on today.

Americans are trading down. If they still have jobs (as 91% of the workforce do), they are worried about losing them. Their homes are no longer cash machines and their investments are in a ditch. Household net worth fell by a staggering $11.2 trillion last year. The rich are cancelling orders for yachts. Working Americans are forgoing even small luxuries. Lindt & Sprüngli, a maker of exquisite chocolate truffles, is closing 50 of its 80 stores in America. Hershey's, a maker of less chocolatey chocolate, is doing rather well. Limited Brands, which owns Victoria's Secret, is not.

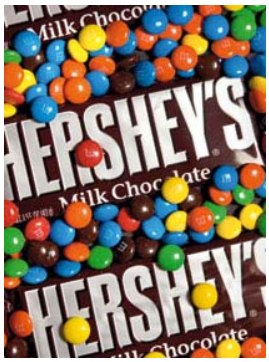
Americans are rediscovering thrift. Retail sales fell by 11% from their peak in late 2007 to April 2009. Personal consumption has fallen 2.5% since last summer. The Boston Consulting Group (BCG), a consultancy, finds that nearly three-quarters of Americans plan to curb their spending over the next year.

Trading down is not difficult. Instead of, say, blowing $4.50 on a Strawberries and Crème Venti Frappuccino from Starbucks, Americans are popping into Dunkin' Donuts for a basic cuppa Joe at a buck or so. Instead of shopping at Neiman Marcus (a posh department store known colloquially as "Needless Mark-up"), they are driving to the out-of-town Wal-Mart superstore or shopping online for bargains at Amazon (see chart 2). A recent Pew poll found that 21% of Americans planned to grow their own vegetables, 16% had held a garage sale or sold things online and 10% had either taken in a friend or relative or moved in with one. Pundits are coining phrases such as "austerity chic" and "luxury shame".

Four-fifths of Americans told the BCG they would defer big purchases that can wait. The most obvious example is a car. After a home, this is the most expensive object a typical family buys. New cars are nice, but old ones can last a long time, as any third-world taxi-driver knows. So Americans are keeping their old wheels on the road. Repair shops are bustling. Desperate dealers are offering interest-free finance. Hyundai, a maker of unflashy cars, has lifted its share of the American market by saying: buy a car from us, and if you lose your job we'll buy it back.

The beneficiaries of the new parsimony are, unsurprisingly, firms that offer low prices. The only two stocks on the Dow Jones Industrial Average that rose in 2008 were Wal-Mart and McDonald's. Wal-Mart, with its hyperefficient supply chain, is so good at squeezing costs that it has a measurable effect on the national inflation rate. McDonald's is enticing cash-strapped diners with meals for as little as $1.

Americans who still eat out are doing so at cheaper restaurants. Russ Klein, a senior executive at Burger King, another fast-food chain, reckons that on balance the recession has helped his firm. High unemployment hurts breakfast sales, because jobless people have less cause to get out of bed. But overall, cash-strapped consumers are buying more burgers in paper bags and fewer steaks served on white linen.



Cheap and cheerful
Bloomberg News

The competition among the fast-food chains is exuberantly vicious. Burger King produces edgy advertisements in the hope that people will pass them around online. Earlier this year it offered users of Facebook, a social-networking website, a free Whopper burger if they would dump ten of their online friends. Facebook soon shut down the promotion, but not before Burger King was able to claim that the public's love of its flame-grilled product was "stronger than 233,906 friendships".

Another way Americans are saving money is by staying at home, so firms that offer a distraction from the horrors of family life are doing well. Netflix, which lets couch potatoes order films from a huge library for as little as $4.99 a month, said in April that it had shipped its 2 billionth DVD. Amazon, an online bookseller that has expanded into music, video games, hiking equipment and even sex toys, boosted profits by 24% in the first quarter.

Of course, if you are going to spend a lot of time at home, you need to be able to defend it. Gun sales are unusually brisk: FBI background checks in the three months from November 2008 were up by 31% on the previous year. Some Americans are stocking up in anticipation of tighter gun laws under Mr Obama. Others fear that the newly jobless will turn criminal. Neither fear is likely to prove founded, but gun stores are still running out of ammunition.

The big squeeze

As consumers cut back, so do companies. Everyone is hoarding cash, trimming costs and painfully burning off fat. Inventories fell by 7% from August 2008 to March this year. Some industries will have to shrink dramatically to survive. Car-parts suppliers, for example, are in dire straits, despite a promise of $5 billion in emergency loans from the government. TI Automotive, which makes fuel tanks, has laid off a quarter of its white-collar staff in North America in the past year. Managers' salaries have been slashed. Blue-collar workers' hourly pay has been frozen and their hours cut by half. The firm is delaying paying its own suppliers unless they can deliver exactly what it wants, when it wants it.

Yet all this belt-tightening will not be enough. Car-parts suppliers must consolidate, says William Kozyra, TI's president. There are typically six to eight of them for each part. To achieve the necessary economies of scale, that must shrink to two or three, he reckons. Unfortunately, suppliers would need to borrow money to finance mergers or acquisitions, and no one will lend right now to an industry whose future is in such doubt.

Other industries are doing better. Few firms have the crushing legacy costs of GM or Chrysler, and few carry such unbearable debts. Most of America's non-financial firms did not go mad in the credit boom. In fact, since the dotcom and telecoms busts earlier this decade, many have put their balance-sheets in order. While households and financial firms went on a borrowing binge, non-financial firms stayed fairly sober. Household debt leapt from 71% of GDP at the beginning of 2001 to 97% in late 2008. Financial-sector debt vaulted from 85% to 121%. But non-financial firms' debt rose only from 66% to 78%.

Despite massive injections of taxpayers' cash to restore lenders' balance-sheets, it will be a while before the credit crunch ends. Between 2000 and 2007 the average American increased his personal consumption by 44%. This accounted for 77% of America's economic growth during that period. Much of it was financed by debt. In five years, American households extracted $2.3 trillion of equity from their homes. They blew 20% of this on consumption, 19% on sprucing up their homes and 44% on assets such as stocks.

The hangover from this party will be long and painful. Households' total outstanding borrowing fell in the fourth quarter of 2008, for the first time since the second world war. The personal-saving rate rose to 4.2% in the first quarter of 2009, from a nadir of minus 0.7% in 2005. "It

is easy to see how consumer deleveraging could result in hundreds of billions of dollars-worth of forgone consumption in coming years," say Martin Baily, Susan Lund and Charles Atkins of the McKinsey Global Institute.

For most non-financial firms, however, there are a couple of bright spots in the gloom. Their balance-sheets are mostly healthier than the banks'. And for the strongest firms the downturn offers opportunities to snap up prime assets cheaply.

Consider Marriott. Although the hotel business tends to rise and fall in lockstep with the wider economy, not every hotelier is equally exposed. The Marriott name (or one of its sister brands) graces more than 3,000 hotels worldwide, but the company owns only half a dozen. The rest are franchised out or managed by Marriott for a fee. Since Marriott owns so few properties, it profits less during a boom. But it suffers less during a slump. It still collects franchise and management fees. Only its performance-related payments shrink.

So while owners are struggling, Marriott is scouting for bargains. Mr Sorenson, the company's president, predicts that distressed hotels could soon be on sale for half-price. He will buy some, perhaps, and sell them when times improve. Like the Rothschilds of old, Marriott likes to buy to the sound of cannons and sell to the sound of violins.

