THE PRINCETON PROJECT ON NATIONAL SECURITY

REPORT OF THE WORKING GROUP ON ECONOMICS AND NATIONAL SECURITY

WORKING GROUP CO-CHAIRS:

Adam Posen
Institute for International Economics

Daniel K. Tarullo
Georgetown University

REPORT OF THE ECONOMICS AND NATIONAL SECURITY WORKING GROUP
PRINCETON PROJECT ON NATIONAL SECURITY*

Contents

---

* Four sessions of the Working Group were held in the period April-July 2005. In addition, all members of the Working Group were asked for comment on an outline of this report, and a number of members generously provided comments. However, all the Princeton Project working group reports were drafted solely by the chairs of the groups, and were not formally cleared with the members. This Working Group was co-chaired by Daniel Tarullo and Adam Posen. Although he participated in all the working group sessions and in discussions on the contents of the report, Dr. Posen was unavoidably unable to participate in its drafting. Accordingly, its final contents are attributable only to Daniel Tarullo.

I. Introduction

The importance of integrating economic policy into national security policy should be self-evident after considering a few central facts: The very concept of globalization, contested as it may be in many particulars, is premised on significant movement in the direction of a single global economy for important segments of markets for goods, services, and capital. Within this process, the relative economic weight of countries is shifting gradually but steadily, with Asia assuming greater importance and Europe likely diminishing in importance. The end of the Cold War not only swept away the prevailing geopolitical order; it also, more subtly, stirred up the prevailing international economic order. More than at any time since the Second World War, economic relations between countries help define the overall nature of their relationship. And, perhaps most basic of all, a nation's military capacity and its ultimate sense of well-being depend on its economic performance.

Despite this strong case for policy integration, U.S. policymakers have had a difficult time achieving it, at both the conceptual and the operational levels. While there have been individual officials in each of the last several Administrations who effected such integration in their own work and thinking, a more stable and consistent mix of the policy areas is required for successful U.S. national security policy in the coming decades. As this report explains, there are certainly ways in which traditional foreign policy thinking must change. Yet the more important conclusion is that, in the situation we confront in the world today, there is potential for considerable mutual reinforcement between economic policy and national security/foreign policy aims. In both areas we confront novel circumstances, in which well-tested policies from the last sixty years may be inadequate, or even counter-productive. The virtues of American leadership in a multilateral system, the importance of managing China's rise, and the longer-term need to adapt to the shift of influence from Europe to Asia more generally are central both to successful economic policy and to national security aims. Achieving each will be far more likely if the connections are well understood and incorporated into both economic and national security policy. Conversely, a failure to do so will result in serious setbacks in both areas.

This Report identifies, in necessarily summary form, the reasons why integration is necessary, the impediments to integration that have existed in the past, the specific challenges that the United States faces in international economic policy, and some suggestions for broad principles to guide an international economic policy that reinforces national security policies.

II. What's Right and What's Wrong in Current Thinking About Economics and National Security

The relationship between economic policy and national security policy has, in both theory and practice, frequently been an uneasy one. As discussed later in this report, the legacy of foreign policymakers who regarded economic and commercial considerations as "low" policy lingers on. Conversely, there is a tendency among some economic policy commentators and many business executives to advocate subordination of much traditional foreign policy to the goal of obtaining more business for U.S. companies. More significantly, the many foreign policy thinkers, national security officials, economists, and business people who *have* tried to transcend their parochial perspectives have generally found a dearth of policy work that successfully integrates economics with national security. It is, accordingly, hard to state with any precision the state of thinking on this subject. Nonetheless, there are numerous background assumptions – observed in policy and academic journals, as well as during policy discussions within and without the government -- that seem generally accurate. There are also several commonly, though by no means universally, held notions that either overlook important qualifications or are simply mistaken.

The former group of largely valid assumptions does not require much discussion; they are, however, worth noting clearly. The latter group of incomplete or mistaken assumptions serves as the springboard for much of the discussion in the succeeding sections of this report.

A. Generally Valid Assumptions

1. *The globalization of the economy increases both U.S. capabilities and U.S. vulnerabilities.* It is well-recognized that a globalized economy exposes the United States to greater possibility of disruption of its own economy from supply shocks, financial crisis spillovers, recessions in important export markets, etc. It is slightly less well-recognized that the globalization of the economy has also increased our material capabilities by introducing new product variations, making foreign capital available to U.S. businesses, enlarging export opportunities, etc. At the same time, increasing international economic activity creates new forms of distributional, adjustment, and regulatory problems that can reopen previous domestic political struggles and, in the process, complicate the conduct of U.S. foreign policy.

2. *The ability of the United States to restrict commerce and technology transfer to other countries is more limited than in earlier decades.* As the only large economy whose industrial base was left completely intact during World War II, the United States enjoyed something close to technological and commercial dominance in the succeeding 10-15 years. As European and Asian economies rebuilt and, in many instances, leapfrogged existing manufacturing methods, this dominance gradually eroded. While the United States remains the world's largest economy and retains technological leadership in many areas, it is generally but one of several countries at the leading edge of new technologies or in the production of advanced products and services.[1] As a result, unilateral efforts by the United States to restrict access by actual or potentially hostile nations to dual-use technologies have a lower, sometimes significantly lower, chance of success than previously. In addition, the end of the Cold War has freed many U.S. allies to make their own decisions about technology and trade sanctions, rather than following

[1] Ironically, the United States has been growing *more* dominant in military terms in the last two decades, with a concomitant dominance in many military-only technologies.

the U.S. lead. However, U.S. ability to limit the economic capacities of state actors remains far greater than our ability to affect the capacity of non-state actors.

3. *Over the long term, international economic development and integration should enhance U.S. national security.* In the longer term, economic development and international economic integration contribute to stability within countries and regions. Over time, economic growth provides employment, reduces fertility rates, lifts living standards, and generally increases the stake of broader segments of a population in continuing along the general trajectory of a nation's economic policies. Sustained economic growth is also associated with pressures for political liberalization. All these tendencies should reduce the appeal of extremist ideologies, domestic and transnational. However, as discussed in the section on misconceptions about economics and national security, these effects are neither inevitable nor universal. Furthermore, while the trends stipulated here should generally have benign effects over the course of decades, they may be *destabilizing* in the short term.

4. *In a globalizing economy, the effects of U.S. economic policy mistakes more rapidly implicate national security concerns.* The international integration of capital and product markets gives the United States a certain degree of leeway in its economic policies, at least for a time. For example, access to large sources of international capital has, in the last five years, allowed the United States Government to finance its budget deficit without an increase in the national savings rate. As a result, consumption levels actually increased during this period of rising budget and current account deficits. However, when misguided economic policies are continued without domestic adjustments, the potential economic and national security consequences are greater. The much-publicized concerns with the twin deficits reflect the possibility that international capital markets will, in a fairly short period of time, conclude that investment in the United States is no longer so desirable relative to other investment opportunities and reduce the net amount of funds being invested here. The result could be significant, adverse effects on interest rates, consumption, investment, and economic growth within the United States. Moreover, so long as the practice of extensive over-borrowing is continued – particularly where the borrowing is from the central banks of other countries – the nation's foreign policy options may be constrained by dependence on the continued flow of capital. Another critical example of this phenomenon is in the energy area, where the absence of effective domestic policies to diversify energy sources and price appropriate risk premia into existing energy channels has repeatedly driven U.S. national security policy in directions that complicate other important foreign policy aims.

