



Congressional Testimony

A WORLD TRANSFORMED: THE GREAT HOLLOWING OUT AND THE RISE OF NEW THREATS

THE SECURITY CONSEQUENCES OF THE CURRENT GLOBAL ECONOMIC CRISIS

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Mr. Chairman, members of the committee, thank you for inviting me to be here today with you. It is a privilege to have this opportunity to appear with the other extremely distinguished individuals testifying before you to address what is likely to be the single biggest driver of geopolitical change impacting the world for the foreseeable future: the consequences of the global economic crisis that began over a year ago. As of now, there is no end in sight to this once in a lifetime event and the best minds...many of whom missed the onset of this crisis to begin with and whose views therefore must be taken with a grain of salt...are agreed about little except that things are likely to get worse worldwide before they get better.

Overview

We have only experienced the first wave of shocks associated with the international economic collapse. It is still too early to say how long the economic dimensions of the global downturn will continue to challenge leaders and populations worldwide, and while it is impossible to predict how much further conditions will deteriorate before the global economy begins to recover as it inevitably will, one set of consequences of the crisis can be predicted with a high degree of confidence. Economic turmoil will beget political turmoil. A crisis of this severity, one that according to the most recent estimate by the World Bank will produce net global contraction in 2009, that has already brought U.S. stock markets to 12 year lows stripping away over half their value, that has deeply eaten into world trade cutting volumes by almost a third and into capital flows and shaken the global financial system to its very foundations, will unavoidably produce serious security consequences for the United States.

A recent report for the Asian Development Bank suggests the crisis has already obliterated approximately \$50 trillion in asset value worldwide - the equivalent of roughly a year of global economic output. We have already seen political reactions in public demonstrations and other violent episodes in a diverse list of countries including Greece, China, Haiti, Latvia, Bolivia, Bulgaria, Russia, Italy, Ireland, Iceland and Lithuania. But these events are just the first rumblings of upsets that almost certainly will ultimately be far more serious and will have important national security consequences for the U.S.. Further, the crisis may in the longer run produce lasting geopolitical shifts as power is concentrated in the hands of nations with available capital, drawn away from those who are net borrowers, and greater and greater constraints limit the options of nations who are likely to spend years seeking to work down the debts incurred during this time of severe global contraction.

This new reality was reflected in the fact that Director of National Intelligence Blair in his February 12, 2009 testimony to the Senate Select Committee on Intelligence on the Intelligence Community's Annual Threat Assessment cited the crisis as the primary driver of concerns in today's world. As he clearly stated, "The primary near-term security concern of the United States is the global economic crisis and its geopolitical implications."

In fact, during the past few months, as the crisis has brought down governments (Iceland) and threatened others (across Eastern Europe), it has also had more pernicious effects that are harder to see. Greatest of these is certainly its impact on the United States, reducing the resources available to this country as well as seemingly eating away at the political will that would be required if the U.S. were to play the active, broad-ranging internationally stabilizing role that has marked our foreign policy since the end of the Second World War. Adding to this is the weakening of our core alliances, not in terms of the desire to collaborate, but rather because allies have been preoccupied by challenges at home. Some leading allies, notably the EU, have in recent weeks seen the viability of their core institutions questioned.

The weakening of international institutions has been a related consequence of the crisis. Without a degree of financial support and political flexibility for vital organizations like the IMF and the World Bank that seems unlikely at the moment, we may well find ourselves at a true crossroads for the international system. At precisely the instance that the crisis has revealed a need for greater global regulatory oversight and stronger financial institutions to prevent and to respond to crisis, rising nationalism, the political imperative of turning inward, and limited resources threaten existing institutions with irrelevance and needed new ones with being stillborn.

Given other weaknesses in this system, such as the dubious value-added of much of the United Nations, the unsettling recent track record of the global non-proliferation regime, the troubles at the WTO with the Doha Round and the failure to establish, as yet, a global environmental organization to address climate change, it is possible to see the crisis neutralizing much of the system built up since the end of the Second World War. The challenges the system faces are made all the more complex by the need to rethink the steering committee for this system and recognize the rise of emerging powers and the declining relevance of some established powers. That this economic crisis has also produced a global crisis of confidence in institutions from national governments to financial markets, from international economic coordination mechanisms that have failed to big corporations, only further exacerbates these already daunting challenges.

