

# Balance Sheet of Power

Globalization hasn't rewritten the laws of economics. State-on-state competition still rules.

By Andrew A. Michta

LAST NOVEMBER, Citigroup announced the sale of a 4.9 percent stake for \$7.5 billion to Abu Dhabi Investment Authority. It's now seeking a \$1-billion infusion from Kuwait and \$9 billion from China. Soon after, Beijing bought 9.9 percent of Morgan Stanley for \$5 billion, and Bear Stearns swapped \$1-billion stakes with China's CITIC Securities Co. Ltd, a state-owned investment company. Also in December, Singapore's Temasek Holdings took a \$4.4 billion stake in Merrill Lynch, with an option to invest an additional \$600 million. The bleeding investment giant is seeking another \$4 billion from the Arabs.

Americans would surely protest if their own government started buying up domestic banks and companies, but they offer no objection when foreign governments do just that. They have been conditioned by the reigning ideology of globalization to reject any form of economic nationalism as isolationist. Dogma has overtaken good sense.

But globalization is not delivering on its bright promise of "complex interdependence." Traditional state-on-state competition is fast re-emerging from its post-Cold War lull and with it, historically proven ideas about what constitutes economic power: a strong industrial base producing competitive goods, a high savings rate and ample foreign exchange reserves, innovative domestic industries, and a highly skilled and educated labor force steeped in the country's technological culture. As in the past, rising economic power generates confident nationalism and produces a

strategic assertiveness, first regionally, then globally.

The United States, formerly the premier industrial power and creditor to the world, is ripe for a corporate takeover from abroad. As the aftershocks of the mortgage crisis continue to reverberate through the markets, America is awaking to the reality of its shrinking industrial base. Only 12.6 percent of GDP came from manufacturing in 2006. We face exploding trade and fiscal deficits, a \$9-trillion national debt, and a flagging currency. Decades of deindustrialization and outsourcing for the sake of short-term profit have even begun to cut into the mainstay of our national security: our defense sector. The prospect of foreign control in critical areas of the economy is shaping up to be the greatest security challenge this country has ever encountered.

Last year, the dollar lost 7.5 percent of its value according to the Federal Reserve's trade-weighted dollar index. It declined 9.5 percent against the euro in 2007, following a 10.2 percent drop in 2006, and reached parity with the Canadian dollar. With our low savings rate and continued deficit spending, the U.S. must import capital at an average rate of \$3 billion per day. Without that daily injection from abroad, our government and businesses would lack the money to operate.

America funds its economy, runs its government, and conducts its wars on a giant foreign-owned credit card. And contrary to received globalist wisdom, the issue of who happens to have the largest dollar holdings is vital to national security.

We owe trillions of dollars to China, Japan, and the oil-producing countries in the Middle East. According to China's central bank, in the past year China added \$461.9 billion to its foreign exchange reserves, which stand at over \$1.5 trillion above all other nations—a net increase of over 43 percent from its 2006 record. In contrast, U.S. foreign exchange reserves hover at around \$90 billion, below Brazil, Malaysia, and Mexico.

Despite skyrocketing energy prices, persistent trade deficits, and federal borrowing out of control, the U.S. continues to incur obligations with its creditors at a breathtaking pace. Now all of those states, armed with cheap dollars, can go shopping at the discounter's deal of the century: the "Wal-Mart" of American corporations.

Over the past decade, foreign governments have been converting their dollar holdings into investment funds to acquire banks, companies, and real estate in the United States and elsewhere in the West. These sovereign-wealth funds have been an important and rather secretive force in global speculation. They are in effect the investment arms of governments, funded by massive trade surpluses and record oil revenues. According to the *LA Times*, there are now an estimated 20 sovereign-wealth funds in the world, with total assets estimated at between \$2 trillion to \$3 trillion. The largest are believed to be owned by China, Russia, Abu Dhabi, Norway, Singapore, and Kuwait. Since the subprime mortgage crisis began, they have risked nearly \$69

billion on recapitalizing investment banks. *The Economist* reports that these funds—essentially foreign governments—“have deftly played the role of savior just when Western banks have been exposed as the Achilles heel of the global finance system.”

America’s transformation into a sharecropper economy is well underway. According to Capital IQ, in 2007, foreign buyers spent \$294 billion on more than 600 mergers and acquisitions involving American banks and companies—the equivalent of what foreigners spent on U.S. assets in the past three years combined. And there is more to come. Morgan Stanley projects that the value of foreign government-owned sovereign-wealth funds could reach \$17.5 trillion in the next ten years—roughly \$4.3 trillion more than the total U.S. GDP in 2006.

That may prove to be a conservative estimate. The McKinsey Global Institute reports that in the past ten years Asian central banks have reported the growth of reserves at an astonishing 20 percent a year, an increase matched by banks in oil-rich countries. In 2007, total foreign bank reserves approached \$7 trillion. Now that money can be spent on discounted U.S. assets by nations that do not share the American commitment to democracy and basic human rights.