B. MISTAKEN OR MISLEADING ASSUMPTIONS

1. *U.S. national and economic security is threatened by relatively faster economic growth in other parts of the world.* At best, this belief is a substantial overstatement. Generally speaking, economic growth in countries friendly to the United States enhances our national security by strengthening our allies. Even where an ally's firms provide strong competition to U.S. industry, the results are usually immediate benefits for U.S. consumers and medium-term adaptations by U.S. firms that increase their productivity.

Economic growth in countries whose relationship to the United States is more ambivalent or essentially hostile presents a more complicated situation. Rarely does economic growth in another country constitute an entirely negative development for the United States. A country's increasing wealth becomes a potential national security concern only to the degree that it is directed into efficient military programs or into international economic activities that attempt to undermine U.S. interests. Even so, the relationship between economic growth and military threat is not a simple one. It is possible for a country to become a significant military power without attaining standards of living associated with America, Europe, or Japan. Alternatively, economic progress in a country can, over time, sufficiently alter domestic politics that a country's foreign policy may also evolve in a more benign direction. Still, there *are* instances where a foreign country's growing wealth may directly support its hostile intentions towards the United States. That said, it is often not clear whether the United States can substantially affect a country's growth prospects.

2. *Economic development policies abroad are at all times security-enhancing for the United States.* Obviously, for reasons stated earlier, economic growth abroad can often contribute to U.S. foreign and national security policy aims. And, as suggested in the preceding paragraph, economic growth abroad rarely implies an unmitigated security loss for the United States. However, there is a misconception among some policy commentators that economic development policies will *always* improve the lot of foreign countries and the security of the United States. At least in the short to medium-term, liberalization of a traditional or state-dominated economy can be economically and socially destabilizing. Privileged elites may see their status threatened and become politically reactionary. Working populations may be displaced as new sources of competition eliminate jobs. If, as is often the case in relatively poor developing countries, there is no viable safety net for the displaced, they may turn to militant political alternatives. Sensible market-oriented policies should eventually produce the growth needed to improve the lot of most people in the society, but there may be difficult times in the interim. Even in the medium-term, the absence of democratic or other political mechanisms to assure broad participation in a country's economic growth may lead to continuing political instability.

3. *Globalization has rendered the United States economy vulnerable to the fate, practices, and whims of other countries.* There is no question but that economic developments abroad are more likely to be felt at home than they were three or four decades ago. However, our economic performance and future are still determined principally by our own economic policies. Indeed, the United States probably has greater control over its own economic future than any other country in the world. Employment levels are determined mostly by fiscal and monetary policy. Moreover, it is not the *fact* of international capital markets itself that makes the United States potentially vulnerable to a shift in investment preferences by foreign holders of U.S. Treasury securities – it is the cumulative effect of unwise U.S. fiscal policies. In sum, it is more accurate to say that a globalized economy magnifies the effects of our own policies, positive and negative.

4. *Globalization of the economy means that economic sanctions and similar pressures applied by the United States are more effective.* Despite the earlier-noted recognition that U.S. dominance of commerce and technology has essentially dissipated, some commentators and elected officials appear more, rather than less, inclined to propose sanctions as a policy instrument. It may seem logical that, if nations are more integrated than ever before into the international economy, then they are also more susceptible than ever to trade, finance, or other economic sanctions. So, in theory, they should be. In practice, however, economic sanctions imposed in pursuit of foreign policy ends are probably less effective than in years past. This is particularly true of unilaterally-imposed export sanctions, the effect of which other countries can usually avoid by seeking alternative suppliers. Experience suggests that even U.S. allies are frequently more than willing to permit their companies to fill the breach when U.S. exporters or contractors are forbidden from doing business with a target country. Multilateral sanctions can, if widely adopted *and enforced*, be effective in altering specific behavior by target countries. But it is notoriously difficult to obtain such sanctions. Targeted import sanctions could have significant effect on the foreign target, but only in the relatively uncommon circumstances in which the U.S. is a major importer *and* the good in question is not largely fungible with goods from other countries.

5. *Economic trends and capabilities are changing rapidly in today's world.* Despite attention-grabbing developments such as financial crises, the relative performance and size of national economies generally change only gradually. Hence the material capabilities of countries to deploy military and foreign policy resources also change relatively gradually. Historically, moreover, the growth rate of countries tends to decrease after they reach a certain stage of technological and institutional comparability with more developed countries. Thus, though the relative economic decline of Europe will likely continue in the coming decades – with important implications for U.S. national security policy – this development will be a measured one. Japan, considered by many commentators only fifteen or twenty years ago to be on its way to economic dominance, experienced a sharp leveling off of growth. Conversely, even after the ensuing decade of economic stagnation, Japan is still one of the world's richest nations. China, the most dramatic recent example of sustained economic growth, will probably continue to develop impressively for the indefinite future. Yet its infrastructural, institutional, and political circumstances will almost surely create significant constraints on growth along the way. Indeed, as discussed later in this report, economic setbacks in China might pose a challenge for U.S. policymakers as great as or greater than a straight-line continuation of current growth trends.

III. Major Challenges

1. *Strategic Integration of Economic and National Security Policy*

The prominence of economics in American foreign policy periodically rises and falls. The emphasis of international economic policy also varies with the times. For a good part of the nineteenth century the United States regularly deployed its diplomatic, and sometimes military, resources in pursuit of fairly narrow commercial ends. In the immediate aftermath of the Second World War, the United States played a dominant role in establishing the major international economic institutions. For much of the post-World War II era, U.S. economic and commercial interests were regularly, though by no means always, sacrificed as part of our Cold War strategy, or in pursuit of discrete foreign policy ends.

The end of the Cold War has ushered in a period of increased prominence for economics. The successive emergence of Japan, Southeast Asia, and now China as vibrant economic actors has resuscitated commercial diplomacy. More generally, the globalization of capital, product and, to a lesser extent, labor markets has resulted in increased public and political attention to international economic policies. Economic relations and disputes are frequently high on the agenda of the U.S. in its bilateral relationships. Yet for all this increased attention and activity, economic policy has not successfully been integrated into our overall post-Cold War national security policy. Instead, U.S. international economic policy has remained more a set of parallel – sometimes inconsistent – tendencies than a coherent element of overall national security strategy.

To some degree, the failure to integrate international economic policy in a conceptually satisfying way reflects the search for guiding principles that has characterized post-Cold War U.S. foreign policy. The triumph of containment policy led to its necessary demise as the paradigm for national security strategy over more than forty years. In economics, as elsewhere, that paradigm had provided at least the starting point for formulating important policies. Yet neither the Bush Administration's post-September 11 foreign policy tenets, nor the responses of its many critics, have provided precepts for international economic policy beyond generalities about promoting open markets that are of only limited value in addressing concrete policy questions.

Historically, another reason for the failure to integrate economics and foreign policy has been organizational. Many foreign policy architects regarded economic policies primarily as tools for supporting exogenous foreign policy ends and otherwise dismissed economics as involving "low policy." (The notable exception has been energy policy, where the global economy's dependence on petroleum resources drives a major component of U.S. foreign policy.) Officials with economic responsibilities were often not included in important foreign policy decision-making. This historic pattern seems to have been broken. At the time of the creation of the National Economic Council (NEC) in 1993 the White House international economic policy staff was designated as reporting jointly to both the NEC and the National Security Council as a kind of institutional bridge between economics and foreign policy. The creation of the NEC also changed the composition of many inter-agency meetings to include relevant economic agencies. The Clinton and Bush (43) administrations have thus done a reasonably good job of giving officials with economic responsibilities a seat at most relevant tables, although this step alone does not assure that the officials in question are influential or that they advocate sound policies. Ultimately, the weight and nature of international economic policies depend on the direction set by the President and the quality of presidential appointments.