Making money by saving money

Firms that help other firms save money are also in a strong position. For example, Accruent, a Californian information-technology firm, helps big organisations make more efficient use of their land and buildings. Its clients include Target (a retailer), Lockheed Martin (an aerospace firm) and Yale University. Organisations such as these may have hundreds of properties, tens of thousands of pages of leases and a labyrinth of obligations to landlords, janitors and the taxman.

In good times property management is seen as a fixed cost, says Mark Friedman, Accruent's chief executive. But now firms are looking for ways to trim their bills. Accruent helps them build more rationally, find cheaper leases and fend off landlords who try to overcharge for extras. The recession creates new problems: leases don't expire just because you lay people off. Accruent helps firms shuffle employees around to create an empty building that can then be sold or sublet.

So its services are in demand. But the sheer unpredictability of the economy still makes Mr Friedman nervous. Quite often, he opens the Wall Street Journal and finds that something bad has happened to a firm he thought he was about to do business with. "It feels like we're driving at 100mph in a fog," he says.

On the plus side, many of the efficiencies discovered through necessity during the downturn will outlast it. For example, firms are cutting business travel by videoconferencing. Mr Sorenson of Marriott plays down the threat, arguing that there is no substitute for meeting people face-to-face. Others are not so sure. Videoconferencing technology keeps improving. Some meetings are necessary, but others are a waste of time. Mr Kozyra of TI Automotive predicts that, when the good times return, "we'll go halfway back" to travelling, and maybe send two executives to meet customers instead of six.

Creative destruction

The struggle is ugly, but the survivors will be stronger.

On A quiet street in Romulus, a suburb of Detroit, is an empty house. Even if there were not a foreclosure sign outside, the rotting newspapers and broken toys on the lawn make it obvious that no one lives here. The owner lost his job and left last year, according to neighbours.

But the house itself is solid and spacious, with four bedrooms and an ample yard. Someone should buy it and fix it up, reckon the neighbours. So long as it is empty, it drags down the value of the surrounding properties, grumbles one, a retired car worker. “Homes round here used to sell for $120,000, but if you can get it for $25,000, that would be a good deal,” he suggests.

The house was sold that same day by an auction firm, Real Estate Disposition Corporation (REDC). The bidding started at a mere $500, but soon grew heated. “We’re approaching the bottom of the market! This is a great time to buy!” buzzed the auctioneer. As his sales patter rattled through the amplifiers, tuxedo-clad “spotters” dashed back and forth among the crowd spotting bidders and shouting out their bids.

The house in Romulus was one of dozens REDC auctioned on March 30th at a hotel in nearby Dearborn. It went for $32,000, to a local entrepreneur who plans to turn it into a home for the mentally ill. Perhaps not what the neighbours most wanted, but at least it will be occupied.

Such auctions are now common in America. They are a conspicuous sign of misery but they serve a purpose. If banks could not seize and sell homes with mortgages in default they would not lend in the first place. And though it may be heartbreaking for former owners to see their homes offloaded cheaply, low prices are good for first-time buyers.

The auction in Dearborn was packed with young couples who until recently could not afford to own a house. There were throngs of landlords, too, looking for bargains to buy, clean up and rent out. Someone has to do this. A mobile population needs rentable homes.

Some think the housing market is about to recover. Optimists took heart when sales of single-family homes rose in February but March’s weak figures undermined their hopes. Pessimists note that one home in nine is still empty. Between 2002 and 2007, at least 1m more homes were built than new households were formed. It will take a while for this surplus to be cleared. In much of the Midwest and north-east demand is unlikely to catch up with supply until 2012, by some estimates.

Bankruptcies are soaring. In the first quarter of this year, 20,251 companies filed for bankruptcy, a 52% jump from the same period last year, according to AACER, a firm that monitors such things. Including individuals as well as firms, AACER expects to see 1.5m bankruptcies this year, twice as many as in 2007.

Bankruptcy lawyers are busy. Douglas Bernstein of Plunkett Cooney, a Michigan law firm, says he could work 14 hours a day, 7 days a week and not keep up with the demand for his services. “Unfortunately, when the economy is bad, they don’t add hours to the day,” he grumbles in an e-mail from his office at 6am.

Companies that recycle the valuable parts of bankrupt companies are doing well, too. Distressed firms typically shed assets to raise cash so they can restructure and continue operating. If that does not work, they may go into liquidation. Everything must then be sold—the goods on the shelves, the shelves themselves, the leases on the shops, the websites, the trademarks, you name it. Firms such as Hilco, a privately held Illinois firm, can help, either by

broking the sales or by buying assets themselves and selling them later. Richard Kaye, a vice-president of Hilco, says there has been a “significant uptick” in its bankruptcy business. In April, for example, the firm agreed to buy the remnants of Polaroid, a once-iconic instant-photo firm whose only significant asset now is its name.

Firms that prey on dead or dying firms are not popular. When someone calls you a “vulture”, it is not a compliment. But vultures have their place. The easier it is for lenders to collect what they are owed, the easier firms will find it to borrow. An efficient bankruptcy process is an essential part of capitalism red in tooth and claw. The weak die. The strong feast on their carcasses. Little is wasted.

In January Circuit City, an electronics retailer, went into liquidation, shutting more than 500 stores and selling its entire inventory. Shoppers snapped up bargains at its closing-down sales. Other retailers pounced on some of its properties. And its rivals in the iPod-and-toaster-hawking trade are fighting to woo its former customers. “We think there’s six to eight billion dollars of business up for grabs,” says Brad Anderson, the outgoing boss of Best Buy, Circuit City’s closest competitor.

An ideal bankruptcy system would transfer resources efficiently from less productive to more productive uses. How close does America come to this ideal? It is less ruthless than Britain, which is quick to force firms into liquidation, but less indulgent than France, which has a “huge bias” towards propping up zombie firms on the assumption that this will save jobs, says Michelle White, a bankruptcy expert at the University of California, San Diego. Overall, she thinks the American bankruptcy system does a “very valuable” job.

But Jack Williams of the American Bankruptcy Institute, a think-tank, adds a caveat. Firms are now finding it hard to use bankruptcy as a temporary shield to allow them to reorganise, because that usually requires a bridging loan of some kind, and at the moment no one is lending. That has given the system an unfortunate bias towards liquidation, he fears.

Recessionary recipe
Eyevine

When times are hard, American firms find it easy to lay off workers. When times are good, however, they are quick to hire new hands. A ruthless labour market and a miserly welfare state have historically meant that Americans are more likely to have jobs (albeit often low-paid ones) than Europeans, and far less likely to be unemployed for a long time. In 2007 America’s jobless rate was 4.6%, compared with an average of 7.9% for the OECD’s European member countries. And whereas the average jobless American was out of work for less than four months, the average jobless European spent nearly 15 months involuntarily idle.

During previous downturns, unemployment in America has risen more sharply than elsewhere but then fallen more quickly, too. This time round, it has certainly followed the painful first part of that script. Joblessness is already almost 9%, and the OECD predicts that it will hit 10.3% next year. The question is: will the labour market rebound as robustly as it has in the past? No one knows the answer. This recession has been particularly severe. More than 2% of American workers have been out of work for six months or more, which is close to a post-war record. And firms are cutting back on hours, too. The average working week fell by half an hour in 2008 to 33.2 hours, the shortest since records began in 1964.

