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In This Special Report

Special Report:
The Global Economic Crisis and U.S. National Strategy

Parallels Between the U.S. Economy and National Strategy

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The current economic emergency and what may be an extended U.S. and global recession could have unintended beneficial consequences for national security and national strategy.

After the demise of the Soviet Union in 1991, the U.S. became the unipolar world power. U.S. primacy became the buzz word and foreign policy experts developed policy based on an unrealistic version of primacy: that the U.S. could impose its policy without any significant pushback from friends, competitors, or adversaries. The mistaken belief in untrammeled projection of U.S. power had adverse consequences. Consultation with friends prior to taking action no longer seemed necessary, why bother?

One example: immediately before the U.S. invasion of Iraq, the U.S. notified Turkey that it was sending the 4th Mechanized Infantry Division to be stationed on Turkey's border with Kurdish areas of Iraq. The Turks were justifiably astounded by this unilateral U.S. decision and they responded appropriately – no U.S. military forces would be stationed on Turkey's border with Iraq. The result was a major shift in Turkish public opinion from 90 percent support for the U.S., in part, to 90 percent anti-American sentiment.

The notion of primacy has been a principle of U.S. global economics. Money has flowed to the U.S. in vast amounts based on the assumption that U.S. government Treasury instruments were 100 percent risk-free. As a result, the U.S. has become the world's largest debtor state. China is a major creditor of the U.S. which constrains the U.S.-China relationship. The belief that the U.S. could sustain the $3 trillion expense of the wars in Iraq and Afghanistan – a guns and butter economy – without damaging the economy was mistaken.

The projection of military, economic, and diplomatic power is impossible without a stable, continuing, and prosperous economy. Lack of available funds constrains the military, not only in its operations and force structure, but also in research and development. An unstable U.S. economy creates domestic apprehension and substantially reduces the scope of national security initiatives, all of which require public and congressional support.

The U.S. financial sector is better prepared to recover from an act of terrorism than most other sectors. However, a well-conceived and executed terrorist act resulting in the temporary disruption of the financial networks could have a devastating effect on the stock market and the overall economy. The paramount terrorist strategy may not be to harm people, but to disrupt critical U.S. infrastructure, harming the U.S. economy and endangering prosperity. Consider the effect of a catastrophic incident during the current economic emergency.

There are parallels between the contemporary U.S. economy and foreign policy. Beginning in the 1990s, a belief emerged that U.S. prosperity was guaranteed. Profligacy best describes the attitude of government officials at the local, state, and federal levels, retailers and consumers, and the private and public sectors. Warnings regarding overspending, the perils of budget deficits, and increased borrowing and debt accumulation were virtually non-existent. There was a widespread belief that the goose would continue to lay golden eggs.

It is likely that the U.S. standard of living and our global leadership will decline in tandem until there is a reassessment, and a new set of economic and national security and national strategy policies emerge.

Three principles define the appropriate response to these challenges:

- **Austerity**: rigorous self-discipline, without excess luxury or adornment
- **Consultation**: the ability to listen and synthesize differing views – a complementary strategy
- **Common Sense**: the ability to simplify and make informed choices

These principles have not been operative since the demise of the Soviet Union. There is a reasonable degree of certainty and optimism that the U.S. will recover from the current economic emergency. The parallel is that U.S. diplomatic leadership is at low ebb. The issue is: when will the U.S. economy recover and when will U.S. diplomatic leadership be restored. America is blessed with national common sense; listening and consultation is a relatively easy adaptation. The major problem is whether the American public and its political leaders can adapt to a period of austerity which will be necessary if there is to be a return to stability and increased economic prosperity.

Consumers, economists, and foreign policymakers may differ regarding the meaning of austerity because of their differing perspectives. However, there could be common agreement embedded in the concept of austerity.

(1) **Affordability**: Can consumers afford a new sofa when they have a large amount of credit card debt? Can the U.S. economy continue to have a huge balance of payment deficit and remain a debtor nation? What is the real cost of military undertakings and can the U.S. spread the burden of military operations among friends and allies?

