# Economic Security and U.S. Leadership: Has Globalization Changed the Need for American Leadership in the World Economic System?

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## Introduction

The short answer to the question posed by the title to the lecture is: you bet. And not only is American leadership important to the world economic system, but for our overall foreign policy goals of peace, security, and prosperity. All of this relates to a new research project that I am just beginning, so this presentation provides a convenient opportunity to sketch out the basic themes. I have been motivated to take on this topic by the tendency of those who think about our foreign policy to ignore economics and focus not only on immediate security issues, but also on the use of military power to either preserve the peace or respond to violence when it occurs.

## A Changing World

The starting point for understanding how economics affects international relations and our foreign policy is to recognize that the world we live has changed fundamentally in the past century. We are more connected to the world today through trade investment than at any point in the past.

On trade, it is common for political scientists to discount the recent rise in our interdependence by stating that we are no more dependent on trade than we were a century ago. In a crude sense, that statement is true. A common way to measure how connected we are to the world is to measure trade (exports or imports) as a share of our total economy (that is, gross domestic product, or GDP). Today we export 8 percent of our GDP and import 12 percent. These levels are up sharply from 1960, when both imports and exports were only about 3 percent of GDP. But back in the 1890-1910 period, exports ran 7-8 percent of GDP, and imports 5-6 percent. It is fair, therefore to acknowledge that, as a share of our total economy, trade sagged in the middle of the 20$^{th}$ century (due to the Depression, our imposition of higher tariffs in the early 1930s, and the disruptive effect of the Second World War). But, it is still correct to say that we are even more connected today than we were a hundred years ago, especially on the import side.

Also keep in mind that the domestic manufacturing sector is a smaller share of the economy than it was a century ago. Rather than measuring exports and imports as a share of the total economy, it is more appropriate to view them as a share of total domestic manufacturing output. If we do this, exports and imports today are on the order of 40 to 50 percent of domestic manufacturing output.

Furthermore, trade in service industries has been expanding rapidly and is far more important than it was in the past. Economists used to think of services as being more difficult to trade. In the classic "Econ 101" lectures, professors talk about haircuts; in order to export a haircut, the foreign person getting the haircut would have to travel to our country, limiting the possibilities for trade. But today we have many services that are readily traded—financial services, telecommunications, airline travel, etc. Just consider the fact that back in the academic year 1954-55, only 34,000 foreign students came to the United States to study (limited by the cost of travel and the fact that for much of the world at that time, tuition appeared very high and the cost of living in the United Stat5es was also high). In the 2002-2003 academic year the number of foreign students was 590,000, a huge increase. Especially for some graduate programs in engineering and the sciences, foreign students are now a very large part of the student body.

The other side of international connection is investment. Unlike trade, we do not have reliable economic data on investment flowing into or out of the United States dating back to the 19th century. However, as recently as 1980, the inflow of foreign direct investment (those investments in which foreigners have a controlling interest) represented only 5 percent of what economists call fixed non-residential investment. That is, the inflow of investment by foreign-owned firms was only 5 percent of the plant and equipment investment in the U.S. economy. By 2002 that ratio was up to 17 percent.

Investment can also be in the form of portfolio investment—those investments that do not involve acquisition of a controlling voice. I have not yet collected data on the inflow and outflow of these investments, but it is fair to say that there has been an explosion of investment activity—commercial lending, bond trading, and portfolio equity trading—across our border in the past half century. Among those investments are foreigners' purchases of U.S. federal debt. Today some 35 percent of total outstanding U.S. government debt is owned abroad.

These rising economic connections between the United States and the rest of the world have reached very significant levels. They are not options. Theoretically we could choose to limit both trade and investment, but this would not be good for us economically or politically. Economically, all economists agree that we are better off with more open markets and more trade and investment (the current popular debate about the loss of jobs to China notwithstanding—a subject explored a bit further on). Politically, any effort on our part to limit trade and investment would be met with anger by our economic partners. Even a limited protectionist effort, such as the Bush administration's protection of the steel industry in 2002, irritated Europe, Japan, and other governments around the world.

**How Did This Happen?**

Why have we become so much more interconnected with the rest of the world? And how has our interdependence changed qualitatively? I would argue that there have been three fundamental shifts in the world in the past century.

**The collapse of imperialism.** The predominant organizing principle for the economic relationship between the advanced nations and the rest of the world from around 1600 to the mid-20th century was imperialism. Within these imperialist empires, trade and investment moved very freely; between them there tended to be substantial barriers. While the system might have enhanced trade and investment flows within colonial empires, it ultimately limited such flows because of the barriers among the major powers that grew out of their sense of nationalistic rivalry.

