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Global Business & Development Law Journal

Volume 18 | Issue 2

Article 8

1-1-2005

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In the early 1990s, "Western Internationalist" euphoria was dominant. As communism collapsed, the "Western" OECD[1] democratic market economy/welfare states remained the primary models for development. Most developing countries in Asia, Latin America, and even some African states accepted this trend. Russia and East Europe had switched to "democracy and liberal prosperity." Authoritarian regimes were widely failing and in retreat. Saddam Hussein's Iraqi invasion of Kuwait was routed in early 1991 by a led coalition. The United Nations enjoyed resurgence as a mechanism for peace-keeping. Meanwhile, the International Monetary Fund ("IMF") and new World Trade Organization ("WTO") promoted more open trading and capital markets. Regional economic integration was strengthened in the wider European Union ("EU"), North American Free Trade Association ("NAFTA"), Association of South East Asian Nations ("ASEAN"), and Mercosur (for South American nations—Argentina, Paraguay, Bolivia, Brazil, and Uruguay). A Wilsonian trend of broadening democracy, freer trade, and world peace seemed to be under way. The United States played a strong leadership role for all of this in the early-mid 1990s, seeing itself as the "sole superpower" or "indispensable" nation. By the later 1990s, however, realists observed that a multipolar system had replaced a brief period of U.S. hegemony. The new international relations framework still allowed scope for American initiative but was constrained by a need for extensive support from other nations.

By 2003 to 2004, this new framework was under strain and was possibly unraveling. Rogue states, international terrorists, and nuclear proliferation threatened U.S. interests and world peace, especially in the Mid-East. The Israeli-Palestinian conflict and War with Iraq strained that region and could expand the dangers of terrorism. Although Great Powers (United States, EU, Russia, China, Japan, and India) in the UN Security Council renewed weapons inspections in Iraq in the fall of 2002, considerable disagreement remained in the United States and world community about the next steps. Many believed that Saddam Hussein's regime would get significant nuclear and other Weapons of Mass Destruction ("WMD") capability within several years. This led to a choice in 2003, between the United States and allied intervention, to eliminate Hussein's regime or impose a stronger network of containment, nuclear deterrence, and surveillance from the United States and the UN Security Council. The Bush

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1. Organisation for Economic Co-operation and Development.

administration chose military intervention and regime change. Many nations disagreed. This Iraq war was controversial and its longstanding effects would depend upon how a successor regime could be established.

Meanwhile, faith in global free trade and open capital markets weakened, especially among new industrial countries ("NICs") and less developed countries ("LDCs"). In the early mid-1990s, a "Grand Bargain" seemed to be forming between developing and industrial nations. Let global markets remain "free" in the long run but allow developing and industrial nations an extended period (eight to twenty-five years perhaps) in which they could still employ substantial tariffs, subsidies, and restrictions to foster industrial and economic catch-up. Major asymmetries would be tolerated because multinational corporations ("MNCs") could relocate manufacturing operations to lower-wage countries. Job losses or "transfers" would hurt advanced nations, but their sales and profits could be extended by the MNCs (based mainly in the advanced OECD nations). Service activities (especially those involving high "tech," computers, telecoms, banking, finance, insurance, and securities) would be enhanced in the most advanced countries and spread to developing nations. In this way economic "progress" would broaden and be shared more widely. Big new capital flows surged into "emerging markets," at least for some years. These OECD investments and trading activities helped sustain the "bull market" of 1993-2000 (especially benefiting the United States). Ironically, more capital from abroad also found its way back into the U.S. dollar and stock market, which covered growing U.S. trade deficits.

Unfortunately, economic "progress" of the 1990s was shared unevenly. Many areas felt short-changed and left out. The United States did well overall (despite losses of manufacturing jobs in many communities), until its stock market slumped in 2001-2002. Most of the EU countries did reasonably well during this decade, as did Australia and Canada. ASEAN, Taiwan, and South Korea did well until the Asian crises of 1997-1998, with uneven recoveries thereafter. China did very well, although pockets of unemployment, poverty, and adjustment strains are problems. Japan held its own, more slowly, with continued export success. Japan, however, worries about low wage competition from the rest of Asia. India progressed, though not as rapidly as the Chinese. Most of Latin America did reasonably well, although Brazil, Argentina, Columbia, and Venezuela recently slumped. Conversely, the majority of Islamic states suffered slower growth or stagnation, and most of Africa was stagnant or worse. In Russia and Eastern Europe, the restructuring and building of sound market institutions took longer than many expected, but by the late 1990s, recovery was under way. Following the 1990's prosperity, the world slumped into general recession from 2001 to 2002 and most countries became more defensive in trade bargaining.

Disciplines of international finance intensified this reluctance toward further opening. Most countries had to limit balance of payments and current account deficits. When nations allowed themselves to become "dependent" on large capital inflows from abroad, financial markets raised questions about the "reliability" of these foreign investments. When profits and interest payments to foreigners and MNCs are unreliable, and/or people worry about devaluation of their currency, capital flight follows (and capital inflows turn into capital outflows). As capital markets opened more fully (typically following IMF advice), a vulnerability to capital flow reversals increased. Worries about global industrial competition and excess capacity, especially from the Chinese giant, now make most NICs and LDCs reluctant to open themselves any more to imports. Also, rising new service industries, banks, finance, telecoms, etc., in developing countries want limits on competition from leading MNCs of the OECD bloc. For all these reasons, most NICs and LDCs are now reluctant to move toward the rapid market opening contemplated in the early 1990s. In other words, transitional protection is being extended. We see now a widespread retreat from universal free trade and laissez faire.

As these insecurities and problems increased over the last five years, the "Grand Bargain" on globalization between developing and advanced countries has been challenged. NICs and LDCs complain of increased global competition for manufacturing, serious currency devaluation risks, and major recession risks (at their end). While many people gained, the majority remain relatively poor and insecure. The developing countries want more safeguard relief, more access to richer country markets, reduced MNC property protection, and lower pharmaceutical prices. In short, they seek to realign the "Grand Bargain" in their favor. Meanwhile, advanced countries suffered slowdown and slump in their "post-bubble" economy, and accumulated job losses have been worrisome at their end. Most advanced countries want better safeguard relief, more worker and investor protections, and see little or no need to revise the "Grand Bargain" in favor of developing countries. In fact, a broad dissenting class among both advanced countries and developing nations complains about the excesses of "globalization." Most critics want stronger limits on globalization, although achieving consensus will be difficult among these conflicting critiques.

In this situation, the long-term strength of the U.S. dollar has been called into question. The dollar has been the dominant world currency since World War II, when U.S. industries had a predominant position in the world economy. However, Europe, later Japan, and more recently South Korea, the ASEAN group, and now China, have become major industrial rivals. The United States is no longer economically predominant, and moreover, during the last few years the EU's euro became the currency for twelve important nations, with a clout comparable to the United States in population, output, and global market strength. Further, EU countries now maintain an overall balance in trade with other parts of the world and do not depend on foreign lending or investments to maintain their standard of living. In dramatic contrast, the United States has

suffered increasingly larger trade deficits since 1983 and sizeable current account deficits since 1985. For the last twenty years, U.S. trade deficits totaled negative $4,000 billion and current account deficits totaled negative $3,500 billion. From 2003 to 2004, the U.S. trade deficits were over negative $500 billion, and the U.S. current account deficits are now negative $600 billion (over five percent of the U.S. Gross Domestic Product ("GDP")). External account deficits of this magnitude are simply unsustainable for the United States.

For several years after its launch in 1998, the euro sank from an initial value of $1.17 per dollar to a low of $0.82, which reflected a lack of global confidence in European industrial growth and stock prices as compared to the U.S. economy and its surging bull market. From 1993 to 2000, the U.S. Dow Jones industrial average trebled, while the NASDAQ multiplied more than six-fold. Since those peaks in early 2000, the Dow Jones average declined by roughly one-third, the NASDAQ by two-thirds. Meanwhile, the euro recovered to rough parity with the dollar or about $1.00 per euro in the summer and fall of 2002, and surged back up to $1.35 per euro by November 2004.

