Prepared Remarks

# American Exceptionalism: Time for New Thinking on Economics and Security

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## Introduction: Connecting Economics and Security

It is a pleasure and a privilege to be with you this evening to deliver the Alastair Buchan Memorial Lecture.

The International Institute of Strategic Studies (IISS) played an indispensable role, led by Alastair Buchan and the incomparable Sir Michael Howard, in transforming defense studies from technical military concepts to political and security strategy. John Chipman has skillfully and ably applied that design to a different age.

So there is no better forum to broaden the strategic view further: Tonight, I will seek to connect economics and security. In doing so, I will draw on an earlier American foreign policy tradition to offer a revision to the standard post-World War II history.

The connection between economics and security is usually assumed, not analyzed. After examining the origins of America's foreign economic and security policy, I will describe three phases of the post-World War II international economy and a new, fourth phase, which is just taking shape. I will suggest that the earlier experience—rather than being retired as antiquated—points toward economic fundamentals that are essential to future security in this new era. We need to look "Back to the Future."

Let me start with an anecdote that helped crystalize my thinking.

Earlier this year, Bob Carr, Australia's Foreign Minister and long-time friend of the United States, visited Washington. Carr stated his main message with Aussie clarity: "The United States," said Carr, "is one budget deal away from restoring its global preeminence." He also added a caution: "There are powers in the Asia-Pacific that are whispering that this time the United States will not get its act together, so others had best attend to them."

Bob Carr is the founder of the Chester A. Arthur society—named after America's not-so-renowned 21st president—a proud assembly of Australians who appreciate obscure US political history and humor. So Carr would probably not be surprised to learn that his warning echoes words drafted by Alexander Hamilton for President George Washington's farewell address: The new nation, Hamilton urged, must "cherish credit as a means of strength and security."

These ideas from the Anglo-Saxon periphery should find resonance in this country [the United Kingdom]. Because Britain took care with budgets and credit, this "nation of shopkeepers" was able to rise to what this week might be termed "Olympian feats." The most exciting chapters on the Napoleonic Wars map Bonaparte's bold campaigns—or the Royal Navy's counterstrikes—but the key to Britain's victory in the early 19th century is found in the dry accounts about Pitt the Younger's budgets. By restoring Britain's credit, Pitt enabled his country to fight a long war without choking its economy. Britain even could finance its coalition partners, again and again, until Napoleon succumbed.

**The American Foreign Economic Policy Tradition**

For its first 150 years, the American foreign policy tradition was deeply infused with economic logic.

As some of you may recall, in 1773 a tribe of Bostonians threw 342 chests of tea into the harbor—without damaging other property, I should add—to protest taxes imposed to bail out the nearly bankrupt East India Company. The incident was the most dramatic of waves of colonial "nonimportation" policies dating to the 1760s, early American efforts to employ trade as a tool of policy.

The new American Republic was born amidst a world of mercantilist empires. Navigating around the trading monopolies of the seasoned, established powers—and later blockades and bullying—the former colony fought continually for "freedom to trade." This principle was not "free trade" as we understand it today, but it was definitely a challenge to the old order.

The young United States, under President Thomas Jefferson, tried to exert leverage of its own with nonimportation acts and even a disastrous Embargo of foreign commerce in 1807 to pressure Britain on neutral trade and the impressment of sailors. Ironically, it took the failure of American trade sanctions, and the War of 1812, for the United States to start to develop the manufacturing base that Hamilton sought and Jefferson opposed. That war, by the way, was the one in which some ruffians torched President James Madison's Executive Mansion, which had to be repainted as "The White House."

Britain was not the only object of the United States' economic security policy. From 1801–05, in the face of the Barbary Pirates' attacks on US ships, Jefferson rejected demands for tribute and instead sent the US Navy to assault Tripoli. As the US Marine Corps Hymn has memorialized, this Libyan expedition was not "led from behind."