The heart of the difficulty in successfully integrating economic policy into national security policy may be structural. The United States continues to pursue an ambitious range of foreign policies and – at least recently — has pursued many of these policies without wide support from its traditional allies. Yet the country's economic circumstances are not favorable for supporting such policies. Most obviously, as discussed in more detail below, our large current account and budget deficits place a limit on the resources available to policymakers to sustain ambitious foreign policies. This dilemma can create discontinuities in other parts of U.S. international economic policy. Thus, for example, the Bush Administration gave priority in negotiating bilateral free trade agreements to countries that had been part of the Iraq war coalition. With limited rewards to hand out, the Administration's use of trade agreements as a political favor may be understandable. But it still encroached upon the integrity of the trading system by further eroding the multilateral system. At the same time, the opportunity costs of this policy included sacrificing U.S. commercial gains from negotiations, multilateral or bilateral, with countries having larger markets. More subtly, the twin deficits diminish the authority of U.S. officials in urging policies on others. Even where the U.S. advocates sound policies, we are seen as trying to relieve pressures on our own economy, rather than formulating prescriptions for shared growth.

Competitive pressures on American industries have further complicated the job of U.S. economic policymakers. In the immediate postwar period, any steps towards a more liberal, market-oriented economy essentially guaranteed success for U.S. business, which alone of the world's major industrial powers had escaped wartime destruction. As Europe recovered and Japan accelerated, some U.S. industries lost their front-running position. With the emergence of the Asian tigers, and now the so-called large emerging markets (China, India, Brazil, etc.), the situation is more nuanced. U.S. companies may be able to establish themselves in those markets, but U.S. workers find themselves displaced. The result has been a mix of market access pressures by U.S. exporters that believe they can be competitive in foreign markets and the continuing risk of a domestic backlash against globalization. Both concerns place U.S. economic policymakers in a position of potential conflict with other countries.

None of these phenomena is new, of course. But, as has been widely observed, the end of the Cold War changed the default positions of many American policymakers. The United States has been increasingly inclined to act, in the economic sphere, more "like other countries" – meaning that it will pursue its commercial and economic interests more narrowly than in its system-building days after World War II. This attitude is, in important respects, at odds with America's understanding of its role in foreign policy more generally, where it decidedly does not believe it is, or should be acting, like other countries. The sense of American exceptionalism applies to both the Bush Administration and many of its critics; they differ strenuously on *what* the United States should be doing, but not on its uniqueness.

The challenge of integrating economic and foreign policy has been increased further by the growing importance of non-state actors in both realms. It has long been remarked that the economic and foreign polices preferred by large multinational enterprises may not coincide with those of their home countries. U.S. multinationals seem to be more independent than those of most other large countries, further complicating the job of U.S. policymakers.

A problem of a wholly different type and magnitude is presented by the emergence of non-state-sponsored terrorism as a major national security concern. Most international economic organizations and most economic tools (sanctions, foreign assistance, trade agreements, etc.) are chiefly relevant in the context of inter-state relations. There are few obvious means for utilizing economic power preemptively against terrorist threats, except to the degree that economic growth over the long run diminishes the propensity of disaffected groups to turn to terrorism. In the short term, though, traditional economic development policies may not be effective in restraining this propensity. The liberalization policies that are, to a greater or lesser extent, part of most standard prescriptions for effective development, can begin social transformations that are highly disruptive in societies with strong religious or social traditions. Everything from land reform to educating young girls can be seen as a threat to a traditional way of life.

As a national security problem, terrorism also poses some specifically economic threats. Indeed, short of the use of weapons of mass destruction, much terrorism is designed more to impose costs through economic and social disruption than by the loss of life and property in the terrorist incidents themselves. Frightening consumers so that they stay away from shopping districts, or destroying key parts of the financial infrastructure, or raising fears of oil shortages through attacks on refining centers can significantly harm economies. Measures designed to prevent terrorism, such as security screening of cargo and travelers, can impose significant costs on commerce, at least until more efficient methods are developed to achieve these ends. Likewise, building redundancies into financial and commercial systems can foreclose attacks from disabling an economy, but only at significant cost.

In sum, the United States has fewer economic tools available for its foreign policy ends than in the immediate post-war period, more economic challenges it needs to address, and a new set of costs being imposed on its economy. The margin for error having shrunk, it is more important than ever to coordinate economic and national security policies at both the conceptual and operational levels.

2. *Formulating Policy in a Multipolar Economic World*

To date, the inability of the United States to integrate its economic policies into traditional national security and foreign policy has not had substantial negative consequences. However, changes in the economic map of the world over the last quarter century raise the chances of deleterious consequences flowing from this failure.

The world has moved to a multipolar economic system with a novel set of characteristics. The multiple economic poles include countries at very different levels of development (principally China, as compared to Europe, Japan, and the United States). At the same time, there is an ongoing secular shift in the economic weight of the world's major regions: Most dramatic, of course, is the rise of Asia ex-Japan; of only slightly lesser significance for U.S. interests is the gradual relative decrease in Europe's economic importance.[2] Just as the end of the Cold War and the consequent passing of the familiar bipolar system engendered uncertainty in the political sphere, so the emergence of a multipolar economic system of such unusual configuration leaves us without extensive experience in charting policy in these circumstances.

Since World War II our most important economic partners (Western Europe, Canada, and Japan) have also been our closest allies. For a time, of course, Europe and Japan were dependent on the United States for an infusion of material assistance. Yet even as they recovered and then prospered, those countries remained under the security umbrella provided by the United States. There were economic disagreements, to be sure, some of which placed serious strains on bilateral relationships. Yet we always weathered those storms, in significant part because of the ballast provided by our Cold War alliance. Political and military leaders in all the allied countries would intervene where necessary to keep disputes from getting out of hand. As is often remarked, there has been less ballast in our traditional economic relationships since the end of the Cold War. Economic conflict with Japan was pushed uncomfortably far, until President Clinton consciously used his 1996 state visit to Japan to reaffirm the geopolitical ties that bind the two countries in the post-Cold War period. Recent trade conflicts with the European Union have been numerous but well-managed by both sides, reflecting perhaps the U.S. perception that it is not fundamentally challenged by the member states' economies.

In our economic relationships with China and, indeed, with much of Asia ex-Japan, there is neither a current political bond nor the legacy of such ties. Here, on the contrary, there is a chance that uneasy geopolitical relations could exacerbate rather than ameliorate conflicts that spring from economic interdependence. As India and, perhaps, other countries (e.g., Brazil, South Africa) develop further, a similar dynamic could take hold. The changing geopolitical face of the world is also recasting relations with rising economies such as South Korea and Mexico. The number of important economic actors is likely only to increase with time, along with important regional developments.

In these unfamiliar and delicate circumstances, poor coordination between security and economic policies can have immeasurably greater consequences than in Cold War days. At the same time, it is more important than ever for the United States to take advantage of the spillover benefits to be gained in national security policy from successful economic policy, and vice-versa. Thus multipolar economics calls for a greater emphasis on diplomacy and for a greater dedication of resources to managing this complex set of economic relationships.