Qualitatively, the system of imperialism also created endless conflict among major powers. In the 17th century, when Dutch and British each began developing direct trade with what is today Indonesia to buy nutmeg (highly valued in Europe as a supposed means to protect oneself from the Plague), neither side could conceive of an open trade system in which simply competed in the marketplace. Instead they engaged in decades of warfare to eliminate the other side in this competition (finally ended when the British agreed to stay out, in exchange for receiving control of New York, then a Dutch colony).

This limiting and conflictual organizing basis for global trade and investment continued to the mid-20th century. Even though it was collapsing by the time I began school, I still remember having maps in my elementary classrooms which had many parts of the world colored in red for the British Empire. The process of collapse also created conflict, as local populations struggled against their colonial masters to achieve independence. Even the bloody Vietnam War was an outgrowth of imperialism, dragging in the United States after the French were finally booted out because of our Cold War fears of nationalism leading to Communism. One could argue that even the Iraq war was a lingering consequence of imperialism, with the Middle East still struggling with artificial boundaries set in colonial days and with continuing anger directed at the West.

**Creation of the Bretton Woods Institutions.** Just as the imperial system was on the verge of disintegration, the major powers met in the midst of the Second World War to design a new architecture for postwar economic governance. Named after the New Hampshire resort hotel where they met, the allied powers, led by the United States and Britain, established the Bretton Woods system, comprising of the General Agreement on Tariffs and Trade (which has now become the World Trade Organization), the International Monetary Fund, and the World Bank. Although the creators of this new syst6em did not intend for it to be a replacement for imperialism, it did exactly that.

The GATT and now the WTO provided a mechanism for fair access for all participants by adopting the principle of "most favored nation" (MFN), requiring that a trade concession offered to one partner must be offered to all. This was a radical departure from both imperialism and a prewar tendency by countries like the United States to cut special deals with only some trading partners. Equally important, this new system opened the way for a series of large multilateral trade negotiations that have brought trade barriers around the world down substantially. We do not live in a world of free trade, but we live in a world of much more open trade than a half century ago. Initially focused only on trade in merchandise, this system is now tackling the issue of making trade in services more open as well.

The International Monetary Fund (IMF) provided a parallel framework on the financial side. Initially set up to preside over a system of quasi-fixed exchange rates among major nations (replaced by floating exchange rates in the early 1970s), the IMF has had two major accomplishments in its existence. First, it has become the core global institution to organize responses to international financial crises caused when a particular country cannot repay debts owed to others. Second, it has provided a process of encouraging its members to liberalize financial flows into and out of their countries. Most major countries (though not the United States) maintained substantial barriers to these flows in the first several decades after the Second World War. International capital flows among the developed countries are now virtually gone, and even the developing world has been gradually easing rules restricting these flows.

The World Bank, initially intended to be a temporary institution to help rebuild a war-torn Europe until a viable, sound commercial banking system reemerged, became the mechanism for the developed world to reach out to developing countries to assist in their aspiration to industrialize. In this manner (and through bilateral foreign aid), developing countries could obtain some assistance outside the demeaning and confining mechanism of imperialism.

All three of these institutions have been criticized in recent years for flaws and mistakes. Nevertheless, when viewed in the context of the broad sweep of the history of the past several centuries, they were a revolutionary development and have enabled an extraordinary expansion of trade and investment.

**The revolution in transportation and telecommunication.** Both international transportation and telecommunication costs have plummeted in the past half-century, making global flows of goods, services, and capital more feasible. In transportation, the creation of container ships, roll-on/roll-off vessels, and bulk carriers for oil and other raw materials dramatically lowered the cost of ocean transportation. Just imagine: today the cost of transporting an automobile from Japan to the United States is only about $300, a very small share of the $15,000-$30,000 value of the car. In telecommunications, the drop in costs is equally dramatic. The first time I ever made a phone call from the United States to Japan required going through an operator, and cost $10 for the first three minutes and $3 for every minute thereafter, and this was as recently as 1970. Today we call Japan for only pennies per minute. Even more dramatic is the emergence of the Internet, where I can communicate with Japan by e-mail at zero marginal cost since I pay only a monthly connection fee.

This set of three changes has altered both the quality and quantity of global economic interdependence. The obvious quantitative outcome has been the explosion of trade and investment. For the world as a whole, the ratio of exports to global GDP rose from 12 percent in 1960 to 30 percent by 2002. This expansion has occurred broadly across the world—both rich developed countries and poor developing nations. Economists are almost unanimous in arguing that this expansion of trade has been good—the recent anti-trade groups that have opposed the WTO are quite simply wrong.