Many international economists now believe the U.S. dollar was overvalued with respect to the euro and other currencies. The question is by how much? The answer will be worked out in the next few years. That answer depends upon: (i) real growth rates (discounted for inflation) for the United States and EU; (ii) government budget deficits for the United States and EU; (iii) trade and current account deficits for the United States and EU; (iv) global and domestic confidence in the debt and stock markets for the United States and EU; (v) success or failure in military operations and relative security for the United States and EU; and (vi) overall political cohesion, public morale, and sound administration in the United States and EU. Relatively speaking, the United States did well compared to the EU between 1993 and 2000. Between 2000 and 2002 the EU caught up some, and/or the U.S. post-bubble and September 11, 2001, slump reduced relative confidence in the United States dollar between 2001 and 2003, as compared to the EU and the euro. What will be the verdict of history and markets between 2003 and 2008? And beyond? Time will tell, but the quality and wisdom of U.S. finance, trade, and security policies will have a lot to do with these outcomes. Also, the success (or failures) of U.S. and foreign military operations, alliance relationships, and defense efforts will be important, too.

In this period of strain for global security, trading, and finance, there is a resurgence of realism, with less naïve optimism. The majority of countries want broader world peace, expanding prosperity, and more productive collaboration. But in our multi-polar world, with less hegemonic influence from the United States, the challenge of achieving better results is tougher. We are learning that the UN's Security Council and General Assembly, the IMF, and the WTO cannot easily fashion multilateral policies that guarantee results. Regional and bilateral deals, and even unilateral action, may be the only way forward on some issues. Achieving greater "flex" is essential for international trade-finance. It's worth

emphasizing that the gradual, increased world growth, trade and prosperity from the late 1940s through 2000 occurred largely from loosely coordinated, but mainly national and regional efforts involving the United States, much of the former British Commonwealth, the European Community (EEC becoming the EU), key Asian nations (Japan, the four smaller tigers: Taiwan, South Korea, Hong King and Singapore, and more recently, ASEAN, China and India), together with some Muslim oil states (particularly from the Persian Gulf).[2]

Obviously, a central challenge over the coming years will be how to sustain and broaden this prosperity. As most OECD nations slowed or stalled in 2000 to 2002, so did most developing nations (NICs and LDCs). Was this a temporary cyclical pause, or a potential world depression as occurred in the 1930s? The answer depends upon evolving finance-trade policies, and the prospects for limiting disruptive conflict and terrorism. Clearly, the tragic events of September 11, 2001 remind all that healthy economic performance depends upon preserving security for most countries in the global economy.

I. COORDINATED FLEX FOR ECONOMIC, FINANCE, AND TRADE POLICIES

To understand the need for "coordination" and "flex" in national economic policies we must set aside two grand illusions. First, laissez faire markets automatically coordinate all global investment, trading, and economic activity to best advantage all peoples in every nation without any significant government nurturing or regulation. This naïve approach broke down in the Great Depression. In response, modern social democracies used "New Deal" and Keynesian policies to promote fuller employment, along with social insurance to limit misfortune and suffering from "excesses" of the marketplace. National budgeting, taxes, supports, and regulation are chief instruments for these policies. Such policies were crystallized in the years soon after World War II among most successful OECD economies. Later, most countries also had to learn to limit "excesses" of government including excess budget deficits, widespread inflation, overblown taxes, costly subsidies and regulations, and undue distortions. Getting the right balance, of course, can be controversial. But most budget, tax, and regulatory policies are the responsibility of national governments.

2. In spite of the Cold War (from 1946 to 1990) between the Union of Soviet Socialists Republics ("USSR"), the United States, and NATO countries, the global economy—investments, technology, and trade—improved greatly over the last 55 years. Some even believe that the U.S., U.S.S.R. bipolar balance (with only limited military conflict) strongly promoted a world order and relative peace that allowed OECD nations, at least, and some of their favored NICs and LDCs, to progress and share in a remarkable up-surge in world living standards and technology.

Second, multilateral governance can be established through the UN, IMF, and WTO to provide detailed management and correction of national macroeconomic, tax, and regulatory policies. This is an illusion—it is hard enough for national governments and agencies to perform these functions. Multilateral institutions lack the coherence and information for detailed management and replacement of the national governments.

Thus, national governments still have the primary role in budget, tax, and regulatory policies. Their executive leaders, finance ministers (or treasury secretaries), central banks, trade ministers, and national legislatures are responsible for healthy productivity, improving prosperity, and successful engagement with world markets. Access to global markets, exports, imports, capital, and technology are significant determinants of success, of course, and are partly regulated and lightly supervised by the IMF, the Bank for International Settlements, and WTO. But multilateral arrangements also need considerable "flex" to serve their function of guiding and maintaining some oversight and transparency and providing limited occasional assistance for the national governments (e.g., balance of payments crises).

Paradoxically, both "coordination" and "flex" are crucial to sustainable policies in the fields of international finance and trade. Failure to observe these "dual" requirements explains a lot of the confusion, distress, and breakdowns in recent policy-making. Some "coordination" is essential to mesh and ease the conflicts between national policies that promote industries, finance, trade, and prosperity. But national governments must ensure that their peoples benefit from international finance, investment, and trading activities.

Considerable confusion on these issues comes from misunderstanding the growing convergence and confederation of the EU countries. The fifteen EU countries and another ten to fifteen additional candidates for EU are trying to harmonize their monetary, fiscal, and regulatory policies. For a better functioning, more integrated economy, and broader political benefits of an enlarging EU federation, substantial coordination is desired. But EU countries are not submitting to detailed governance by the IMF and/or WTO, nor should they. The EU, like the United States, Russia, China, Japan, and India, needs substantial "flex" and latitude for their currency's value, exports and imports, fiscal policies and regional regulation.

A. *Strains in the Finance Regime*

Floating exchange rates, global capital markets, international banking, and IMF stabilization "assistance" to countries suffering balance of payments and adjustment problems are key features of international finance. In many ways this finance system works reasonably well. Financial market disciplines (reinforced by IMF surveillance) force most countries to live within their means, and they have worked since the 1980s to greatly reduce inflation in many countries.

IMF decision-making and conditionality disciplines evolved gradually during the 1950s and 1960s. Weighted voting according to capitalization (overall size of economies) was early established for the IMF's Executive Board. Super-majority requirements assure blocking votes for both creditor countries and debtor nations, as well as for the United States and EU, along with other sizable blocs. Accordingly, IMF assistance is generally available for most countries but not too generously. Most IMF assistance packages try to coordinate international bank financing and continued access to global capital markets for other foreign investments. Excess debt buildups are dealt with normally by stretching out or rescheduling obligations, preserving national credit-worthiness, and limiting disruptive defaults or financial breakdowns that could undermine later financial support and investor confidence. In this way the stability of global financial obligations and international bank lending can also be assured. These are sound policies oriented toward resilience.

During the stressful 1970s and 1980s the IMF and international banks coped with big crises. Any of these could have broken the post-World War II prosperity, brought global panic, collapse, and depression. First came the Organization of the Petroleum Exporting Countries ("OPEC") I and II; oil-raw materials price shocks of 1973 and 1974 and 1979 to 1981. Petro-dollar recycling, liberal international bank credits, and IMF support eased the immediate oil-food crisis, but excessive lending and credit expansion later reinforced a world-wide inflation surge. Second, borrowing by developing countries got out of hand, leaving many with debt overloads. When the United States, Germany, Switzerland, U.K., and Japan cracked down on inflation in 1980-1981, with IMF encouragement, nearly eighty countries (mostly NICs and LDCs) found themselves with excess debts that could not be serviced with recession-reduced exports. A world debt overload crisis threatened international insolvencies and general default. The IMF and international banks responded with liberal debt rescheduling and stretchouts. Later in the early-1980s and 1990s, developing countries were encouraged to privatize much of their "public sector" activities. Much of this debt was switched (and partly written down) into equity investments widely accepted by OECD creditor nations. As many developing countries recovered and partly privatized, renewed foreign investments aided their recoveries. However, some of this capital flowed to excess.

In the 1990s euphoria, unfortunately, excessive capital inflows hit many emerging markets. Not surprisingly, these countries welcomed the additional prosperity. However, speculative excess and asset bubbles proved unsustainable in some countries. Nervous domestic and foreign investors soon reversed net capital flows, thereby greatly shrinking foreign exchange reserves. In many of these emerging market countries, large current account deficits accumulated when their governments became dependent upon net foreign capital inflows to sustain their economies. When confidence broke down, currency devaluation, banking crises, and disruptive recessions often followed.