Now for the creative part

Despite the gloom, there are several reasons for believing that American business retains its underlying dynamism. First, one can listen to what businesspeople say. They may be feeling wretched this year, but few doubt that things will get better. Bill Green, the boss of Accenture, a consultancy, predicts that America will come out of the recession “much earlier” than other parts of the world. He talks constantly to other chief executives around the world, he says, and their consensus is that America will begin to recover later this year or in early 2010. They give three reasons. The recession started earlier in America than elsewhere. The government’s stimulus package is likely to work. And “they believe that we have a natural competitive streak—that people are going to want to get back in the game.”

Second, one can look at America’s admirable record of dealing with turmoil. A study by the Ewing Marion Kauffman Foundation, a think-tank that studies entrepreneurialism, found that America’s high rate of economic “churning” boosts productivity and hence material well-being. Between 1977 and 2005 some 15% of all American jobs were destroyed each year as firms closed or cut back. Thanks to the expansion of successful firms and the entry of new ones, however, many more jobs were created than destroyed. Start-ups (ie, firms less than five years old) provided a third of the new jobs during this period.

Start-ups that went bust were on average 32% less productive than mature incumbents. Mature firms that went out of business were 27% less productive than mature survivors. Start-ups that survived, however, were 3% more productive than mature incumbents; five years later they were 5% more productive. This was true of all industries but especially retailing, in which stores the size of football fields have given way to even larger ones.

The credit crunch is making it harder for new firms to find capital. That matters: not all entrepreneurs start up in their garages with money from “family, friends and fools”. In a survey for the Kauffman Foundation of 4,163 companies started in 2004, Alicia Robb and David Robinson concluded that 80-90% of start-up capital for a typical firm came from two sources. One was the entrepreneur’s savings. The other was external debt: either a bank loan or a credit-card balance.

Most start-ups do not require huge amounts of capital. The average in the Kauffman sample was $78,000. Some need far less. Saudia Davis, for example, founded Greenhouse Eco-Cleaning, a green apartment-cleaning firm in New York, with $800 she earned from mopping floors herself. She now has between seven and ten cleaners working for her and would like to expand, but banks are not lending, she says. She is looking for an “angel” investor but this is tough when you have no intellectual property, so she may have to grow organically.

The recession itself sometimes generates start-up capital, in the form of severance payments. Adrienne and Kelly Lumpkin got their start with the help of a redundancy package Mr Lumpkin received from IBM in the early 1990s when Big Blue was in trouble. Alternate Access, their Raleigh, North Carolina-based firm, helps florists, doctors and other small enterprises do clever things with internet telephony. It offers call-centre services, for example, and sells software

that helps employees see, on their computer screens, whether the person calling them is an important customer or a deadbeat.

Despite the recession, Americans started 530,000 businesses a month last year. And firms founded during tough times have to be tough. Although more firms typically start up in fat years, Paul Kedrosky of the Kauffman Foundation found that each bad year in America since the second world war produced just as many firms that have subsequently grown large enough to list their shares. He concludes that firms that begin in bad times are more likely to turn out to become economically important: think of Microsoft, Apple and Krispy Kreme doughnuts.

During good times, any idiot can get his ideas funded, says William Barnett, a professor at Stanford University's business school. During bad times, only the most impressive and persistent entrepreneurs can. Mr Barnett has discovered that firms which are set up shortly after a successful IPO (initial public offering of shares) by another firm that does roughly the same thing tend to do very badly. By contrast, firms founded shortly after news of the bankruptcies of firms doing roughly the same thing tend to do well. Google, for example, got started just after a clutch of other search-engine firms crashed.

During a crisis, says Mr Barnett, the market's signals are clearer. During a boom, people buy stuff without much thought. During bad times, they are much choosier. So only firms with genuinely superior products or services will thrive.

Red tape and scissors

Despite crazy rules, convoluted taxes and rampant lawyers, America is still a great place to do business.

Incomprehensible tax returns
Getty Images

America is supposed to be the land of laissez-faire, but it doesn't seem that way to Erroll Tyler. He wants to run tours of Cambridge and Boston, cities that nestle on opposite banks of the Charles river. He would pick up punters in an amphibious vehicle, show them the sights and give them a pleasant cruise. But Boston will not let him. Officials say he needs a sightseeing licence. Alas, there is a moratorium on such licences. It was imposed for fear that Boston would get congested during the Big Dig, a construction project. But the Big Dig ended three years ago. Mr Tyler thinks the real reason he cannot get a licence is that someone is protecting a cartel of local tour operators. He is suing the city authorities.

Mr Tyler is not the only American who feels that red tape is garrotting his business. Senseless rules that benefit cartels are common. Oklahoma protects consumers from the perils of unlicensed interior decorators. Marylanders are barred from massaging animals without a vet's licence. Wisconsin until recently banned the sale of excessively cheap petrol (gasoline).

Not all rules are pointless. Under George Bush, the White House Office of Management and Budget reckoned the total yearly cost of federal regulations between 1997 and 2007 was $46 billion to $54 billion. The benefits, in terms of pollution averted, lives saved and so on, were far higher: $122 billion to $656 billion a year. But businessfolk still have plenty of gripes.

First there is the tax code. Overall, American taxes are light and the tax code is highly progressive. But corporate taxes are steep. Federal and state taxes on profits together average 39.3%, the second-highest rate in the rich world. And the system is repulsively complex. Federal, state and local rules accumulate each year in a vast and impenetrable heap. No one understands it. Some 82% of individual filers pay for professional help or tax software.

Big business can cope—clever accountants find all manner of lucrative loopholes. But small businesses "face a particularly bewildering array of laws, including a patchwork set of rules that governs the depreciation of equipment, numerous and overlapping filing requirements for employment taxes, and a vague set of factors that govern the classification of workers as either employees or independent contractors and that can keep businesses and the IRS battling each other for years with no obvious 'correct' answer." Those are not the words of an anti-tax zealot but of the Internal Revenue Service itself, in its annual plea to Congress to simplify the tax code.

A second gripe is America's lottery of a legal system. Litigation cost the country $252 billion in 2007, according to Towers Perrin, a consultancy. At nearly 2% of GDP, that is about twice the burden that lawsuits impose on other rich countries. Yet the Pacific Research Institute (PRI), a conservative think-tank, thinks it a gross underestimate. By including indirect costs, such as products never launched for fear of litigation, PRI arrives at a total of $865 billion a year. Of this, it reckons two-thirds is wasted; that is, it neither compensates the injured nor deters the reckless.

Whatever the size of the "tort tax"—and this is hotly disputed—nearly every business grumbles about the system's unpredictability. Most juries are reasonable, but many misunderstand complex disputes and some impose penalties that bear no relation to any harm suffered. Trial lawyers are adept at crafting suits aimed at whoever has deep pockets. Judges sometimes fail to apply common sense.

Free to be arm-twisted
AP

In a recent case, a patient lost an arm because a health assistant injected a drug into an artery. She sued the hospital. Fair enough. But she also sued the drugmaker, Wyeth, although

the drug was approved by the Food and Drug Administration and came with six warnings not to inject it into arteries. She won $7m in damages. “The simple lesson businesspeople took was that the drugmaker could not have done anything to avoid being sued,” observed Gordon Crovitz, a columnist.

