4

National Security Risks from Accumulation of Foreign Debt

ADAM S. POSEN

Every successive year's accumulation of foreign debt (or reduction in the US international investment position) increases the national security risks for the United States. The dollar's global role—in trade, invoicing, and official reserves and investor portfolios—depends critically on the belief that assets held in dollars will not be subject to sustained devaluation. But as foreign indebtedness rises, this perception of the US currency weakens. The United States' political leadership in security, commercial, and even cultural affairs globally has a critical two-way linkage with the faith in the dollar in the monetary realm. When the dollar is believed to have underlying strength, it is to traders' advantage to sign contracts and to price in dollar terms and to trade with countries that also deal in dollars—including the United States—so economic ties between dollar-reliant nations deepen.[1] When the dollar is considered universally liquid and a reliable source of value, regimes that are linked to the United States on foreign policy grounds tend to also peg to the dollar or at least use the dollar as a reference currency.[2]

Adam S. Posen is deputy director of the Peterson Institute for International Economics, where he has been a senior fellow since 1997.

1. In the economics literature, this is referred to as the "endogenous currency area" argument for foreign exchange relationships, as coined by Jeffrey A. Frankel and Andrew K. Rose—i.e., a common currency gives rise to greater trade.

2. Most countries engage in at least managed floating with reference to a specific currency, even if they do not formally peg their currencies, as established by Guillermo A. Calvo and Carmen M. Reinhart's "fear of floating" research. In Posen (2008) I give examples of the interaction between security ties and exchange rate relationships.

This positive economic dynamic that emerges from relative US financial stability has significant benefits for the global role of the United States beyond the monetary or even trade realm. Some of what is taken for granted in foreign policy as the benefits of American military preeminence or political leadership is actually in part attributable, or at least importantly supported by, this economic reinforcement of the US role. This includes many of the "soft power" attributes that the United States enjoys in the cultural and ideological arena, as well as more direct military advantages in terms of access to technology and key geographic areas (and intelligence about them) and ability to encourage bandwagoning with US initiatives rather than balancing behavior by potential allies (in the sense of Stephen M. Walt's [1987] view of alliances) during peacetime or periods of limited conflict. As a result, the erosion of US financial stability through ongoing sizable current account deficits also eats away at US national security.

The Short-Term Risk: Financial Constraint When Responding to Urgent Situations

The usual concern voiced about the national security harms from excessive current account deficits has to do with the risk of dollar-denominated debt being dumped on the market by potential enemies during conflict; occasionally, concern for the accumulation of wealth concentrated in the hands of hostile governments is also expressed.[3] Most national security analysts and financial economists, however, tend to downplay these risks. In times of conflict, the risk is more to the hostile state holders of US debt than to the United States itself, in that fire sales of such debt would amount to the lenders intentionally forgoing part or all of their repayments. The US government would already have (and probably spent) the money lent. In terms of investments in US properties and companies, it is not as though those are transportable to hostile homelands once disputes escalate, as Iran found out in 1979–80. From friendly governments, the threat of such dumping of US government securities is even less credible, especially in times of conflict, when most of the likely large holders of debt (Japan, Germany, Singapore, Saudi Arabia, Taiwan, Korea, and the United Arab Emirates) are militarily dependent upon US security guarantees. If anything, the fact that US hegemony allows the US government to borrow on better terms than any other entity globally should be seen as a privilege (as Charles de Gaulle recognized).

Far more realistic, however, is the national security risk to the United States from current account deficits that emerges when a crisis requiring great public resources occurs during times of relative peace. This could be

3. Chinn (2005), Chinn and Steil (2006), Setser (2007), and Bergsten et al. (2008, box 1.2) are all good examples of such discussions.

a military matter, like intervention in Afghanistan, or a broader human security difficulty, like Hurricane Katrina or the Asian tsunami. It could even be the kind of financial crisis in which the United States currently finds itself. In such situations, fiscal expenditures must take a sudden jump. For military interventions or large natural disasters, they usually run in excess of 1 percent of GDP a year for at least two years; for financial crises, the costs are upwards of 5 percent of GDP, sometimes as high as 20 percent of GDP, spread over several years. In all of these cases, demands for US government largesse both at home and from the affected populations abroad go up as well—the United States must be seen as doing its part in leading the effort and the monetary contributions, lest others begin to doubt the benefits of US leadership or even see other countries arise as leaders. Excessive burden sharing is usually counterproductive, not least because it is perceived as an abdication of the US role, leaving the weak and allied in the lurch, if not in danger of outright exploitation.

