Chapter 1

The Global Redistribution of Economic Power

Economic power is the bedrock of sustainable military and political power. The severity and expected duration of the financial crisis that gripped the world in 2008 make it all the more imperative to understand the national security implications of U.S. and global economic trends. This chapter focuses on selected economic issues from a broad strategic perspective. The topics are diverse, ranging from extreme poverty to high finance, but together they illustrate a key theme of this study: the global redistribution of power.

The chapter begins with a definition of economic power and an exploration of its use and limits. It continues with a historical overview of the rise of the West, beginning with the Industrial Revolution, and the subsequent shift of economic power from the West to "the Rest," mainly Asia. Along the way, living standards on average have vastly improved, and new sources of wealth have arisen. Globalization has greatly accelerated these positive trends, but it has also created new sources of instability.

The third and fourth segments and a sidebar analyze one of these sources of instability: the rapidly changing world of finance. A sound and prospering financial system is an indispensable foundation of economic (and therefore military) power, but the size and speed of borderless financial markets far outstrip the resources available to slow-moving national governments and international institutions. As the current financial crisis has shown so vividly, the speed of global financial flows exposes participating economies to sudden job losses and extreme volatility in equity markets.

Nowhere is the global redistribution of economic power more evident than in the world of finance. Although the role of governments remains crucial, the size and speed of private transactions mean that financial power has largely shifted from public entities to the private sector. In addition, a role reversal has occurred: financial institutions in the developing world have helped rescue Western banks and financial institutions. As of late 2008, China had accumu-

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Trader reacts to activities on floor of Indonesia Stock Exchange lated almost $2 trillion of foreign exchange reserves, out of a world total of about $7.3 trillion. Taken together, Taiwan, India, South Korea, Singapore, and Hong Kong accounted for another trillion.

Although the fundamental strengths of the U.S. economy are still in place, American-style capitalism has suffered a loss of prestige. The subprime mortgage crisis of 2007–2008, the Wall Street meltdown that began in September 2008, the collapse or near-bankruptcy of hallowed firms, the freezing of credit markets, the massive size of proposed bailouts, and the gyrations of stock markets around the world—all complicated by a U.S. Presidential transition—damaged U.S. economic power and thus undermined Washington's global influence.

The fifth section of the chapter, on economic security, documents another source of instability: poverty. Within the developing world, economic success is accruing to some countries but not to others. Roughly 1 billion people in some 60 countries, mainly but not exclusively in sub-Saharan Africa, are being left behind. Some of these countries are subject to repeated civil wars; some provide havens for nontraditional threats to U.S. national security, such as terrorism, illegal trafficking, and pandemic disease; and some generate calls for humanitarian intervention. The analysis concludes with several policy recommendations and a plea for the more coordinated use of military and civilian instruments.

The chapter ends with a look at one U.S. reaction to the redistribution of economic power away from the West: protectionism. With the U.S. economy slowing to a crawl, trade is virtually the only source of growth. Measures to restrict trade and investment inflict damage on not only the American economy, but also U.S. power and influence. Vigorous and farsighted leadership will be required to reverse this trend and strengthen America's ability to lead.

What Is Economic Power?

There is general agreement that in the 21st century, economic power is an important strategic asset. But what is economic power? How is it changing? And how can it be measured?

Economic power can be broadly defined as the ability to control or influence the behavior of others through the deliberate and politically motivated use of economic assets. *National economic power* implies that a government is in a position to use, offer, or withhold such assets even when they are in private hands (for example, by mandating trade embargoes or imposing controls on exports to targeted countries). In fact, the exercise of economic power may well have economic costs because almost by definition it entails interfering with decisions made for economic reasons.

Economic power can also be thought of as the ability to *resist* external control or influence because dependence on external suppliers is sufficiently diverse to preclude vulnerability to outside pressure. The United States, for instance, imports about two-thirds of its oil from foreign sources and is thus vulnerable to oil exporters as a group (although not to any one country). But what is sometimes forgotten is that sellers need markets. If the United States were to significantly reduce its appetite for foreign oil, it would gain relative economic power over these suppliers. Persuading others to establish a "consumer cartel," as some have suggested, would have an even greater effect on the balance of economic power.

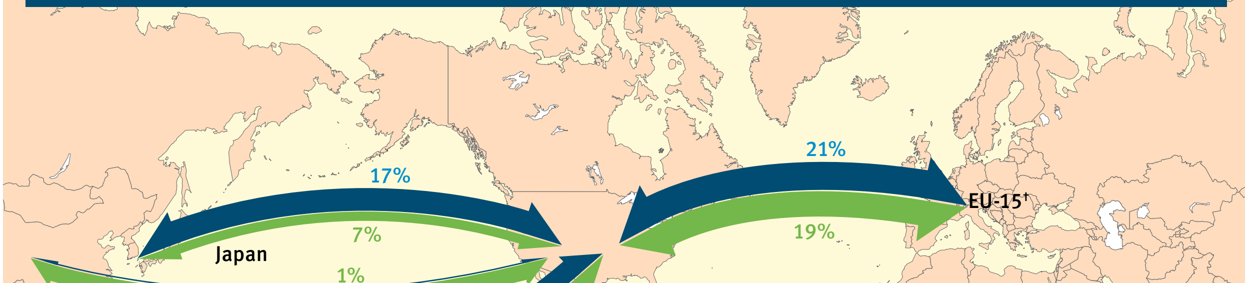
An extreme example of the ability to resist external control is economic self-sufficiency. Certain great empires of history, such as imperial China, were almost entirely self-sufficient. But in today's world, the pursuit of economic self-sufficiency results in lower levels of technology and productivity and a greater degree of poverty than would otherwise be the case (North Korea is a perfect example). If market forces are allowed to operate, some countries will be more self-sufficient than others, but none will be completely self-sufficient in all sectors.

National economic power has often been used to punish other governments. Whenever another government behaves in a way that violates international norms, a common U.S. response is a call for economic sanctions. Certain "smart sanctions"—such as denying U.S. visas to family members of dictators and freezing their bank accounts—may have some effect. But efforts to apply trade embargoes and other forms of economic coercion to influence another country's political or military behavior fail more often than not, especially when the targeted regime perceives that the reforms sought by the outside world threaten its survival. Worse still, economic sanctions often end up enriching elites, who have ready access to the black market, and impoverishing everybody else.

Globalization and Economic Power

Throughout much of recorded history, the assets associated with economic power consisted primarily of land, natural resources, and the ability to spend more than one's adversaries spend on weapons and wars. In a global economy, these elements, while still

World Economic Trends



Two-way Merchandise Trade with United States

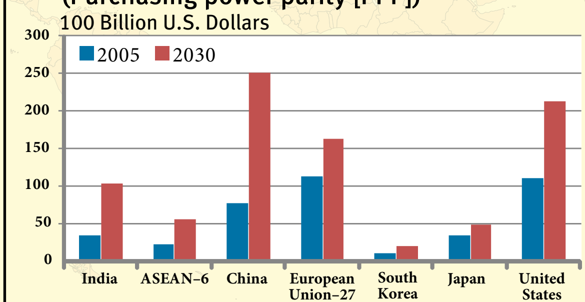
1987 2007

Line thickness proportional to percent of U.S. trade

† Number of EU members in 1987

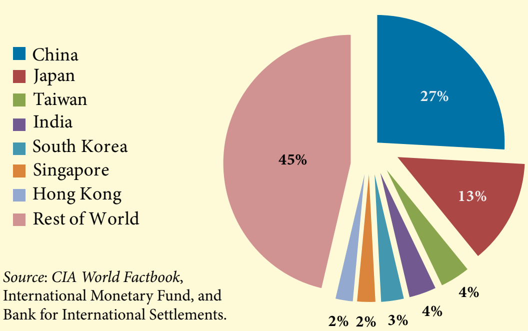
Source: U.S. Department of Commerce.

Projected Gross Domestic Product (Purchasing power parity [PPP])



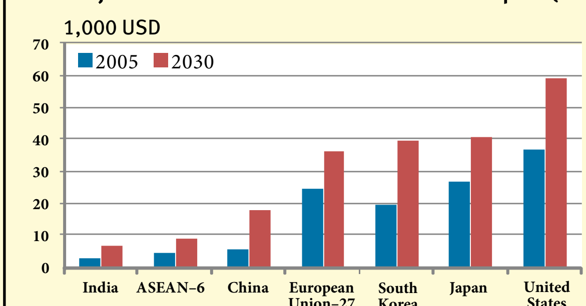
Source: Japan Center for Economic Research.

Asian-held Foreign Exchange Reserves 2008



Source: *CIA World Factbook*, International Monetary Fund, and Bank for International Settlements.

Projected Gross Domestic Product Per Capita (PPP)



Source: Japan Center for Economic Research.

Economic and Social Indicators

Country	GDP per Capita (PPP)	Broadband (per 100 people)	Cellphones (per 100 people)	Median Age	Population (millions)	Life Expectancy
United States	$45,800	23.9	83.5	36.6	305.7	78.06
Hong Kong	$42,000	26.4	149.2	41.2	7.0	81.77
Canada	$38,600	27.6	61.7	39.1	33.4	80.34
Japan	$33,500	22.1	83.9	43.5	127.7	82.07
Europe / EU	$32,700	14.2	109.6	37.7	494.8	78.70
Taiwan	$30,100	20.9	106.1	35.5	23.0	77.56
South Korea	$25,000	30.5	90.2	35.8	48.2	79.10
Russia	$14,800	2.8	114.6	38.2	141.9	65.87
Mexico	$12,400	4.3	62.5	25.6	106.7	75.84
Brazil	$9,500	0.4	63.1	28.6	188.1	72.70
China	$5,400	5.0	41.2	33.2	1,327.5	72.88
India	$2,600	0.3	20.0	24.8	1,141.1	68.59

Source: Broadband and cellphone data from International Telecommunication Union. All others: *CIA World Factbook*, most recent data as of October 2008.

important, contribute less to overall economic power than what societies and governments can create for themselves: sound financial and macroeconomic policies, an educated and adaptable work force, market-based competition, a supportive infrastructure (including transportation, communications, and energy distribution), and a stable and welcoming investment climate, backed by good governance and predictable rules.

These self-created assets virtually guarantee a competitive niche in the global economy. They fueled the remarkable performance of Japan and the "four tigers" (South Korea, Taiwan, Hong Kong, and Singapore) during the 1970s and 1980s. Similarly, the reforms launched by Deng Xiaoping in the late 1970s transformed China from an autarkic economic backwater to the economic powerhouse that it has become today. Thanks in part to China-centered production networks and widespread pro-market reforms, Asia has experienced robust growth. Its success should not be exaggerated, however; the region suffers from a variety of economic, political, and demographic weaknesses. It is highly dependent on the global economy and remains vulnerable to internal and external shocks.

Just as globalization has altered the content of economic power, so it has limited the sovereignty associated with it. A single nation has only a partial ability to claim autonomous economic power and to use it unilaterally. China, for instance, still depends heavily on markets in North America, Europe, and Japan. This means that China's national economic power cannot be wielded autonomously and at will because doing so would undermine the confidence of foreign investors and thus retard the economic growth that the Chinese leadership needs to maintain its legitimacy. China's alleged "dollar weapon" is not a weapon at all.

Until fairly recently, products were made in one country and sold to customers in another. But thanks to the revolutions in transportation and information technology, most of the world's biggest companies now operate in numerous countries. Although the components of a product may come from multiple sources, that product's label usually records only the point of final assembly and shipment. Interdependence also characterizes the operation of international financial markets. The first decade of the 21st century has witnessed a major shift in financial power from the West to other parts of the world, particularly Asia. Countries in the region hold roughly two-thirds of the world's foreign exchange reserves.

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Peering into the Abyss: Implications of the Global Financial Crisis

The 2008–2009 global financial crisis may one day be remembered as the greatest setback to the world economy since 1945—and perhaps even the Great Depression. It has already inflicted considerable pain on many countries, thereby jeopardizing their social and political stability as well as their commercial prospects and eroding what was a remarkably widespread consensus in favor of market capitalism. The sudden slump in global growth has also undermined U.S. prestige and influence and will complicate Washington's diplomacy and security relationships for years to come.

Overview

Typical recessions are officially induced. Monetary authorities see that the economy they oversee is overheating and starting to generate inflationary momentum. They react by tightening the flow of credit, which causes corporations and households to curtail their expenditures and hence retards the pace of gross domestic product (GDP) growth. When inflationary pressures abate, the central bank loosens policy and allows private-sector demand to resume its upward trajectory. The present disaster, by contrast, stems from the simultaneous and cataclysmic resolution of two distortions in the global economy. The unique elements of this crisis ensure that its impact will be much deeper and more enduring than that of ordinary recessions.

Of Leverage and Deleverage

The first structural flaw was a gradual rise in leverage—borrowing money to finance extra consumption and investment—that occurred over decades as households, corporations, and governments assumed ever more debt. This phenomenon accelerated in the 1990s and early 2000s, when deregulation and the development of new financial products emboldened financiers to take on more risk and allowed households in the most liberal economies to borrow against the equity in their homes in order to enhance their purchasing power and raise their standards of living. The ratio of debt to global GDP accordingly rose to unprecedented heights. This increase in leverage occurred, furthermore, beyond the ken of regulators who chose to close their eyes to new developments and consequently failed to appreciate the dendritic connections that were forming between the various new markets. So while many observers accurately perceived parts of the problem, few if any understood the combined magnitude of the stresses that were building in the international financial system.