A similar expansion of flows of direct investment has also occurred. Back in 1970, the ratio of foreign direct investment to global capital formation was only 2 percent. This ratio began rising in the mid-1980s and by 2002 was 17 percent.

Qualitatively, this new system is much more robust. The Bretton Woods system has enabled a spread of the rule of law to government trade, investment, and the inevitable commercial disputes that arise. In the past two to three decades, an increasing number of developing countries have lowered their trade and investment barriers because they realized that they could do so without raising the specter of a return to colonialism. Similarly, the great powers have accepted the idea that their domestic firms can compete around the world, but within a set of rules that apply to all. Governments have no legitimate role in supporting the interests of the corporations of their own country through the threat or use of military power. This is an enormous change from the past. Just realize that the British and Dutch were fighting over access to Indonesian nutmeg only 400 years ago—hardly a long time ago in the broader sweep of history. They were also fighting with Indonesian—a premodern society that was unfamiliar with the rapidly emerging legal systems governing trade in Europe, and which would often comply with Western rules only at the point of a sword. Even today, corporations from advanced nations often chaff against what they regard as protectionist or poorly designed laws and regulations in other countries, but they accept the notion that they must abide by those rules (and work through the rules of the WTO or IMF in the longer run if they want to change these laws and regulations). The essential robustness of the contemporary global economic system should provide food for thought for those Americans who are still convinced that our military power is a necessary part of maintaining security of oil supply in an unstable Middle East (more on that later).

As a result of these changes, the current global system is also much less conflictual than the imperialist system that it replaced. Great powers need not, and do not, engage in the kind of commercial rivalries that characterized the past. As recently as the 1930s, the United States drifted toward war with Japan because of fears that we would be excluded from markets in China as Japan extended its imperial reach. While the Japanese were particularly bloody in their approach to conquest and colonization of its neighbors, there were doing something essentially similar to the Western powers, and the result was the Pacific War. Today such an approach to trade and investment by Japan is simply inconceivable.

I have deliberately painted a rosy picture above. The game of international trade and investment is certainly often a messier one than economists have in mind when the airily draw supply and demand curves on the blackboard. Corporations readily bribe host government officials for favored access to the local market. Our governments try to help domestic firms operating abroad by showering foreign aid or outright bribes on developing country governments. We engage in our own protectionist policies when politically convenient. We fight vigorously in bilateral negotiations or through the WTO to get others to lower their trade and investment barriers. But the key point is that military power—either its existence in the background or its actual exercise—no longer has any legitimate role in global trade and commerce.

More importantly, we are now confronted with new conflictual issues related to rich and poor countries. In the rosy picture painted above, I neglected to mention that not all countries have succeeded in growing and industrializing. The poorest countries in the world have been falling relatively farther behind the United States in the past 30 years. For example, GDP per person in Africa was 10 percent the U.S. level back in 1970 and had fallen to only 5 percent by 2000. Bad government, corruption, ethnic conflict, poor policy responses to the oil crises of the 1970s, all conspired to keep some countries off the escalator of economic development. The poverty, diseases, and bitterness accompanying these failures make such countries breeding grounds for terrorism and/or aggressive behavior toward their neighbors. To be sure, not all poor countries are hotbeds of terrorist activity, but some are and others could easily become so.

**Implications for American Policy**

Our national interests are affected by these changes in the global economy in three important ways:

1. Managing interdependence has become far more important to us, and the cost of behaving unilaterally has gone up. We are obviously much more intertwined with the rest of the world than in the past. Politicians and pundits often speak of making the U.S. more independent on oil, for example, but this is simply unrealistic. The fundamental reality is that we are—and will remain—dependent on the outside world for oil and a wide variety of other raw materials, manufactured goods, and even services. There is no away around this dependency so we had better learn how to live with it. The essence of living with it is to realize what interdependence really means: we choose to behave unilaterally in ways that damage the interests of our partners at our own peril. Every player, big or little, in the economic system has the capability to retaliate against us should we behave badly, and that right is enshrined in the WTO. Similarly, when we want others to lower their trade or investment barriers, we can do so only through a bargaining process in which reciprocal concessions are the name of the game; simply demanding that others give into what we want is insufficient.