(2) **There is a need for strategic thinking**: for consumers, the objective should be to live within their means; economists have a responsibility to clearly articulate what is known to them regarding the potential for future economic train wrecks including massive defaults of credit card debt; national strategy and national security policymakers have a responsibility to clearly define U.S. vital interests and the consequences of action to be taken, and to apply a cost-benefit analysis that is not necessarily measured in dollars.

Austerity means spending available funds wisely and well. For example, a major investment in repairing and restoring the U.S. railroad infrastructure could result in substantial energy savings – an economic and national security goal. •

Call Out the Leviathan

Frank Schell

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Like the captain of Longfellow's ill-fated ship Hesperus, America has not listened to much advice. When a country's store of value is also the world's reserve currency, it creates a moral hazard larger than any other: an all pervasive culture of debt, also known as leverage. America's bad listening skills about trade and treasury deficits have embraced several decades and administrations, but to be fair, crises are never predicted, except by a few seers to whom no one pays much real attention.

It is no secret that America has been consuming and living well beyond its means for some time, engaged in a non-partisan frenzy of gluttonous leveraging up, resulting in an outsized standard of living, where seldom was heard the word "enough." The Hummer, the tall latte with nutmeg, and 65-inch flat screen TVs are but a few examples of the nomenclature of indulgence.

No doubt some view excess as great – if you can get away with it. But in a world of free movement of labor, capital, ideas, and electrons, it will eventually be reckoned with by the world's credit and capital markets, which are beyond the real control of sovereign or consumer forces.

Falling housing values have impaired loan to value ratios, the immense mortgage backed securities market, the ability to refinance, and reduced the incentive to service debt on property. Through the technology of securitization – creating securities out of pools of residential mortgages – and with instant telecommunications, the problem has infected investors globally, from the G-7 to the emerging markets, often at the speed of light.

For several decades, a mosaic of deregulation, competition, and a short term view of performance and incentive compensation have led to the assumption of undue concentrations of risk. And mark to market or Fair Market Value accounting, recently relaxed by the SEC but never intended to bring the United States to its knees, has done just that by initially making bad decisions even worse.

It is very early to judge the longer term implications of this economic emergency. Besides the interventions by the Department of the Treasury and its recent focus on putting $250 billion of equity into the banking system, and besides the actions of the Fed and FDIC, and the G-7 acting in concert, further recapitalization of our banking system must occur. Estimated write-downs or losses thus far exceed $500 billion, and some predict twice this figure or more. This capital must be replaced from domestic or foreign sources, including sovereign wealth funds that have already ridden to the rescue.

It is hard to imagine that a global recession can be avoided. The vital commercial paper and London Interbank markets must function well for daily funding of the global corporate and banking sectors. Further, residential foreclosures continue to mount, and over $8 trillion of stock market capitalization capital has been wiped out in the U.S. in the past year. There is a climate of fear about how bad it will be for IRAs, employment levels and small businesses, which have limited alternatives to raise capital and employ over half of the U.S. work force. And as the American consumer deleverages, our standard of living will decline.

The nation's economy is built on the principle of access to capital – debt and equity. Until confidence is restored in our financial system, we will not see a return to normalcy. We are reaching a point where after the U.S. Treasury and other G-7 systemic actions, only time will tell. What has not been publicly discussed much is their effect on the nation's money supply, its relationship to future inflation, and what this means for future spending priorities.

On a philosophical level, this crisis will call into question the notion of the risk free rate, long a staple of financial theory. Pricing debt off a Treasury instrument of similar maturity, U.S. government risk has been assumed to be zero, with interest to reflect a premium for inflation. But the debt, equity, and contingent exposure being assumed by the Department of the Treasury, at this time an unknowable but vast figure, will affect how the world sees and prices U.S. sovereign risk.

