9-29-2015

Strategic Insights: Economic Power: Time to Double Down

John F. Troxell

Strategic Insights: Economic Power: Time to Double Down

September 29, 2015 | Professor John F. Troxell

A recent editorial in *The New York Times* asked the question, “Who threatens America most?” It proceeded to compare recent pronouncements by incoming senior military leaders, the President, the FBI director, and finally the Director of National Intelligence. The major candidates included the usual nation states (Russia, North Korea, and China), a few nonstate terrorist organizations (ISIS and al-Qaeda), and a couple of unattributed capabilities (weapons of mass destruction and cyberattacks). The editorial concluded with the lament: “If officials cannot agree on what the most pressing threats are, how can they develop the right strategies and properly allocate resources?”[1] Given the confusion and uncertainty generated by the current strategic environment, compounded by America’s resource-driven retrenchment, it is a fair question. However, I contend that we could pursue a more focused national strategy and do a better job of allocating resources if we focus on the opportunities as opposed to this wide array of threats. The opportunity that beckons is the increasingly interconnected global economy and the integral role played by the United States in both its institutional design and future evolution. A functioning, interconnected global economy will mitigate most, if not all, of the previously mentioned threats, whereas a fractured and disconnected global economy will exacerbate them.

Since the end of the Cold War, there has been fairly wide acknowledgement that economic power would play a more significant role in the relations between nation-states. However, the 2008 global financial crisis not only set back the U.S. economy, it also tarnished the set of underpinning policies of the global economy, referred to as the Washington Consensus. The consensus, espoused by the United States and the Washington headquartered International Monetary Fund (IMF) and World Bank, postulated a set of market centric policies and open international trade and financial flows. The Chinese economy, on the other hand, was racing ahead and threatened to transition to economic leadership with a much different model, sometimes referred to as the Beijing Consensus. Diana Choyleva, chief economist at Lombard Street Research, recently characterized this as the Wizard-of-Oz effect: "Chinese leaders were perceived as omnipotent and great managers who had a very precise, top-down approach."[2] More recently, we have seen China bullying her neighbors, particularly in the South China Sea; Russia striking back against Ukraine and threatening her near-abroad; and sanctions regimes, the trump card of economic power, coming up short in Iran.

However, an assessment of the global stock market gyrations of August 2015 should establish two points arguing in favor of the United States reasserting a strategy focused on economic power. The first point is to recognize that the global economy is more interconnected than ever. In a *Wall Street Journal* editorial at the end of August, Niall Ferguson observed that, "For the first time in financial history, a sneeze in Shanghai gave Wall Street—and almost every other stock market in the world—a cold."[3] A slow down or hard landing in China will negatively impact emerging market nations who export commodities to China, and negatively impact developed economies that rely on Chinese consumers to import goods or purchase products manufactured in China by foreign invested enterprises. Recall Apple CEO Jim Cook trying to dampen Apple's stock price decline by noting continued high demand for Apple products in China. Global interconnectedness observed in stock and currency markets is also related to the "taper tantrum," driven by U.S. Federal Reserve Board policies concerning interest rates. The point is, that nations now understand that they are much more reliant on each other for the operation of a healthy global economy.

The second point relates to the relative economic power of the major players in the global economy. It should now be clear that the United States retains the strongest hand. China's global economic footprint has never been larger, but the green curtain of the Wizard-of-Oz has been pulled back, revealing the immense challenges that China faces as it attempts to reform its economic model and its leadership may not be as omnipotent as advertised. The U.S. economy is not perfect, but it has maintained a steady growth rate, much better than other developed nations. Other strengths include innovation and research and development spending, higher education, a recapitalized banking system, increasing energy production, and ownership of the world's reserve currency. Finally, the United States continues to play a leading role in all of the major institutions that support the global economic system. An argument could probably be made that the United States is even more dominant in military power than economic power, but economic power can be applied with fewer constraints and conditions, and potentially generate a longer lasting payoff.

Power can be defined as the ability to produce preferred outcomes and can be exercised in a coercive or co-optive manner.[4] Coercion is often viewed as hard power and co-option or attraction or persuasion is consider soft power. Economic power fits in both categories. Sanctions represent the application of hard economic power in an attempt to deny access to markets, or other financial resources. I consider sanctions, or the application of hard economic power, to be more tactical in nature. For example, the economic sanctions regime imposed against Iran was a tactical approach to get Iran to negotiate over their nuclear program. However you judge the outcome of the negotiations, the sanctions regime did what it was intended to do, bring the Iranians to the table. A recent study by the Center for a New American Security (CNAS) discusses the concept of coercive economic measures.[5] As the CNAS study makes clear, economic sanctions will continue to be an effective instrument in the exercise of national power. However, the soft power aspects of economic power are much more important at the strategic level.

The strategic framework that best captures the utility of an economic approach to U.S. strategy was presented by Thomas Barnett in the *Pentagon's New Map*.[6] Barnett focused on the concept of connectivity: national economies that are either connected or not to the global economy. The resulting strategic imperatives are to expand the core—that group of nations that are connected; and shrink the gap—those that are disconnected. A rules-based international economic system that is proven effective and inclusive will attract nations to participate and pursue the common goal of economic prosperity. Barnett's framework has been integral to U.S. strategy for a number of years. As early as 2005, Deputy Secretary of State Robert Zoellick urged China and others to become "stakeholders" in the global economy.[7] Economic development has been a "core pillar" of U.S. foreign and economic policy for many years. These concepts are not new, but the current circumstances make it propitious to reemphasize this approach and prioritize actions to drive it forward.