Lessons drawn from these recurrent financial crises (Mexico, Asia, Russia, South America) are that more caution and care in global finance must be enforced—the "Washington consensus." Improved transparency, higher quality accounting, and more investor prudence are needed. Stronger capital requirements, tough prudential supervision, and closure before insolvency are essential to strengthen banking regulation and insurance company regulation. Securities disclosure and regulation, like that of the Securities and Exchange Commission ("SEC") are needed for all countries seeking investment from global capital markets. And improved business bankruptcy laws and administration (similar to Chapter 11 proceedings in the United States) can assure more efficient salvage for distressed industrial business enterprises.

Restrictions are appropriate in many countries to limit excess capital inflows (and inhibit speculative "bubbles"). Whether limits on capital "flight" can be engineered for countries under strain is more doubtful. If business confidence breaks down, capital flight and devaluation will be hard to avoid. Failing governments normally try to "keep the lid on" a little while longer, but these efforts are seen as warnings to "head for the exits." Not that many naive investors and companies are left in the global economy.

Exchange rate regimes are a crucial variable. Reasonable flexibility with floating potential seems necessary for most countries. Rigid pegging or fixed rate regimes are vulnerable to stress, eroded confidence, and periodic breakdown (except for little countries or island states that are closely linked in trade-investment flows to major nations like the United States, EU, U.K., etc.). Adoption of a major country's currency can work well for nearby satellite states. However, the recent collapse and failure of Argentina's "dollarization" policy illustrates serious difficulties for larger countries in adopting a distant country's currency (with no close linkage in trade or investment flows).

Resurgent budget deficits and inflation pressures for Argentina, combined with a major slowdown and more unemployment, destroyed confidence in the Argentine Currency Board and its dollarization program. The new Argentina peso then collapsed in value.

A dangerous problem still remains for the poorest countries that often lack adequate infrastructure, secure property, market institutions, and government competence. These countries feel left out in the march of economic progress. Many suffer repressive governments that do not feel much responsibility to their people beyond political sloganizing. The most tragic situations involve grievously "failed" states, where barbarism, vicious civil wars, or thuggery have taken over a people or an area (e.g., Liberia, Rwanda, Zaire, or Sierra Leone). Unfortunately, failed states present urgent security problems that often spill over into their neighbors or even more widely in the world community. With light arms, explosives, rockets, and other weapons readily available (often supplied by outside terrorist or criminal organizations), these problems are not simply financial. For example, the accumulated problems of Afghanistan (after a ten-year war against Russian intervention and civil wars thereafter) led to the

ascendancy of the Taliban (closely linked with Osama bin Laden). Even decent, well-governed countries with sound economic policies can be attacked or destabilized this way. Sadly, as the world learned in the mid-late 1930s, there is no substitute for timely and effective collective security measures. When rogue states, fanatical terrorists, or irresponsible thugs gain momentum and intimidate the peaceful countries, the stability of healthy trade-finance can be undermined for many nations.

Finally, the U.S. government must give careful attention to the gradually accumulated but excessive and unsustainable U.S. trade and current account deficits. Within reasonable limits, net capital flows into the United States were logical for the last twenty years. They reflected a bigger, more reliable, and prospering U.S. capital and equity market. But when Japan, China, and many developing countries under-valued their currencies to stimulate exports and followed neo-mercantilist trade strategies to restrict unwanted imports of manufactures, a serious "structural" trade-finance imbalance problem developed. By 2004, U.S. current account deficits reached nearly six percent of gross national product ("GNP"), and U.S. net indebtedness to other nations approached thirty percent of GNP. Eliminating these excessive, unsustainable external deficits requires major international currency realignments (not only for the EU, U.K., Canada, and Australia, but also for China, Japan, and other Asian nations).[3] In addition, neo-mercantilist and unequally open trade policies must be phased out. The United States must enforce more reciprocity, more equal openness, and better balanced trade flows. U.S. trade partners will be reluctant to cut their large export surpluses by themselves, so this adjustment process is likely to be stressful. But the United States and its trade partners must realize that the elimination of U.S. current account deficits requires a mix of U.S. import cuts and export increases. It can be spread over a few years, but overall balance must be enforced.

3. By December 2004, the EU euro and U.K. pound were overvalued, but China's currency was substantially *under*-valued (perhaps by 20 to 25 percent).

Chart 1

Conflicting "Freer Trade" Outlooks

- **Adam Smith's Freer Trade** (Reciprocity Oriented)
- **National Development Freer Trade** (With Development Tariffs, e.g., Hamilton and Friedrich List)
- **British Empire Freer Trade** (With Restricted Foreign Access to British Colonies)
- **Neo-Classical Freer Trade** (One World Model – Everyone Supposedly Gains)
- **Socialist Internationalism** (Liberated from Class Oppression, Fraternal Socialist Cooperation)
- **Cobdenite, Wilsonian Freer Trade** (Free Trade, Democracy, and World Peace)
- **UNCTAD – Group of 77 Plus Freer Trade** (With Strong NIC, LDC Preference)
- **U.S. Cold War Freer Trade** (Led By U.S. and OECD, Preferences for the Developing Nations Accepted by U.S.)
- **WTO Model Freer Trade** (Strong LDC Preferences, With Aspirations for Gradually More Opening)
- **Reciprocity Freer Trade** (Led By U.S. to More Equal Openness, With Preference Only for Poorer Countries Treating Foreign Capital Fairly)
- **MNC Oriented Freer Trade** (Freedom for MNCs to Operate Everywhere, Subject to Restrictions By Developing Nations to Promote Their Industrialization)
- **Neo-Mercantilist Freer Trade** (Exploit Openness of Others, But Insist Upon Limits to Protect Key Industries, Interests, or Trades)

B. *Strains in the Trade Regime*

The 1947 General Agreement on Tariffs and Trade ("GATT") trade regime promoted freer trade (led by U.S. tariff concessions) with important loopholes, off-sets, safeguards, anti-dumping, and countervailing subsidy provisions. The United States came out of World War II with dominant industries, big export surpluses, and overly protected markets. In the early Cold War years the United States could afford to open itself to imports and sponsor a broad "free world" alliance against communism. Thus, the United States did not fully enforce its own trade laws and 1947 GATT remedies to maintain overall trade reciprocity. The United States accepted increasingly asymmetrical trading relationships in which U.S. companies moved much of their manufacturing overseas to benefit from lower wages and locally protected markets. Likewise, so did Western European and Japanese companies. However, as more jobs moved "downstream" to lower wage countries, a blacklash of U.S. unionized labor, smaller businesses, and farmers objected. In the mid-1980s, as the IMF was trying to orchestrate successive LDC debt rescheduling, there were widespread fears of renewed "protectionism" like in the 1930s. Financial meltdown and heavy protection could be a disaster. This worry stimulated efforts toward a broader international trade negotiation (the Uruguay Round, 1985-1994), designed to "save the system." MNCs and international banks wanted to secure their advantages, and to provide greater continuity. The WTO was created with "stronger" dispute resolution mechanisms. The "final" Uruguay Round results were the GATT 1994-WTO agreements.

The GATT 1994-WTO trade regime has three major characteristics: (i) extensive asymmetries or unequal openness, entrenched by the new WTO's dispute resolution process; (ii) strong conservative momentum with little incentive for favored "protected" interests (free riders) to open themselves up or to equalize import access; and (iii) voting in the WTO that relies mainly upon "one country one vote," i.e., UN General Assembly style voting, so that the great majority of developing countries need not yield to pressures for greater reciprocity from nations that may be losing net market shares, real incomes, or jobs to "emerging nations." This style of voting plays out in the current logjam of conflicting proposals for the Doha WTO round of trade negotiations and limits much change in "multilateral" trade relations. According to "bicycle theory" advocates, however, it is vital for MNC interests to "keep full control" of trade negotiations so that no general unraveling or widespread relapse into "protectionism" occurs.

A big complication is the very large U.S. "structural" trade and current account deficit problem. For twenty years the United States has run large external deficits, totaling more than negative $4,000 billion of merchandise trade deficits and negative $3,500 billion in current account deficits. Annual U.S. trade-current account deficits reached almost six percent of U.S. GDP in 2004. Extraordinary U.S. external deficits of this magnitude are not sustainable over the long run.

