

Is military intervention abroad necessary to protect U.S. economic interests?

Paying to Keep the Peace

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THE UNITED STATES MILITARY IS VERY busy these days battling rogue states and hunting down terrorists. But another U.S. military mission demands even more resources than the operations that grab headlines. The U.S. military spends most of its time — and allocates most of its force structure — in pursuit of the quiet, unseen mission sometimes called “enhancing stability,” sometimes called “shaping,” and sometimes called “policing the empire.” While the words “stability,” “shaping,” and “policing” sound wise, what exactly does the United States gain through those efforts? Is America’s spending on global stability a good investment?

The U.S. military’s primary mission was once much more tangible than the current “stability” operation. During the Cold War, the United States feared that a powerful, hostile Soviet Union would conquer the other areas of the world that had major concentrations of industrial strength: Western Europe and East Asia. Such an accumulation of resources would pose a great threat to the nation, so the United States formed military alliances and deployed troops to defend Europe, Japan, and South Korea.

The collapse of the Soviet threat left the U.S. military in search of a job. A new mission was born: The United States maintained its global alliances and overseas military deployments (at somewhat lower troop levels) to promote stability among the major powers. The “American pacifier” would dampen security competition among the other wealthy countries because overseas arms races, if unchecked, could cause

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our economic partners to divert their efforts away from productive activities and toward defense spending. In Thomas Friedman's words, America's new task was to promote "sustainable globalization" by policing the global "web" that defines the new era and benefits the American economy.

The strategy underpinning the stability mission is misguided. The United States does not need to police the world to defend its major allies or to protect the global economy. America's major allies are rich and powerful and can afford to defend themselves. Furthermore, fear that security competition near the world's economically vibrant areas would disrupt our economy is built on a flawed understanding of economic globalization. Ramped up military spending by America's wealthy allies would not prevent them from participating in the global economy. Even in the worst-case scenario of a major power war involving one or more of those nations, the increasingly flexible global economy and its natural adaptations would greatly mitigate the costs borne by neutrals. Because the global economy is flexible and adaptable, the spillover costs of war for neutral countries are much smaller than commonly believed; in fact, neutral countries often fare well during wars.

The forward deployment of the American military to police the most economically vibrant parts of the world is a poor investment.

Contrary to the beliefs of the apostles of American leadership, there is no "hegemonic duty" to provide global military stability.