“Patent trolls” pose another problem. These are firms that buy up patents, not to turn them into products but solely to sue other firms that may have infringed them. Since the United States Patent Office grants patents freely and courts enforce them zealously, every inventive company lives in fear of trolls. If one can convince a court that a billion-dollar product incorporating hundreds of patents infringes only one of his, he can get an injunction to stop it being sold. The victim typically settles. Michael Heller, author of “The Gridlock Economy”, argues that such vaguely defined and aggressively asserted property rights stifle innovation and cost lives.

Another common complaint, especially among medium-sized firms, is that it costs so much to list on an American stock exchange. After the Enron scandal of 2001, in which auditors failed to notice a vast fraud at a publicly traded energy firm, disclosure requirements were tightened drastically. A hastily passed law known as Sarbanes-Oxley includes provisions for financial reporting that can cost millions of dollars to obey. Mark Friedman of Accruent says he cannot take his firm public because compliance costs might erase his profits. Founders of high-tech firms, who once hoped to make their fortunes with an IPO, now pray that a big firm such as Google will buy them.

Finally, businesspeople are worried about how the new administration might rewrite the rules. For the most part they are not reflexively hostile to Barack Obama. But since he has such a short record in office, they don’t know much about him; and they don’t like uncertainty. The government has taken control of large chunks of the financial and carmaking industries. Is this a temporary response to the crisis, as the White House insists? Or will the Democratic Congress, some of whose members would love to harness private firms to pursue policy goals, find ways to prolong it? No one knows.

A more immediate worry is a bill that would in effect abolish workers’ rights to a secret ballot before being unionised. The measure, misleadingly named the Employee Free Choice Act, would let a union win automatic recognition simply by cajoling a majority of employees to sign cards. The firm would then have to reach a deal with the union or accept one brokered by a government-appointed arbitrator.

If the bill passes—and it faces a struggle and possible revision in the Senate—unions hope it will revive their shrivelling membership. Businesses fear it will let unions do to them what they have already done to Detroit. Arne Sorenson of Marriott predicts that his typical employee, a diminutive Hispanic housekeeper with shaky English, will find it hard to say no to the tall, articulate union man who turns up and asks her to sign a card. Some Marriott hotels are already unionised—typically in cities that insist on it. Its non-union ones are 10% more profitable, says Mr Sorenson, mostly because of more flexible work rules. At one unionised hotel, he recalls, the pool attendant was not allowed to take the deck chairs out of the pool when the wind blew them in. It was not his job.

Bigger is better

Despite such grumbles, nearly every entrepreneur and executive interviewed for this report judged the United States the best place in the world to make money—or at least, one of the best. Impartial observers tend to agree. “Doing Business in 2009”, a World Bank report on regulation, finds that America is the third easiest place to do business, beaten only by Singapore and New Zealand. Its labour market is the world’s most flexible. Starting a business

involves few bureaucratic hassles: America ranks sixth out of 181 countries on this score. Enforcing contracts is straightforward (also sixth), as are registering property (12th) and trading across borders (15th).

Using a broader range of more subjective measures, the World Economic Forum puts America first out of 134 countries in its annual “competitiveness” rankings. It scores only adequately for macroeconomic stability (66th) and health and primary education (34th). But it ranks near the top for infrastructure and the efficiency of its market for goods. And it comes top for labour-market efficiency, absolute market size and innovation.

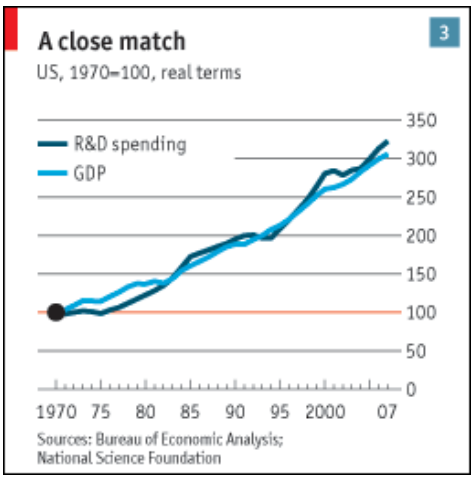
Amar Bhidé, a business professor at Columbia University, thinks these last two points are connected. Because America’s market is so huge, it is the best place to test new products. American consumers not only spend more than those of other nations; they are also more “venturesome”, says Mr Bhidé. That is, unusually willing to try new things. Their purchases reward innovators. And their feedback helps those innovators fine-tune their products.

Innovation tends to come incrementally, says Mr Bhidé. “Eureka!” moments are rare. More often, inventors incorporate at every stage what their customers teach them about what works, what doesn’t and why. Apple’s iPod, for example, was not based on truly original technology. Rather, it skilfully integrated technology from multiple sources and countries. Millions of Americans bought the clunky, expensive first version; it was much more popular in the United States than in other rich countries. Apple used the cash and feedback from the first iPod to develop smarter and more user-friendly versions. The product is now a global hit. A similar tale could be told of Amazon’s electronic book-reader, the Kindle.

American customers know what they want, and they want it now. They are not always reasonable, but as far as businesses are concerned, they are always right. Saudia Davis of Greenhouse Eco-Cleaning recalls a client who demanded that she replace a cleaner who was ruining her apartment’s feng shui by being too thin. Ms Davis says she “yessed her to death” and sent someone else.

The only time customers do not know what they want is when they do not realise what is technically feasible. For that reason, Intel, a microchip-maker, hires ethnographers to watch people in their homes and search for unmet desires that might be fulfilled. They discovered that Americans still love television but would like to combine it with the internet in an undemanding way. With Yahoo!, an internet firm, Intel took a step towards this last year by unveiling the Widget Channel, which lets viewers look up such things as the name of the actress in the soap they are watching.

Despite the downturn, American firms continue to spend copiously on research and development (R&D). Software firms, which used to keep offering more and fancier features, are now concentrating on doing things more quickly and cheaply. In February Intel said it would plough $7 billion into factories in New Mexico, Arizona and Oregon to make chips with transistors so small that 60m could fit on the head of a pin. If something is technologically possible and you don’t do it, someone else will, says Paul Otellini, Intel’s boss.



Since 1970 industrial spending on R&D in America has never fallen significantly from one year to the next, though it dipped a bit after the dotcom crash of 2000-02 (see chart 3). This recession may be different, of course. Jules Duga of the Battelle Memorial Institute, a think-tank, predicts that R&D spending from all sources (government, business and universities) will rise by 3% in 2009 but contract slightly in 2010. As American firms outsource more technical work to cheaper countries such as India, however, they will find that each research dollar goes further.

Some observers worry that America is growing complacent about its technological prowess. In a report for the Information Technology & Innovation Foundation, Robert Atkinson and Scott Andes rank America 6th out of 40 countries for innovation and competitiveness, but contend that it has improved the least in the past decade. They liken America to “an ageing sports dynasty that has won the Super Bowl for many years but blithely ignores the rising performance of younger teams”.