The reversal of that trend through almost universal deleveraging—that is, the attempt by borrowers to reduce their debts to more comfortable levels—is what differentiates the current crisis from normal recessions, and puts it in the same category as the Great Depression and Japan's "lost decade." In this latest instance, the crisis started when the bubble in the American subprime residential market began to deflate in 2006. This damaged the balance sheets of the many American and European banks and non-banks that owned subprime mortgages, and compelled them to seek to strengthen their balance sheets by selling off other assets and calling in loans. In the autumn of 2007, some parts of the credit market therefore froze, causing costs for other corporations and financial institutions to surge even as the stocks, bonds, derivative securities, and real estate in their various portfolios depreciated. Soon, even richly capitalized enterprises with no exposure to dubious American properties were seeing the value of their assets erode, and they felt compelled to join the wave of deleveraging.

As was the case in 1990s Japan, the usual governmental remedies lost their efficacy in the face of such inexorable debt repayment. Lowering short-term interest rates toward zero cannot stimulate credit creation in such an environment because lenders do not want to incur new financial obligations at any price. Nor is bank recapitalization an adequate countermeasure, since banks comprise such a small part of the spectrum of indebted financial and nonfinancial entities—investment banks, credit card companies, consumer financing outfits, automobile manufacturers, and many others—that are withdrawing credit and divesting assets. So conventional efforts must be supplemented with "quantitative easing," the practice whereby monetary authorities stop focusing on short-term interest rates and start trying to reduce long-term rates by purchasing stocks, bonds, currencies, or even real estate and other tangible things. The objective of this "unconventional" policy is to push down credit costs for mortgage holders, corporations that raise their money directly from capital markets, and government. But while this bold approach, in conjunction with aggressive fiscal policy, may cushion the macroeconomic impact of deleveraging and prevent the onset of a depression, it probably cannot precipitate a sustained recovery until firms and households have approached their target debt ratios and are no longer determined to sell off their investments. This adjustment, sadly, probably will not reach completion until at least 2011.

A Precarious Imbalance

The deleveraging process would have been traumatic enough had it not interacted destructively with the extremely rapid resolution of a second structural problem: namely, the global financial imbalances. The consensus view as recently as a year ago was that those imbalances resulted from excessive consumption in the United States and a few other countries. American households, in particular, borrowed and spent so copiously that the country ran an enormous current account deficit—peaking at 6 percent of GDP in 2006—which sucked up the liquidity that the high-saving economies were so much more responsibly and magnanimously providing. An equally valid explanation for the problematic pattern of capital flows, however, works in precisely the opposite direction. In that view, the world suffered from a glut of capital in the 1990s and 2000s, as aging people in China, Japan, and elsewhere saved a disproportionate fraction of their income in anticipation of retirement; and developing economies, frightened by the exchange rate crises of the last decade, insisted on generating current account surpluses and amassing ever larger foreign reserves for use in the event of an emergency. Then came the commodity boom of recent years, in which oil producers and some other exporters of raw materials reaped windfall profits so large that they could not exhaust them domestically and were forced to ship much of their surplus income abroad. But since savings represent foregone consumption and investment, the resulting glut of capital in the international market could easily have caused world demand to fall structurally below supply, and hence caused a protracted recession—and perhaps even deflation. The only way to avoid this outcome would be for someone, somewhere, to absorb the surfeit of capital and expend it on goods and services.

This is where the leverage and current-account stories converge. Over the last two decades, central banks pumped vast amounts of liquidity into the world economy, where financial institutions used new products and ever-increasing leverage to expand the supply of new credit still further. That money poured into the most liberalized national markets, meaning primarily the United States, United Kingdom, Australia, and Spain, where it produced conspicuous bubbles in local real estate markets. The citizens of those countries availed themselves of this appreciation and the availability of home equity loans to finance additional consumption, which pushed their national current accounts into deficit and soaked up the rest of the world's exports of goods and services.

Everyone accepted this situation because it raised standards of living in the deficit countries while permitting the parsimonious countries to achieve rapid GDP growth even as they built up their foreign reserves. The United States and the other spendthrift economies thus served as the engine of global commerce in the 2000s.

A Dismal Outlook

That engine has now stalled. By destroying something approaching $15 trillion in American wealth (a figure that could rise higher), the crisis has impoverished American households and caused them to curtail consumption and to begin ratcheting up their savings rates. This year's current account deficit will accordingly decline by more than two-thirds from the 2006 peak of 6 percent of American GDP. The sharp contraction in demand for foreign exports already has eviscerated international trade, which was increasing at an average annual pace of over 8 percent in 2006 and 2007, but will actually decrease this year and perhaps next year as well. At this point, the data suggest that 2009 will be a dismal year, with GDP contracting by at least 2 percent in the United States, European Union, and United Kingdom—and Japan's economy shrinking by two or three times that figure. Even the speed of China's economic expansion will fall by well over half from its peak early last year of 13 percent. As a result, the global rate of GDP growth this year, measured at prevailing exchange rates, will fall below zero for the first time since World War II.

The immediate recession may end in late 2009 or 2010, but an early return to trend growth will not then ensue. A sustained weakness in international demand is portended by not only the steadily rising savings rate in the United States, but also the much larger loss of one-third of worldwide wealth that has simultaneously occurred. While corporate profitability and savings rates around the globe may fall, newly impoverished households in Japan, China, and the other aging countries will hardly increase their consumption and residential investment. Meanwhile, the 8 to 10 percent shrinkage in Ireland's GDP that seems likely to happen this year cannot help but underscore developing countries' fear of liberalization and their consequent desire to amass more foreign reserves. The global imbalances will doubtless decrease in size, since by definition the sum of all surpluses must fall to the level of the overall deficit registered by the more profligate countries. But this change will occur through an economic slowdown that presumably will last well into the next decade.

Broader Implications

Today's crisis should not prove as disruptive as the Great Depression, but its global scope assuredly entails more international problems than did Japan's 1990s stagnation. Among the most salient of the impending events are changes in the structure of financial markets; more activist and intrusive government; more protectionist sentiment around the world; movement away from American dominance in multilateral forums; and a marginal diminution in global political stability and international cooperation.

Financial Markets. The crisis has virtually wiped out investment banks, whose dependence on short-term funding proved fatal when credit markets seized up in late 2007 and 2008. Even such flagship enterprises as Goldman Sachs have transformed themselves into more conservative institutions with more traditional fundraising and operational schemes. At the same time, the implosion of the worldwide bubble has devastated the private equity and hedge funds, whose portfolios depreciated precipitously and whose sources of capital must inevitably dwindle. All of these industries will revive eventually, albeit in diminished form and with much less leverage, and hence lower profitability. Even the fledgling sovereign wealth funds will lose prominence, both because the trade surpluses

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Circuit City store in Richmond, Virginia, advertises going out of business prior to filing bankruptcy that produced their capital are shrinking, and because they, too, relied on aggressive leverage to improve their returns—leverage that is no longer readily available. The world therefore will emerge from the present crisis with a less dynamic and volatile financial system that also contributes somewhat less to GDP growth.

Governmental Intrusion. To maintain economic stability amid plummeting consumption and investment, the world's governments will expand their spending considerably over the next few years: in the United States and United Kingdom, for instance, official budget deficits could reach 10 percent of GDP in 2009, and will remain voluminous for some time thereafter. Bank recapitalization, meanwhile, will give the authorities big equity stakes in many countries' financial enterprises. Regulators also will become more intrusive in their relations with private enterprise. The virtually universal failure of oversight agencies to monitor and discourage the increase in leverage within and between economies is already perceived as having contributed to the genesis of the crisis. It follows that political pressures will mount for governments to impose new laws and regulations in order to forestall a recurrence of the current disaster. Many of these changes will of course be salubrious, but the adoption of some ill-advised rules seems inevitable. There will, in short, be some degree of retreat from the norms of liberal capitalism.

Protectionism. Before the crisis unfolded, most analysts believed that the global imbalances would eventually resolve in a manner that promoted American exports. As their holdings of U.S. bonds grew ever larger, foreign investors would ultimately lose faith in the United States, sell the dollar, and move their money elsewhere. This sudden loss of confidence would depress the value of that currency, causing imports to decrease and exports to surge. The result would be a contraction in the current account deficit that benefited the American manufacturing sector.

What has now happened, though, is that the adjustment has occurred almost entirely on the import side of the ledger and with no significant benefit to American exporters. By destroying vast sums of American wealth, the crisis has crippled consumption of both domestic and imported goods even as it induced dollar appreciation and thereby disadvantaged manufacturers. The loss of the U.S. increment of international demand, in turn, has harmed the entire world. The volume of global trade was rising at an average of over 8 percent in 2006 and 2007, but decelerated somewhat in 2008 and will actually contract this year and perhaps next. The upshot is a crushing blow to exporters everywhere, whose employees are understandably prodding their governments to protect what is left of their domestic market. Illustrative of this new mood was the attempt by many Members of Congress, backed by the steel industry, to add "Buy American" language to the infrastructure section of the Obama administration's draft stimulus bill in early February 2009. This protectionist trend will soon become more widespread because of the effect that the rapidly diminishing current account imbalances are having in all but the most isolated of countries.

American Dominance. In the short term, the crisis has reinforced the U.S. position at the heart of the global financial system, for the main beneficiaries of recent events are first the yen and then the dollar. Both currencies are viewed as safe investments that may appreciate as deflationary forces intensify; appreciation in the euro, by contrast, is constrained by rigid labor markets and the relative inflation that they entail. The yen additionally benefits from the reversal of the carry trade, in which foreigners borrowed at cheap rates in Japan and then invested the proceeds at higher rates abroad, while the dollar gains from the general expectation that the United States will be the first big economy to recover. For the time being, therefore, the dollar should retain its place as the preeminent reserve currency.

Yet Washington has certainly lost some of its prestige in the international community. That the crisis originated in U.S. real estate markets and amplified through the most liberal Western markets has, to some extent, discredited the Anglo-American regulatory system. *Dirigisme* of the French variety consequently has reared its head, and Russian and Chinese leaders have used their public pronouncements at the World Economic Forum in Davos and elsewhere to criticize U.S. capitalism. Likewise, calls are multiplying for a stronger developing-country voice in such multilateral organizations as the International Monetary Fund—whose policies in the 1997–1998 Asian financial crisis were widely seen as too austere and which appear largely irrelevant in today's debacle. In this atmosphere of skepticism regarding U.S. values and Western-sponsored organizations, the eminently reasonable and long-overdue process of giving the newly emerging economies more institutional prominence could take on a certain anti-American flavor and thus further vitiate Washington's influence.

Political Stability. While the unfolding crisis will doubtless harm the whole world, its effects on some states will be particularly pronounced. The present trauma may, for instance, be the straw that breaks the back of the Japanese party system, inaugurating a period of even weaker governance in that critically important country. Meanwhile, such commodity producers as Iran, Russia, and Venezuela are already watching their oil revenues collapse and their government budgets deteriorate markedly—with untold implications for their social and political stability as well as their foreign policies. It is true that the erosion of these states' power may advance American interests in the immediate term, but the present regimes could conceivably be replaced by even more minatory leaders. Meanwhile, the governments of such nations as China, where economic development is the main pillar of legitimacy and political stability, may also encounter more difficulty managing their domestic affairs over the next few years. Even Europe will suffer greater political strain as the economic downturn imposes disproportionate pain on the eurozone's poorer members, underscores the divergence of their interests from those of Germany, and raises questions about the utility of the currency union itself.

The 2008–2009 financial crisis will inevitably complicate many forms of international cooperation, and may well threaten stability in some key regions. A number of countries will suffer wrenching economic pain and a degree of social and political unrest, while many more will become more politically self-centered and perhaps even nationalistic. This trend toward introspection will also have economic ramifications as governments, in an understandable attempt to help their peoples in this inclement global environment, become more protectionist and paternalistic. Market-oriented economic reforms will also decelerate in some parts of the world, further stunting opportunities for trade, investment, and improvements in GDP growth. In fact, it would not be surprising to see a range of states react to their straitened conditions by reducing their military budgets, withdrawing from some of their overseas commitments, and scaling back their investments of time and energy in multilateral diplomacy. Overcoming this new reticence and the resentment against the United States engendered by the crisis will be critical to the success of the Obama administration's foreign policy.

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Well over half of those reserves are denominated in dollars, and much of that is recycled back into the U.S. economy. Foreign governments therefore have a large financial as well as a commercial stake in the health of the American economy.

Security ties help to explain the continuing predominance of the U.S. dollar as a major reserve currency. Other governments' decisions to accumulate dollar reserves and to link the management of their currencies to the movement of the dollar rest in part on the belief that the United States remains the predominant, if not the sole, provider of security. They watched in dismay as the fall in the value of the dollar caused the value of their dollar-denominated assets to tumble. In the future, their mix of reserve currencies may well continue to shift toward the euro and the yen. Nevertheless, security ties with Washington will likely prevent them from tilting too far in this direction.