THE SECURITY SITUATION

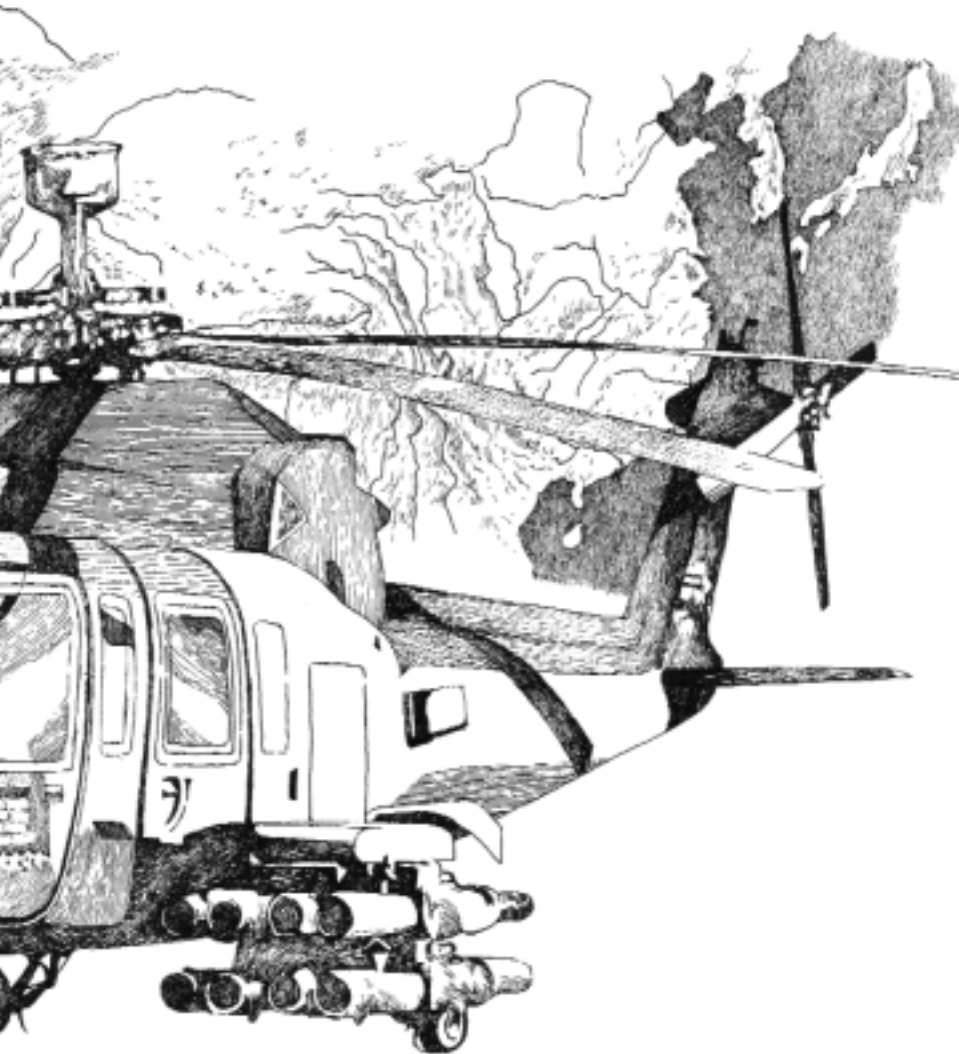
America's Cold War allies are safe. Our European allies do not border any avowedly hostile countries. If an adversary were to emerge, the Europeans have enough wealth and technological sophistication to buy whatever defenses they would need to ensure their security. Within Europe, the rough parity in the distribution of nuclear and conventional capability among the major European powers will prevent any nation — Russia, Germany, France, the United Kingdom, or any other — from gaining a strategic advantage against the other European countries. And all of the European countries know that the others have comparable levels of latent power, so none has an incentive to start an arms race or bid for regional hegemony.

Moreover, any scenario for European instability presumes the unraveling of years of European efforts to harmonize their policies in the European Union — efforts that are increasingly including negotiations for a common security policy that would amount to a tight European military alliance. It is perhaps hard to believe that the Europeans will be able to forge a unified military today when they do not face a common external

threat, considering that they were unable to cooperate against the Soviet Union without U.S. support. But it is equally difficult to believe that the American pacifier is the only thing that prevents open hostility from emerging between Germany and Italy or France and the UK.

Asia In Asia, the situation is also stable. America's allies have many of the same advantages that they enjoy in Europe. No one faces a potential adversary with disproportionately more military power. Furthermore, several Asian countries have favorable geography on their side: Open water separates China from Japan and Taiwan. The sea provides a crucial buffer zone and warning time before any impending attack, reducing the risks of surprise or accidental conflict. Moreover, the current state of military technology in Asia strongly favors the defense. Long-range sensors and standoff weapons multiply the difficulties faced by an aggressor that contemplates an amphibious invasion.

Japan, for example, is protected by the moat that surrounds it, and also has a larger economy and spends more on defense than anyone else in the region. The Japanese have a modern and powerful air force and navy, well-equipped to maximize the defensive advantages provided by the sea and modern technology. The Chinese military is not in the same league as the Japanese armed forces. Even in the unlikely event that China's rapid economic growth continues at its current breakneck pace, the Chinese cannot easily bridge the military-technical gap, and Japan would not stand



still with its military investment if threatened by a belligerent China. Lest that analysis make Japan sound dangerous, geography protects China from the Japanese, and it is hard to imagine anyone successfully attacking the vast population and geographic expanse of the People's Republic of China. China and Japan are safe. Each can defend itself but cannot effectively attack the other.

Taiwan is much weaker than Japan, but it can defend itself from China. Taiwan owes its safety to the water that separates it from the mainland and to its technologically sophisticated air force and modern anti-ship weapons. A Chinese amphibious invasion across the Taiwan Strait would have little chance of success; the outdated Chinese navy would be too vulnerable to Taiwanese air power and anti-ship missiles. Taiwan will need to continue to buy cutting-edge weapons, but the Taiwanese are rich and can afford to do so.