In an age where power arose from territory, resources, people, and then commerce, the implicit American strategy understandably concentrated on the North American continent and open immigration. Land and settlement provided security.

In a lost tool of diplomacy, the United States resolved disputes by buying lands—the Louisiana Purchase; Florida; old New Mexico, California, and the Gadsden Purchase; Alaska; and even the Virgin Islands at the start of the 20th century. Admittedly, in some cases use of force led to price discounts. In another touch of irony, Jefferson needed Hamilton's Bank of the United States and credit system—which Jefferson had opposed—for his greatest achievement, the Louisiana Purchase.

The theme of Western Hemispheric integration—a partnership of young democracies, not an empire—was advanced by Secretary of State Henry Clay in the 1820s, revived in the 1880s and '90s, and found first fruits a century later in the North American Free Trade Agreement (NAFTA) and then five more US free trade agreements with Latin America. Today, those free trade agreements encompass over half of the hemisphere's non-US GDP.

*The Federalist Papers*, the touchstone of American Constitutionalism, are replete with references to the need for a strong, federal government to secure the United States' place among foreign nations, including through healthy commerce and credit. Indeed, John Jay (in Federalist No. 4) cautioned in 1788 that the growing trade with China would one day draw the United States into conflict in the Far East. The United States' first forays into international relations were called Treaties of Amity and Commerce.

In 1854, US Navy Commodore Matthew Perry "opened" Japan to trade. By 1899, Secretary of State John Hay was resisting carving up China, as Africa had been, in favor of an "Open Door" policy to secure equal commercial opportunity.

This race through US foreign economic policy is not intended to suggest that the American system was all peaceful commerce. To the contrary, and to my core point, even if the connection was driven by interests and not explicit planning, the economics and security policies worked hand-in-hand. These interests were often infused with a healthy dose of what those generations called spreading "civilization," and which we call "values." With trade and the flag came missionaries—and their schools. After the defeat of the Boxer Rebellion in 1900, the United States pragmatically used its share of the indemnity imposed on China—which the United States had opposed—to found Tsinghua University in Beijing and fund scholarships for Chinese students in the United States. As a maritime country, the US Navy looms large in America's foreign economic policy, just as the Royal Navy does for Britain.

The objects of these policies were hotly debated, too. Ironically, the US war with Spain in 1898, precipitated by conflicts over Cuba, led the United States to acquire the Philippines (for $20 million) to keep the islands from being grabbed by others whose fleets were hovering—but the United States did not take Cuba. Teddy Roosevelt stirred up a revolt in Panama so he could build a canal that linked the two great oceans, commerce, and fleets of the US Navy.

The American foreign economic policy helped spur early interest in international law—what we now awkwardly call "rules-based systems"—to resolve disputes. The United States was an active participant in the first Hague Conference of 1899 and lent its support to the Permanent Court of International Arbitration. Secretary of State Elihu Root negotiated arbitration treaties with 25 countries early in the 20th century.

The decades that followed continued the pattern. “Dollar Diplomacy” sought to support American enterprises in Latin America and East Asia, through what we now call transnational actors—but who in those days were railroad and mining engineers, bankers, and merchants. In World War I, Great Britain wisely learned a lesson from a century before, and shrewdly played on the US commitment to neutral rights on the seas.

After World War I, reacting against what the United States viewed as the old European politics of perpetuated hostilities, the country withdrew from European military security. Yet even during the 1920s and 1930s, the United States relied on banker-statesmen—Charles Dawes and Owen Young in Europe, Tom Lamont and Dwight Morrow of the House of Morgan in Mexico—to negotiate debt and reparations to revive broken economies. To secure peaceful seas, the United States even launched the idea of global arms control through the Naval Disarmament Conferences of the 1920s.

In the depths of the Great Depression, however, the United States withdrew from the world economy, and political-military “isolationism” followed.