What governments can do to exercise financial power is extremely limited compared to the burgeoning size, speed, and pace of innovation in private capital markets. In the past, finance more or less followed trade flows, but financial flows now occupy a separate and ever-expanding universe. Private capital resources dwarf anything that governments and international institutions such as the World Bank and the International Monetary Fund (IMF) can provide. Governments with sufficiently good credit ratings prefer to borrow from private sources, thus avoiding the politically onerous conditions often placed on support packages negotiated with the IMF or the World Bank.

Financial flows provide needed liquidity (ready cash) to international markets, but they can be extremely destabilizing. As Asians learned in the financial crisis of 1997–1998, the sudden withdrawal of private capital can topple governments and send economies reeling. The proportion of Indonesians living in absolute poverty, for example, doubled almost overnight, from 13 to 26 percent. The credit crisis of 2008 stemmed from risky behavior on Wall Street, but stock markets around the world plunged.

Measuring Economic Power

The national security implications of economic power transcend the ability to finance a higher defense budget and field expensive weaponry. Signs that a country is on the road to economic power include a strong and stable currency, adequate foreign exchange reserves, inflows of foreign investment, rising productivity, manageable inflation, and a declining level of poverty. Other indicators reflect the degree of urbanization, levels of education, social indicators such as life expectancy, and others. All of these can be measured.

The most common indicator of economic power is the size of a country's *gross domestic product* (GDP), defined as the sum of consumption, gross investment, government spending, and net exports, or alternatively, as the sum of all goods and services produced in a given year. GDP is calculated in two ways: by measuring output in terms of prevailing exchange rates, or by calculating the purchasing power parity of each currency relative to some standard (usually the U.S. dollar). To simplify, one measures how much a nation's output is worth abroad (usually in dollars), and the other measures how much people in one country have to pay for a given basket of goods compared to what people in other countries have to pay.

The rate of GDP growth is also a key measurement. As a general rule, developing countries grow faster than highly industrialized ones, provided that they have reasonably good economic policies and a functioning government in place. Such countries start from a low base; double-digit growth, while impressive, is not uncommon.

GDP per capita is also widely used. Economists have predicted that several decades from now, China's GDP will surpass that of the United States. This achievement certainly signifies China's growing economic power. But because of China's huge population, when this threshold is crossed China's GDP per capita will likely be only about one-quarter to one-third of the U.S. level. Which figure matters more to perceptions of economic power? The answer will vary according to the values and goals of the observer.

Several yardsticks have been developed to measure various other contributors to economic power, such as market-oriented policies and low levels of corruption. The World Economic Forum's *Global Competitiveness Report* measures "the productive potential of nations." Top marks in 2008 went to the United States, Switzerland, Denmark, Sweden, and Singapore, while China came in 30th and India 50th out of 131 countries polled. The International Finance Corporation's 2007–2008 report on the ease or difficulty of doing business abroad names Singapore, New Zealand, and the United States as the top 3 among the 181 economies that were ranked, with Guinea-Bissau, the Central African Republic, and the Democratic Republic of Congo bringing up the rear; China and India are ranked 83d and 120th, respectively. Another index, produced by the Heritage Foundation and the *Wall Street Journal*, measures "economic freedom": top winners in 2008 are Hong Kong and Singapore, with the United States ranked fifth.

Good governance is a key pillar of durable economic power. Politicians who demand huge bribes and send millions of dollars to foreign bank accounts stunt their countries' development in multiple ways. An index developed by Transparency International measures perceptions of corruption. Based on a scale of 1 to 10 (10 means least corrupt), top prizes in 2008 went to the Nordic countries, New Zealand, and Singapore. The United States trails at 7.3 points, and China and India earned scores of 3.6 and 3.4, respectively.

Concern for the environment has given rise to several indices of "sustainability." The idea here is not only that the environment should be protected, but also that GDP growth will falter if a government depletes its natural resources and sickens its people.

Small countries may get high marks in these various contests, but size matters. It used to be said, for example, that a large population of poor people was a liability. But as markets grow, large numbers of people who are eager for jobs, education, and training are now seen as an asset. From this perspective, China, India, the United States, Russia, and Indonesia all carry economic weight no matter what they do.

Finally, two related elements of economic power are popularity and prestige. If a given country is highly anti-American, resistance to U.S. economic power will be stronger. A trade minister from a country whose press spews forth daily attacks on the United States will have less freedom to make trade "concessions" than a trade minister from a country where the United States is admired and liked.

Prestige has been a longstanding American asset. Thanks to its huge market, skilled manpower, and ever-growing stock of leading-edge technology, the United States is still an economic powerhouse. But huge trade and budget deficits, heavy dependence on imported oil, record-high consumer debt, and rising levels of protectionism have tarnished America's economic reputation and undermined U.S. influence abroad.

American prestige suffered a further blow in 2007, when the U.S. subprime mortgage crisis sent many major U.S. financial institutions to Asian banks for relief. In September 2008, the crisis ballooned. The dramatic financial crash and associated bailouts shook Wall Street to its foundations and seriously undermined America's economic image. Although the shakedown can be seen as a healthy corrective, it has diminished America's near-term economic power.

Economic Power and National Security Strategy

In today's world, economic power has become largely synonymous with successful engagement with the global economy. Paradoxically, the greater such engagement becomes, the more limits governments face when they contemplate using their country's economic resources as a coercive tool to influence the behavior of other governments.

Used constructively, however, U.S. economic power bolsters Washington's influence abroad. But sustaining such influence depends critically on sound policies at home. The risky behavior and lack of oversight that ultimately ignited the financial crash of 2008 damaged America's relative power and influence. Restoring them requires paying heed to the old adage, "Physician, heal thyself."

Sustained economic power is at the root of sustainable military power. Strategic planners need to overcome stovepipe thinking that consigns economic and security issues to different mental boxes. They must understand global economic trends and incorporate them—not as an add-on, but as a core element of their analysis. Drawing on this broader concept of national security, America's elected leaders will be better equipped to make decisions about using economic power. They will also understand that America's economic vitality, flexibility, and spirit of innovation are the true foundation of U.S. economic power, and that adopting the right mix of policies to sustain them is a national security imperative.

The Rise of the Rest

The 1990s were marked in the West by triumphalism. The "end of history" thesis, articulated by Francis Fukuyama, argued that a combination of liberal democracy and market capitalism had become so dominant that, with communism and fascism vanquished, the Western way of governance would no longer face significant challenges. This thesis held that the West, and specifically the United States, had no effective rivals and for the indefinite future could rule at will.

Most noteworthy in the first decade of the new century, however, has been the appearance of nascent power centers outside the traditional Western sphere, especially in Asia. On balance, this is a positive trend, but it poses a long-term challenge to the U.S. global standing.

AP Images (Stephen Jaffe)

International Monetary Fund financial committee meets in Washington, 2008

Background

The current dominance of the West has its roots in the Industrial Revolution of the 19th century, and specifically in Britain's newly acquired ability to grow its economy by around 2 percent per year. That capacity spread to much of Europe and the United States on the heels of industry and capital. Britain's capacity for regular growth provided the economic foundation of the British Empire. Broader Western growth at 2 to 4 percent, in contrast with the economic stagnation of most of the Middle Eastern, Asian, African, and Latin American regions, underlay global dominance by the West in the 19th and 20th centuries. The Industrial Revolution was, of course, fueled in large part by the wealth and raw materials that the colonial powers stripped from those regions. Still, this concatenation of Western dynamism with Confucian and Islamic stagnation was historically unusual. In the pre-Renaissance Middle Ages, the reverse had occurred.

AP Images (Gerald Herbert)

Executives from Big Three manufacturers and United Auto Workers union testify before Senate Banking Committee on auto industry bailout, December 2008

Japan's successful industrialization in the Meiji era created an alternative power center in the first half of the 20th century. Alone among South and East Asian countries (except for Thailand), Japan maintained its independence from Western domination. While Thailand remained poor and underdeveloped, Japan borrowed Western techniques and became a modern power. After its defeat in World War II, the Western consensus was that Japan would remain a backward agricultural economy and a minor power indefinitely. Japan began to grow 10 percent per annum, however, and quickly became treated as a major power—for instance, as one critical leg in institutions such as the Trilateral Commission and as leader of the Asian Development Bank. Japan's emergence initiated a new era of postwar history.

Gradually, South Korea and Southeast Asia adopted policies that resulted in 7 to 10 percent annual growth, or about three times the rate that underlay Western dominance. In the 1980s, China's new generation of leaders learned to emulate the dynamic growth techniques, and in the 1990s India, responding to the sudden loss of patronage from the Soviet Union, began to emulate China by dismantling the complex and bureaucratic business licensing system called the "license raj," welcoming foreign investment, and abandoning socialist planning. Even Pakistan managed to raise its growth rate. Now nations encompassing about 3 billion people, roughly half the human race, were growing at several times the rate that underlay Western dominance.

Implications

What are the implications of this new era of rapid growth in "the Rest," especially Asia?

First, *the consequences of the "Asian Miracle" have so far been extremely stabilizing.* Rapid growth has stabilized the internal politics of countries from Japan to Indonesia. As late as the mid 1960s, Japan's internal stability seemed to be in doubt. Moreover, Indonesia contained both the world's third largest communist party and more Islamic militants than the rest of the world combined. Following a severe crackdown on the communist party in 1965, the Suharto government launched an era of rapid growth that significantly diminished political unrest in most of the country. Economic growth has also stabilized regional geopolitics. Ideological demagoguery and proselytizing have declined throughout the Asian Miracle region. The ability to achieve national prestige and influence rapidly by focusing on economic growth, together with the costs that modern military technology imposes on any attempt to achieve those goals by military means, has led to a vast shift of strategy from geopolitical aggressiveness and territorial disputes to economic priorities.

This shift has occurred throughout the entire Asian region. South Korea moved from a failed strategy of military priorities under Syngman Rhee to a brilliantly successful economics-focused strategy under Park Chung Hee and his successors, leaving the economy of the once hapless South Korea over 22 times larger than that of its formerly superior northern rival. Other regional successes have included Indonesia, which abandoned territorial claims covering most of Southeast Asia, and China, which has settled 12 of its 14 land border disputes to the satisfaction of the other parties and which has embarked on a remarkably successful campaign of "friendship diplomacy" in order to focus on economic development. India, which has also adopted "friendship diplomacy," shows early signs of making a similar shift, despite greater difficulty. None of the rapidly rising Asian powers has yet shown any inclination to revert to obsolete territorially focused strategies. This shift toward stability appears to belie the argument among prominent realists that rising powers are invariably disruptive. Asia's shift to stability shows that similar economic progress could stabilize other regions.

Second, most of these great economic successes have been based on movement toward integration into the Western-style market economy and acceptance of the basic institutional arrangements that the West created after World War II: relatively open trade and foreign investment, a competitive internal market, market-driven domestic pricing for most things, Western-type law, a substantial degree of freedom of inquiry, considerable freedom to travel and exchange ideas, Western-style capital markets and banking systems, and engagement with the most important Western economic institutions (notably the IMF, the World Bank, and the World Trade Organization [WTO]). None of these movements is irreversible, but the dominant trends in these success stories have included rejection of autarky (Burma vs. Thailand), xenophobia (Sukarno vs. Suharto), the command economy (North Korea vs. South Korea), arbitrary personal rule (Mao Zedong vs. Hu Jintao), and other forms of behavior that are antithetical to the modern market economy.

Third, convergence in economic policy has been accompanied by some elements of convergence in systems of governance. So far, all of the fully successful industrialized Asian economies, from Japan to Indonesia, have adopted variants of democracy from fully competitive democracy (Taiwan, South Korea, Indonesia) to dominant-party democracy or quasi-democracy (Japan, Malaysia, Singapore). Those in earlier stages of development have all had to accept key elements of the Western system of governance, such as some degree of freedom of inquiry, increasing transparency, Western-style legal norms, reduction of arbitrary rule, and the like. But the degree to which China and Vietnam will be compelled to follow the paths of South Korea and Taiwan remains open to question.

Although the eventual degree of convergence remains quite controversial (can China and Russia sustain capitalist autocracies?), the degree that has already been reached constitutes a substantial triumph of Western norms. The argument can be made that, on the one hand, continued success on the part of the rising powers will require a good deal more convergence with Western political norms. On the other hand, the successful emerging economies may also develop competitive advantages that force traditional Western systems to bend some old norms. European-style pension systems and adversarial unionism are potential candidates for Darwinian decline, along with American-style lack of national infrastructure planning and low educational standards.

Finally, the balance of influence in all the major institutions of the post–World War II world—the IMF, World Bank, WTO, United Nations, and others—will have to shift; those institutions must either bend or break.

Crucial Uncertainties

Projecting economic growth is rife with uncertainties. A generation ago, many people believed that Japan's continued success would make it the world's leading economy. There are even greater uncertainties about how economic prowess will translate into geopolitical influence. A few of these uncertainties will be highlighted here.