While the bulk of such temporary surges in expenditure can be financed through US (future) domestic taxes and savings, capital inflows to the US economy can make that financing much easier.

During relatively peaceful times, global capital flows are part of the normal course of economic activity. In fact, the influence of foreign lenders, even those of potential hostile intent, increases during such periods because businesses are willing to depend on such flows and because the selloff of dollar-denominated assets is more credible in such a context (more value will be retained and more viable alternative investments exist).

If the United States essentially maxes out its normal line of credit through excessive and repeated current account deficits during periods without costly crises to which to respond, the terms of US borrowing can erode much more quickly when it goes to the markets for increased bond sales in a short span of time. Moreover, the inflows to US private-sector businesses, for which increases in government funding are an imperfect substitute (as the recent credit crunch amply demonstrates), would be hit even harder if interest rates rise and sentiment turns against dollar investments. Thus not only is there a shortfall in US government resources but also an additional cost to growth in such a period. Finally, if the United States is not seen as a place of relative financial stability, it will not benefit from flight to quality, which usually offsets such problems (again, as seen recently). Hegemony may have its exorbitant privilege, but the United States still is better off saving use of that privilege for when it is really needed. The risk of too much foreign debt is not of being cut off from credit in the true extremis of international conflict but of what happens to American economic performance, relative global standing, and overall resilience when minor but still serious crises occur and US credit is overextended. Too many of such instances mismanaged add up to a long-term erosion of US capabilities and credibility.

The Long-Term and More Important Risk: A Dynamic of Unwinding US Prominence

The positive long-term dynamic that emerges from relative US financial stability begins with the global use of the dollar in trade and investment matters, including as an anchor for other currencies. Such pegging and trade ties orient further the other country's leadership—military, financial, and otherwise—toward US society and politics, be it in public matters of macroeconomic linkages and arms sales or in private decisions about forms of wealth accumulation and where one's children are educated. Private decisions to invest in the United States, both at the corporate level and by individuals, are supported by the desire to gain insider access to key decision-making processes and to membership in US-centered transnational elites; in fact, it is this desire for membership and access that is a major source of the financially unrewarding investments made by foreigners in the United States.[4] Taken together, these many nonfinancial motivations for orienting toward the dollar contribute to the United States' exorbitant privilege to pay for its current account deficits in its own currency at low interest rates.

Yet this mutually reinforcing interaction between currency, trade, investment, and security relationships—which has played out to the United States' national security benefit in countries ranging from South Korea to Saudi Arabia and Panama to Poland—also can go into reverse. Initially, the cumulative nature of these ties means that the United States has more room for error with its currency before things start to unravel, much as the United Kingdom had with the exchange rate ties of its Empire and Commonwealth to the pound persisting even after that nation became a significant foreign debtor. This could explain in part the ability of the dollar to persist in its global role despite the substantial erosion of its net international investment position over the last 40 years. At some point, however, a switch out of the dollar occasioned by the accumulation of too much foreign indebtedness would start to unwind these other ties. Less faith in the dollar would mean fewer contracts and invoices in dollars, lower investment in dollar assets, and diminished trade and financial ties. The elites in the one-time dollar peggers would be economically discouraged from orienting too heavily toward the United States, which could also lead to cultural reorientation and participation in other transnational networks that exclude the United States. And the endogeneity of deepening ties with currency linkages would run in the other direction, away from the dollar.

The distance between the United States' current position and such an unwinding scenario is not all that great and gets closer every year that the

4. Charles Maier (2006) and Susan Strange (1996) have made extended historical cases for this process.

dollar's perceived strength is undercut by the country's trade deficit. Given the rise of the eurozone and East Asia as important sources of international trade and global growth, and the substantial role of geographic proximity in determining trade patterns, there is a strong argument for a large number of currencies to peg (or managed float) against the euro, or even the yen or yuan, rather than against the dollar. If undervaluing the exchange rate for export success is important to emerging-market countries, then that is another argument for the targeted currency to shift from the dollar to a basket or to change to a more appropriate anchor as export markets shift.