In 1941, the United States learned, again through harsh experience, that economic and military interdependence were linked. The United States had imposed embargoes on the sale of petroleum and scrap iron to Japan to counter Japan’s invasion of China and its threats to Southeast Asia. Imperial Japan responded with a surprise attack, in part to secure its sources of oil and raw materials. The United States, caught unprepared, paid a terrible price.

**The Rise of the National Security Concept**

World War II and the opening of the Cold War led to a sharp break in the American foreign policy tradition. At least that is the impression left by the masters of mid-20th century security studies.

The dawn of the nuclear age, the face-off between communism and the West, led to a new concentration: national security strategies. Issues of war and peace, and the work of Alastair Buchan and others, prompted deterrence theories and later proposals for arms control. Understandably, in a world of superpower confrontation and containment, the traditional American foreign policy aims of amity and commerce seemed quaint and outdated. Military balance took precedence. For the first time in its history, the United States maintained a large conventional army, a significant part based in Europe, with other troops fighting in East Asia in the 1950s, ’60s, and ’70s, and in Southwest Asia in the ’90s and for the past decade.

Economics became a resource factor in the national security state. And economics became the handmaiden of the strategic policy process. The US National Security Act of 1947 is full of references to new offices to manage the mobilization of people and resources for total war. Yet the Act did not even make the Secretary of the Treasury a statutory member of the new National Security Council. Ever since that time, the US government has struggled to integrate economics into its national security strategies.

The transformation of US foreign policy priorities—from a fusion of economics and security to national security policy—signaled a change in the training of the stewards of American foreign policy. The new specialties were Soviet studies, political-military affairs, defense policy, and eventually Middle East policy. Short of home-grown talent on the central front, America even outsourced security strategy to immigrants from continental Europe—Henry Kissinger and Zbigniew Brzezinski—who had grown up in a world of threat and power and balance in Eurasia. Some of the best younger Americans came to IISS to sharpen their strategic thinking.

**Reintroducing Economics into the Post-World War II Narrative**

I would like, however, to offer an alternative view of the Cold War and its aftermath that reinserts economics into the narrative.

Since the end of World War II, the international economy has been marked by three phases: from the creation of the Bretton Woods system to its breakdown in the 1970s; then, a capitalist revival from the late 1970s through the end of the Cold War; and third, the rise of globalization in the 1990s, extending to the Crash of 2008. We are now stumbling into a fourth phase—one that is vital for us to shape.

**Phase One: From Bretton Woods to the 1970s**

Seeking to learn from the failed Peace of 1919 and the causes of conflict in the 1930s, the United States and Great Britain began, even as World War II still raged, creating new international economic institutions to address currency exchange rates, trade, reconstruction, and development. The United States and Europe launched the Marshall Plan—and Europe created an Economic Community—to shore up the economic foundations of the free world. The United States exported capital and imported goods to boost recoveries in Europe, Japan, and then Korea and others in the developing world.

The economic internationalists of Bretton Woods and the European Community were not driven primarily by a plan for "containment" or to counter the Soviet Union. They were trying to counter the economic causes of political and security breakdown in the 1920s and '30s. Over time, the imperatives of the Cold War led to a pragmatic convergence of the national security planners and the economic designers.

Yet there is a crucial difference in the way the 20th century national security model embraced economics. The national security focus on resources of the state treated international economic issues as benefits to be exchanged to support security aims: trade concessions, foreign assistance, military aid—not necessarily inclusive growth, good governance, and open, competitive markets.

This difference is important. The national security perspective of state power risks overlooking an important reality: that sound economic policies are the underpinning of both individual freedom and national power—not only military power, but also the dynamism, innovation, and influence of the economy and society. The 20th century concept of national security also overlooked how economic change—within economies and internationally—can be a powerful force of its own in international relations.

President Eisenhower understood this distinction. He invested political capital in balanced budgets, low taxes, and sound monetary policies. He recognized the underlying strength generated by investments in national highways, education, and science. On the international stage, as Anthony Eden learned to his sorrow in the Suez Crisis, Eisenhower would even use the power of the US dollar over the British pound to stop the use of force in Egypt.