Most obviously, both the success of the West and the rise of "the Rest" have depended on the steady progress of globalization. So long as globalization advances, the most open economies win, but by the same token, they will be the ones most damaged by a crisis of globalization. Singapore, Hong Kong, South Korea, and Taiwan would be devastated. The trend toward competing geopolitically on the basis of economic priorities rather than military ones would surely be reversed in many places. Raw materials producers would suffer severely from declining demand and radical price collapses. Financial markets would suffer catastrophic reversals, with the United States, Germany, and the United Kingdom probably hurt the most. The reverse sequence is also possible: the financial crisis that exploded in the late summer and early fall of 2008 could deal a serious blow to globalization, depending how quickly recovery proceeds and confidence in the financial system is restored.

A second great source of uncertainty is the impact of demographic differences. Many countries, including most of the rich ones, are graying, meaning that the number of productive workers is declining relative to the number of elderly retirees. In countries such as Japan, where there is resistance to immigration and radical domestic productivity reforms, graying implies relative economic, and probably geopolitical, decline. In the United States, tendencies toward graying have so far been more than offset by immigration and rising productivity.

The greatest contrast in approaches to demographic challenges is between India and China. India is betting on continued population growth to avert graying, but it has so far failed to provide the education and infrastructure to ensure that its large and youthful workforce will have the requisite ability to work competitively and productively. India's risk is that whole population segments and geographic regions will be left out of or prove unable to cope with global competition, and that severe social unrest will ensue. An indigenous Maoist insurgency is already taking advantage of popular disaffection in some of India's poorest states. China, on the other hand, has recently recommitted itself to a "one-child" policy (a partial misnomer) that ensures a rapid decline in the ratio of the working population to the nonworking. China is betting that rapid progress in education, infrastructure, urbanization, and globalization, combined with a relative reduction in environmental stress, will raise productivity and offset the effects of graying. These contrasting strategies comprise one of the most consequential bets in human history and may largely determine Asia's and the world's future economic and geopolitical balance.

A third source of uncertainty centers on energy and food prices. The 2008 upsurge proved a temporary phenomenon, but future spikes are possible once global growth resumes. The effects will vary enormously from country to country. Moreover, the long-term consequences of sustained high prices depend heavily on whether today's primary consumers compete destructively or, for instance, collaborate on clean coal technologies that could shift the economic and geopolitical balance away from the Middle East and toward the United States, China, and India. The world's future economic and political balance hangs on these multiple layers of uncertainty.

Finally, climate change is another great unknown. Desertification, declining fish populations, the melting of the polar ice cap, and other aspects of climate change are to the advantage of some groups economically, while giving the disadvantage to others, and will potentially cause political strife both within and between countries. Governments are already jockeying over competing claims to possible energy resources under the ocean floor, while access to water is an increasingly potential source of conflict across many parts of the world.

Despite these uncertainties, Asia's political evolution and economic success seem almost certain to bring new stability to key areas of the world by persuading its governments to selectively adopt market-oriented economic policies and substantial elements of Western-style political management. Such a transformation will gradually diversify the economic basis of geopolitical influence to an extent that permanently reduces Western dominance of global prestige and power. Paradoxically, the relative decline of the West represents the victory of what Singapore's Kishore Mahbubani calls key Western contributions to the "march to modernity": free markets, science and technology, meritocracy, pragmatism, a culture of peace, the rule of law, and education.

Issues for the New Administration

The rise of new powers and the failure of others to adapt create profound challenges for the new administration. First, continuation of the virtuous circle, whereby globalization creates economic takeoffs, and economic takeoffs in turn stabilize world politics, can only occur if the United States leads. But instead of celebrating their successes, Americans have fallen into a mood that assumes, falsely, that the United States cannot compete successfully against rising economic powers and that the emergence of new powers inevitably brings increased risks of violence and instability. If the current defeatism is not overcome, the United States will suffer disproportionately in any crisis of globalization. Reversing this defeatist mood will require strong, positive political leadership.

More specifically, the executive branch and Congress will have to work together to find new ways to distribute the fruits of globalization. Doing so will require major changes in tax, welfare, and education policies. There will also be a need for a Presidential campaign to educate the public about the changing global economy. The President will have to explain why Americans should welcome, rather than fear, rapid economic growth in China and India. He will need to point out, for example, that surging Asian demand for African energy and raw materials is boosting growth rates in Africa and reducing the risk that jihadism will spread throughout the continent.

Second, economic and geopolitical changes will challenge many assumptions and force many institutional changes. The governance of all major global institutions will have to be revised to accommodate the new powers. Otherwise, these institutions will become ineffective and discredited.

Third, the President will need to find ways to draw more of the Islamic world into the global economy. It was economic globalization that substantially ameliorated radical Islamism in Indonesia, Malaysia, and India.

Finally, there is no possibility that the United States will be able to extend its military dominance to every country in the world. It needs allies more than ever. But the U.S. alliance system will have to adjust to the relative decline of Japan, an important partner that in some ways is failing the test of globalization, and to the emergence of China, which is embracing globalization relatively well and which, despite its serious domestic challenges, will necessarily be a principal U.S. partner on a range of global issues.

Finance and Power

A critical challenge for the new administration will be to reassert American leadership in the international economy and rebuild America's financial health. Economic strength has underpinned the national power and influence of every state in history. Economic strength, in turn, is driven by a strong financial system, capable of raising large amounts of capital and efficiently deploying it. No nation has long maintained its strategic or military dominance after it has ceased to be the world's foremost financial center. If a nation allows its financial system to weaken, it undermines its economic strength, and by extension its ability to project its power and influence into the larger world.[1]

Wars put heavy stress on financial markets and fiscal resources and also put national prestige at risk. Great Britain learned this lesson going into World War II: when combined with economic depression, systemic fiscal and financial frailty, and a decline in the global power of one's currency, war can become a mile marker for hegemonic decline, even in victory.

To some extent, the costs of the conflicts in Iraq and Afghanistan also weigh down U.S. prospects for a quick economic recovery. Although the upfront costs of those wars and related military responses following 9/11 are far less than those of World War I, World War II, or the Vietnam War, they still are considerable, amounting to $859 billion thus far (or roughly 6 percent of GDP).[2] The price tag for rebuilding America's military forces in the wake of this conflict will add greatly to this figure.

In 1992, Clinton administration advisor James Carville said that in his next life, he wanted to come back as the bond market so that he could scare everyone. His comment, although framed as a joke, was a stark admission that finance was already driving U.S. policy and that no major decision could be made without taking the reaction of the bond market into account. When Carville made his comment, global financial assets, including the market for U.S. Government debt, totaled about $42 trillion, and the combined GDP of the world was $21 trillion. If these huge numbers worried Carville in 1992, he would likely be panic-stricken to face a world where financial assets are now over $167 trillion with a global GDP of $48 trillion. These numbers represent not only huge growth in a short time, but also a divergence of the financial market from the underlying real economy.

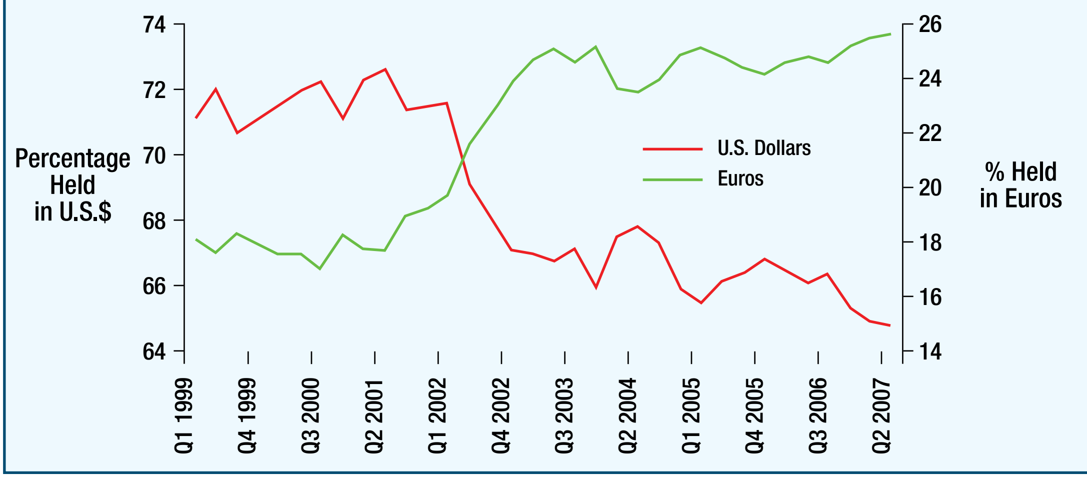
When Ronald Reagan assumed the Presidency, global GDP and financial assets were relatively equal. By the time Bill Clinton became President, the ratio of financial assets to GDP was 2:1, and by 2008 it was closing in on 4:1. How the United States adjusts to this rapidly changing and little understood world of global finance will determine its strategic influence in the 21st century.

Unfortunately, for at least the past decade, the United States has set itself squarely on the path of wrecking the financial system that has maintained its global prominence for the past seven decades or more. Drastic action is now required in order to change course in time, for once economic rot sets in, it is historically very difficult to reverse. If the United States is to have any chance of doing so, policymakers must first understand how the global financial system works and how much it has changed since Carville first voiced his trepidation about the bond market.

A number of measures reveal that America's leadership position in the international economy has gone through a remarkable period of decline over the last decade. This is best reflected by the value of the dollar, which from 2001 to 2008 depreciated by 56 percent against the euro, 30 percent against the Canadian dollar, 24 percent against the British pound, and 4 percent against the Japanese yen. Remarkably, although the trade-weighted value of the dollar against all currencies declined by over 23 percent in that period—which should have given U.S. exporters a large competitive boost—the U.S. trade deficit nearly doubled before exports began to rise in 2008.

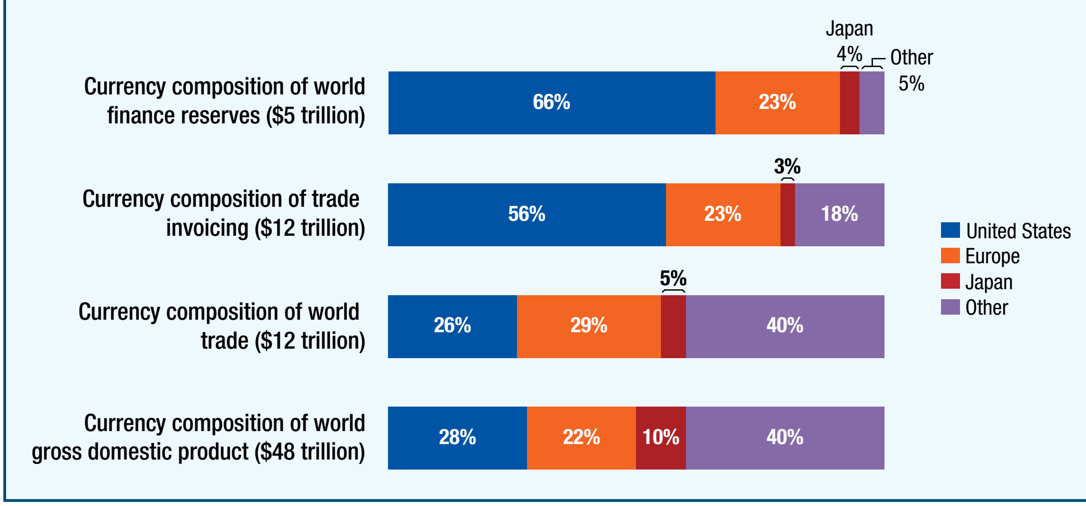
Likewise, the cheapening dollar is becoming progressively less attractive as a store of value for

Figure 1–1. Currency Composition of Global Foreign Exchange Reserves (percent)



Source: Independent Strategy Ltd.

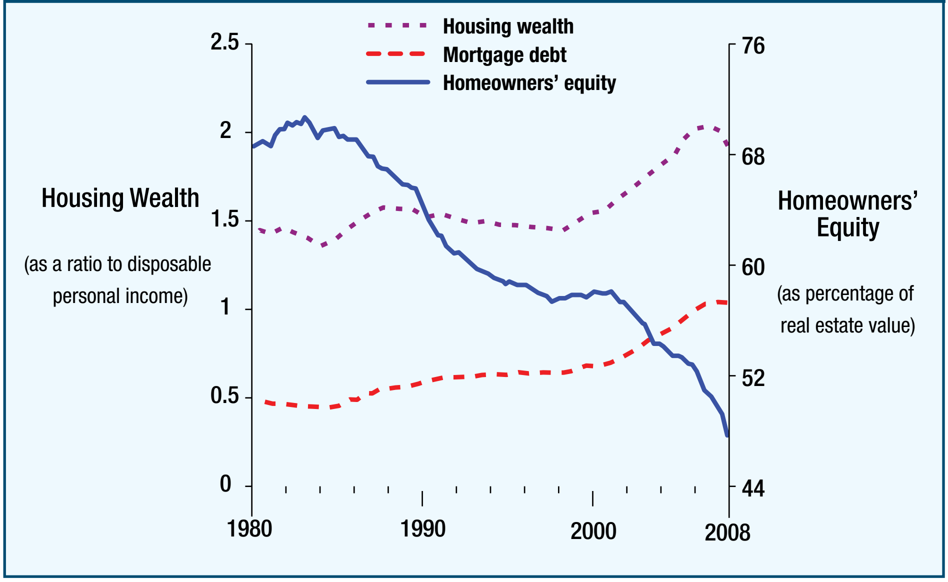
Figure 1–2. The Hegemony of the Dollar



Source: Independent Strategy Ltd.