This crisis has been consistently underestimated since early 2007, when the first shots were fired in the write-off of subprime loans in the U.S. Since then, we have seen wild gyrations in the stock market, and in the summer of 2007 a contraction in the now $1.6 trillion commercial paper market, affecting the ability of corporations to fund short term. Until the very recent systemic remedies, government interventions have been situational or ad hoc, directed only at certain floundering institutions. The disturbing question is how can so many brilliant minds and mathematical models be caught so unprepared?

Decades of free market theology and the principle of laissez-faire have been abandoned in a matter of weeks. Even some of the most ardent believers in deregulation have cried out for intervention, hoping there is a giant sovereign somewhere that can mitigate the mayhem – like the all powerful Leviathan of Thomas Hobbes – to avert a descent into chaos.•

The Financial Crisis and U.S. Military Policy

John Allen Williams

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Recent economic events serve as a stark reminder of the importance of a healthy economy for the achievement of national goals. This is not a new insight: President Eisenhower was so aware of the linkage between the economy and national security that he put Secretary of the Treasury George M. Humphrey on the National Security Council alongside the Secretaries of State and Defense.

Economic weakness will impact defense in two ways. First, diminished economic activity reduces the resources available for both public and private purposes. As a result, there will be fewer resources available to government without a significant tax increase. Second, defense needs will face increased competition from other governmental priorities. There are "opportunity costs." Other important initiatives cannot be pursued because of the massive level of resources that will be devoted to economic stabilization and possibly to domestic initiatives generally. The result could be an almost perfect storm diverting resources away from defense.

The new administration will inherit a military that is overstretched, undermanned, and badly in need of recapitalization to replace hardware used up in current wars and to develop and procure new weapons systems needed for future contingencies. Hopes of strengthening the military to prepare for post-September 11 challenges here and abroad are fading rapidly as we enter a period of retrenchment in defense spending. The projected retrenchment will involve both equipment and personnel.

Some recapitalization of equipment will occur, since the requirements for replacement and modernization are so apparent and hardware expenditures affect jobs in the civilian sector – including the jobs of Members of Congress from affected districts. The only way to save money quickly, however, is to reduce personnel, and the fastest way to add to the defense budget is to increase personnel. Despite promises to the contrary, neither party will now make appreciable increases in the size of the military. This will aggravate the strategy/force mismatch that has placed such a burden on military forces in the form of repeated and lengthy deployments, stop-loss programs to extend soldiers on active duty beyond their expected end of service, the use of reserve component forces in ways not previously contemplated, and well-documented problems with recruitment and retention.

So what is to be done in view of the economic crisis and the fact that national security issues are less important to the electorate than economic ones and will remain so unless there is a sudden crisis or terrorist attack? The answer lies in a combination of two strategies: repositioning and reconceptualization.

Repositioning. No one is more eager to move troops out of Iraq than are U.S. military leaders. But differences exist within the military about how fast troops can be withdrawn and how they should be used in the interim. When the situation in Iraq seemed most grave, some military leaders would have been willing to risk losing quickly in Iraq in order to free up forces to be available for use in areas they considered to be of more strategic importance. Iraq duties are eating away at the force, leaving the U.S. with little strategic reserve for deployment if other emergencies should arise. The relative calm in Iraq now gives one hope that the U.S. military footprint can be reduced. We can expect a significant shift of resources away from Iraq and toward Afghanistan.

Reconceptualization. The combination of new challenges and economic retrenchment will cause the military to reconceptualize how they do business. Economies must be found, whether this means deferring or reducing the buy of the highest technology combat equipment or increasing the use of Defense Department civilians and civilian contractors to perform missions previously thought purely military.