Indeed, some observers (Bergsten 1997a, 1997b; Portes and Rey 1998) predicted before the euro's launch that the euro would some day rival the dollar as a reserve currency, producing a bipolar monetary system. If the fundamental drivers of reserve currency shares are the relative economic sizes, financial depth, and commitment to low inflation of the dollar and euro economic blocs, then all of these could converge between the United States and eurozone over time, if not eventually, to favor the euro.[5] This economic reality is consistent with financially based calculations of "optimal" reserve shares for countries to hold, which usually suggest the dollar share should be much lower than it currently is. Rather than ascribing this persistence of the dollar's leading role to unspecified "network effects," it makes more sense to view it as the national security bonus from which the dollar currently benefits—and as a marker of just how much economic factors are pushing toward unraveling those ties.

Some analysts (e.g., Bergsten 2005) have argued that for the euro to overcome the inertia of the dollar's role and attain codominance, the United States will have to commit a series of significant policy mistakes or suffer a balance-of-payments crisis. These analysts assume such a process to have been operating when the pound sterling lost its role to the dollar in the 1930s, when the United Kingdom's balance of payments and monetary discipline flagged. The dollar, however, was spared such a fate during the 1970s only because neither the deutsche mark nor the yen was a viable alternative at the time. If the existence of an alternative reserve currency is the key factor, conditional on the basic factors (economic size and financial liquidity) being in place, then recent events indicate that the time is ripe for an accelerated switch from the dollar to the euro, if not a formal regime change.

Such a shift in currency regimes would have significant impact on US national security relationships as well. It is not an accident, for example, that the Central African CFA Franc Zone, where France still intervenes militarily, is the only group of countries outside eurozone membership candidacy to peg to the euro, while EU members with the strongest desire

5. Chinn and Frankel (2007) go further and suggest that within 10 years the euro will have displaced the dollar; if the United Kingdom joins the eurozone, adding not just size but also financial depth, this would be accelerated.

for independent security policies (Poland, Sweden, and the United Kingdom) are the ones that have refused to enter the Exchange Rate Mechanism II (ERM II) in preparation for eurozone membership. A wholesale shift to the euro by global investors and official portfolios could possibly tip those countries into deepening their links with the European Union via eurozone membership, thereby starting a cycle turning them from an Atlanticist security orientation toward a more assertive common European foreign policy. And that would be *within* the North Atlantic Treaty Organization (NATO) alliance. Imagine as well the national security impact in East Asia were South Korea, Singapore, and even Taiwan or Japan to feel pushed economically toward deepening ties with China in explicit diversification away from dollar-denominated activities and investments. The impact would be only a little less were such a diversification toward some kind of regional Asian currency arrangement rather than toward the Chinese yuan per se. That would in turn also reduce their educational and cultural linkages to the United States, the volume of transpacific trade, as well as the perceived nonfinancial benefits of holding dollar assets. This dollar decline would not only raise the rate of interest on US obligations but also start a vicious circle of allies distancing themselves from the United States.

In this context, it is worth emphasizing that the main driver in the accumulation of official reserves in this decade has not been the relative reallocation of euros versus dollars. Instead, the big story is the massive accumulation of primarily dollar reserves by Asian developing countries and oil exporters. Developing-country reserves have risen as a share of the global total as their national incomes have risen on the back of export-led growth.[6] This accumulation in East and South Asia is in part motivated by foreign exchange intervention to undervalue these nations' currencies for export promotion and in part to self-insure incumbent governments that they will have sufficient reserves to deter speculative attacks on their currencies of the sort that occurred in 1997–98. In the Persian Gulf, this accumulation has come through inability to sufficiently invest and distribute wealth at home. Whatever the reason, these governments stand to lose the most in financial terms were the dollar to crash or steadily decline in value—these governments are also most on the line geopolitically and in terms of basing for US national security strategy vis-à-vis China and Russia.[7] Thus, the interdependence of the dollar's global role and US

6. According to the latest International Monetary Fund's Currency Composition of Official Foreign Exchange Reserves (COFER) data, 75 percent of total developing-country reserves, even counting Japan, are now in official hands. See Truman and Dowson (2008) for discussion of these data.