The 2015 *National Security Strategy* includes all of these points, but lacks an established priority. It recognizes that America's economic strength is the foundation of our national security and influence abroad, that it is in our interest to support an open international economic system, and includes many proposals to strengthen that system. We just have to implement the strategy. Specific measures that should be emphasized:

- Continue to support the Bretton Woods institutions, but push for necessary reforms to both the IMF and World Bank. To the extent that other institutional arrangements are proposed that adhere to existing international standards, they should be supported. A case in point is the Chinese sponsored Asian Infrastructure Investment Bank. The United States mistakenly tried to block membership, only to have this effort fail and thus create further distrust with China. The need for infrastructure development is huge, more than enough to go around.
- Support free trade agreements. Both the Trans-Atlantic and Trans-Pacific pacts should be pursued, with a current emphasis on closing the negotiations on the Trans-Pacific Partnership. The most important aspect of this agreement is its expansibility. We should encourage additional nations to apply as soon as the

agreement is finalized. China has expressed some interest and should be encouraged to join.

- Demonstrate fiscal responsibility. The U.S. dollar's global reserve status confers tremendous benefits for the United States. We must follow sustainable policies to preserve its status. Fiscal responsibility has always been an important dimension of national security, not only because domestic prosperity is in itself an important national interest, but also because the state of domestic economic health has an obvious and direct bearing on overall national power.
- Demonstrate global leadership by pursuing this list of policies which will strengthen the global economic system and attract stakeholders and adherents, and show that the United States remains committed to an open and free global economy.[8]

One brief example will demonstrate the rationale for a global strategy based on economic power. The effectiveness of any strategy should be judged by the resultant relationship between the United States and China, because this relationship will define the 21st century. The global stock market volatility from this past August, referred to by the Chinese *People's Daily* as "Black Monday," highlights the need for economic reform in China and the difficulty of achieving it. The economic reforms initiated by Deng Xiaoping have done a great job in propelling China forward, but its economic growth has been based on exports through cheap labor and easy technology adoption. That model has run out of steam, and China has reached the middle-income trap where further growth depends on transitioning to a consumption based, post-industrial model. The Chinese leadership knows what is at stake and proposed a sweeping package of reforms in November 2013, proclaiming a "decisive role" for the market. China's reforms and the road ahead for the Chinese economy is closely aligned with the rules of the established international economic order. In fact, many of the actions taken by the People's Bank of China associated with the "Black Monday" crisis, to include cutting the link between the dollar and the yuan, and further liberalizing interest rates in the Chinese banking system, are in line with Western approaches to monetary policy. Edward Steinfeld, director of the MIT China Program, had earlier concluded that, "China today is doing what we in the United States and the advanced industrial West more broadly have for decades hoped it would do. It has invested itself in our global system," it is playing our game.[9] To the extent that we focus on economic issues and continue to refine and support the global economic system, we will be able to attract stakeholders and encourage other nations to strive for the common good of global prosperity.

Steinfeld also argues that America should recognize the opportunities represented by China's integration in the global system. That is the point of this article. The various threats and concerns that were enumerated in the first paragraph are still there and must be addressed by the application of all instruments of power: diplomatic, information, military, and economic. But these threats are not existential, they are manageable and most are being managed today. What really matters for the long run and what will have the greatest impact on the security and prosperity of the United States is to get nations to pursue the common goal of economic prosperity. The United States should focus on the opportunity presented by an increasingly interconnected global economy, ruled by institutions and rule-sets we created, and in which we hold the strongest hand.

ENDNOTES

1. "Who Threatens America Most?" *The New York Times*, August 12, 2015, available from *www.nytimes.com*.

2. Diana Choyleva, "For All Its Heft, China's Economy Is a Black Box," *The Wall Street Journal*, August 24, 2015, available from *www.wsj.com/articles/for-all-its-heft-chinas-economy-is-a-black-box-1440467253*.

3. Naill Ferguson, "'Chimerica' and the Rule of Central Bankers," *The Wall Street Journal*, August 27, 2015, available from *www.wsj.com/articles/chimerica-and-the-rule-of-central-bankers-1440717632*.

4. Joseph S. Nye, Jr., *The Future of Power,* New York: Public Affairs, 2011, pp. 7-11.

5. Zachery K. Goldman and Elizabeth Rosenberg, *American Economic Power: The New Face of Financial Warfare,* Washington, DC: Center for a New American Security, June 2015, available from *www.cnas.org/sites/default/files/publications-pdf/CNAS_Economic_Statecraft_061115_v02.pdf*.

6. Thomas P.M. Barnett, *The Pentagon's New Map: War and Peace in the Twenty-First Century*, New York: G. P. Putnam's Sons, 2004.

7. Robert B. Zoellick, "Whither China? From Membership to Responsibility," Remarks to the National Committee on U.S.-China Relations, September 21, 2005, New York, available from *https://www.ncuscr.org/sites/default/files/migration/Zoellick_remarks_notes06_winter_spring.pdf*.

8. A recent study from the Atlantic Council, although focusing solely on the Asia-Pacific region, provides an excellent discussion on additional institutional reforms and enhancements the United States should support to strengthen the global economic order. See Olin Wethington and Robert A. Manning, *Shaping the Asia-Pacific Future: Strengthening the Institutional Architecture for an Open, Rules-Based Economic Order,* Washington, DC: Atlantic Council, June 2015, available from *www.atlanticcouncil.org/publications/reports/shaping-the-asia-pacific-future-strengthening-the-institutional-architecture-for-an-open-rules-based-economic-order*.

9. Edward S. Steinfeld, *Playing our Game: Why China's Economic Rise Doesn't Threaten the West,* New York: Oxford University Press, 2010, p. 234.

*****