But these rankings include measures that have little to do with innovation, such as the size of a country’s trade deficit. Also, they fail to give corporate America due credit for its knack of turning raw science into marketable products. Nearly all the best universities are American—17 of the top 20 by one recent ranking—and they all work arm in arm with industry. Firms that exploit advances in cloud computing or genomics tend to cluster around the top colleges. Start-ups are fed and nurtured by venture capitalists. Big firms snap up small ones with marketable ideas. That said, many of the best students and academics at America’s universities, and indeed many of the entrepreneurs they turn out, are foreign—which means that the country’s success in turning ideas into dollars would be imperilled if the recession prompted Congress to tighten immigration laws still further.

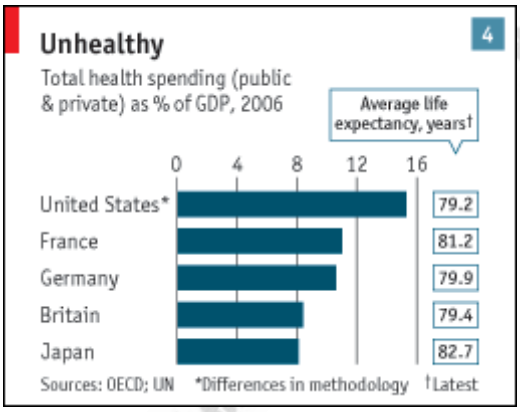
American firms such as Google, Microsoft and Cisco have changed the way almost everybody handles information. As yet unheard-of American biotech firms are working on drugs tailored to individual patients’ genomes. But one of the glories of American capitalism is the way firms apply complex technology to the most basic businesses. Hollywood uses awesome computer power to tell fairy stories. Burger King has invested oodles of money to develop restaurant layouts that let workers put sandwiches swiftly in customers’ hands. A study by Diana Farrell and other McKinsey researchers found that of the five sectors that contributed most to American productivity growth between 2000 and 2003, three were refreshingly unglamorous: retailing, wholesaling and administrative and support services.

Life is expensive

Treating the sickest part of America's economy.

A Middle-aged man felt chest pains. As an executive at IBM, an information-technology firm, he had excellent health insurance, so he went straight to a specialist. His cardiologist put him through a bunch of tests, including a computerised tomography scan. A radiologist noticed something odd in his neck, so he went to a neck surgeon, who checked him out and found nothing. He went back to the cardiologist, who gave him an angiogram, which caused dangerous complications and landed him in hospital for a while. In all, he ran up more than $150,000 in medical expenses before the chest pains disappeared on their own.

When they reappeared several months later, he spoke to Paul Grundy, the head of health-care technology at IBM. Dr Grundy, a doctor of preventive medicine by training, asked him if his lifestyle had changed recently. The executive mentioned that he had taken up gardening again. Dr Grundy quickly established that his chest pains sprang from a muscle he had strained through overzealous weed-whacking.



Such stories are all too common. Americans will spend a staggering $2.5 trillion on health care in 2009, says the Congressional Budget Office. As a share of national income that is far more than other rich countries spend (see chart 4), despite America's slightly younger population. To say that Americans do not get value for money is putting it mildly. They live no longer than Europeans and die younger than the Japanese. Meanwhile, 46m of them lack health insurance.

There are many reasons why American health care costs so much. Americans love fancy new medical technology. New drugs, for example, are prescribed a year or two earlier in America than in Europe, and do not come cheap. American doctors pay a fortune to insure themselves against frivolous lawsuits. A study in the New England Journal of Medicine found that even in cases where no medical error was found, plaintiffs received payments a quarter of the time. And half of medical malpractice payments were gobbled up by lawyers and overheads.

But the central problem is that most Americans get their health insurance through their employers. This dates back to the era of post-war wage controls, when firms offered benefits instead of pay rises. Today's tax code sets it in stone. Employers can buy health insurance with pre-tax dollars. Individuals cannot.

This creates an agency problem. When a typical patient goes to the doctor, he has no idea what anything costs. He pays only about 15% of the bill, so if the doctor recommends something he will probably say yes. The doctor gets paid for everything he does, so he has a powerful incentive to perform costly, unnecessary procedures. Besides, he may be socked for damages if he omits a test that a lawyer subsequently convinces a jury might have been

useful. The costs are passed on to insurers, who pass them on to employers in the form of higher premiums, who then pass them on to workers in the form of lower pay.

This last point is not widely understood. Many Americans think of soaring health-care costs as a burden on companies. And it is true that some high-profile ones, such as carmakers, have come unstuck by promising health benefits that subsequently became too expensive. GM spends more on health insurance than on steel. It is also true that small firms find the bureaucracy of health insurance hasslesome. However, in general the real victims of health-care inflation are not businesses but ordinary Americans. As the cost of coverage rises, their wages are squeezed, or coverage is dropped altogether.

The proportion of the cost of employer-provided health insurance shouldered by employees is "at or close to 100%," says Jonathan Gruber, an economist at the Massachusetts Institute of Technology. Last year, employer-provided health insurance reduced wages by 7.9%, according to the Bureau of Labour Statistics. The stagnation of middle-class incomes in recent years is in large measure caused by health-care inflation. Tying people's health insurance to their jobs also makes it harder for them to switch jobs or set up their own firms.

Reforming health care is Barack Obama's domestic priority. He is determined to increase coverage and curb costs. To increase coverage, he would subsidise individuals and small firms to buy insurance and bar insurers from excluding sick people. To promote competition, he would create a national insurance exchange where people could shop for different plans. As well as private insurance, he would offer people the option of buying into a public plan like the one that covers federal workers. To curb costs, he would promote the use of information technology and "evidence-based medicine", the notion that you measure what works and only do it if it does. He would also allow imports of drugs from countries where they are cheaper (for example, because prices are set by a state monopsony).

Getting all this through Congress will be an ordeal, as Hillary Clinton discovered in the 1990s. But some kind of reform is likely, perhaps this year. The consequences could be far-reaching. Mr Obama seems determined to offer every American the option of buying government health insurance and if Congress agrees, private insurers will be walloped—some say wiped out.

A government scheme could offer much lower prices. Unlike a private insurer, it would not have to make provision for future liabilities; it could simply stick the bill to future taxpayers. Medicare, the government scheme for old people, has unfunded liabilities of $36 trillion—two-and-a-half times America's GDP. If opened to all, it could undercut private insurers by "screwing our children and grandchildren", says Regina Herzlinger, a health-care expert at Harvard Business School.

The insurers that survive will be those that keep costs under control. Fee-for-service insurance must adapt or wither. Managed care will return. This is the model whereby doctors work for the insurer, which pays them to keep people well. Instead of letting patients go straight to a specialist, managed-care firms like Kaiser Permanente make them see a primary-care doctor first, who will figure out whether the problem is serious. This is crucial. Specialists tend to recommend their own specialism—surgeons advocate surgery, and so on. The lack of a gatekeeper in traditional fee-for-service insurance leads to over-doctoring that is often harmful as well as costly, as that IBM executive discovered.

Managed care, provided by firms also called health-maintenance organisations, (HMOs), grew rapidly in the 1990s but then retreated. One reason, according to Alain Enthoven, a health-care specialist at Stanford University, is that firms pushed their staff into HMOs without a choice, which angered many. Another is that they failed explicitly to pass on the savings to employees. This might change. For example, Stanford gives employees a choice of five health

plans. If they pick the cheapest, (Kaiser, which is also arguably the best, says Mr Enthoven), the university pays the full cost. If they pick a more expensive one, they must pay the difference. Four-fifths choose an HMO.