7. Obviously, Chinese accumulation of dollar reserves is *not* motivated by deepening strategic ties with the United States; one theory does not fit all. At the same time, though, Russia's decision to be the one BRIC (Brazil, Russia, India, China) economy that has openly moved

global security really comes to the forefront today in Asia and the Middle East and underscores the risks to American national interests from current account deficits eroding the dollar's standing, in addition to the direct economic costs.

Since the causality runs both ways from US economic leadership to foreign policy leadership, some seemingly separate aspects of US hegemony will tend to rise or fall together. It is not just that if the United States were to lose reserve currency dominance, military activities would become more difficult to finance—though, of course, they would. Major increases in American foreign indebtedness through current account deficits would also erode the willingness of other countries to deepen ties and networks with the United States and would thus create a negative feedback loop between US economic and security capacities.

References

Alogoskoufis, George, and Richard Portes. 1992. European Monetary Union and International Currencies in a Tripolar World. In *Establishing a Central Bank: Issues in Europe and Lessons from the U.S.*, ed. Matthew Canzoneri, Vittorio Grilli, and Paul Masson. Cambridge: Cambridge University Press.

Bergsten, C. Fred. 1997a. The Dollar and the Euro. *Foreign Affairs* 76, no. 4: 156–80.

Bergsten, C. Fred. 1997b. The Impact of the Euro on Exchange Rates and International Policy Cooperation. In *EMU and the International Monetary System*, ed. Paul Masson, Thomas Krueger, and Bart Turtelboom. Washington: International Monetary Fund.

Bergsten, C. Fred. 2005. The Euro and the Dollar: Toward a "Finance G-2"? In *The Euro at Five: Ready for a Global Role?* ed. Adam Posen. Washington: Institute for International Economics.

Bergsten, C. Fred, Charles Freeman, Nicholas R. Lardy, and Derek J. Mitchell. 2008. *China's Rise: Challenges and Opportunities*. Washington: Peterson Institute for International Economics and Center for Strategic and International Studies.

Calvo, Guillermo A., and Carmen M. Reinhart. 2002. Fear of Floating. *Quarterly Journal of Economics* 107, no. 2: 379–408.

Chinn, Menzie. 2005. *Getting Serious about the Twin Deficits*. Council Special Report 10 (September). New York: Council on Foreign Relations.

Chinn, Menzie, and Jeffrey Frankel. 2007. Will the Euro Eventually Surpass the Dollar? In *G7 Current Account Imbalances: Sustainability and Adjustment*, ed. Richard H. Clarida. Chicago, IL: University of Chicago Press.

Chinn, Menzie, and Benn Steil. 2006. Why the Deficits Matter. *The International Economy* (Summer).

Maier, Charles. 2006. *Among Empires: American Ascendancy and Its Predecessors*. Cambridge, MA: Harvard University Press.

Portes, Richard, and Hélène Rey. 1998. *The Emergence of the Euro as an International Currency*. NBER Working Paper no. 6424 (February). Cambridge, MA: National Bureau of Economic Research.

Posen, Adam S. 2008. Why the Euro Will Not Rival the Dollar. *International Finance* 11, no. 1: 75–100.

---

to a euro-dollar basket for its exchange rate reference is a good illustration of how desire to assert a national security identity independent of the United States can influence currency decisions and reinforce such an orientation.

Setser, Brad. 2007. *The Case for Exchange Rate Flexibility in Oil-Exporting Economies*. Policy Briefs in International Economics 07-8. Washington: Peterson Institute for International Economics.

Strange, Susan. 1996. *The Retreat of the State: The Diffusion of Power in the World Economy*. Cambridge: Cambridge University Press.

Truman, Edwin M., and Douglas Dowson. 2008. Reserve Diversification. Peterson Institute Research, February 5. Photocopy.

Walt, Stephen M. 1987. *Origins of Alliances*. Ithaca, NY: Cornell University Press.