---

[2] The economic importance of North America has slipped slightly in relative terms, while Latin America and Africa have, regrettably, still not been able to achieve a rising trajectory relative to the rest of the world

3. *Responding to the Emergence of China as a Global Economic Power*

In the economic arena, as in the geopolitical one, China's emergence will be the single most important challenge for U.S. foreign policies in the next several decades. The integration of China[3] into the world economy is creating an unprecedented situation in the form of a massive, relatively rapid increase in the effective global labor force. Many of the new entrants are possessed of skill levels not traditionally associated with developing countries. A growing China could be an important boost for the global economy over a sustained period, and thus yield great benefits for the United States. But even the most salutary effects will not come without disruptions in economic policies and activities elsewhere. The emergence of China is already affecting incomes, interest rates, investment opportunities, and most other significant economic variables in the United States. These effects are likely to be sustained for some time, with consequent impacts upon U.S. workers and businesses.

This challenge of China's economic rise is of particular concern because, at least in the modern era, the United States does not have experience in managing a relationship with a country that is potentially its principal economic *and* geopolitical rival. The Soviet Union, while posing an ideological challenge to U.S. economic policies, never provided effective head-to-head competition. Our most important economic rivals -- Western Europe and, more notably, Japan – were political allies. This absence of relevant experience, along with China's own inexperience in its new role, raises the possibility of serious missteps on both sides, further complicating what will at best be a difficult task.

China is, to a considerable extent, still a newcomer in existing international economic institutions and arrangements. It may have more difficulty than long-time economic powers in, for example, treating a trade dispute in the WTO as a discrete problem that does not constitute a threat to broader relationships. There is no guarantee that, even as it acquires experience within these institutions, it will adopt views similar to those of Japan or a Western European country. The very fact that China *is* perceived as a potential rival by the United States may make it react differently even if the U.S. does its best to approach economic disputes just as it would with a traditional ally. The resulting problems of economic management would be further exacerbated were China to conclude that the United States has adopted a 21st century version of a containment policy towards it.

A further complication is that the rise of China also brings a set of frictions different from those encountered in other U.S. economic relationships. The United States does have experience integrating into the world economy countries with low-cost labor, undeveloped domestic legal systems, or the anomalies associated with an extended transition from state control. However, these experiences have been in the context of states that were at most secondary economic powers. Moreover, many concerns

---

[3] The more gradual rise of India and other large emerging markets augment many of the economic developments detailed in this section. However, since none of these other countries is a potential geopolitical rival, I concentrate here on the unique challenge of the U.S.-China relationship.

prompted by China's rise are not within the mandates of existing institutions: outsourcing, energy consumption, and state-provided financing for corporate takeovers. Thus even as the current mechanisms for mediating international economic disagreements are under new strains in dealing with seemingly familiar problems, they face a new set of issues that they are not even organized to address.

The magnitude and novelty of these issues could, in the context of geopolitical or ideological rivalry with China, lead to economic conflict that would dwarf the U.S.-Japan friction of earlier decades. The controversies in 2005 over China's reluctance to alter its exchange rate regime and the CNOOC tender offer for UNOCAL provided a preview of how politically explosive the economic advances of "Communist China" could prove to be. The apparent uncertainty of both the U.S. and Chinese governments as to how respond, while perhaps understandable in the case of CNOOC, increased the risk that political reactions in both countries would spiral out of control.

Problems can also arise if China's economic performance lags, rather than races ahead. Even a moderate slowdown would make the government less willing to alter its exchange rate practices or implement promised economic reforms. There is, however, more than a trivial possibility of a serious setback to its economy in the next 5-10 years, such as a rapid decline in investment in the face of overcapacity created through the administered pricing of capital that still prevails in many sectors. Any such setback would be accompanied by significant increases in unemployment, a phenomenon historically associated with political instability in China. The Chinese leadership could go to great lengths to avoid instability though protectionist actions that would have serious regional, and perhaps global, consequences. Where even stringent economic measures fail, the leadership could attempt to deflect growing internal disaffection by unleashing nationalistic feelings through lashing out at the West or, in the worst case, launching a military strike against Taiwan.

For the present, China's core policy of maintaining good relations with the United States will help contain disputes. However, as former Senator Sam Nunn observed nearly a decade ago in assessing U.S.-China relations, history is littered with examples of established powers failing to manage effectively the rise of a new power. It is inevitable that disagreements and tensions between such powers will arise during the course of this shift in relative positions. But it is not predetermined that the U.S.-China relationship will eventually be another example of failure. To avoid that outcome, it is essential for the United States to establish the foundations for managing the shift.

Since there has never been a case where economics was so central to the overall relationship between an established power and a rising one, the United States must, first, formulate and follow a national security policy that incorporates economics. The overall need for integrating economic and foreign policy is nowhere more important than in the context of China relations. A bilateral relationship can handle successfully only a limited number of active disagreements at any one time. Likewise, it is difficult to demand changes too resolutely in one issue area when one is relying on assistance from the other country in a different issue area. A good example of the latter dilemma has played out over the last two years, when the U.S. decision largely to outsource its North Korea problem to China constrained the vigor with which it sought changes in China's exchange rate and other economic policies. It is, accordingly, critical that the United States government make an informed and considered choice of its policy priorities in dealing with China.

Second, the United States and its traditional allies must try to modify existing international economic institutions to address the economic challenges posed by China's rise and to provide an appropriate role for China in the collective governance of the global economy. The United States cannot fundamentally determine whether China becomes one of the two most important economies in the world sometime during this century. But it can have considerable effect upon the role China plays in the conduct and governance of the global economy. With foresight and subtlety, the United States could help smooth China's assumption of more influence in international arrangements – assuring China of the position it will surely believe it deserves, but doing so in a manner that maximizes continuity in those arrangements.

4. Decline of U.S. International Economic Leadership

Over the last quarter century, there has been a gradual but steady decline in the level of international economic leadership provided by the United States. It has provided fewer global public goods. That is, the United States is now less likely to sacrifice short-term economic interests for the sake of creating or strengthening international economic arrangements, even where the resulting institutions would be broadly consistent over the longer-term with preferred U.S. policies. The United States is also more likely to engage in conflict over economic matters. The forbearance from conflict in the interests of supporting the international economic system as a whole has significantly – though by no means entirely – given way to an inclination to act more like other countries in pursuing immediate economic interests vigorously.

This secular change in U.S. orientation results from several interrelated developments:

First is the cumulative effect of the decline, both perceived and real, in U.S. economic performance beginning in the 1970s. At a macroeconomic level, the stagflation of the late 1970s, the apparently chronic trade and then current account deficits, a slowdown in productivity increases, and wage stagnation all contributed to a sense that the United States was falling behind economically. These problems led politicians, business executives, and the public collectively to conclude that the United States needed to change what was asserted to have been its past generosity towards the rest of the world.

At a microeconomic level, a series of major industries suffered competitive reversals at the hands of foreign firms. An early warning of this trend was provided by the travails of the textile and apparel industry beginning in the 1960s. But it increased exponentially in the 1970s, when a progression of flagship U.S. industries lost ground to their Japanese competitors. Steel, autos, and semiconductors were, in succession, the most celebrated casualties, though by no means the only ones. The fact that Japan was the major source of the competition in each case raised the specter of a specific country that could overtake the United States as the most dynamic economy in the world.