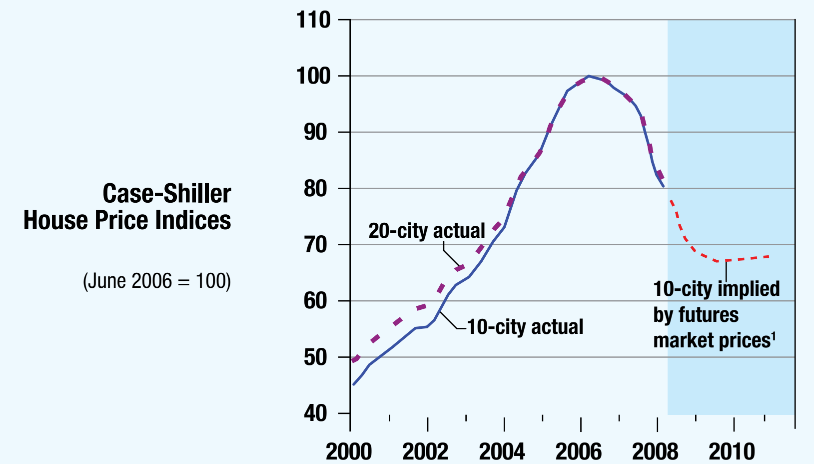
other central banks. Markets are already adjusting to the fact that a weakening dollar is being increasingly replaced as a reserve currency by a strengthening euro (see figure 1–1). Since the turn of the decade, reserve holdings of the dollar have fallen approximately 8 percent, while euro holdings have risen in rough proportion. Although the dollar remains the chief currency for global trade finance, this leading status has come under stress (see figure 1–2). Presently, the United States accounts for only about a quarter of world trade, while over half of global commerce is dollar-based. This strategic advantage could dissipate if confidence in its reliability as a storehouse of value slips further. As economist Barry Eichengreen notes, "Never before have we seen the extraordinary situation where the country issuing the international currency is running a current account deficit of 6 percent of GDP. Never before have we seen the reserve currency country so deeply in debt to the rest of the world."[3] By 2008, that ratio had fallen to 5 percent, but unless these trends are more substantially reversed,

Figure 1–3. U.S. Household Wealth



Source: International Monetary Fund/Haver Analytics.

Figure 1–4. U.S. Housing Prices



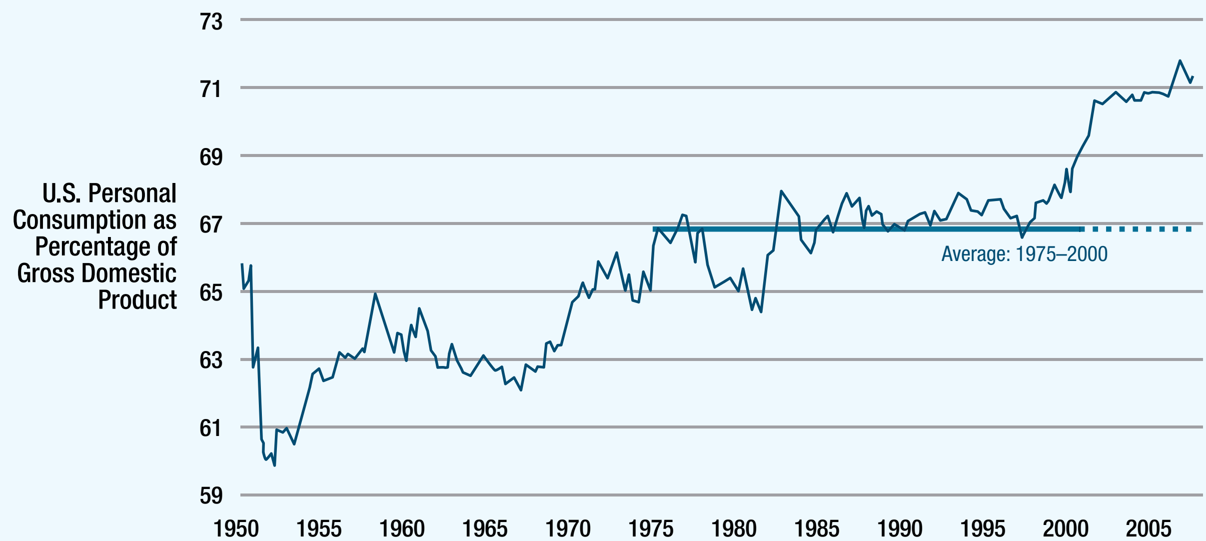
[1]*Illiquidity in market may lend a downward bias to prices implied by futures contracts*

Source: International Monetary Fund/Haver Analytics.

the dollar's dominant position in global trade will rapidly erode.

Making matters considerably more challenging, America's financial system and private finances have entered their darkest period in decades. In the last decade, Americans became more financially leveraged than at any time since World War II. Before the housing bubble burst in 2007, consumer and business debt had jumped by nearly 50 percent—twice the run-up experienced in the 1980s (see figure 1–3). Household mortgage debt accounted for the largest percentage of total private debt by far (see figure 1–4). In turn, the ready availability of subprime and adjustable rate mortgage financing drove a major increase in home ownership and sent property values skyrocketing. Consumers substituted these rising home values for savings, which at both the national and household levels are at 75-year lows. The abil-

Figure 1–5. The U.S. Consumption Binge



Source: Morgan Stanley Research.

ity to cash out home equity also drove a personal consumption binge of historical proportions (see figure 1–5). Even as the national savings rate turned negative, consumption accounted for ever greater amounts of GDP (over 71 percent in 2008). Consumption as a percentage of GDP reached 4 percent over its 25-year average, far higher than at any other point in American history.

In June 2007, the housing bubble burst. In the next 15 months, home prices fell by 7 percent nationally—the first sustained decline since the Great Depression. The housing crisis, in turn, triggered a string of bank failures. The first casualties were the large regional bank Indy Mac and the famed investment bank Bear Stearns. Unfortunately, in succeeding months, the Treasury and Federal Reserve still failed to get ahead of a crisis they hardly understood. Two U.S. Government–sanctioned institutions, Freddie Mac and Fannie Mae, saw their capital wiped out and had to be nationalized at a cost to the taxpayer initially estimated at over $200 billion.

Even those steps did not stem the tide. In September 2008, two more large investment banks vanished, and the world's largest insurance company was taken over by the Government. The details of the largest government-led market intervention in history were recently hammered out with Congress. As a result of these negotiations, the U.S. Government initially announced that it would begin recapitalizing the banking system through a combination of direct capital injections ($250 billion) and purchase of certain financial instruments ($450 billion) currently sitting on banks' books in order to set a price floor under the debt market.

In April 2008, the IMF estimated that the total cost of the U.S. subprime crisis could amount to over $1 trillion, but it is now clear that this was a lowball estimate. Worse still, the subprime blowout is buffeting other financial markets: the Standard & Poor 500 index fell to levels last seen in January 2001.

The U.S. Government can continue to backstop the market without imperiling its fiscal position, as a debt-to-GDP ratio of under 70 percent still gives financial officials some room to maneuver. It will become increasingly difficult, however, for the Government to absorb the costs of the largest financial bailout in history while dealing with slipping tax revenues, slower economic growth, and increasing public sector imbalances. It should be remembered that Japan went from having the best fiscal position in the Group of Seven (G–7) in 1990 to the worst in 2000, because, in response to its own financial and banking crisis, it mismanaged and delayed writeoffs and selloffs. Combined with the long-term funding challenges of entitlement programs such as Social Security and Medicare, the United States may be laying the groundwork for the emergence of an even worse financial crisis.

The implications of America's financial distress for the world economy are considerable, not simply because of the role that U.S. consumers play in driving global growth, but also because the entire global financial system has become leveraged to the U.S. household sector. This situation arose largely as a result of the explosive growth in financial instruments linked or leveraged to U.S. property markets, which were marketed heavily to foreign investors by U.S. investment banks. There were myriad strategies that offered apparently low risks and high returns (but, in hindsight, had high risk and potentially no positive return). These included "structured investment vehicles" that many banks used as a way to earn money off their balance sheet, arbitraging their ability to plow low-cost, short-term capital into longer dated and high-yielding asset-backed securities. These worked until the market for asset-backed securities imploded.

Another supposedly low-risk investment class was in collateralized debt obligations (CDOs), instruments issued by investment banks and backed by U.S. subprime loans, mortgage-backed securities, commercial mortgages, debt financing, and leveraged buyouts. Pools of CDOs were packaged into super-leveraged instruments called "CDO squared" or even "CDO cubed." Incredibly, these CDOs were given AAA ratings by the rating agencies, which implied almost no probability of default, because investors in CDOs had taken out insurance with bond insurers. Ironically, investors would learn, when it was too late to change anything, that these insurers had inadequate capital to cover a default, and that they would head toward bankruptcy themselves. Chasing these Ponzi-like schemes were pension funds, banks, insurance companies, and other supposedly smart institutional investors that bought into the assumption that financial risk could be largely engineered away. Many of these investors came to realize gigantic losses. Investment banks such as Citigroup, Bear Stearns, and Merrill Lynch that were involved in selling CDOs also got clobbered. With the market for selling CDOs gone, Merrill Lynch decided in July 2008 to liquidate its mammoth unsold inventory of CDOs at 20 cents on the dollar.

The financial crisis of 2008 revealed that perhaps the fastest growing segment in the rapidly expanding derivatives universe was also its most dangerous: credit default swaps. In simple terms, they are a type of insurance policy contracted between two parties, whereby one guarantees a payment to the other in the event of a default, in exchange for an insurance premium paid along the way. The Bank for International Settlements estimated that, as of the end of 2007, there was over $57.8 trillion in credit default swaps outstanding—a fourfold increase over the level at the end of December 2005.[4] Large financial firms such as the now-defunct Lehman Brothers and Bear Stearns issued massive amounts of these swaps to cover their myriad risks. Among the biggest buyers of these default swaps were the banks and insurance companies, which also had snapped up the aforementioned CDOs. The net result was that when Lehman and Bear collapsed, already beleaguered banks and insurers were left holding the bag, with an expected payout on the failure of Lehman's credit default swaps alone of over $365 billion.[5]

Today, the notional value of the derivatives market adds up to 976 percent of world GDP—a nearly tenfold increase since 1990.[6] In Berkshire Hathaway's annual report to shareholders in 2002, Warren Buffett pointedly described derivatives as "financial weapons of mass destruction." Buffett further commented:

Unless derivatives contracts are collateralized or guaranteed, their ultimate value also depends on the creditworthiness of the counterparties to them. In the meantime, though, before a contract is settled, the counterparties record profits and losses—often huge in amount—in their current earnings statements without so much as a penny changing hands. The range of derivatives contracts is limited only by the imagination of man (or sometimes, so it seems, madmen).[7]

As a result of the derivatives boom, financial distress in the U.S. household and banking sectors has been magnified globally, adding to the stresses facing European and Asian economies. The potential unwinding of the globalization of financial leverage threatens the success of economic globalization itself.

At risk is the almost-century-long U.S. primacy as the world's foremost financial power. If that primacy declines, economic growth will slow as capital becomes more costly and harder to obtain. Furthermore, as Cicero pointed out 2,000 years ago, the key to success in war is "endless streams of money." That remains as true today as it was then. If raising capital in vast amounts becomes harder, America's ability to finance the military forces it requires in the future will be more difficult.

The United States has always snapped back following times of economic doubt and apparent decline. The stagflation and stagnation of the 1970s produced in the wake of the Vietnam War, the 1973 oil shock, and the decisive break with the fixed exchange rate system were followed by the economic boom of the 1980s and victory in the Cold War. There is no reason to believe that recovery should be any different in the coming decade. But understanding the scope of the problems—and devising and implementing a strategy to solve them—will be imperative.

Noted economic historian Charles Kindleberger observed that nations that have turned back negative economic tides and emerged stronger from moments of seeming decline are those that possess flexibility and adaptability, rather than passivity and rigidity.[8] Americans are known for being flexible and adaptive. Unfortunately, however, the scale and scope of America's global economic and financial challenges are considerable and they will defy any easy or rapid solution.

Brave New World

What has happened to the American economy?

As of late 2008, four of America's great money center banks had ceased to exist, the entire banking system was going hat in hand to emerging economies to beg for multibillion-dollar bailouts, inflation was rising, housing prices had collapsed, thousands of people were losing their homes, and the U.S. Government had launched the largest market intervention in history. Meanwhile, the price of gasoline soared to over $4 a gallon before falling back to more normal levels.

Eventually, U.S. policymakers will hit upon on the right measures to stabilize the system, and markets will once again demonstrate their remarkable resilience. But a major lesson of the credit crisis is that the monetary and financial levers that policymakers have used for the past generation were rather ineffectual and in some case downright harmful. More importantly, these levers will become ever more obsolete with time, leaving the United States (along with the rest of the global economy) at risk of further financial shocks that will undermine our economic strength. And as goes the U.S. economy, so goes U.S. military strength and strategic influence.