Rising competitors with the United States—China in particular—will soon be well placed to fundamentally change the balance of economic power. Globalism will finally have to surrender to the reality of international power politics.

The consequences of such a fundamental re-ordering of the world’s financial hierarchy will be comparable to the effects of the great, system-transforming wars of the past. The price of defeat is the loss of control over a nation’s economy and hence its political destiny. Instead of prospering in the new world of “complex interdependence,” the

losers will learn what it means for their security to depend on others for capital and technology. We may believe the 21st century to be a postmodern era; most of the world, however, begs to differ.

Economists who point out the grave implications of this impending shift in the great power game are accused of scare-mongering. Efforts to tighten the guidelines for approval of foreign acquisitions by the inter-agency Committee on Foreign Investment in the United States, while supported by some in Congress, have been criticized as “anti-free trade” isolationist paranoia. The public is continually told that while deficits may be an unpleasant reality, in this Friedmanesque “flat world” of ours, the U.S. can count on attracting foreign capital to fund its borrowing almost indefinitely.

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That is, of course, a good thing—a sign of America’s perceived strength abroad, a vote of global confidence in the stability of our economy. But by this logic, there is no meaningful difference in terms of power relations between the creditor and the debtor, just as allegedly there is no difference between energy suppliers and energy consumers, for they are both bound by the same market.

To believe this is to ignore the most basic tenets of the relationship between economic strength and national security. To insist that that our indebtedness does not give dangerous political leverage to foreign creditors is to pretend that the fundamental rules of inter-state relations no longer apply and that savings and bankruptcy are simply two sides of the same coin. Upon this delusion, we have wagered American security.

The staggering volume of dollar holdings outside the U.S., the precipitous decline in the value our currency, and the dismantling of our domestic industries combine to create a perfect storm that could sweep aside our global pre-eminence. America’s foreign creditors are in a strong position to displace the U.S. from the center of world affairs not through military force but through the acquisition of assets.

For decades, the U.S. has staked its national security on the unyielding primacy of its defense technology, where the qualitative edge compensates for the manpower limitations inherent in our professional military. But even here, globalization has been making unwelcome inroads. Today the U.S. remains the undisputed leader, although our ability to rely on domestic industry to

build the critical weapon systems is coming into question. Defense technology requires not only strong design and engineering, but also a robust manufacturing base. During the Cold War, the Soviet Union produced groundbreaking research through outstanding mathematicians, physicists, and computer programmers, but it was unable to translate those designs into working weapon systems that could match the United States. In the end, it did not really matter how sophisticated their chip design was if the Soviets could not produce a consistently performing silicon wafer.

Is the United States in that position today? No, but our competitors are beginning to close the technology gap. An ever greater portion of the defense industry’s innovation is driven by the civilian sector, especially in IT and biotechnology fields. The prospect of

foreign-government ownership of segments of American industries that are related—even indirectly—to the defense sector ought to give us all pause. Should we be sanguine as, together with Bain Capital in a \$2.2 billion deal, the Chinese firm Huawei Technologies takes an “undisclosed minority position” in the communications networking group 3Com Corp—a U.S. company whose focus is on sensitive communications networks? Can America be sure that even minority foreign government ownership of a U.S. contractor will not give China access to vital defense technology? Do we believe that corporate managers will remain oblivious to the preferences of their foreign stakeholders? Should we not care if critical defense contractors move to internationalize a portion of their capacity?

We are spending close to \$2 billion a day on defense, and like all government agency budgets, the Defense Department budget is funded through runaway borrowing. Yet the Bush administration entertains plans to remain in Iraq and Afghanistan for decades, sets up a new combatant command in Africa, and prepares its contingency options against Iran and in the event of an explosion in Pakistan. We seem determined to expand our military commitments regardless of our declining ability to pay for them, as though we believed that the basics of money and power no longer apply.

The world may appear flat in a best-selling book or in a lecture delivered after dinner at a rotary club, but it is full of peaks and valleys. For some states the globe is filled with new opportunities for national greatness. For others it may already be sloping sharply downwards. State-on-state economic competition, whether local or global, has never gone away.

After World War II, the U.S. was uniquely positioned to lead the competition. But the national economic interest

**President Bush and Vice President Cheney’s public and private comments disparaging the Dec. 3 National Intelligence Estimate on Iran have significantly increased the animosity of intelligence professionals toward the White House.**

The dismissive comments that the intelligence community is an “independent” arm of government and that the administration does not necessarily embrace its judgments is being seen as a repudiation of the entire intelligence process, which has been painfully rebuilt in the aftermath of the heavily politicized 2002 Iraq NIE. Some senior officers at the Pentagon are also beginning to suspect that the president is still determined to initiate military action against Tehran, despite their advice that such an attack would not serve the national interest and would, in fact, be counter-productive. Both the CIA and the Director National Intelligence office have been informed privately by their foreign counterparts of critical off-the-record comments made by President Bush during his recent Middle East tour. Bush told both the Israelis and the Saudis that he does not accept the NIE key finding that Iran has abandoned its development of nuclear weapons, adding his personal belief that the program has been re-instated. The Israelis conveniently provided their own evidence to support the president’s contention, information that had previously been reviewed and rejected by the DNI’s office. Israel has also been supporting an aggressive lobbying campaign in the U.S. to undermine the findings of the NIE, using its friends in the media and Congress. Some recent private comments made by Dick Cheney have also been reported back to CIA and the intelligence chiefs at the Pentagon. Cheney has been telling his contacts and supporters that the intelligence community has “betrayed” the president and that some of its leaders are “traitors.” When the use of that epithet was revealed, the intensity of the reaction was predictable, with a number of senior officers stating their intention to resign if a war were to start.