Their recent tolerance by the global economy reflected two factors: (i) ascendancy of the U.S. dollar as primary reserve currency; and (ii) enjoyment of the U.S. bull market (with somewhat higher U.S. interest rates) by EU, Japanese, and other OECD, NIC, and LDC investors as a parking place for investment resources. Now that the U.S. stock market and economy has slumped, the EU's euro is challenging the dollar's dominance. As the European Central Bank ("ECB") held its interest rates steadier since 2001, deeper interest rate cuts by the U.S. Federal Reserve have brought U.S. rates somewhat below EU rates in 2001-2003. Now, many experts see a likely tougher euro challenge in the coming years.

U.S. leaders must be ready to take strong action if a major shortfall of investment funds is threatened, and a seriously disruptive recession and/or dollar devaluation crisis hits the United States. What are the best policy responses? Realistic contingency planning is in order.

U.S. policy should target "fundamental flaws" in the current world trade regime: (i) we need to correct unsustainable U.S. trade imbalances and asymmetries that cannot continue much longer; (ii) we should suspend unconditional, non-reciprocal most-favoured-nation treatment ("MFN") in GATT Article I that entrenches unbalanced trade and investment flows; and (iii) we must understand that reciprocal trading-investment relationships will be achieved more sensitively through bilateral and regional bargaining.[4] The present WTO with 144 national members (and only one vote for the United States) is incapable of prompt, responsible action to reform trading relationships in any serious global-U.S. dollar crisis situation. Nor is the WTO inclined to help the United States ease its balance of payments problems.

Fortunately, this "logjam problem" is increasingly recognized in the global marketplace. Nobody really expects another WTO round to change anything very much. This is why, in fact, multinational lobbying interests need this WTO round so badly—to maintain their system. Yet the United States will be expected to "do something" promptly and effectively in a global-dollar crisis situation. It is important psychologically that the U.S. act with ample "consultation" among significant trade partners, with "sensitivity" to the vital interests of other countries. The global marketplace is bound together in mutual interdependence.

Accordingly, U.S. policy should emphasize GATT Article XII, Balance of Payments relief measures, with one important extra twist—careful joint and independent action to eliminate and excessive and unsustainable U.S. trade deficits with key trading partners. Most of the U.S. trade-current account deficit problem arises out of only a few relationships: U.S.-Japan trade, U.S.-China

4. In early GATT-round years, approximately 1946 to 1967, when the United States enjoyed a big financial, industrial, and technological lead over its trade partners, U.S. support for "unconditional MFN" was reassuring to "catch up countries" in Europe, Japan, and developing nations. But by the late 1990s it was becoming clear that reciprocity ("conditional MFN") was now more appropriate for world trade, except for the poorest and least developed countries, that need more kindness and protection for infant industries.

trade, U.S.-ASEAN trade, and to a lesser extent, U.S.-EU trade and U.S.-NAFTA trade. This is a manageable list of key bilateral-regional relationships. IMF consultation is also built into GATT Article XII, Balance of Payments relief, and the GATT 1994 Understanding on Balance of Payments Problems. Fortunately, the IMF's executive board is a more flexible, workable institution (with weighted voting and healthy traditions) than the WTO's General Council and occasional trade round negotiations (with consensus agreement expectations) and entrenched asymmetries.

Interestingly, the Bush administration and its U.S. Trade Representative, Robert Zoellick, have already implemented a broader, more supple trade negotiation strategy. The United States now gives equal emphasis to three simultaneous tracks for trade negotiations: (i) multilateral negotiations and the WTO; (ii) regional negotiations and the Free Trade Area for the Americas ("FTAA"); and (iii) bilateral trade relations. This is the only sensible way to go for U.S. trade policy.[5]

Fortunately, the logjam of conflicting agenda and demands in the Doha round explains the constraints and the limited "give" in global trade arrangements. NICs want more safeguard relief (from the advanced countries and each other), less risk to their employment, business potential, and growth

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5. Of course, the United States must be prepared, if necessary, to exercise its withdrawal rights under Article XV of the WTO Agreement. Only six months notice is needed for U.S. withdrawal. Withdrawal would signal to all U.S. trade partners that further trade access into U.S. markets will be governed by bilateral and regional arrangements. A convenient structure might be the following "A,B,C,D" tiered access to U.S. markets:

> (i) "A class countries" with minimal tariffs and open capital markets would enjoy minimal U.S. tariffs and restrictions. Most OECD countries fit this framework already; (ii) "B class countries" would get 8-10 percent U.S. tariffs. This would apply to nations using 10-20 percent average tariffs and somewhat restricted capital markets; (iii) "C class countries" would get 15-20 percent U.S. tariffs. This would apply to nations with 25-50 percent tariffs and substantial capital and intellectual property restrictions; and (iv) "D class countries" would face greatly restricted access to U.S. markets, and now offer only very limited access to their own markets, with little or no opportunity for capital flows and/or intellectual property protection. With this reciprocity-based ladder of conditional access to U.S. markets, countries could choose the degree of openness they prefer in trading with the United States (and vice versa). Special GSP preferences could still be given to the poorest countries, i.e., those not yet capable of handling more reciprocal trade with the United States and other OECD nations. This new A, B, C, D system of graduated access would solve the "free rider" and "asymmetry" problems left uncorrected by the Tokyo GATT Round (1974-79) and the Uruguay-WTO Round (1985-94). Trade flows could be much better balanced this way, and the U.S. "structural" trade and current account deficits could be quickly eliminated after a few years.

An interesting question is whether the United States should consider WTO withdrawal and tougher trade bargaining in the early stages of its new War on Terrorism and the current WTO negotiating "round" launched at Doha, Qatar in November 2001. It probably does not need to for awhile. But the United States does not need to "subsidize" a new WTO round with costly one way concessions any longer. In the long run, U.S. "partners" in the global economy-security system must carry their "fair share" of the load. Americans have carried heavier defense burdens than most of its allies for 50 years (except for a few nations with special vulnerability, e.g., Israel or South Korea.) When the United States enjoyed substantially higher living standards and an industrial lead, a policy of unequal trade openness seemed acceptable. Now, however, American tolerance for "free riding" and unequal burden sharing is approaching its limits.

prospects from the world market. LCD's agree, but stress their lack of sufficient benefits in recent export expansion and foreign capital investments. Dissimilarly, most advanced countries (like the United States, EU, and Japan) are conflicted. They seek expanded exports and growth, but many domestic interests are concerned with limiting dislocations for labor, business, and environmental progress. Faith has eroded that freer world markets guarantee good results. Most nations represented at the Doha Ministerial have interests and sectors that offer little room for additional "concessions" or risky openings, except from "other nations." Yet, MNC lobbies feel strongly that their dominance and opportunities must be "protected" to prevent an unraveling of global prosperity. At the heart of the Doha round difficulties is another grand illusion. The world has not established universal, reciprocal free trade with a level playing field. However, in the United States and other OECD countries, the Uruguay Round and WTO were packaged and sold as equal, fair, and reciprocal free trade. Yet, developing nations think they got a permanent system of LDC preferences. In fact, this is a double illusion trading system, quite vulnerable to breakdown and misunderstanding.[6]

In fact, the Collapse in Cancun of the WTO Ministerial Conference in September 2003, and the "Two Track Outcome" of the Miami FTAA talks in November 2003, suggest that U.S. trade bargaining is already moving toward selective bilateralism. Many NICs and LDCs insist upon retaining substantial tariffs, subsidies, restrictions, and limitations upon foreign MNCs. The United States is focusing further trade negotiations on countries (like most OECD nations) that are willing to accept more complete openness for goods, services, and capital flows. With heavy, unsustainable U.S. trade and current account deficits, it is time for the United States to limit unconditional MFN treatment, and impose more reciprocity. The United States should enforce conditional MFN as the basis for continuing trade relationships. This allows U.S. trade partners to select the degree of openness they prefer in dealings with the United States and other OECD nations. This deference and sensitivity to the needs of most NICs and LDCs will be appreciated abroad, and yet it greatly limits the dangers of excessive free riding and non-reciprocity.

6. Diplomacy often uses illusions and creates ambiguities to paper over important conflicts of interest, perceptions, and ideology among countries. The best diplomats must be realists. The architects of diplomatic ambiguity and illusion should know better, fully understand their game, and appreciate the "realities" and implications of the *modus vivendi* that they create and maintain.