In the 1970s, a new generation of international relations thinkers, led by Robert Keohane and Joe Nye, questioned the realist power model of Hans Morgenthau that accompanied the Cold War national security concept. They did not dismiss power, and indeed recognized the vital role of military force. But Keohane and Nye supplemented realism with a description of complex interdependence. Their framework reinserted economic and other considerations not involving force into foreign policy. Their attention to diverse regimes and international organizations was timely, given the breakdown of the Bretton Woods system of fixed exchange rates and the rise of oil power through OPEC in the 1970s.

Thus, during the 1970s, the first phase of the post-World War II international economic system came to a messy close. The world economy stumbled toward a new reality of floating exchange rates, oil shocks, big bank loans of petro dollars to developing world sovereigns, and stagflation.

It is intriguing to observe that Henry Kissinger—the master strategist of classic realism—struggled to integrate these seminal economic events into his Weltanschauung. Some critics even argued that Dr. Kissinger's lack of understanding of economics led to a balancing strategy based on the assumption of a Spenglerian decline of the West. From the dominant national security perspective, however, Kissinger had shrewdly extricated the United States from military defeat in Vietnam while opening relations with China as a counterweight to his Soviet foe.

Keohane and Nye recognized that they had a blindspot, too. As presenters of a "framework for using <u>international factors</u> to explain change and stability in world politics" (emphasis in the original), they acknowledged that they did not examine the connection between domestic and foreign policies. They focused on international systems—rules, norms, and regimes. Yet critical domestic choices—particularly economic ones—will infuse foreign policy and shape—for good or ill—the principles, practices, and diplomacy of those international systems.

**Phase Two: The Revival and Success of Capitalism**

Margaret Thatcher and Ronald Reagan understood intuitively the connection between national economic revival and foreign policy. Their priority was to revive capitalism at home—so as to extend it to the world. In doing so, they defined a second phase of the postwar international economy.

The promotion of global capitalism seemed to many to be disruptive, the antithesis of rebuilding an international economic system that was reeling from shocks. After all, Joseph Schumpeter had explained that capitalism is creative destruction. Yet this very disruptive quality enables capitalism to respond flexibly and continually to technological and other changes. There are risks to overregulation—just as there are to weak supervision. Zealous social protections, though perhaps well-intended, can add costly rigidities.

Germany’s commitment—pursued by Social, Free, and Christian Democrats alike—to sound economic policies and export competitiveness demonstrated that social market economies can work. East Germans saw the stark contrast with their existence. Japanese manufacturers responded to the oil shocks with a huge increase in energy efficiency.

Together, the domestic economic policies of the Trilateral partners—the transatlantic community and Japan—enabled the “West” to adjust to the 1970s breakdown of the post-World War II economic security system.

The Soviet Union could not adapt to its economic challenges. The USSR could not cope with change in information technology, new drivers of productivity and competition, and eventually $15 a barrel oil.

The combination of the democracies’ economic regeneration, the US military buildup with advanced technologies, and transatlantic solidarity over Euromissiles led Mikhail Gorbachev to conclude he had to reform communism. But his perestroika didn’t work.

Reagan believed that the regimes and institutions of interdependence should be tested for effectiveness in boosting international growth and opportunity. After all, those were the standards of economic freedom he was applying at home. Moreover, at a time of economic flux—whether at home or abroad—the international regimes needed to foster flexibility and adaptation. Reagan believed that the international rules definitely should not constrict domestic economic revival.[*]

Reagan and Thatcher saw the link between the national and international. They worked to shape the postwar international economic system after the 1970s upheaval. The United States drew criticism by rejecting some international schemes—UNESCO’s New World Information Order, the UN General Assembly’s New International Economic Order, and the deep seabed mining regime in the Law of the Sea Treaty. Britain championed the European Community’s Single Market and challenged overregulation.