**It is unlikely that Bush would order military action against Iran without a specific *casus belli* such as the seizure of U.S. vessels in the Persian Gulf.**

But Tel Aviv and Washington have discussed a scenario by which the Israelis would attack first and then be backed up by the U.S. in a bombing campaign directed against Iran’s nuclear infrastructure. The White House has been setting the stage by quietly disseminating the view that the “Israelis are out of control” and thus cannot be dissuaded from taking decisive action against Tehran. This suggests that the Israelis would be encouraged to initiate unilateral strikes against Iran with the U.S. claiming to have no choice but to support them. It should be noted that there does not appear to be any hard operational planning for such an attack, which is currently a “what if.” But Dick Cheney recently told an associate that Iran is such a significant threat that President Bush cannot leave office without taking action for fear of being replaced by a “Hillary Clinton who will not make the hard decision.”

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has been sacrificed to an ideology that sees the new world as one market, but fails to recognize that today, as always, state power is key, and governments intervene in investment and currency decisions to maximize their countries' strength. Even in a globalized system, capital, knowledge, and technology flow to the most adept players, separating winners from losers, forging new great powers and undoing old ones.

## **ECONOMIC STRENGTH AND SOUND MONEY, BOTH UNDERPINNING A ROBUST MILITARY, ARE AS CRITICAL TODAY AND AS AT ANY POINT IN HISTORY.**

Before we allow our leaders to reassure us yet again that the United States will remain the dominant power spreading democracy across the globe, we should at least for a moment consider the fundamentals.

Can any state call itself a great power while it lives on borrowed money—its national debt out of control, its infrastructure crumbling, and its core industries disappearing offshore as it forfeits the technological culture it took generations to develop?

Can the United States look with confidence to a future in which the dollar is no longer accepted in international transactions, in which our defense budget can only be funded through promissory notes, and in which—having staked our security on cutting-edge technology—we no longer have the autonomous capacity to manufacture the most advanced weapon systems?

If we fail, the world will lose its balance. A bankrupt America cannot stabilize its position in the fast changing global order, an environment in which China contends for preeminence, where India is rapidly becoming another leading Asian player, and countries such as Russia and Brazil are catching up with European leaders.

Globalization has not reinvented the rules of international relations. It is taking the United States back into the future—into a time where sovereign economic strength will define international status in much the same way it has for centuries. We are about to rediscover the most basic principle of political realism: the size of the GDP tells an incomplete story, for national power without a structurally sound industrial

economy is an illusion. To pretend otherwise, as the United States policy elites have done for years now, is an exercise in self-delusion. The greatest Republic in history is going on the auction block.

Since the U.S. has not been beaten at the global economic game since the triumph of free-market ideas, the radical decline of America's position seems unlikely. But just such a change is coming on fast. If our current economic policy does not change, we will live in growing insecurity, dependent on U.S. debt holders and in fear that they may cut off our credit. In the long run, a country with a large military but economic feet of clay will not endure.

Even at this late stage, we have a choice: we can recognize what is at stake, or we can continue to delude ourselves that what is happening is just the normal global business cycle and represents no threat. After all, officials connected to China Investment Corporation have reassured us that they plan to buy only minority stakes in U.S. companies and that they will avoid airlines, telecommunications and—after the backlash that followed the failed bid by China's nationally-owned CNOOC oil company to buy UNOCAL—oil companies. For now.

The globalist mantras that a national manufacturing base no longer matters, that the traditional export-import calculus no longer applies, that our collapsing currency only makes our exports more competitive, and that our national debt is but a sign of continued foreign confidence in our economy ring hollow. They require the sort of mental dexterity that can no longer be mustered in the face of facts.

The international order taking shape today amidst considerable flux and uncertainty is neither unipolar, as neo-conservatives would have us believe, or one of supranationally managed multipolarity, as liberals would have wanted it. Economic strength and sound money, both underpinning a robust military, are as critical today and as at any point in history. A country that pretends otherwise does so at its own peril.

The panacea is not protectionism or rejection of the global market. It is the opposite—to start competing on terms others have chosen: maximizing energy independence, insisting on strict market reciprocity, and putting national interest ahead of a short-term uptick in the corporate balance sheet. Great nations cannot be built on credit. The essentials of what makes a power great remain constant: a vibrant industrial base, technological leadership, and cutting-edge exports. Those first lessons of traditional realist thinking are about to be taught to America again. ■

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