Of course, Japan did not overtake the United States. Telecommunications, information technology, financial services, and other industries have stepped in to provide new sources of dynamism in the American economy. To some degree, then, the response to the earlier developments was based on perceptions that turned out to be exaggerated. However, there is no denying that the United States, while still the most important economy, accounts for a smaller share of total global product than in earlier decades. And significant industries have been affected, sometimes decimated.

Second, the end of the Cold war accelerated the change in attitudes that economic developments were already prompting. From the Truman Administration onwards, U.S. policy under presidents of both parties was based on enhancing economic growth and thus stability in those parts of the world not under the domination of the Soviet Union. It was also important to U.S. policymakers that, as an ideological matter, the market-oriented economic system advocated by the West be proven superior to central planning. There were, accordingly, substantial incentives for the United States to provide public goods in the international economic system. In addition, the imperatives of the Cold War conflict would regularly lead the United States to trade a tangible security benefit for a certain measure of economic free-riding (e.g., obtaining German bases on the border of the Warsaw Pact countries in return for acquiescing in an undervalued Deutsche Mark). The dissolution of the Soviet Union, literally overnight, removed these important incentives for U.S. leadership.

Third, and less remarked upon than the preceding two factors, is the disappearance of "business statesmen" from the U.S. policy process. In the first few postwar decades, leading figures from industry, finance, and law regularly involved themselves in public policy debate and activity on matters transcending the immediate interests of their firms or clients. Through formal and informal organizations, they in essence represented the interests of American business as a whole. In this role, they explicitly looked to longer-term considerations, one of which was the creation and extension of the world trading system and other international economic arrangements. Thus these "business statesmen" provided reliable support for U.S. international economic leadership (although there were sometimes political controversies over the aims to be pursued).

In the last fifteen years, however, the focus of people at the top of industry, finance, and law has shifted noticeably away from this public policy role. Boards of directors have become less tolerant of executives who play such a role instead of spending all their time and political capital on the immediate interests of the company. While major multinational companies will nominally support most trade agreements, for example, they tend now to commit their advertising and lobbying resources chiefly to issues of specific importance to the company. At the same time, the internationalization of business has made the interests of the United States and major multinationals somewhat less congruent. In fact, MNCs are now as likely to be resisting government efforts to forge international cooperation on tax enforcement or other regulatory ends as they are to be supporting government efforts to strengthen the foundations of the global economy.

The robust U.S. economic performance of the 1990s, particularly in contrast to Europe and Japan, at least temporarily placed in abeyance many of the earlier concerns of U.S. economic decline. However, instead of reverting to its previous style of leadership, the U.S. government has had a greater propensity to lecture other countries on economic performance and policies. More recently, this lecturing has acquired a distinct ideological flavor, quite apart from economic policy views. The renewal of U.S. self-confidence has thus given rise to a hectoring tendency that unnecessarily alienates government officials and the public in many other countries. This tendency is particularly damaging because the resurgence of U.S. economic growth was not accompanied by sizeable financial contributions for global public goods, with the important exception of the Bush Administration's increased commitment to foreign development assistance.

The decline in U.S. international economic leadership has two deleterious effects on our overall international position. First, the historic positive spillover effects from international economic leadership to global political influence have been significantly reduced. Second, by leaving at least a partial leadership vacuum, the United States has given other countries an opportunity and incentive to fill that vacuum with regional or localized initiatives, or to define themselves as following an indigenous model in implicit opposition to U.S. policies. Thus, even as China works to maintain good bilateral relations with the United States, it takes advantage of waning American influence to foster Asian regional economic arrangements that exclude the United States. France and Brazil try to leverage rough-edged American economic and commercial diplomacy or rhetoric into rallying points for regional integration based on resistance to U.S. policies. Although these efforts have not to date created arrangements that pose a realistic challenge to existing, more U.S.-friendly institutions, they will eventually yield successes unless U.S. policy is seen as fostering a global economic system that can accommodate the needs and interests of all countries.

5. *The Shift in Global Economic Influence from Europe to Asia ex-Japan*

As noted earlier, today's world economy is a multipolar one. But within this system there continues a slow but steady shift in relative importance from Europe to Asia. Although this transition is likely to be sufficiently gradual so as not to require near-term policy adjustments, the implications for U.S. policies and interests will be far-reaching over the next several decades. Well before the shift is complete, we are likely to see some important interim consequences.

Despite recent setbacks in efforts to increase economic and political integration in Europe, it is far too early to declare movement in that direction at an end. Yet even if the integration process revives, and even if it leads to considerable structural reform (a result that is far from certain), Europe will continue a gradual decline in global economic importance. Demographics are a key reason. A stable or declining population is a major constraint upon national economic size and growth, though not necessarily upon technological sophistication or overall welfare. Even with the addition of new members whose population is growing, the EU faces a rapidly aging population and, over the next several decades, overall declines. It seems implausible, particularly in light of social and ethnic tensions between immigrant and native groups in many Western European countries, that they would accept the levels of immigration necessary to reverse this trend.

Long-term estimates of economic strength and performance are always fraught with difficulty, since the impact of fairly small changes in assumptions is magnified greatly over the course of several decades. With that caveat, it is worth noting that some reasonable estimates of the impact of population changes on the size of the European economy suggest that, by mid-century, Europe is unlikely to have the material resources necessary to play a major global role, even if it wishes to do so. In particular, the western European nations could reassume a globally significant military position only with a sustained rise in defense investment of as much as 2% of GDP per year above current levels – an increase that seems almost inconceivable in light of domestic preferences and politics.

Europe will retain substantial world economic importance for some time to come. Many of its member states have already taken steps that could, with further measures, reenergize their economies. Its more affluent states will quite likely continue to enjoy per capita incomes among the highest in the world. Its cultural influence and diplomatic traditions may give it significance exceeding its capacities even as those capacities wane. If, as should be the case, political relations between them continue to improve from the low point reached in 2003, Europe and the United States should together be able to sponsor important global economic initiatives.

At some point, however, Europe's ability to affect economic developments, whether through the market or through international arrangements, will have declined sufficiently that its approach may shift from trying to shape those developments to adapting its policies to them. The result will, at the least, be the loss of the most important American partner in the establishment and development of current international economic arrangements. Another effect may be a growing reluctance by European nations to subordinate immediate commercial interests to U.S. geopolitical aims, as the perception of potential national security threats recede and the imperative of garnering international business increases. The heretofore isolated disagreements – over supplying the Iranian oil industry in the 1990s and the Chinese armed forces today – may become pervasive.

The loss of Europe as our key economic partner cannot easily be replaced as one center of economic gravity shifts to Asia. Although our political alliance with Japan may well strengthen in the near-to-medium term, as China continues to rise and Japan faces threats from North Korea, it is unlikely that Japan can serve as the foundation for a new, Asian partner for the United States. Sixty years after the end of World War II, the lingering mistrust between Japan and many of its mainland neighbors imposes a severe handicap on any Japanese effort at regional leadership. Moreover, despite its position as the second largest national economy in the world, Japan has not manifested the willingness or capacity to exert regional or global leadership. Finally, of course, Japan will hit its own demographic wall well before Europe does, with even dimmer prospects for extensive immigration to offset its declining native population.[4]

Realistically, then, the United States will face within a quarter century one of two situations: First, there may simply be no economic power with which it can cooperate to write a good part of the global economic agenda. Second, there may be an economic power – either China alone or China within an Asian regional economy – with the requisite heft but without the incentive to partner with the United States.