The high price of pills

Health-care reform worries drug firms. Under the current system, Americans not only adopt new drugs more quickly than people in other rich countries; they pay 50% more for the same drugs, according to McKinsey. In a more government-dominated system, drug firms' profits would suffer. So would their incentive to innovate. It typically costs them a billion dollars to develop a new drug. They can only recoup their vast R&D outlays thanks to high margins in America. The rest of the world enjoys a free ride. But that could change.

Billy Tauzin, the drug industry's chief lobbyist, protests that European-style rationing would cost American lives. But drug firms are already bracing themselves for leaner times. Several are merging to cut overheads and pool their research skills: Merck with Schering-Plough, Pfizer with Wyeth, Roche with Genentech. And many are finding that they can cut costs by outsourcing drug-testing. Quintiles, the largest firm that undertakes such work, saw its revenues grow by 19% last year. Pharmaceutical research is getting more expensive because it is getting more complex, says Dennis Gillings, Quintiles's chief executive. Many new drugs are aimed at old people who may already be taking several other pills. Testers have to be sure that they will not interact harmfully.

Mr Obama plans to spend $19 billion to promote health IT. The system is sorely in need of the efficiencies that digitisation might make possible. Only 4% of American doctors have a fully functional electronic medical-records system and another 13% have only a basic one, according to the New England Journal of Medicine.

Simply putting computers on doctors' desks is not enough, however. They must have incentives to use them. For managed-care firms, the incentives are already there. If their doctors can call up a patient's medical records on a screen, along with information about suitable treatments, they can get better results for less money. Fee-for-service doctors, who gain nothing by providing more cost-effective care, have been slower to digitise. Mr Obama says he will offer them incentives to do so. Meanwhile, private firms are trying to show them that IT can make their lives easier.

By chance, one of these firms, Athena Health of Massachusetts, is run by a cousin of George Bush. Rather than trying to sell doctors software which they might never use, Jonathan Bush says he uses software to provide a service, just as Amazon uses software to deliver books. His firm helps 13,000 doctors to digitise their patients' records and handle the maddening process of billing insurers. Mr Bush says his clients get paid 11% more than before (because insurance firms' bureaucracy sometimes used to defeat them) and 34% faster. He saves the patients money, too. Doctors without electronic records often find it easier to do another $500 chest X-ray today than to dig up the results of the one they did yesterday, marvels Mr Bush.

A green revolution

Saving the world will not be cheap.

The best way to curb global warming would be a carbon tax. The money raised could be divided up among citizens or used to repay the national debt. A tax on carbon dioxide (CO_2) would give everyone an incentive to emit less of it. It would be simple, direct and transparent. For these reasons, it will never happen in America.

Frank talk about energy policy is rare. Politicians hate to admit that anything they plan to do will cause pain to any voter. During the election campaign, both Barack Obama and John McCain proposed a cap-and-trade system for curbing CO2 emissions, not because it would work better than a carbon tax but because it did not have the word “tax” in its name. Both candidates also gave the impression that their green policies would yield huge benefits while imposing no costs. A shift to alternative energy, they agreed, would not only check global warming but also create millions of green jobs and help break America’s dependence on foreign oil.

Neither dwelt on the fact that cap-and-trade will raise energy prices, that subsidies for renewable energy will have to be paid for, or that both policies will destroy jobs as well as creating them, while probably cutting growth. The Congressional Budget Office estimates that a 15% cut in CO2 emissions will cost the average American household $1,600 a year. If politicians pretend they can save the planet at no cost, they risk a backlash when people realise they were fibbing.

Greenery is both fashionable and in flux. Every business wants to boast about its efforts to avert climate change, even if those efforts, on closer inspection, amount to little. At the same time, many big investments in planet-cooling activities are on hold because no one knows what incentives the government will put in place, and when. This year’s economic-stimulus package allocated $65 billion in subsidies and tax breaks to the energy industry, most of which had at least a green veneer. But the big reforms are still to come. First and most important is cap-and-trade. The budget Mr Obama submitted to Congress in February assumes that such a system will be up and running by 2012. Tradable permits to emit an amount of CO2 will eventually be auctioned to the highest bidders.

Mr Obama’s budget assumed he would raise $80 billion a year from cap-and-trade, of which $15 billion would go to subsidise renewable energy, and the rest would pay for a tax credit for all but the richest 5% of Americans. For many, that would make up for higher energy bills. For those who live in states that mine or burn a lot of coal, however, it probably would not.

This is where the problems start. Mr Obama’s plan must pass through Congress, which is doing its best to make it murkier, more complex and less effective. Every state, industry and special interest is clamouring for loopholes or handouts. On May 15th Henry Waxman, a Democrat who heads the House energy committee, disgorged a 932-page cap-and-trade bill that would loosen Mr Obama’s emissions targets and give away 85% of the permits to pollute, while auctioning the rest.

House Democrats say this is the best possible compromise. Greens say the bill does far too little to cut emissions. Fiscal hawks fret that it would mess up Mr Obama’s budget. Its micromeddling guarantees unforeseen consequences, just as biofuel subsidies seem to have encouraged the use of nitrous oxide-spewing fertiliser. No one knows how the bill will fare in the Senate. Meanwhile, many businesses say they prefer it to a mooted alternative—regulation of greenhouse gases by the Environmental Protection Agency.

Mr Obama’s other big plan is to insist that 10% of electricity be generated from renewable sources by 2012 and 25% by 2025. That implies a surge in wind, solar, hydroelectric and geothermal power, and so on. If that target were rigidly enforced (for example, if firms get no credit for energy efficiency), the Boston Consulting Group reckons that 50-60 gigawatts of renewable capacity would be needed, over and above current projections, by 2012.

Clean-energy firms are salivating. Most have been hit badly by the plunge in the price of oil. And the financial crisis has curtailed, at least temporarily, new lending for investment in green technology. But many predict that, once the recession is over, oil prices will rise again, making

alternative fuels seem less expensive. Combined with the incentives being proposed, this could lead to a green-energy boom.

Wind power accounts for only 1% of electricity generation in America. It could “easily” rise to 30%, says Ditlev Engel, the boss of Vestas, a Danish firm which is the world’s largest maker of wind turbines. America has ample wind, blowing across the plains from North Dakota to Texas. Not harvesting it would be like Saudi Arabia not drilling for oil, he says. Vestas is investing $1 billion in factories in Colorado.

Solar energy is more expensive than wind. It depends on fat subsidies, which means the biggest market is Europe and cloudy Germany is covered with solar panels whereas sunny New Mexico is not. But several firms hope to make solar technology cheaper. For example, First Solar, an Arizona-based firm, makes thin-film solar panels that are more cost-effective than most existing ones. It plans to double its production this year, to 1,000 megawatts, says its boss, Mike Ahearn.

The nuclear option, again

In his election campaign Mr Obama dodged the subject of nuclear power. “New Energy for America”, his eight-page energy manifesto, mentioned it briefly, without enthusiasm. But it is hard to imagine halting climate change without it. Windmills and solar panels provide power only intermittently. To avoid blackouts an energy source that keeps flowing in any weather is needed. Nuclear power, whose CO2 emissions are tiny, fits the bill. But no new nuclear plant has been built in America for 35 years. Mr Obama is now mulling loans to restart the industry. Given the huge upfront costs and the certainty of resistance from environmentalists, firms will have to know the government is serious about curbing CO2 before they commit themselves to building nuclear plants.