Chart 2

Major World Power Balances, 1550-2000

At 1550

France Hapsburg China
Portugal Spain-Austria Turkey India

At 1650

Britain Dutch Sweden Russia China
Spain France Austria Turkey India Japan

At 1750

Britain Prussia Russia China
Spain France Austria Turkey Japan

At 1900

Britain Germany Russia Japan
U.S. France Italy Austria China

At 1940

Britain Germany Russia Japan
U.S. France Italy China

At 2000

U.S. EU Russia China
(?) Islamic Alliance India Japan

II. STRAINS IN THE SECURITY REGIME

Two stages in modern world history seemed to bring great opportunities for broad peace, widespread democracy, general arms reductions, and international collaboration. The first opening came after World War I between 1919 and 1934, and the next came after the Cold War between 1991 and 2001.

A. *Lessons from the Interwar Era*

The victorious allies (led by Britain, France, Italy, the United States and Japan) that defeated the central powers (Germany, Austria-Hungary, Turkey, and Bulgaria) seemed reasonably cooperative after World War II. After drastic demilitarization measures that weakened Germany, Austria, and Turkey, the only major security challenge to the Allies came from the new Bolshevik government in the U.S.S.R. (and Russian efforts to promote international communism). In 1921, the Washington Naval Conference successfully limited expensive postwar battleship construction rivalry among the United States, Great Britain, and Japan. Then, a rapid draw-down in allied military forces seemed reasonable and appropriate. President Wilson's rigidity prevented U.S. Senate ratification and entry into the new League of Nations, which had unfortunate consequences in the 1930s. Yet, this did not prevent active U.S. diplomacy between 1921 and 1932 (e.g., the Dawes plan, Anglo-American debt restructuring, the Kellogg-Briand Pact, various U.S. efforts at mediation and peacekeeping, and Stimson's non-recognition doctrine in response to Japan's occupation of Manchuria).

Sadly, the Great Depression and a rise of anti-military pacifism brought timidity to Britain and France between 1932 and 1938, and isolationism to the United States between 1932 and 1939.

The collective security weakness of the western democracies came just when Hitler's Germany and militaristic Japan were rearming rapidly between 1933 and 1938, and Mussolini's Italy conquered Ethiopia between 1935 and 1936. Only Stalin's Russia (caught between expanding German and Japanese power) substantially rearmed itself between 1933 and 1938. Meanwhile, in the Spanish Civil War (1936 to 1939) the Russians actively supported Leftist Spanish Republicans against Franco's fascist forces backed by Germany and Italy.

Most tragically, Hitler's aggressive German rearmament in 1933 through 1938 emphasized new break-through weapons of air power (the Luftwaffe) and mechanized armored vehicles (Panzer divisions). Germany gained an edge in air-armored forces that helped intimidate the British government between 1935 and 1938, leaving the French alone to focus on their fortified frontier defenses—the Maginot line. Depression era finances also crippled the willingness of Britain and France to make comparable efforts and budget outlays in these new decisive weapons of air power and panzer forces. Ironically, Germany's new military edge was only a few years of lead time from rapid re-armament (1933-1937). Had Britain, France, and the United States rearmed earlier (from 1933-1937) and

acted together with strong collective security measures, Germany would have been outmatched and unable to make more than limited gains (e.g., Austria and perhaps the Sudentenland in Czechoslovakia). However, the idea that Hitler could really want another war seemed unlikely to British and French leaders until the fall of 1938. And even then, some British-French conservatives hoped that Hitler would be satisfied with gains in central Europe and against communist Russia.

Ironically, British governments under Stanley Baldwin and Neville Chamberlain (1933-1938) made major economic recovery and broader industrial employment gains. Had Hitler been satisfied with modest frontier adjustments in the East (which Chamberlain wanted "to appease"), World War II could have been unnecessary in Europe. Japanese aggressions in Asia would have been more limited, too, without the support of a very powerful Germany and Axis alliance.

Thus, collective security among the Western Democracies was sadly neglected in a critical, brief period of economic distress, i.e., 1933-1937. Hitler secretly rearmed Germany from 1933-1935 to create an air force larger than Britain's, and rapidly expanded his army with more tanks and mechanized forces than Britain maintained. The French re-armed somewhat, but concentrated too much on the Maginot line. The French neglected their air forces, and failed to organize their tanks (comparable in number to the Germans) into panzer divisions and mechanized corps. In this way, Germany broke open the fronts of World War I-style infantry and artillery with Blitzkrieg offenses of massed panzer divisions and heavy tactical air support from 1939-1941.

The biggest Allied blunder (Britain, France, and the United States) was the failure of imagination. Why would any "responsible leader" want rearmament and war in the Great Depression? Obviously, Hitler's Nazi Germany, Japan's militarists, and even (to a modest degree) Mussolini's Italy found rearmament and successful wars against weak and timid opponents attractive, not only to achieve fuller employment recovery, but to "get back against and triumph" over the Western democracies (led by Britain, France, and the United States).

Only Winston Churchill stood out from 1933-1938 as a lonely realist, correctly identifying the German military and air power dangers, and stoutly warning of the need for stronger Allied rearmament. It took the humiliation of Munich (September 1938) and Prague (full German occupation of all Czechoslovakia in the Spring of 1939) to awaken Britain and France to their dangers. Rapid British-French rearmament finally followed (five years late), and World War II began in September 1939. By then Hitler was over-confident, and thought Germany could win a string of decisive, quick victories with an edge in Luftwaffe superiority and panzer divisions. Germany did come close to winning World War II between 1940 and 1942. Many historians believe that Germany could have won and retained hegemony in Europe if Hitler had concentrated his forces on defeating Britain in the Mediterranean and Mid-East from 1941- 1942. However, like Napoleon in 1812, Hitler could not resist the temptation or urge to conquer Russia. Both Napoleon and Hitler suffered the same fate. By over-

reaching, they both brought down against themselves too big an alliance, thereby destroying their brief empires.

B. Post Cold War Problems

From 1991 to 1992 post-Cold War euphoria hit most of the world. Near universal condemnation of Iraq's invasion of Kuwait and the U.S. led Gulf War victory suggested that United Nations peacekeeping operations might be relied upon generally. As the U.S.S.R. dismantled itself and reduced military forces, most NATO allies and other democracies now felt they could substantially reduce their own military forces. Between 1992 and 2001 a large scale draw-down in western military forces occurred (by fifty to sixty-five percent overall), comparable in many ways to the big Allied military force reductions of 1919-1934. Understandably, western democracies wanted to economize on military budgets and forward deployments. The risks of war now seemed modest. Only smaller scale, lightly-armed peacekeeping forces seemed likely to find much use. Accordingly, in the United States and western Europe, Canada, Australia and New Zealand, most of Latin America, and much of Africa, it became popular to condemn nuclear weapons and "nuclear free" zones were proclaimed.

For some years into the late-1990s, the United States thought itself to be the surviving sole superpower with a substantial lead in readily deployable forces. U.S. defense leaders focused upon cutting U.S. nuclear warhead stocks and delivery systems, hoping to lead and subsidize Russia into following rapidly with a comparable reduction of nuclear arms. Some U.S. arms control enthusiasts argued that drastic and *near total* nuclear weapons cutbacks were within reach, if only unilateral U.S. reduction measures and negotiations were pressed hard enough.

Unfortunately, by 2002, the world looked considerably different. Russia's national economy was greatly weakened. There was considerable Russian alienation over NATO-EU expansion as well as with the response to Serbia, Bosnia, Kossovo, and Chechnya. Soon, Russia's grand strategy changed. Russia now makes nuclear weapons (strategic and tactical) their first line of defense. By not following the United States in shrinking their nuclear forces, Russia gains a comfortable margin of nuclear superiority—at least in terms of warhead stocks.

Under these circumstances, China felt obliged to increase its nuclear weapon stocks and delivery capability too. Meanwhile, Chinese strength and support of Pakistan's arms and missile program led India to substantially increase their nuclear weapons program. Then Pakistan increased their nuclear weapons. Even though the Pakistanis were outnumbered heavily by the Indians in all categories, Pakistan felt safer with an assured nuclear deterrent of their own. The best estimates by 2002, were that "rogue states" such as Iraq, Iran, and North Korea soon would have limited stockpiles of nuclear warheads, along with some delivery capability. Naturally, Israel would likely enhance their own nuclear capability, threatened as they were by so many hostile states in the Mid-East (after the collapse of peace negotiations and resumption of the intifada and suicide bombings).