   Just to give a small example of how interdependence even extends beyond the boundaries of economic behavior, consider what has happened to foreign students. In our zeal to fight the war on terror, we have made it more time consuming and onerous for foreign students to enter the country. For the first time in at least half a century, the number of foreign students in the United States in 2003-2004 had declined from the previous year. This hurts our universities (lost revenue), especially our graduate science and engineering programs, the future of our economic and technical leadership (which has long depended on an inflow of students from abroad who remain to do significant scientific work here), and our global reputation as a leading nation in the world. Our post-9/11 policy on foreign students (as well as visas for business people) has been a disgrace. Surely our government could have been more careful in approaching the legitimate need to week out potential terrorists, and at least could have realized that it needed to provide a larger budget to process visas if it were to accomplish its homeland security goal without jeopardizing our important export business in higher education.

2. We are confronted by a dynamic world in which the successful global economic system is creating new players. We need to figure out how to incorporate these players peacefully. From the end of the Second World War to the beginning of the 1990s, we cut off China, Russia, and other Communist countries from the new economic order. Now China is growing rapidly, and Russia—after a rocky start in the 1990s—is producing growth as well. One of the most important tasks we face is how to accommodate their growth and engagement with us and the rest of the world without sparking a new round of security tensions.

3. We are confronted with the dilemma of the failure of some poor states. During the Cold War, we showered foreign aid on friendly poor countries (often supporting repressive regimes operating dysfunctional socialist economic systems) through the World Bank and through our own bilateral foreign aid. Once the Cold War was over, our interest in foreign aid flagged. But we need to be concerned with the problem of failed economies as they will present the most troubling foreign policy problems for us in the next several decades.

**What Can We Do?**

So what does all this add up to? What specifically should the U.S. government be doing that is different from how we have handled foreign policy issues in the past? Here are seven possibilities to think about:

1. In the short run we need to finish the Doha Round of WTO negotiations. This round is aimed specifically issues of importance to developing countries, such as American restrictions on agricultural products (including cotton) that developing countries would like to export more of as part of their development strategies. We are about halfway through these negotiations but they have been stalled since the summer of 2004. We need to recognize that these trade negotiations are connected to our broader foreign policy goals and not just our economic interests.
2. Keep American markets open. We also need to resist the temptation to restrict access to American markets. Even within the WTO there are mechanisms governments can use to inhibit access. But we should avoid doing so as much as possible. For example, now that we are removing quotas on the import of

textiles and apparel (a final phase-in of the previous round of trade negotiations—the Uruguay Round signed in 1994), we have already put in place a special restriction on socks from China. If extended to very many other products, this is a very poor way to deal with a China with which we are struggling to obtain full implementation of its own WTO obligations.

3. Reform the IMF and World Bank. Both of these institutions have been heavily criticized in recent years, for reasons of both actual behavior and decision making processes. Some reform has already occurred at both of them, but we should seriously consider further reforms that address the frustrations of the developing countries without jeopardizing the functions of these key institutions.
4. Rethink and increase our foreign aid. The Bush administration substantially increased American foreign aid after 9/11. But we need to engage in a deeper discussion of what to do with that aid, with many criticizing our current policies as to insistent on promoting free markets in recipient countries.
5. Engage China and Russia very closely economically. The so-called "neo-realists" in the field of international relations theory argue that we should contain China, or even prevent its economy from growing. Quite to the contrary, through a combination of pressure on China to open its market to trade and investment further, and resistance to protectionism here at home, we should engage China even more deeply. As China becomes more deeply interconnected with the outside world economically, it has more to lose should it behave foolishly on strategic issues (such as military action against Taiwan). We cannot entirely guarantee China's good behavior, but it is far more likely to behave in ways that we find acceptable if we embrace them than if we contain them. Much the same can be said of Russia, where we need to encourage growth and economic reform and can do so best through expanded economic engagement.
6. Possibly revamp American government policy making. I am still unsure whether it makes sense to engage in changes in some government structures (such as which cabinet secretaries make up the National Security Council). However, there are at least 2 obvious things that should happen. In a very general sense, officials simply need to be taught to be more cognizant of economic issues as they devise foreign policy. Second, in a small way, officials should be made to see outside their narrow interests. In the State Department, for example, young career officials choose either the economic or political/military career path. When I worked in the American Embassy in Tokyo, I was dismayed at the ignorance and misconceptions that those officials in the pol/mil section had about economic issues. Similarly, the economic officers had little interest or understanding of political issues. This stove piping is dysfunctional.
7. Recognize that our future economic and military security depends on our own performance. Our domestic economic policies are usually debated only in terms of their direct impact on the American people. But we need to remember that our own growth and affluence are an important part of our broader influence in the world. We are the leader at the WTO and IMF in

large part because of our enduring economic success. The recent policies that have led to the downturn in foreign students studying in the United States is only one example of the kind of policy where we need to be more aware of what we are doing to ourselves.