Oil and natural-gas firms are in no immediate danger. ExxonMobil earned $45 billion in profits last year, making it the most profitable firm in America. With oil prices barely a third of their peak, that will not happen again this year. But oil is too useful to become obsolete any time soon, and gas is relatively clean. Coal faces a greater threat, and not only because Al Gore is calling for protests against coal-fired power plants. Since coal is the dirtiest of the main fuels used to generate electricity, cap-and-trade could lead such plants to shut or switch to gas. Efforts to make coal cleaner by injecting its CO2 emissions into the ground show little sign of becoming cost-effective, despite subsidies. Only the fact that coal is plentiful in swing states gives the industry hope.

If a price is imposed on CO2 the next big obstacle to renewable energy will be the electricity grid, which is antiquated and sclerotic. Regulations vary from state to state, making it hard to transmit energy across state borders. There are not enough lines to send power from, for example, windy states to populous ones. New construction is stymied by an attitude among regulators and environmentalists colloquially known as BANANA (Build Absolutely Nothing Anywhere Near Anyone).

And the commonsense notion that consumers should be able to sell energy back to the grid as well as buy it has barely taken root, except in California. Lynn Orr, a professor at Stanford University, has solar panels on his home. During the day he sells power to the local utility at 29 cents a kilowatt-hour. At night he buys it back for 9 cents. The system is not perfectly flexible. He can reduce his bill to zero but no further. “So I need an electric car,” he muses.

Mr Obama included incentives for building a smart grid in his stimulus package. Businesses are queuing to build one. “This is the most sexy industry to work in,” says Guido Bartels, who

leads the energy team at IBM. A smart grid would involve sensors to monitor power flow in both directions, and software to help crunch all the data thus generated. If you plug in your electric car at a friend's house, you will want an easy way to be billed, says Mr Bartels. And information can be used in myriad ways to make the system more efficient, for example by imposing variable prices to discourage power use during periods of peak demand. Energy is one of the fastest-growing parts of IBM's business. Manufacturers such as GE and ABB build the physical infrastructure, while IBM vies with such firms as Accenture to supply the information technology and integrate it all.

If the government introduces carbon-curbing incentives, there will be rich pickings for firms that uncork the remaining technological bottlenecks. For example, whoever makes a cheap, powerful and efficient battery for an electric car will be well rewarded. Firms like A123Systems of Massachusetts are working on it, but electric cars are still too costly for most people.

Saving the planet with old tyres

Since nearly every activity requires energy, there are limitless angles from which to address the problem. Lehigh Technologies of Tucker, Georgia, uses cryogenic technology to create a recyclable powder from old tyres. Because the process saves oil, customers will one day claim it as a CO2 offset. Modestly, Lehigh calls its product "The Powder to Save The World".

Many Americans fret that if cap-and-trade raises domestic energy prices, industries will migrate to China. Stefan Heck of McKinsey thinks that unlikely. Firms outsource labour-intensive jobs to China because there is a huge difference in labour costs even after accounting for productivity differences. Cap-and-trade might add 20-30% to energy costs. That is a lot, but not enough to spark a mass exodus.

Although the shift to a low-carbon economy will reduce economic growth overall, there are plenty of ideas that pay for themselves. Making buildings more energy-efficient is an example. Companies such as Ameresco offer to do this in return for a share of the savings. Firms such as Serious Materials of California provide energy-saving windows and environmentally friendly plasterboard. Wal-Mart plans to reduce its packaging, thereby cutting hundreds of thousands of truck trips and saving both emissions and cash.

In Europe, whose cap-and-trade system is already in force, CO2 prices are routinely factored in to business decisions. In America, they are not—yet. Forest Reinhardt, an environmental specialist at Harvard Business School, argues that consumers of fossil fuels should pay for all the externalities: not only emissions, but also the cost of policing the Middle East.

But he concedes that the shift will be extremely hard. The location of everything in America assumes that petrol will cost about $1 a gallon, he says. Commutes are too long. Cars and lorries are too big. Cities are much greener than rural areas: apartments and public transport are more energy-efficient than big houses and pickup trucks. But not everyone can move to a city centre. People in Montana need a car to get around. They are not rich, they spend a big chunk of their disposable income on petrol, and they do not want to move to Massachusetts. The government has to get the incentives right, says Mr Reinhardt, but it is hard for it to make commitments that will bind its successors in, say, 2017.

The fragile web of foreign trade

The recession makes globalisation more necessary, but more precarious.

A few years ago, Niall Ferguson and Moritz Schularick, two economic historians, coined the term "Chimerica" to describe the symbiosis between the world's two great powers. Chinese people save, they observed, allowing Americans to borrow and spend more than they earn. American consumers buy gizmos made in China, keeping Chinese workers in jobs. Both countries benefit.

But the financial crisis has caused many people to rethink this comfortable arrangement. Protectionists have long blamed Chinese imports for destroying American jobs. A new gripe is that, by lending America so much money, China helped inflate the asset bubble that has now burst so painfully. Although no one forced Americans to borrow so much, nor to gamble the money on property, the crisis has fuelled nativist anger. Lawmakers added "Buy American" clauses to this year's stimulus package, and there are still absurdly tight limits on the number of skilled foreigners who can work in America.

The American and Chinese economies are so entwined, however, that any attempt to separate them will end in calamity. If China were suddenly to stop buying US Treasury bills, it would plunge America into a fiscal crisis. It could also spark a collapse in the dollar and thereby wipe out a big chunk of China's foreign-currency reserves, so both sides have an interest in preventing it from happening. This mutual dependence applies to businesses, too. Chinese manufacturers need America's huge market. American firms, to stay competitive, need to buy things from China.

It is increasingly hard to tell if some companies are American or Chinese, says Jonathan Woetzel, a China specialist at McKinsey. Consider Cheung Yan, who was until recently China's richest person. With her husband, she set up a firm in California to gather American waste paper and ship it to China to be recycled. Later, she set up paper factories in China to do the recycling. Some of the waste paper is turned into boxes to hold Chinese-made electronic goods that are then shipped to America. Is their business Chinese or American? And does it matter?

The recession has severely disrupted trade between America and more or less everywhere else (see chart 5). China's exports to the United States, which had more than trebled between 2002 and 2008, collapsed by more than half between September 2008 and February 2009. The slump in American consumer spending may be causing as much pain for some Chinese exporters as it is for American businesses. But hard times are forcing American firms to look harder for savings, and many are finding these in China.

Ever more industries are finding that their supply chains can run through China, says Jimmy Hexter, another McKinseyite and co-author, with Mr Woetzel, of “Operation China”. Wal-Mart’s chief procurement officer lives in Shenzhen. For cheap retailers, not buying goods from China would be suicidal. But as Chinese firms grow more sophisticated, they are selling fancier stuff. China’s exports to America of machinery and electrical goods, for example, grew at twice the pace of its textiles exports between 1993 and 2008.

For American firms setting up in China, the chief attraction these days is not its cheap labour but its increasingly affluent consumers. In a recent survey of American firms in China by the American Chamber of Commerce there, 63% said they were there to sell to locals, whereas only 9% said they were there to sell things back to America. Procter & Gamble is so well established that many Chinese think its products (such as green-tea-flavoured Crest toothpaste) are local brands. GM is doing well in China, unlike at home. American firms are jostling to help China build smart infrastructure and tackle pollution.