Meanwhile, on September 11, 2001, terrorists hijacked four U.S. airliners and crashed three into the World Trade Center and Pentagon buildings. More than 3,000 died outright, and soon thereafter systematic anthrax infections spread in the United States (a form of biological warfare). Most Americans believed that Osama bin Laden, the Al-Kaeda network, and Taliban in Afghanistan were involved, and perhaps the Saddam Hussein regime in Iraq.

Understandably, in a changing security environment, the United States, Western Europe, and Japan would reassess their defense policies and grand strategies. Four new factors must be emphasized. First, multipolar power balance replaces a brief period of U.S. unipolar ascendancy. The major draw down in the U.S. military forces between 1991 and 2001 combined with more independent, self-assertive policies in the EU, Russia, China, India, and Japan. While the United States retains an edge over each of the other major powers in some aspects of military and overall economic strength, we can no longer say the United States is the "dominant superpower." Second, renewed importance for nuclear weapons is evident from the resurgent emphasis on them by Russia, China, India, Pakistan, and the nuclear programs of Iran, Iraq, and North Korea. All this means continued nuclear deterrence is vital for the United States, EU, and Israel, along with a possible need in Japan for a nuclear weapons program. Third, increased risks and vulnerability to terrorist attacks involving cities and strategic installations applies to many countries. Broader availability for weapons of mass destruction (nuclear, chemical, and biological) plus computer and electronic disruptions multiplies the potential costs. Most modern societies are relatively open in many areas, especially near ports and sea coasts. It is hard for these societies to defend against small groups, bombs, and missiles. Finally, increased defensive strength of many nations operates when properly armed with ample light weapons, missiles (air, land, or sea launched), with some aircraft and/or light naval vessels. These factors make it harder to project force easily into many parts of the world, except where very strong intervention forces are willing to impose heavy disruption and/or loss of life on the target states (e.g., NATO's intervention against Serbia in the Kossovo War of 1999). Somewhat greater deference and/or immunity may operate in favor of countries not so vulnerable to air, naval, or ground interventions by outside powers. These reasons explain why peacekeeping operations are more difficult in rough terrain. Forests, mountains, or inaccessible hinterland areas are hard to reach by the major powers. Many of the worst-failed state-peacekeeping tragedies (e.g., Cambodia, Bosnia, Rwanda, Southern Sudan, Liberia, and Sierra Leone) involved such circumstances. Afghanistan was difficult for the United States to reach, except through Pakistan, the Turkestans (and Russia), and/or through the Iranian border. Fortunately, the northern Alliance revolt against the Taliban was aided effectively by U.S. air strikes and special forces. Additionally, the Taliban had become unpopular and were not that numerous.

Collective security alliances and measures (e.g., NATO's action in some circumstances) are vital for preserving regional peace. Where sufficient consensus is lacking (e.g., EU's peacekeeping in Bosnia in 1991-1995), these efforts may be ineffectual. Effective counter measures for the United States and its allies in Afghanistan needed regional support (especially Pakistan, the Turkestans, Russia, and a closed-border with Iran). Maintaining the U.S. *a la carte* coalition against the Taliban and Al-Kaeda network was a major challenge for U.S. foreign policy, and poses an even greater problem in Iraq for 2003-2004 and beyond.

Responsible states (e.g., the United States, EU, and other OECD nations) need enough military strength to intervene effectively for peacekeeping and overall deterrence. Lack of such strength was the tragic lesson for western democracies in the mid-late 1930s. In most of the Cold War (1949-1991), by contrast, stronger U.S. and NATO forces were able to deter major aggressions. Ample allied strength existed for the Gulf War victory in from 1990-1991, which renewed faith in collective security for a few years thereafter. Unfortunately, the western democratic alliance must be seen as having the moral fortitude to use strength in appropriate circumstances. When their will to act seems lacking, aggressors (e.g., North Korea in 1950, Iraq in 1990, or Serbia from 1992-1994 (Bosnia), and from 1998-1999 (Kosovo)) can take advantage of apparent weakness. With the benefit of hindsight, many experts now believe that the military drawdowns of the United States, EU, and other OECD nations went too far. Considerable rebuilding of nuclear, air, naval, and deployable ground forces is now in order. The EU should increase its forces too. If undertaken promptly, this renewal of military strength will help secure nation building in Afghanistan and Iraq, bolster the western coalition, and offset rogue state buildups or other adventuristic actions elsewhere.

If western democracies neglect military needs, especially in the area of nuclear warheads, naval, and air forces, there is danger that Russian, Chinese, and/or rogue state forces could reach a level of "effective immunity" within a few years.

Chart 3

U.S. Defense, GNP, and National Debt Service

Years	Population (millions)	Gross National Product	Defense Army		Defense Navy	Defense as Percent of GNP	Interest on Federal Debts
1792	4.0	$125m(e)	$1.1m		—	.9	$3.2m
1799	5.1	180m(e)	2.5m		2.8m	3.0	3.2m
1803	5.7	230m(e)	.8m		1.2m	.9	2.0m
1811	7.3	300m(e)	2.0m		2.0m	1.3	1.6m
1814	8.3	365m(e)	20.3m		7.3m	7.6	2.5m
1823	10.8	480m(e)	3.1m		2.5m	1.2	4.9m
1830	12.9	675m(e)	4.8m		3.2m	1.2	1.9m
1836	15.0	1.35b(e)	12.2m		5.8m	1.3	—
1841	17.3	1.6b(e)	8.8m		6.0m	.9	.3m
1847	20.2	2.3b(e)	38m		8 m	.6	1.1m
1853	25	3.5b(e)	10m		11 m	.6	3.7m
1860	32	5.0b(e)	6.4m		11.5m	.5	3.2m
1865	34	5.0b(e)	1,031m		123m	24.0	73m
1872	41	6.7b(e)	35m		25m	.9	103m
1881	52	9.2b	40m		16m	.6	82m
1890	63	13.1b	44m		22m	.5	36m
1898	73	17.3b	92m		59m	.9	38m
1906	85	25b	137m		110m	1.0	24m
1914	97	40b	208m		140m	.8	23m
1919	104	79b	9.0b		2.0b	14.0	619m
1924	112	88b	357m		332m	.8	940m
1930	123	91b	464m		374m	.9	659m
1934	125	65b	408m		296m	1.1	756m
1939	130	91b	695m		672m	1.5	940m
1945	140	214b	50.5b		30b	37.5	3.6b
1949	150	258b	<u>Air</u>	<u>Army</u>	<u>Navy</u>	5.4	5.4b
			1.7b	8b	4.4		
1956	165	419b	17b	9b	10b	8.6	6.8b
1961	180	520b				8.8	9.0b
			<u>Defense</u>				
			46b				
1965	191	685b	47b			7.0	11.3b
1970	203	977b	78b			8.0	19.3b
1974	213	1,434b	78b			5.4	29.3b
1978	220	2,164b	105b			4.8	41.9b
1985	240	4,014b	253b			6.5	116b
1993	256	6,577b	291b			4.5	199b
2000	280	10,000b	282b			2.8	233b
2004	295	11,600b	485b			4.2	160b

In other words, nuclear and other potential hostile forces to the United States, EU, and their allies could undercut the credibility of the United States, NATO, and EU's collective security arrangements. Lessons from the 1930s, in this regard, are clear. Three to five years of unmatched military, missile and nuclear buildups by potentially hostile states to the United States, EU, and other OECD nations could be dangerous. Nor are the buildups of potentially hostile states terribly expensive. Wages are low for the militaries of Russia, China, India, Pakistan, Iran, Iraq, North Korea and other possible rogue states. Unfortunately, wage costs are much higher in the United States, EU, Japan, and most OECD nations. Nuclear weapons are not difficult to make. Bomb technology is widely known and accessible. The only bottleneck is processed uranium and plutonium, which all states potentially hostile to the western democracies can get—at least in limited quantities. Ample western counterforce, with adequate and survivable delivery systems, is the only real deterrent. Missile defense technology may well be worth developing, at least against rogue states. Missile defense is unlikely, however, to be sufficiently reliable to obviate the need for nuclear deterrence, i.e., ample nuclear warhead stocks and survivable delivery systems (aircraft, missiles, and nuclear submarines).