America's other major Asian commitment is to help defend South Korea from North Korea. However, in this case, U.S. "stability policy" aids the powerful against the weak: South Korea has nearly 40 times the GDP (in 2001 purchasing power parity-adjusted figures) and twice the population of its adversary. South Korea simply does not need America's help to protect it from the North. If American aircraft, which now supply the bulk of the air cover for South Korea's defense, were withdrawn from the region, South Korea probably would replace them with a beefed up air force of its own. South Korea is wealthy enough to afford the defense investment, and American aircraft manufacturers would be thrilled to sell them the equipment they need. Perhaps North Korea's new nuclear capability justifies maintaining the American nuclear umbrella over South Korea, but it does not justify a continued conventional defense commitment.

THE FLEXIBLE GLOBAL ECONOMY

Some people fear that the major powers may not understand the futility of military expansion as well as this analysis implies. According to those analysts, some nations may engage in arms races or even fight wars despite the balance of power. Even though conquest is unlikely to result from any potential conflict, conventional wisdom suggests that the United States has an economic interest in preventing any instability.

But the United States need not fear the costs of foreign arms races or wars because the world economy — especially in this era of increased globalization — is inherently resilient. Scholars and policymakers tend to overstate countries' reliance on particular trading partners, trade routes, and suppliers of natural resources because they conflate interdependence with vulnerability. The costs of disruptions to peacetime economic behavior are greatly mitigated because economic actors react to shocks by switching to the new best way of doing business, given new international circumstances. The cost of any disruption, therefore, is not the loss of a valuable economic relationship but the marginal decrease in efficiency between the "old best" and the "new best" way of doing business. In fact, neutrals can often find ways to profit from instability and war by selling to the belligerents, by expanding sales to markets formerly served by the belligerents, by lending money at lucrative rates, and by buying up overseas assets that belligerents liquidate to raise money.

Trade during neutrality Overseas conflict could affect a neutral America's economy in a number of ways. First, some normal trade opportunities with the unstable region would be lost; the countries involved in the fighting would cancel some orders for consumer goods and may stop producing some merchandise for export. Increased shipping costs would also hamper trade with combatants, and insurance rates would increase for cargoes that must transit trade routes near the war zone.

But new trade opportunities would also arise. Belligerents would increase their demands for many products, several of which the United States produces (e.g., food, textiles, steel, and of course weapons). The primary economic effect of war is that belligerent countries reduce their saving in favor of a short-term surge in consumption. After all, in a nation at war, many consumption goods — and certainly war matériel — will have no value at all if they arrive "too late."

Furthermore, wars may create new opportunities for a neutral America to trade with non-combatant neutral countries. U.S. businesses might pry open overseas markets previously dominated by firms from the combatant countries. If Japan and China were foolish enough to fight, then American auto sales around the world would likely increase. In some cases, wars might also reduce the political barriers that prevent American firms from being able to compete fairly for overseas markets. Other neutral countries may seek alternatives to preferential trade arrangements previously maintained with countries in the conflict-prone region.

The net effect — balancing the gains from wartime exports and the losses in consumer trade — should be a boost to the American economy. Because wars increase the net amount of consumption in the world, those who profit from the new opportunities would outnumber those who lose. Furthermore, wartime price changes in the global economy are likely to favor neutrals at the expense of combatants — that is, the U.S. economy at the expense of the unstable economies. Belligerents want to buy a lot of war matériel even if it is expensive, few close substitutes exist for war-related goods, and belligerent demand is strongly influenced by factors other than price (notably by military strategy). Meanwhile, neutrals can shift their consumption to alternate products, avoiding the effects of wartime price increases. In sum, neutrals will charge belligerents a large premium for the goods that the belligerents need, but price increases in neutral-neutral trade would be much smaller. The flexibility of globalized trade should allow neutrals to profit from foreign instability.

Lending A second connection between overseas wars and the American economy is through international lending. Wars tend to increase global interest rates. As the belligerents begin spending to fund their war efforts, they reduce the total supply of savings, and the normal laws of supply and demand drive up the "price" of money, i.e., the interest rate. Such an interest rate hike today would increase the amount that the United States pays to service its national debt; American public and private sector debt to international lenders is enormous.

But the cost of that increase is also easy to exaggerate. While wars increase interest rates, they do not increase them uniformly. The risk involved in lending to belligerents is very high. A neutral United States, by contrast, would be a safe haven for

risk-averse capital. Depending on the amount of risk-averse capital that flows into the United States, interest rates here may not rise at all during periods of foreign instability.