To maintain the United States as the preeminent economic and financial power in the world (and by extension, a global military power), policymakers must come to grips with a financial system unlike anything in their prior experience. If they fail to grasp how financial markets have changed, it will be impossible for them to emplace the regulatory and oversight structure that will allow the financial system and the economy to adapt to future crises, which are sure to arise as the pace of innovation and change accelerates.

For the past two decades, the world of finance has mutated to the point that an investment banker from 1980 would not recognize it. Innovation has taken place at such a dizzying pace that very few outside of the world's money center institutions understand it at all. This is a remarkably dangerous situation. Policymakers, reeling from the public reaction to the 2007–2008 credit crisis, are promising increased regulation of an industry they do not even comprehend. Too many of them are apparently formulating policy based on the global financial system enshrined in the 1944 Bretton Woods agreements, which fixed exchange rates, established a new gold standard, and created the IMF and World Bank. Globalized markets killed off that orderly world some time ago.

Unfortunately, however, the relics of that era, in the form of the IMF and World Bank, still exist, and their global employees are constantly casting widely for a new mission. Detailing what is wrong with these two entities would fill many books. Suffice it to say that organizations designed to manage global finance and postwar reconstruction while the guns of World War II still pounded are finding it impossible to find relevance today. When they were created, the dollar was king, and a billion dollars was serious money even for Congress. Today, the dollar is in competition with the yuan, the yen, and the euro, in markets that move literally at the speed of light.

When the Bretton Woods agreements were signed, the widespread assumption was that international financial flows would roughly track trade and investment flows, as they had for centuries. International trade on the eve of the financial crisis was about $3.5 trillion a year, but currency flows are $2 trillion a *day*.

Just as financial markets have been diverging from the underlying economy over recent years, international currency movements have decoupled from trade and investment for the first time in history. This development has implications that rival the challenges faced by the Bretton Woods representatives in 1944. Yet hardly any strategists are studying the implications of these changes, an oversight that leaves a giant blind spot in U.S. strategic planning.

There are sure to be new regulations on the U.S. financial system in the wake of the 2007–2008 credit crisis. Before new rules are enacted, someone must step back and ask what effects they will have on a 24-hour trading book, which moves around the world as various markets open and close. Many problems currently plaguing the U.S. financial system, such as capital-draining "structured investment vehicles," are a result of earlier ill-considered regulations. In effect, any new U.S. regulatory regime that tries to constrain traders or place barriers in front of market liquidity can and will be circumvented by traders, who will just move their operations (or simply their domicile) into countries whose regulatory systems are more accommodating. Such "regulatory arbitrage" will further weaken U.S. dominance of the global financial system.

Structural Changes

The last two decades have witnessed a major structural shift in the global economy and a realignment of the relative influence of various countries. Nations that had spent decades on the periphery of the global economic and trading system, China in particular but also several others, are now critical production centers. Although several serious scandals have revealed that its product safety regulations are poorly enforced, China remains highly competitive.

In the years and months leading to the financial meltdown of 2008, a number of new players began to adopt asset allocation programs that shifted capital flows away from traditional avenues. (That is, there was less reliance on safe U.S. Government debt and a greater willingness to seek higher returns through investing in riskier assets.) Some of these new players, such as pension funds and hedge funds, have been part of the financial landscape for a while, but they now make up a much larger and more aggressive share of the market than in the past. Joining this trend toward accepting greater risk were the major banks, which were trading on their own account and employing significant leverage to do it, thus making themselves the functional equivalents of hedge funds.

Moreover, dozens of countries that are typically thought of as perennial debtor nations have now accumulated significant reserves of wealth. Through "sovereign wealth funds," the governments of these countries began to deploy their cash reserves over a range of asset classes and away from U.S. Government debt. In addition, the new players made greater use of highly leveraged and increasingly exotic financial instruments (derivatives), which have deeply altered the character and risk profile of the market in ways not sufficiently understood by policymakers or, in many cases, by the market participants themselves.

Implications

What has gone practically unnoticed in the ongoing credit crisis is the international role reversal that is occurring. As the developed world searches for solutions to the crisis, it is the emerging world that is riding to the economic rescue. In an unprecedented development, capital is flowing out of emerging nations and into the developed world, where it is being used to recapitalize the rich nations' foundering banking systems. In recent months, estimates place emerging nations' sovereign wealth fund investments in rich world banks at over $70 billion. It is worth remembering that it was only just over a decade ago that the financial collapse in Mexico, East Asia, and Russia prompted a call for the rich countries of the world to deploy tens of billions of dollars to contain those multiple crises.

Today, many of these same nations have used a decade of unprecedented growth, thanks in part to soaring oil prices, to build up substantial financial reserves that will have several major effects. They have partly immunized themselves against current

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and future financial crises because these reserves give them the means to defend their currency and cushion against any future period of adaptation. An almost unnoticed effect of this development is that the IMF, as it is currently structured, has lost its original raison d'être.[9] Emerging nations will no longer need IMF-coordinated bailouts that come with politically and often socially ruinous conditions attached.

Newly accumulated reserves, coupled with the increasing wealth of many persons in emerging nations (the middle classes of both China and India now exceed the entire U.S. population), will increase the amount of domestic consumption in these countries. This means that many of these nations will start shifting production away from exports and toward domestic consumers. This, in turn, will relieve pressure on politicians to implement new protectionist policies and will help reduce the U.S. current account deficit without having to further erode the dollar's value. Moreover, these nations will begin to break free of their reliance on the United States as their ultimate market as their future growth becomes increasingly driven by internal rather than external demand.

As these accumulated reserves exceed what emerging nations consider prudent cushions against exogenous shocks, they will be deployed through sovereign wealth funds into a variety of asset classes in pursuit of higher returns. This activity presents a new challenge to national security planners. Although such funds in and of themselves are not a *threat* in the classic definition of the term, they do introduce some major concerns if they are used for strategic advantage.

One concern is that sovereign wealth funds will not only seek superior returns, but also will be used to purchase strategic assets that will give the nations controlling these funds access to classified information and critical military technology, diplomatic power over weaker nations, and enhanced access to scarce resources. Moreover, there is a risk that some nations will use their intelligence services to help bolster the returns of the sovereign wealth funds. For instance, if Russia were again to use its control of gas pipelines to limit supplies to Ukraine or threaten cutoffs to Europe, an official might first tip off Russian fund mangers so that they can position themselves for the impact that such a move would have on the energy market. The potential interaction among intelligence services, sovereign wealth funds, and national banks strongly suggests that the United States should redouble its efforts to surveil global financial movements.[10]

What Must Be Done

The United States needs to reorder its policies and diplomatic initiatives to adapt to a world where economic power is shifting from the West to "the Rest," particularly Asia. This new and rapidly changing world will eventually require significant adjustments to the system that emerged as a result of the 1944 Bretton Woods Agreements:

- The United States must recognize that the economic power of many G–7 members has been eclipsed by several emerging nations who will have considerable impact on the future global economy. Either the G–7 has to be reorganized, or the United States must develop new structures that involve these new financial and economic powers as full members.
- The Federal Reserve has to complete a full analysis of the global financial system and get legislative approval for the use of new policy levers that are more finely tuned than current instruments and that will be more effective in the new environment. Moreover, the Federal Reserve and U.S. Treasury need to increase levels of international cooperation to ensure a more coordinated approach to future financial imbalances.
- The IMF and World Bank find themselves in an environment in which emerging nations do not need their services. The IMF is being made obsolete by emerging nations whose reserves are such that they can forego IMF funding and its stringent conditionality clauses. As for the World Bank, the amount of investment funds available to emerging nations through the capital markets dwarfs anything it can bring to the table. The best future for these institutions would likely be to have them reestablish themselves as facilitators of multilateral restructuring endeavors. In effect, they would use their technical expertise and international reputation to provide support and political cover for policymakers to undertake required structural adjustments that might otherwise be politically difficult to enact without the backing of a multilateral institution.
- The financial plumbing (back room operations) and risk management processes of all major players in the global financial system need to be upgraded and made more transparent through appropriate regulation.
- Concerns over the use of sovereign wealth funds must be addressed before they kick off a destructive round of financial protectionism and/or increased regulation aimed at limiting global capital flows. Either one of these outcomes would unleash a dangerous reversal of the globalization process, which has raised the living standards of several billion people. As a starting point, managers of these funds need to sign off on an internationally negotiated code of conduct and become more transparent in their activities.

Prospects

Such radical changes in the U.S. and global financial systems will be hard, but they will inevitably be made. The question is whether they will be accomplished in an orderly manner or forced on policymakers in the face of another crisis. As matters stand now, policymakers are trying to deal with the "brave new world" of finance without any real understanding of how the old world is evolving. Even as the 2008 financial crisis is forcing adjustments on its participants, policymakers must undertake a thorough analysis of what the crisis signified, how the financial system is changing, and where it is likely to go.

Once that analysis is complete, strategists can begin to analyze and understand how the developing financial environment affects national security now and in the future. Only then will policymakers be able to get ahead of these changes and avoid reacting to them in ways that further damage America's financial health.

Economic Security

Challenges

Many states are not capable of providing conditions in which the bulk of their citizens can achieve an adequate degree of economic security. Economic insecurity implies poverty so pervasive and persistent that it breeds a wide array of social and personal ills: child malnutrition, low life expectancy, limited education, and little potential for a better future. Societies burdened by economic insecurity are more likely than others to experience civil war and cross-border conflict.

Although there are pockets of such insecurity in most societies, in approximately 60 countries a large majority of people are stuck in these conditions. Their societies are too poor for the redistribution of assets to solve the problem. And they remain stuck because, for the past 40 years, per capita incomes have been practically stagnant. The combined population of these 60 countries is around 1 billion people, sometimes referred to as "the bottom billion." Seventy percent of them live in sub-Saharan Africa. The extent of global poverty is, of course, much wider than just the bottom billion; for example, there are still many poor people living in China and India. There is a strong case, however, for focusing the efforts of the developed world on the bottom billion.

First, a key difference between being poor in China and being poor in Chad is whether a credible basis for hope exists. A poor family in China has reason to hope that its children will grow up in a society that is economically transformed. In contrast, based on the past 40 years' experience, a poor family in Chad does not have good reason for such hope. The critical task is to provide credible hope to such people.

Second, many countries inevitably experience adverse shocks that inflict harm on economically insecure people, who then require assistance from the state. In the societies of the bottom billion, however, the state itself is impoverished and usually ineffective. Hence, these countries are prone to humanitarian crises that can only be addressed by rapid international intervention. Increasingly, thanks to global media coverage, the citizens of developed countries expect their governments to act, but budgetary and logistical restraints sometimes stymie rapid action. The military is the main governmental organization capable of rapid, large-scale delivery of relief supplies, but recipient governments sometimes resist the entry of foreign military forces, even for humanitarian purposes. In 2008, for example, the Burmese government refused to permit Western military ships and aircraft to deliver relief supplies to victims of a devastating cyclone.

Third, because most citizens of the poorest nations are economically insecure, the state becomes politically insecure. For example, we now know that in years of poor rainfall, the risk of a civil war increases. This may be because rebel organizations find it easier to recruit when conditions get desperate. Once civil wars start, they tend to continue for about a decade, further damaging the economy and thus compounding the problem of insecurity. Where rebellion is easy to ignite, hostile neighboring states tend to use it as a form of clandestine international warfare. For example, for many years Uganda and Sudan engaged in low-level international warfare by supporting each other's rebel groups.

In some cases, the weak state becomes a tempting target for neighbors, as was the case with the Democratic Republic of Congo (formerly Zaire). Taking advantage of Zaire's vicious civil war between the postcolonial dictatorship and a popular insurgency, neighbors Rwanda and Uganda contributed forces that first helped topple the regime and then went after its successor. Several other countries threw their weight in as well, and the fighting spread across the region, devastating already weak societies.

Until the end of the Cold War, the international community was not in a position to intervene to end such wars, and as a result the rate at which they started exceeded the rate at which they stopped. By the end of the 1990s, the international community had succeeded in bringing some pressure to bear to resolve these conflicts, and by the turn of the millennium many were settled.

Unfortunately, postconflict situations are typically even more fragile than the preconflict societies of the bottom billion. In the past, 40 percent of all postconflict situations have reverted to conflict within a decade. The typical postconflict society is critically impoverished, and its state institutions are ineffective.

Afghanistan is one example. There are currently over 100,000 United Nations (UN) peacekeeping troops serving in postconflict situations around the world. Hence, the insecurity of the 60 or so countries housing the bottom billion poses an important security challenge for developed countries.

The fourth, and most basic, reason for focusing on the countries of the bottom billion is that by better understanding them, the developed world will be better able to do something about them. In the past, because these countries have been individually marginal, they have been neglected as a group.

Reasons for Failure to Develop

Most developing countries have done just that: develop. There is no one overarching explanation of why some 60 nations of the world have stagnated.

One problem is the lack of accountability in government. Even where elections are held, the elites who run in them have learned how to game them with a mixture of bribery, ballot fraud, and intimidation, as happened in Kenya and Zimbabwe in 2008. Because governments have avoided being accountable, they are not forced to provide effective economic policies.