Does this mean nuclear Armageddon? Not really. In fact, multipolar nuclear deterrence is more reliable than bipolar nuclear deterrence, because it is inherently more survivable. In other words, it is much harder with pre-emptive strikes to knock out the nuclear capabilities of six, seven, or eight major nuclear powers in a multipolar system. The mutual fear of United States and U.S.S.R. pre-emptive strikes had been a driving force in the bipolar Cold War arms race (1946-1991), and survivable second strike capability was crucial to peace.

What about rogue state military and nuclear programs, such as Iraq, Iran, or North Korea? Rogue states are better deterred in an environment of ample Western nuclear weapons capability. Assured western deterrence is really more menacing to rogue states which have only a few or limited numbers of nuclear warheads. The worst case defense scenario, in fact, would be a drastic, one sided Western drawdown of nuclear and other military strength by the United States, EU, Japan and other OECD allies.

Many experts argue that the September 11, 2001 terrorist attacks reshuffled the deck of world politics, threat scenarios, and appropriate grand strategy responses. In the summer of 2001, for example, U.S. experts were concerned about potential Chinese aggressiveness (prompted by the forcing down of a U.S. electronic surveillance plane), renewed Russian military-political pressures on "near abroad" states, Iraq and Saddam Hussein, the Israeli-Palestinian conflict, North Korea dangers, and the problems of Colombia-Venezuela and growing disorder in the Andean-Panama region. Many believed that U.S. forces and readiness needed extensive strengthening, along with overdue replacement of aging U.S. aircraft and naval vessels. Others resisted increases, hoping for a better peacekeeping climate. By late fall of 2004, many agreed that the United States should increase defense budgets, somewhat for all these reasons, in

addition to the economic recovery benefits of enlarged U.S. defense spending to help offset a serious U.S. and global slowdown.

Fortunately, a somewhat improved attitude of Russia's Putin government emerged. Their support for U.S. air operations, and aid through the Turkestans to the northern alliance in Afghanistan eased U.S. insecurities on the Russian relations front. Pakistan's support of the United States was welcome, albeit many disruptive fundamentalist sympathizers that exist in Pakistan. Even China toned down recent hostility to the United States after September 11, 2001, although more mutual reassurance will be needed for Beijing and the United States over the coming years.

The Israeli-Palestinian conflict remains a prime U.S. concern, but after September 11, 2001, its parameters shifted. With the new "War on Terrorism" the United States has less patience for terrorist attacks against Israel. But the United States still needs to be seen as "fair" and not menacing to Arabs (except those declared enemies of the United States like Osama bin Laden and Al Kaeda). Continued U.S. pressure for a balanced Mid-East peace settlement is desirable for the United States to maintain support among moderate Arab states, European allies, Japan, and neutral developing nations. Al Kaeda and Iraqi propaganda linked the United States to Israeli "oppression of Palestinians." Although Arafat rejected the last Camp David-Taba U.S. peace proposals (fall of 2000), continued American support for a "fair" Mid-East peace settlement is important to the maintenance of its *a la carte* coalition against Al Kaeda. Recent Geneva Accord proposals may be helpful too. Neglect of "fairness" could unravel the U.S.-led coalition and topple moderate Moslem governments (Pakistan, Egypt, Saudi Arabia, the Gulf States, and even Jordan). Of course, the United States cannot *by itself* deliver or impose peace on Israel and the Palestinians. However, Americans should be understood as seeking a "genuine" peace accord for the Mid-East. Americans, most Europeans, and neutrals now have this appreciation, which has been built up over many years by U.S. mediation efforts, including President Carter's Camp David Accord in 1978, and the more recent Oslo process years (1993-2000). Interestingly, Arafat's death in late fall of 2004, may signal a window of opportunity for more realistic negotiations.

Nuclear proliferation dangers received increasing attention from 2002-2004. Saddam Hussein's regime in Iraq (and cash flow from expanded oil exports) threatened to provide resources for significant nuclear weapons developments. Saddam also proclaimed goals of uniting all Arabs and the destruction of Israel. President Bush urged stronger measures to change this regime and/or eliminate its nuclear threat. Allies disagreed on the urgency of this Iraqi threat. Some favored strict WMD inspections, others wanted tougher deterrence measures (nuclear, if necessary), while still others endorsed military action.[7] Although

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7. In retrospect Saddam could have been removed in 1991, but the U.S.-led Gulf War coalition feared a

Bush received nearly three to one support from both houses of the U.S. Congress in a war powers resolution in October, 2002, the situation was a tough challenge for the United States in its "leadership" of free world countries.[8] When Bush launched military forces against Iraq in March 2003, Allied support was limited.

The Iraq intervention and nuclear proliferation were crucial issues for 2003 to 2004. The United States and key allies had three main choices: (i) Intervention to eliminate Saddam Hussein's regime. This would be costly and should not have been undertaken without a clear commitment to win with ample forces. A limited effort like the Vietnam War could be a tragic failure, which would encourage anti-Western forces and terrorism in the world; (ii) Strong Deterrence and Containment with ample U.S. nuclear warheads (for U.S. air and naval forces) to prevent any further aggression or terrorism against U.S. and allied interests; and

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power vacuum and did not want to humiliate Gorbachev's weakened USSR government that spring. This opportunity for an easy Iraq regime change was missed.

8. A tricky problem for the United States is the linkage between Iraqi regime change and the Israel-Palestine conflict. Most countries have little respect for Saddam Hussein, and welcomed a less dangerous government. However, many countries did not want involvement in another mid-east war, and more would support the United States if it would somehow bring "peace" between Israel and its Arab neighbors.

Unfortunately, after four years of resumed *intifada* and suicide-bombing, the Israeli public has largely lost faith in Arafat and the Palestinian willingness to accept Israel's existence. The Oslo formula of "land for peace" broke down over requirements for Israeli security and a fair trade-off between Israeli settlements and the return of Palestinian refugees. Israel would not survive with any general "return" of Arab refugees (and all their descendants) from the War of Israeli independence in 1948, so that the nearly successful Taba accord of late December, 2000 provided for only minimal return of Palestinian refugees *in exchange for* only minimal retention of Israeli-settlements in the West Bank. Joint capitals in the Jerusalem area would be acceptable on both sides, provided that Palestinians receive almost all of the West Bank and Gaza as their territory, and that Israeli land and air forces retain full security jurisdiction over these external borders (including the Jordan river and Galilee). Both sides must accept full recognition of their mutual historical legitimacy in the lands of Israel and Palestine, and a Joint Religious Commission could be established for all faiths with jurisdiction to preserve and protect their historical and religious sites in these areas. This Commission should have co-qual representation of Jews, Muslims, and Christians (including Catholic, Orthodox, Protestant, Armenian, and Syrian). The guiding principle for a realistic Israeli-Palestinian compromise should be two peoples living in peace, side-by-side, with full respect for their historical and religious rights, and strong security guarantees. Because terrorism threatens Israeli existence from Hamas, Hezbollah, and Al-Aksa brigades, Israel will insist upon its rights to protect their external borders, airspace, and police terrorism. A compromise peace along these lines would be seen as fair and reasonable in most parts of the world, and could receive endorsement by the UN Security Council. Finally, the recent Saudi proposal of full normalization of relations between Israel and all Arab-states should be part of this final settlement, which would allow Palestinian refugees to get full citizenship in the Arab nations of their choice.

Healthy regime change in Iraq was difficult. Possibilities in November 2002 were: (i) soft containment; (ii) weak inspections; (iii) strong inspections and sanctions; (iv) support Iraqi insurgents (and perhaps assassinations); (v) hard deterrence with forward nuclear deployment; (vi) slow, steady air campaign like Kosovo; (vii) large conventional campaign like Gulf War; (viii) selective nuclear strikes against Saddam's palaces, republican guards, and head quarters. Weak options risked Iraqi aggression and subversion against moderate and weak Moslem states (e.g., South Arabia, other Gulf States, Jordan, and Egypt), but strong options with large Iraqi casualties risk alienating the Arab world.

North Korea did not seem so difficult because that regime is weak and surrounded by stronger powers (including China, Russia, and the United States —all with large stocks of nuclear weapons). To the Bush administration, Saddam's Iraq was more dangerous, because many moderate Arab-states in the Mid-East were weaker and lacked secure governments. Until Saddam's regime was changed or becomes more peaceable, Iraq presented a serious threat to that region, moderate Arab states, and U.S. interests.