IV. Major Principles

1. Integrate Economic and National Security Policy

The first principle for U.S. international economic policy follows directly from the first challenge identified earlier. The nation needs to have an international economic policy and a national security policy that are mutually reinforcing, at least in their broad outlines. This section offers some guidelines for successfully integrating the two sets of policies. The substance of several key international economic policy principles will be suggested in the major principles enumerated in the rest of this paper.

At the conceptual level, we note first that it is neither practical nor desirable to construct an elegant and self-contained model that incorporates all policies relevant to a national security strategy. In running foreign policy an administration is always faced with competing interests, and is often faced with conflicting interests. The emphases afforded these interests will vary on a context-specific basis. Still, nearly everyone would agree that, in approaching specific foreign policy issues, an Administration will be most effective if it has a well-conceived set of principles that provide a starting point for analysis and action. A successful incorporation of economics into national security policy requires recognition of the following:

- *Economic interests are an independent and important national interest*. This point seems almost too obvious to need stating, but in practice economics has too

[4] China, too, faces an aging population – the consequence of the one-child policy it has long maintained. As incomes rise in China, a further decline in the fertility rate can be expected. However, the assimilation of China's still enormous rural population into manufacturing and other endeavors tied to the global economy will offset the impact of absolute population declines for at least a few decades.

often been subordinated to other foreign policy ends. While the nation's physical security must be assured to enjoy prosperity and a higher standard of living, this does not mean that every step taken to increase security is desirable. No one wants to live in a nation with all guns and no butter. Moreover, the military and technological assets necessary to assure security can be generated over a sustained period only in a strong economic environment.

- *Well-conceived economic policies and arrangements have an integrity that can be damaged when they are used excessively as means to other ends*. Political considerations inevitably affect a country's policies within all international arrangements. But the efficacy of economic arrangements and policies can be adversely affected when they are too much distorted for non-economic reasons. For example, admitting a country to the WTO or the G-7 for foreign policy reasons has costs for the operation of the trading system or the coordination of national economic policies when that country lacks the capacity to assume the obligations of the arrangement. The integrity of economic policies and arrangements can also be impaired by what appear to be economic motives. Where the United States uses strong-arm tactics to pursue specific U.S. commercial interests that are not consistent with the principles of relevant international economic arrangements, we damage those arrangements and our own credibility in advocating them. If the arrangements serve overall U.S. economic and foreign policy interests (which they presumably do), their integrity should be preserved.

- *Reach out to non-governmental groups.* In general, the government is not optimally positioned to engage in medium- and long-range thinking, including addressing such issues as how to integrate economics into national security policy. Officials may have formed their own thoughts before beginning government service, of course, but theirs are not collective policies. And while government can form strategic assessment or planning groups, by definition those groups tend not to involve the most influential policymakers, who are consumed by immediate concerns. A comparative advantage in this kind of thinking may thus lie with non-governmental analysts, scholars, think tanks, and other agents, particularly those who have themselves previously served in government. There is an enormous amount of such output already, of course. Still, government officials may suggest directions and questions that could be particularly useful for those outside groups to address. Where such suggestions come from non-career government officials, it is probably best not to create formal consulting arrangements with non-government actors, since this may increase the chances of the product being written to conform to the official's predisposition.

When particular kinds of interests are undervalued in government policy, advocates of those interests almost invariably suggest creation of new departments, offices, or procedures to enhance their influence. As stated earlier, the main obstacles to integrating economics effectively into national security policy are no longer organizational. Nonetheless, we do have two operational suggestions that, if regularly observed, could enhance the functioning of current agency and inter-agency processes:

- *Convene the right mix of people/agencies for specific decisions.* This is essentially a point of common sense. It is simply self-defeating (though, in the past, not unusual) for a government to make a decision where it is not even aware of the economic consequences of that decision. The establishment of the NEC and related changes by recent administrations have largely assured that the right people are involved in the policy process. However, as anyone who has been in government knows, there is frequently a disjuncture between formal inter-agency processes and the ad hoc meetings in which decisions are actually made. If the latter efficiently incorporates the analysis produced in the former and simply reduces the number of participants, the process need not be harmful to economic interests. If, though, the ad hoc meetings involve no economic officials at all, the chances of the proper weight and understanding being attached to economics are reduced. In this regard, it is important that the individuals appointed to key economic coordinating or agency positions have some background and sympathy for economics (i.e., something more than a commitment to serving specific domestic constituencies).

- *Regularize assessment of economic costs of proposed foreign policy measures.* Notwithstanding the progress that has been made in injecting economic considerations into foreign policy decisions, analysis is still too likely to be haphazard. There should be a specific effort to regularize in the inter-agency process an assessment of the economic costs and consequences of foreign policy proposals. This is most obvious in the case of proposed sanctions, whose costs to U.S. business and consumer interests have been misunderstood in the past. But it is also desirable in other kinds of decisions. Whether it is understanding the unintended consequences of those decisions on markets, or improving the chances that those policies will work (nation-building being the obvious example), economic analysis is important.

2. U.S. Interests are Best Served by Leadership in a Primarily Multilateral Economic System

a. *The Rationale for Leadership:* The rationale for a renewed U.S. commitment to multilateral economic leadership is reasonably straightforward. For the foreseeable future, the United States is the only country that possesses the combination of power, wealth, willingness, and political capacity to play the leading role in shaping the international economic system. Thus, when the U.S. sets out to exercise leadership, it is almost assured of asymmetrical influence. While some countries may resist that leadership, many others understand that there is no realistic substitute for the United States, at least at the global level.

A second consideration is that, unlike the early years of American leadership in the 1940s and 1950s, the United States is not possessed of such disproportionate wealth relative to the rest of the world as to make "buying" favorable foreign policy outcomes a viable alternative. Even if the nation were more inclined to spend increased resources to this end, the changing cast of key complementary players (e.g., China, India, and Brazil) and the related increase in the number of those players makes foreign policy "purchases" much harder to carry out. Hence investment in leadership may be the more cost effective route to influence in any case.[5]

There would be several important benefits from a successful reinvigoration of U.S. international economic leadership. Most obviously, the prevailing international economic environment will be at least generally compatible with U.S. economic principles and practice. Norms such as regulatory transparency and regularity will almost certainly be diffused through international arrangements that reflect significant U.S. influence. Although the exercise of leadership may sometimes require forbearance from pressing for special short-term commercial benefits, the evolution of an international economic system compatible with important market and governance principles should yield significant gains for U.S. firms over time. American advantages in technology and financial management can be better realized through multilateral arrangements that enforce common standards and openness on all parties (including the United States) and that limit the more obvious forms of mercantilism and fostering of national champions.