After a pause, the United States would lead, with pragmatism and compromise, in reshaping international economic relations. In Reagan’s second term, the United States steered the International Monetary Fund (IMF) to a new role in the Latin American debt crisis in the 1980s. It led a major recapitalization of the World Bank to support developing countries’ economic reforms and debt reschedulings—until banks could write down losses.

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[*] It seems that many scholars, working within the boundaries of their specialized disciplines, miss this relationship between the national and international. When a group of authors published *The New Federalist Papers* in 1997, they, unlike the original Federalists, totally omitted the connection between America at home and abroad.

The United States pushed to expand global trade through the launch of the Uruguay Round under President Reagan, completed much of the negotiation under President George H. W. Bush, and closed the deal to create the more influential and liberalized World Trade Organization (WTO) out of the old General Agreement on Tariffs and Trade (GATT) under President Bill Clinton. President George H. W. Bush helped initiate the Asia Pacific Economic Cooperation forum (APEC) to foster economic ties across the Pacific after the Cold War and negotiated NAFTA, which President Clinton enacted.

In the late 1980s, Secretary of the Treasury James Baker launched a process of international economic coordination in the G-7. This process took the important step of including central banks and it gave life to the unfulfilled assignment to the IMF of "surveillance." Although the IMF surveillance system and G-7 coordination process drifted after Baker's tenure, the Crash of 2008 revived it through an expanded G-20 regime.

The end of the Cold War and its immediate aftermath brought the second phase of the postwar international economy to a close with astounding success. Renewed economic vitality domestically led to a vast expansion of private markets around the world and advances in international economic regimes based on market principles and openness. The national security aims of the Cold War in Europe were achieved with hardly a shot fired. It may not be coincidental that the principal US secretaries of state in this period—George Shultz and James Baker—had served as secretaries of the treasury, too.

**Phase Three: Globalization's Promise and Perils**

The huge changes in the world economy in the 1990s precipitated yet a third phase in the postwar international economic system.

The end of the Cold War reunited Europe. The European Community became a deeper and wider union, and some of its members even launched a common currency.

Just as important, China, India, and other developing countries moved from planned socialism and import substitution schemes to market competition.

Over the course of a decade, the number of people engaged in or actively affected by the world market economy surged from about one billion to four or five times that. Information technology leapt ahead. Capital raced around the globe. Rather than look to the world economy of Bretton Woods as the point of reference, the earlier era of globalization before World War I seemed to offer a closer policy parallel.

Yet the adaptation to markets on a truly global scale—integrating developed and developing countries alike—was bound to be discontinuous and fraught with challenges.

In the late 1990s, countries in East Asia and Latin America faced harsh financial blows and painful restructurings. Almost all are now stronger for the experience.

The recovery strategies of some developing countries planted the seeds of a new problem: "imbalances"—whether of savings, reserves, trade accounts, or other dimensions. Some economists maintain that the low prices of goods available from new suppliers led central bankers to persist in easy monetary policies for too long, risking widespread asset price inflation, especially in real estate markets.

The institutions of the international economic system adapted incrementally, often with difficulty. The economic firefighting of the IMF and the World Bank made them principal targets of an antiglobalization movement. The continuing boom then almost put the IMF out of business. Unfortunately, neither international nor domestic supervisors of financial markets kept up with the innovations—or the frauds and foolishness that inevitably come with long boom periods.

The WTO added many new members. The trading system even withstood terrorist attacks—and fears of more. But the travails of the Doha Round of the WTO, launched in 2001, signaled a new challenge. The traditional developed economies wanted the middle income countries—China, Brazil, India, and others—to assume more responsibility for lowering barriers to trade, while all would offer special treatment for Africa and the poorest. The major developing economies, in turn, pointed to their large numbers of poor people, and wanted to maintain the privileges of "special and differential treatment." This debate is far from resolved. It reverberates not only in trade, but in monetary affairs, investment, development, and energy and the environment.