Investment Finally, one of the key changes in the modern trend toward economic globalization is that the total amount of foreign direct investment (FDI) is increasing dramatically. Overseas instability may affect America's economic fortunes by reducing the value of its foreign direct investments. Facilities located in conflict-ridden areas run the risk that they might be nationalized or destroyed, and globalization has expanded the number of American-owned facilities in conflict-prone regions.

But instability creates new opportunities for FDI in addition

the actual economic effect of the war was smaller than expected, and the war ended up driving down oil prices to the benefit of neutrals like the United States.

During the war, Iran and Iraq each intentionally targeted its enemy's oil exports. Iraq used its air force to attack Iranian oil port facilities and shipping. Iran responded with attacks on tankers and cargo ships, punishing Iraq and the Gulf monarchies that were providing financial support to the Iraqi war effort.

Despite the efforts of Iran and Iraq to block each other's oil exports, oil prices returned to only slightly above their pre-war level within months of the outbreak of the war because the world economy adapted. Four main factors prevented the fighting from imposing a substantial cost on neutral countries. First, other oil

In the Iran-Iraq war, the economic effect was smaller than expected, and resulted in decreased oil prices to the benefit of neutrals like the United States.

to the risks. First, some of the risks that wars seem to pose for FDI are probably overstated. Belligerents cannot afford to steal from neutrals; they want smooth relations because they desperately need imports during the war and they will undoubtedly need new investment to rebuild after the fighting stops. The only real risk to FDI is that some factories may be unlucky enough to be destroyed in the fighting.

Any losses, however, will be offset by wartime opportunities to scoop up cheap investments in other neutral countries or at home. One way that combatants can raise money to fund their war effort is by borrowing, but another way is by selling investments abroad. As combatants liquidate their overseas assets, neutrals can buy those investments at fire-sale prices and then profit from them for years to come.

In sum, overseas instability is likely to have both positive and negative effects on the American economy, but the net effect should not result in a large cost. Trade with some neutrals may be slightly less efficient, but American exporters may break into previously inaccessible markets. Interest rates might rise in the United States, but the increase likely will be small. Finally, lucrative export opportunities to the belligerents will likely overwhelm the other costs. Globalization provides the American economy many options in the face of foreign instability. American policymakers have little to fear from foreign belligerents' presumed threat to economic security.

RECENT EXPERIENCE

Fortunately, we do not have any recent examples of major power wars to demonstrate this global economic resilience. However, we observed this sort of international economic adjustment in the 1980s when two key suppliers of oil fought against each other in the Iran-Iraq War. Despite fears that disruption to the oil market would strangle the world economy,

suppliers, in the Middle East and elsewhere, increased production to compensate for interdicted oil supplies. Second, the Gulf States took steps to reduce the vulnerability of their exports to attacks against Gulf shipping. Iraq built major new pipelines to the Mediterranean Sea through Turkey and to the Red Sea through Saudi Arabia. Iran expanded its port facilities outside the Persian Gulf—out of range of Iraqi attacks. Third, the volume of oil-related shipping in the Persian Gulf is so high that the missile, bomber, and mine attacks used during the war were unable to reduce significantly the supply of Persian Gulf oil on world markets.

Finally, oil was a vital export for Iran and Iraq, so in order to fund their war efforts the belligerents took extraordinary steps to get their oil to market. Iran repeatedly increased production and lowered prices to expand its market share during the war. The nation even offered low-premium insurance to international merchants willing to serve its frequently targeted oil terminals. For years, Iran and Iraq attacked each other's oil industries, but the result was a global production glut that drove the world price of oil steadily downward throughout the period.

Ironically, stability in the Persian Gulf is a more likely culprit for high global oil prices than instability. Peace and stability in the region make it easier for the Gulf States to cooperate in setting OPEC quotas, while greater animosity among oil producers would exacerbate the natural tensions involved in setting production limits. Furthermore, the slow, conflict-prone negotiations that maintain the cartel would likely find it difficult to adjust to rapidly changing international conditions. Decentralized, market-based transactions would deal much more effectively with instability than the collusive activities of a cartel would. While the main markets that would be affected by any instability among the major powers in Europe and East Asia are not governed by such explicit cartels, it is reasonable to think that more competitive markets would adapt following similar dynamics.