Perhaps as important as the economic advantages are the positive spillovers into the political and security realm. Economic and political leadership are mutually reinforcing. When the rest of the world develops confidence that the United States is genuinely seeking an economic system that responds to the needs of, and promises benefits for, all countries, then U.S. credibility and goodwill are likely to be enhanced in other areas. Even where other countries may have reservations about U.S. proposals on, say, countering financing of terrorism, they will be more inclined to acquiesce at least partially in those proposals as a price they pay for U.S. economic leadership.

b. *Risks of Regionalism*. The foregoing points make the case for U.S. international economic leadership, but not necessarily for a policy that focuses that leadership on the multilateral system. Since the late 1980s, when the Uruguay Round of trade negotiations bogged down, some policymakers have seen regional initiatives as a useful supplement to, and agent for reenergizing, the multilateral process. This was a break from the traditional U.S. aversion to regionalism, which was associated with

---

[5] Of course, a third method for achieving desired ends is coercion. With the exception of assuring access to petroleum supplies, military action is essentially not an option in contemporary international economic policy. However, the United States has used successfully milder, non-military forms of coercion to achieve some economic ends. In the trade area, for example, the United States has threatened – in general or specific terms – restrictions on other countries' exports unless those countries changed certain of their own policies that affected U.S. commercial interests. Most such tactics would now run afoul of World Trade Organization rules. More fundamentally, there is a limit to the frequency with which even the most powerful country can use coercion while continuing to embrace a rules and market-oriented international economic system. Thus, while coercive measures may be occasionally efficacious on discrete issues, coercion does not define a viable *strategy*.

various European preferential arrangements. The Bush (41) Administration intended the negotiation of NAFTA and the increased profile of APEC (the Asia Pacific Economic Cooperation forum) as signals to Europe that the United States had options outside the GATT system, in which the inability of the European Union to make concessions on agricultural trade had brought negotiations to a standstill. This tactic contributed to the eventual successful conclusion of the Uruguay Round.

But there is good reason to believe that the complementarity of regionalism and multilateralism may have been a transient phenomenon. APEC's "open regionalism" has not proven a practical alternative to more traditional negotiating fora. And, in any case, major economic powers will not find credible an implicit U.S. threat to focus its attention elsewhere if the elsewhere is not composed of important markets. Thus the string of Bush (43) Administration trade agreements with second- and third-tier economic powers has not jolted Europe or anyone else into renewed commitment to the Doha Round. Also, a strategy that relies on competitive liberalization, or upon regional deals being eventually brought together in grand multilateral bargains, has a serious drawback: If the multilateral process runs off the rails despite the intended prod from the regional initiatives, the result will be a reinforcement of regionalism.

Indeed, a multilateral vacuum – whether in trade, finance, or other economic areas – invites regional initiatives. A circumstance in which regional arrangements are the growing, dynamic parts of the international economy is unlikely to be favorable to the United States. The contemporary interest in regionalism in Asia and, to a lesser extent, Latin America centers on arrangements that would exclude the United States. To some degree, the interest in regional economic initiatives derives from the political aim of limiting U.S. influence. That is, the positive spillover benefits for the United States from multilateralism are paralleled by negative spillover effects for the United States from regionalism as currently conceived. Even if the United States can bull its way into these negotiations or arrangements, there will be a risk that the U.S. – as demanding "outsider" – will be pitted against the countries of the region where integration has proceeded.

c. Adjusting U.S. Multilateral Leadership to New Circumstances. A reinvigoration of U.S. multilateral leadership will not be a simple matter of reverting to the status quo ante. The changes detailed earlier are real and profound. Thus the nature of renewed U.S. leadership must be adjusted to meet the new circumstances of both the world and the United States itself.

The steady increase in the number of countries in the multilateral trading system and the greater diffusion of economic power have made the successful conclusion of negotiations more difficult. Similar complications exist in reaching agreement on key issues within international monetary and financial arrangements. However, the United States could leverage this hurdle into a national advantage by advancing vigorously its roles as enlightened convener, idea-generator, and architect of compromises. In general, the larger the membership of the international arrangement, the more likely it is that governance will proceed through a formal process that plays to U.S. advantages. The key for the United States will be to avoid negotiating and decision-making structures that grant veto power to individual countries. Precisely because the United States will play the most important part in shaping these agreements and decisions, it does not need a formal veto.

At the same time, to be successful in its new leadership role, the United States will have to be more solicitous of the views and preferences of other countries, particularly those traditionally excluded from influence at critical times in trade negotiations, IMF deliberations, or other decisions. With respect to China and other large emerging markets, this means reshaping the informal and, where necessary, formal features of existing institutions in order to afford them voice and influence commensurate with their growing importance to the world economy. With respect to smaller or less rapidly growing developing countries, successful leadership will depend in significant part on the willingness and ability of U.S. officials to fashion proposals for international economic arrangements that accommodate at least some interests of these countries. Relatively speaking, the United States has fewer resources available for "side payments" than in its earlier decades of leadership and thus will usually need to accommodate other countries within the confines of the arrangement being negotiated.

In addition to adjusting its tools and tactics, the United States could profitably augment its aims in international economic institutions. The U.S. should take advantage of the regular gatherings of appropriate national officials at these institutions to multilateralize new problems and challenges through ad hoc, informal, less legally driven processes. For example, an informal consultative group at the WTO could have played a useful triage role in confronting the implementation and compliance problems that were inevitable following China's accession agreement. To the degree such informal processes yield consensus on priorities or compromises, they can also facilitate organization and delivery of desirable technical assistance.

Multilateralizing more international economic issues does not necessarily mean simply placing those issues on the *formal* agenda of existing institutions. The transformation of the GATT into the WTO has, for example, changed what was arguably an underlegalized trading system into one that relies excessively on a kind of international litigation. This can be particularly counterproductive in the case of developing countries, which have been asked to assume a broad range of obligations for whose implementation they lack capacity. Even among developed countries, there is need for some arrangements that are less legalized, particularly where it is important to foster trust and cooperation among national officials in pursuit of a shared goal. One of the more important tasks of international economic leadership is determining the optimal level of formality and rule-orientation in specific arrangements.

Finally, it is important to emphasize that a policy of multilateral economic leadership does not prevent the United States from vigorously promoting its discrete commercial interests. To the contrary, it would be a mistake *not* to do so in a world in which the competitors of U.S. firms benefit from their governments' advocacy (and, frequently, considerably more than advocacy). Moreover, tit-for-tat support for U.S. commercial interests may be necessary to induce other countries collectively to foreswear practices that are wasteful when practiced by everyone or that distort market-based decisions by purchasers.

d. The Role of Bilateralism in U.S. Foreign Economic Policy. Not all issues can or should be handled in a multilateral context. Bilateral arrangements are appropriate, if used selectively, for strengthening ties, embedding economic reform, addressing unique problems, etc. But their excessive use – as in rewarding countries joining a military coalition with trade agreements – risks diverting resources at the expense of U.S. economic interests and at the risk of enhancing the drift towards regionalism. Contrary to the assurances of some U.S. officials in 2002 and 2003, it is now apparent (and has been admitted by other officials) that the focus on bilateral and regional trade agreements did detract from efforts to move the Doha Round of multilateral trade negotiations.

Bilateral arrangements are insufficient for implementing comprehensive U.S. international economic policies and, at the same time, may ultimately make those policies harder to achieve. Some issues, such as reducing agricultural subsidies, are simply not susceptible to bilateral resolution. More generally, a strategy of divide and conquer is not a viable policy. The pursuit of multiple bilateral arrangements is unlikely to create a "template" for an eventual multilateral arrangement. Although the United States can dominate any bilateral negotiation with the smaller economic powers interested in a trade or investment agreement, larger countries will resist provisions they dislike –whether in their own bilateral dealings with the U.S. or together in a multilateral or plurilateral forum. The example of investment agreements giving special rights to foreign investors is instructive. The U.S. has successfully included these controversial provisions in many bilateral agreements with developing countries. Yet Australia would not agree to such a provision in its bilateral agreement with the United States, and an American initiative to multilateralize this approach in the OECD failed utterly.