The problem of unaccountable government is particularly severe in countries with large revenues from exports of valuable natural resources. Potentially, this is an opportunity for transformation, but because the revenues accrue to the government, harnessing the opportunity for development depends on good governance. To date, the possession of valuable resources has usually proved to be a curse. Nigeria, a major oil exporter, is probably the most obvious example: by any reasonable counterfactual, its citizens are now poorer than they would have been if oil had not been discovered there 40 years ago. The key problem is that valuable resources controlled by the government become a honeypot contested by different groups, usually organized along ethnic lines. Not needing broad-based taxation, the state never provokes citizen scrutiny; in many cases, mechanisms for such scrutiny do not exist. Rival elites jockey for power, divorced from the interests and concerns of ordinary citizens.

At a deeper level, the problem is that these countries are structurally insecure. On the one hand, many African countries are too large to be unified by a sense of nationhood, in that their citizens identify more strongly with subnational ethnic and religious groupings than with the nation. This situation is a result of the artificial borders imposed by the European colonial powers, without regard to historical tribal and ethnic boundaries, during the land grabs of the 18th and 19th centuries; Kenya is an example. On the other hand, the countries of the bottom billion are too small to be effective states. They have tiny, typically agrarian and extractive economies—often smaller than a medium-sized American city—and so cannot reap economies of scale in the provision of key public goods such as military security.

A further problem is geography. Many of the poorest countries are landlocked, which makes it difficult for them to integrate into the global economy. Their access to major roads and ports may depend on hostile neighbors; for example, Ethiopia cannot use the closest port because it lies in Eritrea, which is a bitter enemy. Many of them suffer from widespread disease (notably malaria and AIDS), which drains manpower and resources and thus inflicts high economic costs.

Issues Deserving Early Attention

The international community has four policy instruments for dealing with these problems: foreign aid (publicly funded development assistance); trade policy; military security; and rules and codes of governance. To date it has relied excessively upon foreign aid relative to the other three. Multilateral leadership in the provision of foreign aid has shifted from the United States to Europe and Japan: for example, Britain now provides the most money for the World Bank's International Development Association, which is the main multilateral source of grants and soft loans for the world's poorest countries.

Trade policy has never been effectively focused on the poorest countries; the WTO is basically a bargaining forum in which the countries of the bottom billion have little influence and the developed countries have other priorities than assisting them. The international provision of military security has lurched between excessive caution, as in Rwanda, and military intervention, as in Somalia and Haiti. The international provision of rules and norms of governance has largely bypassed the countries of the bottom billion: the ruling elites have preferred to protect their power by hiding behind national sovereignty, and the international community has not assigned a high priority to overcoming economic security.

Although there is plenty of scope for using all four policy instruments more effectively, four issues seem ripe for action.

Improving the Conduct of Elections. Three recent African elections (Nigeria in 2007 and Kenya and Zimbabwe in 2008) have all been fiascos. Kenya and Zimbabwe were such high-profile disasters that they provoked international outrage and eventual intervention by members of the African Union. The African Union alone is unlikely to resolve the problems entirely, however, because it harbors too many vested interests in preserving business as usual. While international action in support of democratic institutions is necessary, the United Nations is unlikely to be a viable route because China routinely opposes any action that it believes infringes on national sovereignty; in the case of Zimbabwe, for example, Beijing blocked proposed UN Security Council decisions aimed at putting pressure on the Robert Mugabe government to honor the country's election laws.

The international community has probably oversold elections relative to other important attributes of good governance, such as the rule of law and financial transparency. Because elections are such high-profile events, they have come to be seen as the defining feature of good governance. It would be helpful to shift the prestige away from elections per se, to elections that are reliably judged to meet international standards.

On this issue, it should be feasible to get Europe, Japan, and the large emerging market democracies such as India and Brazil to be supportive. A possible way forward is to encourage a "democracy club," not in the form of a military alliance such as the North Atlantic Treaty Organization, but rather as a group committed to enforcing democratic standards and norms among its own members. Countries that claimed to be democracies could join, thus committing themselves to certain minimum standards. Their electoral performance would then be monitored by election supervisors.

The principle of supervised elections is already well established, but at present there is no coordinated assessment. (The European Union conducts an official assessment, but no larger group does so.) Nor is an adverse assessment linked to any consequences, such as expulsion from a group; the worst that an offending government can expect is international condemnation. Whether such an approach can work would depend in part on whether governments other than established democracies chose to sign up to the commitments. It can be assumed that some would. For example, President Mwai Kibaki of Kenya would probably have committed himself to signing when he was running for office in 2002 in order to reassure voters of his willingness to abide by democratic norms.

However, elections, even if well conducted, are not enough to guarantee real democracy; it is important to supplement them with checks and balances on government power. In some societies, elections can

AP Images (Chen Xiaodong)

Workers process piles of carrots in China as wholesale market price hit lowest point in 15 years be polarizing because leaders have yet to build a sense of common nationhood. Nevertheless, improving the conduct of elections is both highly topical and supportive of many other reforms, and so it is a good place to start the long process of making democracy work.

Securing Postconflict Societies. Postconflict societies are fragile. Currently, there are a lot of them, so developed countries should do what they can to avoid a repeat of past disasters. For example, southern Sudan may well head back into war.

Three types of actor determine whether postconflict situations result in a durable peace: providers of peacekeeping troops, providers of postconflict aid, and postconflict governments. The actions of these three are mutually interdependent. Prolonged peacekeeping is needed to create an environment in which development assistance can work. Peacekeeping is effective in radically reducing the risks of further conflict, but to date it has been conducted in a hit-and-miss manner. Postconflict aid for reconstruction can foster the economic growth that provides a workable exit strategy for peacekeepers. Even where postconflict aid is effective, however, often it is allowed to taper off too soon.

Decent governance, including the reform of bad economic policies imposed during wartime, is also necessary for rapid recovery. All too often, postconflict governance is weak, corrupt, or more dedicated to revenge and spoils-taking than rebuilding a damaged nation. The Peace-Building Commission of the United Nations, established in 2005, provides a possible forum in which these mutual responsibilities could be recognized. It established a form of compact analogous to the UN Global Compact founded by Secretary-General Kofi Annan in 2000, which links corporate behavior to 10 universally accepted principles of human rights, labor standards, environmental protection, and anticorruption measures. Together with some minimum standards and norms, the mutual recognition of responsibilities would provide a mechanism to improve the management of postconflict situations.

Guiding the Commodity Booms. The commodity booms taking place in some African countries present an opportunity to alleviate economic insecurity. Angola alone is getting more money in oil revenue than the entire stock of foreign aid flowing to the 60 or so poorest countries. The recent fall in prices shows that the large pulse of income was mainly temporary, and so it is vital to save and invest it rather than simply increasing consumption in an unsustainable way. Much of the recent revenues have yet to be spent and so the decision as to how to use the revenue will be taken in the coming months. It is vital that the history of mismanagement not be repeated. Brave people in these societies are struggling for change and the key decisions are being taken now.

The developed democracies can help the forces pressing for reform by establishing voluntary international standards and codes that can be used to guide economic decisions. One such code, the 2002 Extractive Industries Transparency Initiative, has already prompted 23 governments to pledge adherence to a standard of revenue reporting. There is an urgent need to build on this success with new codes that focus on how revenues are used.

Harnessing Social Enterprise for the Delivery of Basic Services. In recent years, there has been a huge growth in social enterprise, especially in the United States. This kind of initiative has the potential to deliver basic social services in those environments where government provision has broken down beyond immediate repair, as in Liberia. Currently, there is no organizational model that connects publicly funded development assistance with social enterprise on a national scale, in a way that could transform the provision of basic services in such societies. Such aid tends either to remain channeled through traditional agencies of government or to be provided piecemeal and in an ad hoc fashion to particular initiatives. There is an urgent need to develop a 21st-century model of social funding acceptable to and inclusive of government. It should create genuine, measurable competition among different social entrepreneurs seeking funds. And it should be capable of pooling aid inflows from public *and* private donors and directing them on a sustainable basis to the purchase of services for ordinary citizens in the most difficult environments.

The developed world has a range of policies with which to tackle the problems of the bottom billion, yet to date they have not been coordinated. U.S. operations have often demonstrated how detached military policy was from the development instruments needed to rebuild a poor country's postconflict infrastructure. The same could be said of the other three instruments: foreign aid, trade, and codes of governance. Sometimes the United States has overrelied on the military, sometimes on aid. It has tended consistently to underplay trade and governance codes.

Coordinating all these instruments would not only promote poverty relief, but also reduce the likelihood of further civil wars and cross-border conflict. Usually, difficult situations require a package of policies. Only heads of state can bring about such a profound change in political and bureaucratic culture. A shared commitment to launch such a coordinated initiative has become increasingly urgent.

Protectionism

The promotion of protectionism in the U.S. Congress and in the public at large has reached the point where it seriously threatens America's strategic interests as well as its economic leadership. An immediate challenge facing the U.S. administration is to channel the political pressures fueling protectionism away from broadside attacks on trade expansion and other forms of international economic engagement and toward the enactment of meaningful measures to help U.S. workers and companies adjust to rapid globalization.

Why Protectionism Harms U.S. National Security

Protectionism is usually seen as a trade issue best left to trade negotiators and their counterpart committees on Capitol Hill. But protectionism should also be seen as a national security issue because it endangers U.S. domestic and global security interests in a variety of ways:

- Protectionism undermines the image of the United States as a global leader. It belies the generosity, openness, and optimism once associated with postwar American leadership.
- Protectionism damages U.S. relations with allies and friends. Since the United States preaches free trade and aggressively pursues the opening of markets for its own products and services, protectionism fuels charges of hypocrisy and double standards.
- Protectionism deprives poor people in developing countries of the chance to compete. It stunts job creation in those countries, thus undermining the stability of governments still struggling to consolidate legitimacy. The prospect of long-term unemployment makes it more likely that frustrated young people, especially men, will take to the streets or join radical movements.
- Protectionism gives other governments an excuse to delay opening their markets and provokes retaliation against U.S. exports, thus stifling U.S. job growth in the most competitive sectors of the economy. By shielding the weakest companies within a given sector, protectionism effectively punishes more competitive ones. By reducing competitive pressure, it slows the drive to improve productivity and develop more advanced technology.
- Protectionism sets a poor example for governments striving to make a transition away from socialism and find a niche in the global economy. These governments face stiff resistance from vested interests, who seize on protectionism elsewhere in the world to shield themselves from competition.
- Protectionism limits choices that would otherwise enhance U.S. military capability. "Buy American" and other protectionist laws and regulations impose costly procurement requirements on the U.S. Armed Forces and preclude purchase of the best products, technologies, and services.
- Protectionism contributes to inflation and harms the poor because it makes imports more expensive and thus raises the price of basic items such as clothing and shoes.
- Export protectionism (restricting certain exports on national security or other grounds) burdens U.S. high-tech companies, creates political tensions with other governments, and hampers military-to-military cooperation.
- Investment protectionism discourages the inflow of foreign capital into key sectors and inspires or reinforces corresponding barriers to U.S. investment abroad.
- Incoming-visitor protectionism (the denial of visas to would-be visitors and students) creates much ill will and reinforces the widespread view that Washington overreacted to 9/11.

Declining Political Support

Examples of protectionism in 2008–2009 include the insertion of "Buy American" language in President Obama's stimulus bill; congressional resistance to a major free trade agreement with South Korea; calls to postpone or reopen other free trade agreements negotiated in good faith, including the North American Free Trade Agreement (NAFTA), signed in 1993; efforts to halt or retard the offshoring of U.S. jobs by threatening to impose tax penalties on offending U.S. companies; opposition to certain incoming foreign investment bids; and alarm over the perceived threat posed by sovereign wealth funds (funds held by governments or government-affiliated entities). The combination of agricultural protectionism at home and aggressive market-opening demands on poor countries partially contributed to the 2008 collapse of the ongoing Doha Round of multilateral trade negotiations under the auspices of the WTO.

More damaging in the long run, perhaps, is that Congress has refused to renew the procedure, formerly known as "fast track" and now called Trade

Promotion Authority, which effectively permits the President to negotiate new trade agreements. In 2008, a dispute between Congress and the White House over the proposed U.S.-Colombia free trade agreement became so hostile that the White House submitted the agreement without the usual consultation, prompting the leadership of the House of Representatives to revoke Trade Promotion Authority's time-honored procedural rules.

Not all trade restrictions should be labeled protectionist. WTO rules permit the temporary imposition of import restrictions, known as safeguards, to cope with sudden import surges. Certain other agreements permit the use of trade limits in response to subsidies, violations of intellectual property, and other trade-distorting measures. Governments can invoke national security to block certain imports or to restrict foreign investments in militarily critical industries. New issues are arising that may justify expanding the scope of existing trade-limiting measures, such as disease control and climate change. Legislation calling for steep duties on imports from China to offset its determination to restrain the pace of currency appreciation is in a category by itself; some economists with impeccable free trade credentials support congressional action to impose a corresponding tariff on Chinese imports.

But leaving aside these exceptions, U.S. political support for engagement with the global economy in general has eroded so badly in the last 15 years or so that Congress has bottled up new agreements or passed them by a handful of votes after fierce and divisive debate. This hostility to deeper international economic engagement has spilled over into investment and finance.[11] Meanwhile, the list of technologies, systems, and components requiring U.S. export licenses remains too long despite decades of effort to narrow it down to truly critical items. U.S. military commanders complain that the unnecessary classification of entire systems impedes their ability to conduct joint exercises and training with other countries' forces.