American business is as deeply entangled with other parts of the world, too. Supply chains criss-cross oceans, letting firms buy whatever they want from whoever makes it most efficiently. Despite Barack Obama’s claim that green jobs cannot be outsourced, a study by Brown-Wilson Group, a research firm, finds that they can. Granted, the man who fixes a solar panel to a roof in Ohio has to be in Ohio. But the panel itself can be made in China, and the software for the smart grid that will one day make the solar panel economic can be written in India. Without free trade, saving the planet will cost a lot more.

The coming recovery

It could take a while, but Main Street will bounce back.

Getty Images

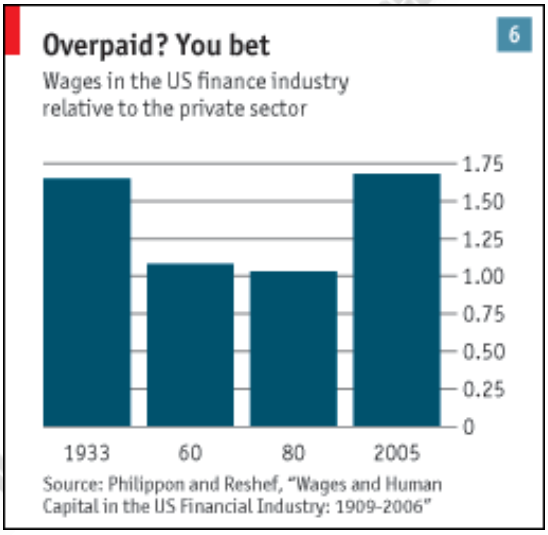
John Rich, a country-music star, sings an angry song about the recession. “While they’re living it up on Wall Street in that New York City town/Here in the real world they’re shuttin’ Detroit down,” complains Mr Rich. He adds that “The boss man takes his bonus pay and jets on out of town/And DC’s bailing out them bankers as the farmers auction ground.” The accompanying video shows a car worker losing his job and home.

Mr Rich is not just another bleeding-heart celebrity. He wrote John McCain’s campaign song last year and performed at the Republican convention. But he is furious about fat-cats. And whereas one can quibble that the folks on Wall Street are not really having much fun this year, or that carmakers and farmers have also received hefty subsidies, it is worth pondering his rage, for it is shared by Americans of every ideological hue.

Few understand what a credit-default swap is, but everyone knows that Wall Street messed up, and nearly everyone feels it, too. Those who have not lost a job have seen their wages frozen or the value of their savings crumble. The financial collapse has exposed newsworthy frauds, like the colossal Ponzi scheme run by Bernard Madoff. Such swindles were not typical. The crisis owes far more to incompetence than criminality. But neither explanation reflects well on the captains of capitalism.

A Rasmussen poll in April found that only 53% of Americans think capitalism is better than socialism, with 20% preferring socialism and 27% unsure. Those are alarming numbers for believers in free markets. They may be misleading, however. Some Americans are hazy about what "capitalism" and "socialism" mean. A later poll found that 77% of Americans preferred a free-market economy to one managed by the government. And hardly anyone thinks the government would do a better job than the private sector of running banks or car factories.

Americans are angry first and foremost with financiers. They also take a dim view of overpaid and underachieving bosses, particularly if they fly to Washington by private jet to beg for a handout from taxpayers. But they admire entrepreneurs: 79% think them critically important to job creation. And although a slim majority approve of Barack Obama's expansion of government to tackle the immediate crisis, only 13% want that expansion to be made permanent. In short, Americans favour incremental rather than radical change. They want to see Wall Street tamed, but they are not clamouring to reinvent the relationship between government and business.



They will probably get their wish. The financial industry grew far too big. Its share of corporate profits in America peaked at an incredible 41% in 2007. Its employees, who were paid about the same as those in other industries until the early 1980s, pocketed 1.8 times as much in 2007 (see chart 6). Judged by the fruits of their labours, they did not deserve it. Thomas Philippon of New York University and Ariell Reshef of the University of Virginia estimate that 30-50% of the wage gap between financial and non-financial workers between the mid-1990s and 2006 was the fruit of what they judged to be rent-seeking rather than genuine wealth-creation. That will now change. A smaller, humbler, more regulated financial sector will emerge. Many of the brainy youngsters who used to flock to investment banks or hedge funds will put their talents to other, perhaps more productive, uses.

Mr Bush of Athena Health thinks this is terrific. The clever people he could not recruit because Goldman Sachs was paying them $65,000 a month are suddenly available, he says. Robert Kaplan of Harvard Business School, a former vice-chairman of Goldman Sachs, applauds the prospect of pay in financial services reverting to less giddy levels. Only people genuinely

interested in finance will seek careers in it, he says. Fewer will do jobs they hate just for the money. More will start their own companies. Mr Bhidé of Columbia University calls for a return to “more primitive finance”, with deposit-taking banks strictly regulated and strictly separated from the more innovative, risky financial firms, to avoid a repeat of the recent contagion.

Main Street will recover only when America’s finances are on a sounder footing. That will take time. Total private-sector debt (households, financial and non-financial firms combined) reached nearly three times GDP last year. Reducing that load will hurt. Money spent repaying debt cannot be spent on the products that American firms are so desperate to sell.

Corporate profits collapsed by 10% last year, and continue to slide. But they will eventually rebound. Chris Varvares, the president of Macroeconomic Advisers, a consultancy, predicts that they will find a sustainable level of about 9% of GDP by 2011. That is well short of their 13% share in 2006. But it is high enough, for example, to help pension funds to start recovering from their recent pummelling.

There are reasons for guarded optimism. One is Mr Obama. Businessfolk worry that he is too cosy with lawyers and labour unions, that he will raise taxes to enterprise-throttling heights, or that his propping-up of badly run firms is unfair to their better-run competitors. None of these worries is baseless. But the evidence so far suggests that the new president understands America’s economic problems and is pragmatic about seeking solutions. There is no reason—yet—to doubt his promise to tackle the budget deficit once the crisis subsides. And America is fortunate to have had a change at the top just as the crisis exploded. A crisis requires a bold response. Mr Obama’s fresh mandate and personal popularity make it easier for him to provide one.

The spirit of enterprise

When the crisis ends, America will still be the best place in the world to do business, says Niall Ferguson of Harvard University. Unlike in parts of the developing world, its political stability is not in doubt. American innovation continues apace, just as it did during the Depression of the 1930s (which saw the invention of nylon, canned beer, the photocopier and the drive-in cinema) and the stagflation of the 1970s (Post-it notes, bar codes, the microprocessor). Not only is America’s market the largest, but that market is homogeneous: a firm that works in one state can probably work in any other. “I laugh when people talk about diversity here,” says Mr Ferguson. And America has economic policy levers commensurate with its size: the European Union has no central treasury to compare with America’s, and America’s central bank has acted more aggressively to tackle the crisis because it can.

Finally, there is that gung-ho spirit of enterprise. “I think people will be surprised how quickly [business] will pick up when it does,” says Mr Sorenson of Marriott hotels. One can discount his words, of course. Business people are by nature optimistic, especially in America. But their optimism can be self-fulfilling.

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