3. *Strong Economic Growth in Asia ex-China is the Key to Geopolitical Management in Asia*

Any U.S. effort to contain China's economic and geopolitical rise would be unilateral and, ultimately, futile. Since economics would certainly be enlisted as a major component of any such strategy, U.S. companies would, with some justification, characterize a containment policy as a form of commercial suicide. Other countries, including our traditional allies, not only will decline to join such an effort. They will take the opportunity provided by any restraints on U.S. firms to improve their own economic position in China.

If France is, as is apparently the case, willing today to provide China with anti-submarine technology that could pose a serious threat to the U.S. Navy in the Taiwan Straits, then surely it – and even countries more sympathetic to U.S. security interests – would happily fill in behind American firms in genuinely commercial transactions. Most new technologies will find their way to China regardless of U.S. export control policies. In fact, U.S. chances for success in seeking cooperation from its allies in restricting export of a relative handful of leading edge technologies with important military applications will be enhanced in circumstances where firms from around the world are already free to compete for the overwhelming proportion of business that China and its firms wish to conduct. Similarly, galvanizing international pressure on China to enforce certain key commercial commitments – such as intellectual property protection on high-tech items – will be considerably easier in an environment in which both China and other countries believe the United States committed to integrating China fully into the global economy.

The futility of a containment strategy does not mean that concerns about China's economic, much less geopolitical, rise are groundless. Rising powers, including the United States more than a century ago, are at the same time both inexperienced in their new role and enormously self-confident. This disconcerting mix makes them potentially unpredictable and, since nationalism tends to increase within rising powers, potentially aggressive for at least a time.

The preceding Major Principle #2 suggested, among other things, that the United States seek to create an influential place for China in the major international economic arrangements. There are presumably parallel measures available for integrating China peacefully and productively into non-economic international arrangements. A second key strategy for maximizing the chances that China's rise will be more benign than otherwise is to promote strong and sustained economic growth in the rest of Asia. Healthy, growing economies in South, Southeast, and Northeast Asia make a balance of political and military power in Asia more likely without requiring any form of containment policy. On the contrary, the goal of economic growth throughout the region would contemplate the *integration* of China into the global economy, while simultaneously making it far less likely that any country could dominate. In fact, while China's economic position relative to other Asian countries would be more favorable if they grew slowly, its *absolute* economic position will be much more favorable if they grow quickly. And, of course, absolute growth is necessary to reduce poverty and achieve political stability.

Although this strategy may seem obvious, recent public discussion – including some from the Administration – suggests a misunderstanding of how to make the strategy succeed. Neither India nor most other Asian countries would likely cooperate in any policy they understood to be directed at China. If the United States asks them to play the role of strong, stable anchor in one part of Asia, they may well seek ways to make clear to China that they decline to play such a role by, for example, ostentatiously rejecting some U.S. overture to which they otherwise would have been receptive.

This goal will best be achieved through a combination of a reinvigorated multilateral system and creative, complementary bilateral measures. By maintaining multilateral organizations at the center of international economic activity, we assure that no country can dominate, given the multipolar quality of economic power.[6] Regional

---

[6] This includes the United States, which has the capacity to *lead*, but not dominate, the contemporary world economy.

economic arrangements, on the other hand, are much more susceptible to domination by a single powerful economy. Furthermore, although the growth of intra-Asian economic activity will almost surely outstrip the growth of Asian economic activity with the rest of the world, liberal multilateral arrangements will give full opportunity for the latter to increase. Having a diversity of sources of direct investment, capital, and export markets will reduce the chances of an entire region depending upon China for growth.

The bilateral measures contemplated in the preceding paragraph would not generally be trade agreements or other formal treaties. Indeed, "measures" may often be decisions *not* to act, as by forbearing from pressing for advantages or concessions sought by domestic constituencies that might harm the economy of the other country. There will also be opportunities for discrete initiatives to enhance economic capacities in the other country, or to remove potential sources of friction.

4. *Domestic Economic Policy Must Be Changed*

Strength abroad begins at home. This sentiment has been repeated so many times as to have become a cliché. Yet, when it comes to economics, the truth behind this statement has not been fully appreciated by many foreign policy thinkers and, it would appear, by current policymakers. In the medium term, the combination of enormous federal budget deficits, personal savings rates that are perilously close to zero, unfunded pension and retirement obligations, and rising healthcare costs is simply unsustainable. The longer action to address these problems is delayed, the worse the problems become. The historically low rate of net national savings is accompanied by current account deficits that are, in the combination of their magnitude and duration, unprecedented. The result, of course, is that the United States has quickly become the world's largest debtor nation. This circumstance raises the possibility of a fairly rapid reversal in foreign governments' and investors' appetite for U.S. assets, leading to a rapid depreciation of the dollar and, quite likely, a significant increase in interest rates.[7] Such a development would only compound our economic problems.

Consider the direct national security policy consequences of sustained lower levels of performance by the American economy: The material resources necessary for a strong military and an influential foreign policy will be increasingly difficult to deploy. The country will face a situation of "overreach" not because it is taking on too many new commitments abroad, but because it is losing the ability to fund existing commitments. The nation's political leadership will be persistently absorbed in domestic economic and social travails and thus less involved in all but the most critical foreign policy issues. The resulting vacuums in international affairs will be invitations to other countries to seize leadership of an issue. Sometimes the leadership may be relatively benign from a U.S. perspective, but sometimes it will not. In any case, U.S. leadership will have suffered.

---

[7] It is always important to emphasize that the *possibility* of a dollar crisis does not mean that one is *probable.* Because we are in unknown territory – the world never having witnessed a reserve currency country running current account deficits of an order that usually produces financial crises in other countries – no one can say with any assurance how great this possibility is. What is certain, though, is that the longer the gross imbalances persist, the greater the possibility becomes.

There would also be consequences that indirectly impaired U.S. national security and foreign policy aims. The spillover benefits from U.S. international economic leadership will be reduced, or even lost completely. The unwillingness of the U.S. government to accept appropriate responsibility for the global imbalances in savings, consumption, and investment has already diminished our effectiveness in urging economic adjustment or reform upon others. Even where our positions are sound (e.g., in calling for policies to induce greater domestic demand in Europe or Japan), they are seen as special interest pleading by a nation unprepared to do its necessarily substantial part to change its own unsustainable policies. Also, chronic large current account deficits usually elicit calls for import-restricting action. When subpar performance means that the economy is not creating new jobs in adequate numbers and quality, these calls are far more likely to be heeded. The resulting restrictions will then create a new set of foreign policy problems.

Those concerned with foreign and national security policy, both in and out of the government, should already have concluded that fiscal policy is too important to be left to those who have been making that policy. The best combination of measures to begin to tackle our economic problems continues to be debated. The precise mix of policies is less important than that the country make a credible – meaning significant – start. National security officials may want to demand a seat at *economic* policymaking tables, at least to the extent necessary to make this point.

While irresponsible fiscal policy poses the greatest threat to both our economic performance and our national security posture, there is also a need to adapt U.S. education, training, labor market, and R & D policies to current economic circumstances. Our education system is still largely based on early twentieth century models, our training mechanisms still of questionable effectiveness, our R & D policies in need of reinvigoration. Changes in each area are needed, both to enhance the productivity increases needed for sustained economic growth and to assure the equitable distribution of economic gains that will be needed to sustain popular support for international economic integration.