The international scene is not promising either. As of 2009, the Doha Round was likely to fall far short of its original goals even if negotiators revived it. A trans-Pacific free trade area, originally adopted as a goal by the leaders of the Asia Pacific Economic Cooperation (APEC) forum in 1993–1994 and endorsed by President George W. Bush and others in 2005–2006, is still in the study phase. A few U.S. bilateral and regional trade agreements have been negotiated and ratified, but others have run aground. The most important of those still awaiting congressional approval is the Korea-U.S. free trade agreement, which would be the largest single trade deal since NAFTA.

Causes of the Protectionist Upsurge

Growing doubts about the benefits of international economic engagement reflect a general loss of American faith in U.S. competitiveness. According to one series of polls, 10 years ago, 58 percent of Americans thought that growing engagement in the global economy was "good" (because of new markets and jobs associated with exports), as opposed to "bad" (because of unfair competition and cheap labor). By December 2007, that figure had dropped to 28 percent.

Current economic conditions contribute to the new pessimism. Prior to the current financial crisis, these included long-term wage stagnation and a decline in the number of manufacturing jobs, white-color layoffs, record U.S. trade and current account deficits, spikes in food and energy prices, soaring health care costs, and the huge income gap between the working class and the super-rich. Many blamed these trends on the globalization of production of goods and services and the spectacular rise of Asia, particularly China. Adding to the malaise are massive job losses, foreclosures, and business failures stemming from the severity and expected duration of the financial crisis.

Jobs. The most powerful driver of U.S. protectionism is the actual or feared loss of U.S. jobs, particularly in the manufacturing sector. It is a political fact of life that the jobs lost to import competition or outsourcing are far more visible than the jobs created either by imports (port services, retail, distribution, trucking, insurance, and so on) or by new export opportunities.

Like other industrialized countries, the United States has experienced a long-term increase in manufacturing productivity, and consequently a long-term decline in manufacturing employment. In the period 1940–2000, the proportion of workers employed in manufacturing declined from 32 percent to just below 13 percent, while manufacturing output increased elevenfold.[12] Wage stagnation, which began 10 to 15 years before NAFTA, has fed a widening income gap between blue-collar workers engaged in manufacturing and those in the higher end of the services sector.

Trade Deficit. In the last few years, the U.S. trade deficit has soared to record levels, cresting at over 6 percent of GDP in 2005. As long as Americans consume more than they produce, and invest more than they save, they will necessarily depend on imports to fill the gap. They pay for these imports by sending dollars abroad, putting huge piles of dollar-denominated assets into foreign pockets.

Much of the trade debate seems to rest on the obsolete assumption that goods are produced in one country alone. Most Americans, for example, would assume that a product bearing the label "Made in China" was wholly manufactured there. In reality, one-half to two-thirds of Chinese exports consist of imported materials and components. A similar proportion of China's exports are produced by foreign-invested enterprises investing in China, with or without a local Chinese partner. In 2007, for instance, almost half of what the United States imported from China flowed between parent companies and their subsidiaries. In other words, bilateral U.S.-China trade statistics disguise both the role of U.S.-based multinational companies and the region-based content of China's exports.

Even less well understood is the highly linked nature of trade and investment. Well over half of China's exports are produced by multinational companies, either alone or in joint ventures with Chinese partners. According to the U.S. Census Bureau, in 2007 trade between parent companies and subsidiaries accounted for 29.6 percent of U.S. exports (China was eighth on the list) and a whopping 47.4 percent of U.S. imports (China was fourth on the list).

In the year following the outbreak of the credit crisis in 2007, trade accounted for roughly three-quarters of U.S. growth.[13] The low value of the dollar stimulated a U.S. export boom and helped to keep an otherwise reeling economy growing. But this clear illustration of the value of trade evidently did little to dispel the appeal of protectionism.

Protectionist Rationale. The *-ism* in the world *protectionism* suggests an ideology of sorts, a systematic set of ideas and goals. But the people seeking protection from competition represent widely different interests; textile and apparel workers, for example, have little in common with sugar growers.

What unites protectionist forces is a sense of unfairness. It is only natural for people who lose their jobs to feel upset. But when lobbyists who represent them come to Washington, they tend to embed job losses in a broader narrative that runs something like this: Americans play by the rules, but foreigners do not. Americans are naive, but foreigners are sophisticated. Americans are willing to compete on a level playing field, but that field is tilted against them. Americans believe in decent wages and working conditions, but foreign workers are willing to put up with exploitation. Because of this inherent unfairness, Americans have lost tens of thousands of jobs.

In some cases, the argument goes, national security is at stake. The United States is very vulnerable. We should not allow foreigners—even friendly ones—to acquire an influential role in any sector that is vital to America's military self-sufficiency. Whereas American companies are market-driven, foreign companies may become tools of their governments, whose hidden goal is to acquire and exercise political leverage. And if foreigners win a major defense contract, American military forces would become dangerously dependent on others and might not be able to operate freely in wartime.

When it comes to particular industries, this rationale attracts bipartisan sympathy. At a rhetorical level, one political party extols free trade and the other rallies around "fair trade," but that contrast quickly blurs when specific complaints arise. The Congressional Steel Caucus, for example, contains members of both parties. The result is a form of mercantilism: one-sided rhetoric that aggressively promotes exports abroad but justifies protection at home.

Priority Issues for the New Administration

Holistic Strategy versus Stovepipe Decisionmaking. The new administration needs to draw up a comprehensive, Government-wide strategy that integrates both military and economic components of U.S. foreign and domestic policy and deals with protectionism in that context. Such a holistic approach is particularly urgent in the case of U.S. policy toward Asia, where economic and security perspectives go hand in hand.

Implementation of such a strategy should be designed to overcome traditional stovepipe decisionmaking, which perpetuates turf battles and segregates decisions that ought to be made within a broad strategic framework. The new President should signal his intentions by revamping the staffing and organization of the National Security Council to fully reflect the intersection of political-economic and political-military issues. Decision memoranda brought to his desk should routinely incorporate both perspectives. He should also direct the relevant departments and agencies to ensure that trade policymaking is consistent with broad strategic concerns; narrow the scope of export controls and visa denials; and improve the review of incoming foreign investments by developing and applying key judgments consistently, such as degree of dependence, foreign availability, and industry concentration, among others.[14]

Embedding responses to protectionism in a broad domestic and strategic context means paying more attention to the legitimate political and economic needs of poor and middle-income countries. The result will be a negotiating posture that is a little less demanding, less fearful, and more generous.

Calibrating the new approach with the demands of good trade policy should not go too far. Many domestic reformers in other countries rely on American pressure to strengthen their case for carrying out needed changes in economic policy. Similarly, foreign entrepreneurs whose opportunities are currently blocked by domestic protectionist measures that favor vested interests would not support retaining the commercial status quo.

The main obstacle to such a shift in the tone and content of the U.S. negotiating posture is Congress. A new international economic policy will be dead on arrival unless the President and his top officials reach beyond trade subcommittees and appeal to a broad spectrum of members. They must justify the policy shift as a key element of a global national security strategy. They should point out, for instance, that a "kinder, gentler" trade policy would provide a constructive counterpoint to China's highly successful commercial diplomacy.[15] At the same time, they must bracket trade expansion with a far-reaching, comprehensive package of adjustment measures.

Comprehensive Domestic Adjustment. The long-term solution to protectionism lies in better education and domestic adjustment measures such as portable pensions, affordable health care, some form of wage insurance, and lifetime learning for all workers, not just those affected by trade. New legislation will require substantial efforts to overcome the current congressional gridlock. But since many Members of Congress are sympathetic to domestic adjustment measures and dislike having to cast trade votes, prospects are reasonably promising.

Ratification of Korean-U.S. Free Trade Agreement. The controversy surrounding the Korean-U.S. (KORUS) free trade agreement, and especially a dispute over the safety of eating American beef, has inflamed Korean public opinion and hobbled President Lee Myung-bak's ability to work constructively with Washington. The United States should not walk away from an agreement negotiated in good faith with an important ally. The President may have to include KORUS in some kind of package deal to get it ratified. Passage of other trade agreements will probably depend on the vigor of the initiatives recommended above.

Revitalization of the Multilateral Trading System. Bilateral free trade agreements are no substitute for global and trans-Pacific trade liberalization. They effectively penalize countries that are left out. Complex rules of origin requirements are particularly burdensome for small countries. Wrapping up the Doha Round of multilateral trade negotiations should be the top priority, followed by trade and investment liberalization across the Pacific. Rather than spending political energy pushing for a trans-Pacific free trade agreement all at once, Washington has wisely decided to join the trade-liberalizing Transpacific Strategic Economic Partnership, initiated within APEC by Brunei, Chile, New Zealand, and Singapore.

Reducing protectionism to a politically manageable level is a strategic imperative. Telling people that "open markets are good for you" just does not work. Devising a multifaceted domestic adjustment policy, embedding trade and investment policy in a broader strategic policy framework, and explaining these vitally related initiatives to a skeptical Congress and the public are strategic imperatives. **gsa**

NOTES

1 An efficient financial system can make up for a number of other strategic deficiencies. For instance, France, during the Napoleonic era, was more populous and had a far larger economy than Great Britain. Throughout the Napoleonic Wars, however, Britain consistently raised more capital than France—cash that William Pitt used to fight a global war, while also subsidizing most of Britain's continental allies. It stands to reason that the opposite—that weak financial institutions undermine a nation's strengths—is also true.

2 With enactment of the Fiscal Year (FY) 2008 Supplemental and FY2009 Bridge Fund (H.R.2642/P.L. 110–252) on June 30, 2008, Congress approved about $859 billion for military operations, base security, reconstruction, foreign aid, Embassy costs, and veterans' health care for the three operations initiated since the 9/11 attacks: Operation *Enduring Freedom* (OEF), for counterterror operations in Afghanistan and elsewhere; Operation *Noble Eagle*, to provide enhanced security at military bases; and Operation *Iraqi Freedom* (OIF). This $859 billion total covers all war-related appropriations from FY2001 through part of FY2009 in supplemental appropriations, regular appropriations, and continuing resolutions. Of that total, the Congressional Research Service (CRS) estimates that Iraq will receive about $653 billion (76 percent), OEF about $172 billion (20 percent), and enhanced base security about $28 billion (3 percent), with about $5 billion

that CRS cannot allocate (1 percent). About 94 percent of the funds are for DOD, 6 percent for foreign aid programs and Embassy operations, and less than 1 percent for medical care for veterans. As of April 2008, DOD's monthly obligations for contracts and pay averaged about $12.1 billion, including $9.8 billion for Iraq and $2.3 billion for Afghanistan. See Amy Belasco, *The Cost of Iraq, Afghanistan, and Other Global War on Terror Operations Since 9/11*, CRS Report RL33110 (Washington, DC: CRS, July 14, 2008).

[3] Barry Eichengreen, "Is the Dollar About to Lose its International Role?" April 14, 2005, available at <www.econ.berkeley.edu/~eichengr/reviews/handelsblatt5apr29-05.pdf>.

[4] See Statistical Annex to Bank for International Settlements Quarterly Review, September 2008, 103, available at <www.bis.org/publ/qtrpdf/r_qa0809.pdf>.

[5] Heather Landy, "Lehman Credit-Default Swap Payout Could Climb as High as $365 Billion," *Washington Post*, October 11, 2008, D3.

[6] "The New Monetarism and the Credit Crunch," October 20, 2007, Independent Strategy, London.

[7] Berkshire Hathaway, Inc., 2002 Annual Report, available at <www.berkshirehathaway.com/2002ar/2002ar.pdf>.

[8] Charles Kindleberger, *World Economic Primacy, 1500–1900* (Oxford: Oxford University Press, 1996), 36.

[9] The original purposes of the IMF, listed in Article I of the IMF's Articles of Agreement, include "to promote exchange stability," to provide fund resources to members "to correct maladjustments in their balance of payments," and "to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members." Today, private capital markets dwarf IMF resources.

[10] Note that neither of these potentialities is currently being manifested by any sovereign wealth fund.

[11] Agitation in Congress was mainly responsible for the withdrawal or cancellation of at least three major investments: the would-be purchase of Unocal by China's national offshore oil company in 2005; also in 2005, Dubai Port World's purchase of the U.S. portion of a London-based company that manages six major American ports; and Bain Capital's planned purchase of 3Com with a minority interest held by a Chinese company.

[12] Kristin J. Forbes, "U.S. Manufacturing: Challenges and Recommendations," Council of Economic Advisers, March 25, 2004, 3.

[13] Krishna Guha, "Revision Puts Focus on Global Conditions," *Financial Times*, August 29, 2008.

[14] See, for example, Theodore H. Moran, "Three Threats: An Analytical Framework for the CFIUS Process: Identifying Genuine National Security Risks and Threats, Dismissing Implausible Allegations," July 8, 2008, unpublished paper originally prepared under the auspices of the International Business Advisory Panel, National Intelligence Council.

[15] See Ellen L. Frost, James J. Przystup, and Phillip C. Saunders, *China's Rising Influence in Asia: Implications for U.S. Policy*, Strategic Forum No. 231 (Washington, DC: National Defense University Press, April 2008), 4.

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