(iii) Softer deterrence and inspections by the UN to identify Iraqi WMD programs and gain broader allied support. However, if the UN inspectors failed in 2003, to uncover significant evidence of a clandestine Iraqi nuclear program, then allied support for direct U.S. military intervention would be undercut. Those opposing military intervention wanted a generous period (about nine to twelve months) for UN inspection efforts. But political support in the United States and among allies for military action would erode in a year, so that those eager for intervention felt it best to act promptly. Weather conditions in the Persian Gulf also made a campaign in October to April more feasible than from May to September. Thus, U.S.-allied military action in Iraq was undertaken in early 2003.

U.S. and coalition forces overthrew Saddam's regime in a five week blitzkrieg (from March to April 2003). Thereafter, Iraq's reconstruction bogged down a year later with increased opposition and terrorism. Many felt that substantially larger U.S. forces should have been deployed to provide more security. Some wanted a faster handoff and earlier elections for the Iraqi's. Unfortunately, Ambassador Bremer used an overbroad ban on the Baath party, police, and military people. This ban widened the network of Iraqi opposition. In contrast, some Saudi's advised that most Iraqi government officials and army should have been retained with a generous three month salary payment to encourage loyalty to a successor regime. How big was a realistic "makeover" for Iraq under all these circumstances? Few Iraqis regretted Saddam's overthrow. But provisional government and elections should have been put together within six to nine months. U.S. "occupation" officials were naïve and unrealistic about Iraqi tolerance for a leisurely U.S. reconstruction. Also, the United States should have welcomed prompt UN, French, German, and even Russian involvement, if possible, to broaden international support. Ironically, after the quick overthrow of Saddam, some nations that sharply criticized the U.S.-led intervention were willing to temporarily endorse a "successful" transformation. However, some U.S. allies later cut back their support after an extensive Iraqi uprising developed in the spring of 2004. Of course, those critical of the Bush intervention at the outset complained that such difficulties were predictable and hardly surprising. Sadly, these delays and disruptions weakened U.S. and allied support and increased casualties in Iraq. The disruptions could limit American staying power, especially with the upcoming 2004 election. Naturally, die-hard Saddamites, Al-Kaeda, and other anti-U.S. elements welcomed a reversal of fortunes, and pressed harder in their intimidation campaigns against moderate Iraqis. At the end of 2004, it was unclear how the U.S.-regime change efforts might work out. It could take a few more years for this conflict to be resolved. Prospects were fiercely debated and uncertain.[9]

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9. Many people in the Bush administration believed that the Iraq intervention was necessary to pre-empt the dangers of anti-western fanaticism and terrorism spreading in the Arab and other Muslim states. Broader support for the United States and its coalition would follow if the United States could persevere and

Unfortunately, this leaves terrorism from Al-Qaeda as a continuing threat to U.S. security interests and some allies around the world. North Korea's determination to continue its nuclear weapons program is another serious problem, together with Iran's on-going nuclear weapons developments. The main danger is not an attack by either state, but from collaboration in nuclear weapons development with other rogue states or organizations (like Al-Qaeda). A potential threat could come from Chavez, the Venezuelan dictator, who could finance anti-U.S. guerillas or terrorists in Latin America from large oil exports. Many moderate Islamic regimes (like Jordan, Egypt, Saudi Arabia, other Persian Gulf States, and Indonesia) are targets for terrorist assassination, disruption, or pressure against U.S. interests and friends. For all these reasons, substantial U.S. military force levels (naval, air, ground, and nuclear weapons) will be needed for some years at least, regardless of how U.S. intervention in Iraq (2003-2005) turns out.

Whatever the United States did about Iraq, i.e., a costly U.S.-led intervention or a major increase in U.S. deterrent forces in the region, a significant increase in U.S. military outlays was needed. The mix of forces probably would mainly be conventional for an early war. However, more substantial air-naval-nuclear forces will be required for the Mid-East and western pacific regardless (to deal with Iraq, Al-Qaeda, and North Korea) over the longer run.

In any event, the United States should now increase its overall defense spending, which had been cut too far back in the later 1990s (See Chart 3). U.S. defense spending has fluctuated greatly over its long history. Substantial increases occur for external threats and wars.[10] Now for 2004-2005 another upsurge in U.S. defense spending and homeland security is required. U.S. defense outlays, border control, and public health measures should be increased from $355 billion by at least $150 billion annually (or about forty percent). This would bring U.S. defense spending as a share of GNP to at least 4.5 percent annually. Included would be increased navy, air, and land forces (at least twenty to twenty-five percent), improved readiness, considerable replacement of aging aircraft and naval vessels, and renewal of nuclear forces and their readiness. Some outlays for missile defense, pilot programs, and testing are desirable (but nothing major until this technology is proven). U.S. defense increases include essential militarily (to

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successfully "hand off" to a moderate Iraqi regime. Skeptical critics worried that U.S. efforts could easily fail and aggravate the dangers of anti-U.S. backlashes. Many remained unsure, including other nations. But the "winning forces" in Iraq would get bandwagon benefits of increased backing in the Mid-East and Muslim world. The 2004 U.S. election complicated the struggle. The Bush re-election did provide more credibility for U.S. staying power for awhile. A successful handoff to Iraqi's remains crucial for the U.S. and coalition efforts.

10. Major U.S. war emergencies were the undeclared war against France from 1798 to 1799, the war of 1812 to 1815, the Civil War (1861 to 1865), World War I (1914-1918), World War II (1940 to 1945), and the Cold War (1946 to 1991). (See Chart 3). In the post-Cold War era the Bush administration cut defense spending from six to 4.5 percent of GNP (1989 to 1993). Clinton's administration and Congress cut defense spending much further between 1993-2000, i.e., from 4.5 to 2.8 percent of GNP. In retrospect, these recent cuts went too far. More like 4.5 percent is needed again until the Iraq intervention is resolved, along with other security challenges in the Mid-East, Korea, and Caribbean.

rebuild more strength, for the Iraq crisis, and a continued "War on Terrorism"), but just as important, an overall economic stimulus. If further defense outlays become needed over the longer term (e.g., ten to twelve years), then sur-taxes or value-added taxes should follow for healthy fiscal discipline (to limit inflation). Remember that U.S. defense spending was relatively high through most of the Cold War from 1950-1990.[11]

III. CONCLUSIONS

The global economy of the early twenty-first century is a mixed picture. On the one hand, rapid industrial progress and improving technology are good news for most of humanity. But the world marketplace is under strain. The trade regime is too rigid, somewhat fragile, and fosters asymmetries, free riding, and imbalance problems. The present WTO is stuck in a logjam of conflicting interests, with little prospect for multilateral resolution. Only more realistic regional and bilateral trade deals are likely to improve the trade situation. The finance regime is in better shape, but has been strained by excessive speculation, hot money flows, and disruptive financial and banking crises. Misaligned currencies are a serious problem. The poorest countries suffer unmet financial needs, but substantial progress for them requires more responsible governments and better security arrangements. The world's security regime has become strained lately. Over-confidence, naiveté, anti-military attitudes, and neglect aggravate these problems. Sadly, in much of the world, i.e., the Mid-East, Africa, the Americas, and parts of Asia there are active conflicts or strained relations. Lessons from the 1930s, the Cold War, and the post-Cold War era teach that western-style democracies (United States, EU, and other OECD states) should not neglect their armed forces, and particularly their nuclear deterrent and delivery systems. Thus, the international trade, finance, and security regimes all need serious work, architectural improvements, and careful political handling in a multi-polar world.

Skillful, respectful, and realistic diplomacy is essential. Arrogant and domineering pressure from the United States will not be successful. Extensive resentments against the United States have already accumulated much around the globe. We must better appreciate that all major powers, and lots of lesser states, have important concerns and vital interests. The United States must learn to listen more patiently, and show more teamwork.

11. The outcome for the recent U.S. intervention in Iraq was unclear in 2004, although the Bush re-election allowed more time for the intervention efforts. Initial U.S. and allied military operations were successful, but the economic-political-military reconstruction effort was slow and uneven, with growing opposition. Critics include those wanting stronger U.S. forces, better supervision, and a faster "handoff" to Iraqi's, while others doubted the overall feasibility of U.S. and allied intervention and its desirability.

On the other hand, the United States has important economic, industrial, agricultural, and trade balance interests of its own. It is unrealistic to believe that the United States can or should make unreasonable or disproportionate sacrifices of its own interests in order to procure collaboration from others. No. The theme of U.S. policy should be mutual gains, trade, and security with as many countries as possible.