To sum up this alternative narrative of the post-World War II experience, as viewed through an economic lens: The first phase of reconstruction and reintegration of advanced economies—creating a new trilateral system—ran from Bretton Woods to the 1970s breakdown. The second phase was marked by a period of drift and oil shocks, until Reagan expanded the revival of capitalism at home into pragmatic but principled adjustments in regional and global economic systems. The success of the trilateral democracies, capitalism, and markets led to a third phase, running almost two decades—creating a truly global marketplace.

**Phase Four: What Is to Come?**

Now the Crash of 2008 has ushered in a fourth phase. Global financial capitalism—and our countries—face a new crisis—of credit, conduct, and even confidence.

After harsh blows, the advanced economies are struggling to reduce debt and revive jobs and productivity through structural reforms. Unemployment is up. Confidence is down. Protectionism is rising. Publics are anxious. Politicians are struggling.

Developing economies have been hit, too, although many have fared relatively better. The 60-year long leadership of developed economies is in question.

The relationship between economics and security is again the principal issue. The strategic and security stakes are high.

Will the euro area and the historic success of Europe's peaceful integration survive—and with it, Europe's influence in the world?

Will the middle income developing countries—some of which are rising powers—overcome the so-called "middle income trap" to become high-income countries and "responsible stakeholders" in the international system that has benefited them—but which they did not design?

Will the poorest—the "Bottom Billion"—have an opportunity to prosper too, or will they be breeding grounds for transnational insecurities?

Will the new political systems of the Middle East and North Africa lead to new economic policies for inclusive growth and peaceful integration into the world economy?

Will the United States show leadership—at home and internationally—in reviving its core economic strength while simultaneously leveraging those capabilities through an activist economic diplomacy?

**The American Experience and Responsibility**

Tonight is not the occasion to present a full agenda for the United States.

Yet this is the place to suggest that the American experience in actively connecting economics and security needs to be revived.

In his classic study, *The World in Depression, 1929-39*, Charles Kindleberger argued that it was critical for one major power to take the lead in shaping an international economic system. This power could not dictate, but instead needed to invest in encouraging a shared approach to trade, capital flows, currencies, and reliance on markets. Kindleberger described how during the Great Depression the United States had the means but not the will to lead, while Britain had the will but no longer the means. If the United States does not lead now, who will?

I do not believe a slow growth economy can lead.

Bob Carr's warning about America's need to resolve its budget mess is correct: The United States must restore its credit for its own health and to enable it to lead.

The United States does not need just any budget deal. It needs one that rebuilds the fundamentals of long-term growth. It needs to limit government spending. It needs to encourage private sector innovation and productivity. It needs inclusive growth, which empowers all its citizens to fulfill their potential. It needs to favor makers over takers.

The United States should combine economic revival at home with adaptive and flexible adjustment of the international economic system.

Free trade is one of the best drivers of microeconomic and structural reforms. But the free trade agenda has stalled.

The United States will need to integrate its foreign economic policy with its strategic and security interests. In years past, the interconnections highlighted the importance of freedom of the seas and the US Navy. In this era, the linkages also point to open skies safeguarded by air power with superior technology, and cyberspace capabilities that can secure, deter, and defeat threats to the United States or the international economic system.

We do not yet know what this fourth phase will be named.

Fears, fragilities, and failures might lead to a “renationalization” of policies that spirals downward into protectionism.

Or we could return full circle, to where Hamilton and other American Founding Fathers began: with the idea that a new nation, conceived in liberty, could achieve greatness by building an economy for a country that would shape the world.

The United States will lose its identity on the global stage if it loses its economic dynamism.

Therefore, the United States must address the fundamentals of its economic strength—because that power touches every dimension of influence—from markets and innovation, to ideas and international politics, to military strength and security.

Through twists and turns, the American experience has demonstrated that its greatest asset is its openness—to ideas, goods, capital, people, and change. Every country makes mistakes—but open countries are quicker to correct theirs—and to forge ahead.

That’s what the United States needs to do now.