IMPLICATIONS

Given the current U.S. economic situation, how might we estimate the potential cost to the United States of instability among the major powers in the near future?

The U.S. economy is highly dependent on trade today. U.S. exports and imports sum to more than 25 percent of GDP. But only 11 percent of U.S. trade is with the major European powers; 18 percent is with the leading states of Asia, and two of America's three leading trade partners are Canada and Mexico. Increased globalization has diversified America's economic relationships and reduced America's reliance on any specific region of the world.

Global production is also highly diversified. The major economies in Europe produce 22 percent of world product, while the four largest Asian economies account for 19 percent. American companies can find suppliers and customers around the world, even if a particular region were consumed by chaos.

The United States is also well suited to increase exports during foreign wars to profit from the belligerents' accelerated consumption and to move into belligerents' overseas markets. First, the enormous size of the U.S. economy means that adjustment costs are likely to represent small fractions of total U.S. gross domestic product. Second, the United States is currently a leading producer of goods usually sought by belligerents: munitions, grains, manufactures, etc. Finally, the U.S. economy is structured for rapid adaptation. America enjoys efficient capital markets stocked with venture capital and waves of consultants who make their livings helping companies restructure to adapt to changing market conditions. And with computerized inventories and "just-in-time" delivery, it is less likely that instability will leave American companies with large warehouses full of produced — but no longer demanded — goods.

In terms of international finance, on the other hand, the United States faces a minor vulnerability. The U.S. external debt — the part that would cost the United States as a whole if interest rates were to rise — amounts to 22 percent of GDP. The current trade deficit compounds the problem because foreign instability is not likely to lead to enough of an export boom to reverse America's net debtor status. Creditor nations are the ones that can buy up foreign assets at wartime discount prices. In fact, if interest rates rise in the United States because of foreign instability, the nation will need to finance its debt and trade deficit by borrowing money at the higher interest rates. That increased cost would reduce American national wealth.

But that finance cost is not likely to be large. First, U.S. interest rates are not likely to increase much, even if a major war broke out overseas. The total amount of global capital available for investment today dwarfs the likely incremental demand that a major war would provoke. More importantly, if there were a major war in Europe or East Asia, the United States would be an ideal safe haven for investments. Notice that during the 1997 East Asian financial crisis, capital flowed to the United States from the plummeting East Asian economies and the moribund European economies.

America's large foreign indebtedness is the only significant mechanism whereby international instability might threaten U.S. prosperity. However, granting that the financial effect would hurt, the total effect of overseas shocks balances likely

American gains from trade against that small loss of wealth. If the United States were to take the mantle of hegemonic leadership in the hope of maintaining a *Pax Americana*, and even if those efforts were perfectly successful, the economic benefit of avoiding shocks would be small.

A BETTER PRESCRIPTION

This analysis suggests a clear policy recommendation to help protect the American economy in the age of globalization, although not the usual one that the U.S. military should redouble its efforts to spread stability. Instead, the United States should capitalize on its economic flexibility. The globalized parts of the world are already quite stable, and America's wealthy allies can afford to take responsibility for their own neighborhoods. But if Americans want additional assurances that our domestic economy will not be crippled by instability abroad, the best policy is to reduce the loadstone of America's enormous external debt. Policing Western Europe and East Asia is an inefficient way to protect the American economy.

America's out-of-date alliance commitments to its rich, safe allies cost the nation tens of billions of dollars each year in extra weapons procurement spending, in salary and benefits payments to personnel, and in direct operations costs for foreign deployment above what would otherwise be needed for America's defense. The funds now spent to promote stability in the safest parts of the world should instead be used to pay down the debt, more effectively reducing the American economy's vulnerability to foreign disruptions. And if the war on terrorism requires more U.S. military effort in the future, the resources now committed to defend Europe, Japan, and South Korea — both troops and dollars — would be freed up to combat al-Qaeda or other attackers.

To be sure, war is a terrible thing. Because wars are so tragic, Americans in some cases will choose to threaten military action to prevent an outbreak of violence. Sometimes that choice will be made for humanitarian reasons; other times it will be to protect a valued ally. But there is no economic need for the United States to make the world's military problems its own. Neither America's national security nor its continued prosperity requires the United States military to protect the rich countries of Europe and East Asia. **R**

READINGS

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