Similarly, the services need to consider the nature of the future battlefield and train and equip their forces effectively. Extensive debates are already underway in the military about the role of counterinsurgency operations as opposed to traditional war fighting missions. The result of these discussions will impact strategy, personnel, training, and equipment. Hanging over this entire discussion is the possibility that military forces could be tasked to perform some very unpopular missions inside the U.S. border. Most everyone understands and appreciates the military's role in the wake of natural disasters, but certain manmade disasters pose special problems for the military. Imagine the nightmare of the military being used to enforce a quarantine around a U.S. city. It is easy to understand why the military does not want to take the lead in disaster rescue efforts, but prefers to operate in support of whatever agency is responsible. Military operations are far more popular "over there" than they are "over here."

The silver lining of the economic crisis is that it is causing a thorough rethinking of military forces, missions, and strategy that is long overdue. Former Defense Secretary Rumsfeld famously remarked that you go into a war with the Army you have. More systematic thought may ensure that the military we have for the future will be more appropriate for the challenges we face.•

How Much Can We Afford?:

The Tensions Between Domestic and Foreign Policy Priorities

Endy Zemenides

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Despite years of massive budgetary deficits and a doubling of the national debt, three areas have escaped the scalpel of our nation's leaders: Social Security, Medicare, and national security (defined as defense spending). Even before the latest financial crisis, deficit hawks of all political persuasions declared American deficit spending as "unsustainable." For example, there is universal agreement among budget analysts regarding the need for entitlement reform. Defense spending has exceeded real expenditures at the height of the Korean War and approaches a level not seen since the end of World War II. All of this took place against the backdrop of a $400 billion deficit. Given the current credit crisis, the prospect of a deep recession, and the cost of the various bailout and stimulus packages, the United States is confronted with a deficit that could approach $1 trillion.

There has been debate over how much "blood and treasure" Americans are willing to sacrifice with regard to our foreign engagements. The primary concern, of course, has been American casualties. But in the current economic atmosphere, the concerns will also be about "treasure."

The next president and Congress will face at least three new realities:

A Return to Big Government

Given new financial priorities, some agencies will get at least as much attention as the Department of Defense in 2009. The highest profile appointment of the next president will be the Secretary of Treasury, whose priorities will be given greater weight than or will be on par with the Secretaries of Defense, State, or Homeland Security. National/homeland security may not be cut back substantially, but any additional spending will be allocated elsewhere.

Iraq Fatigue

The American public will seriously question the need to spend $10 billion per month in Iraq. Currently the Iraqi government is pushing for a status of forces agreement that commits the U.S. to a timetable for withdrawal subject to the conditions on the ground. There may also be political progress with provincial elections in 2008 and parliamentary elections in 2009. Additionally, Iraq may end 2008 with a budget surplus between $57 billion and $80 billion. These developments will move the debate from "was this the right war?" or "did the surge work?" to "isn't it time to stop spending so much on this war?"

Inability to "Go it Alone"

The need for coordination with the rest of the G-7 proved that the world is more interconnected than ever. We need our allies more than ever, and their actions can force us to take action. This became clear when British Prime Minister Gordon Brown acted to invest government funds directly in the U.K.'s banking system. The global economy may need to rework the Bretton Woods financial architecture in order to emerge from this crisis; if so, this will have major implications for United States influence in international financial institutions, and, therefore, its soft power. There is a great need for coordinated economic policies, and unilateralism will not be a viable strategic posture.

While much remains uncertain about the situation the next president is going to inherit, we know that budgetary deficits and the national debt are going to present the greatest long term challenge to our government. At the same time, American citizens will have lost substantial paper wealth in the stock market and in home values, the credit crunch will continue, and both the foreclosure and unemployment rates may have increased. In this environment, no area of the federal budget can remain sacrosanct – even spending for national defense.•

About the National Strategy Forum

The National Strategy Forum was founded in 1983 by Morris I. Leibman, a Chicago attorney and advisor to three US presidents. For more than 25 years, the NSF has taken the lead on a variety of cutting-edge strategic issues including US homeland security and defense, global counterterrorism, nuclear non-proliferation, cyber warfare, and emergency preparedness for a catastrophic incident.

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