Beyond threats to stabilizing forces and the international system, individual countries and key regions are also likely to see decline and unrest brought on by the crisis. Some of this unrest is likely to take the form of regime changes or social instability. Other risks associated with the crisis will come as opportunists seek to use anger at the failures in a system that is closely associated with the U.S. to foment hatred, to fuel recruitment for extremist and anti-US organizations and to simply produce distractions from local problems via the time-tested means of identifying foreign or domestic scapegoats and lashing out against them.

In short, the international security environment is likely to deteriorate over the next several years both because of a great hollowing out and weakening of the stabilizing forces in the world as well as from the emergence of new, destabilizing factors.

This committee is to be commended for undertaking its investigation of how the crisis is likely to impact the national security interests of the United States. The short answer is: sweepingly, enduringly and perhaps irreversibly (if we remain burdened with debt and resource-constrained in ways that can only weaken us as a nation). What follows is a brief discussion of how to look at the different ways that the crisis is likely to impact geopolitics and U.S. national security interests first in terms of a taxonomy of threats and then in terms of some specific potential flashpoints that illustrate broader trends or are likely to be of special significance.

Risk Drivers and a Framework for Considering the Threats Likely to Arise

There are a host of drivers associated with the global economic crisis that are likely to produce increasing geopolitical tension and create security problems worldwide. Among these are:

- ***Destabilizing Internal Effects of the Crisis:*** The crisis eats away at the foundations of stable governments. Reduced growth produces reductions in tax revenues making it more difficult to provide security or social programs. Reduced capital inflows undercut growth and the ability to create or maintain jobs. Substantial losses of jobs and savings produce social tensions, anger, unrest,

resentment toward the “haves.” Current estimates suggest as many as 50 million people may lose their jobs as a result of this recession by the end of 2009. This may include pressures leading to internal migration of people seeking employment or better conditions, which in turn may be destabilizing as it produces competition for resources and unsafe living conditions, and tensions associated with hardship. Governing parties are seen as complicit in the downturn and lose political credibility. Etc. As a consequence, viable states will become weaker and some weak states will become failed states, unable to keep the peace, combat crime, etc. At the same time, opposition groups including legitimate political opposition, rebel groups and criminal cartels will seek to use the crisis as a wedge issue or to mobilize support for their anti-government views. Finally, as noted above, global or regional actors such as the U.S., the EU or China which may have played a stabilizing role through diplomatic, military, aid or other forms of intervention may feel resource-constrained or may lack the political will to prevent or contain emerging or active conflicts. Should the weakening or retreat of these actors become chronic or permanent taken along with the potential weakening of international institutions and alliances (see above and below), a void may be created that itself will invite, prolong or deepen the threats to U.S. national interests worldwide.

- ***Destabilizing Bilateral or Regional Effects of the Crisis:*** The weakening of states can produce instability that spills across borders or can produce social pressures that increase migration and create associated tensions along borders. The rise of opposition groups can create an opportunity for like-minded neighbors to support their activities and thus cause rifts and potential conflicts to spread. Political and economic weakness in nations can be seen by opportunistic neighbors (some wishing to produce distractions from their own crises) as an invitation to intervene in their neighbors politics or even to step in and take control of neighboring territories or to seek to use force to resolve in their favor long-simmering disputes. In the same vein, old animosities may be inflamed by the crisis either because they produce tensions that play into the origins of old rivalries or because political leaders seek to play on those rivalries to produce a distraction from their inability to manage the economic crisis. Need may enhance tensions and produce conflicts over shared or disputed resources. A desire to preserve national resources, jobs, or capital may produce reactive economic, border or other policies that can increase tension with neighbors. This can include both trade and capital markets protectionism (in traditional and new forms—see below), closed or more tightly monitored borders, more disputes on cross-border issues and thus both an increase in tensions and a decreased ability to effectively cooperate with neighbors on issues of common concern.
- ***Destabilizing Global Effects of the Crisis:*** Quite apart from the global impact of the economic downturn itself—reduction of growth, reduction of liquidity, reduction

of capital flows, reduction of trade—there are a number of secondary effects, consequences of these primary problems, that will happen internationally impacting many countries, inter-regional relationships, international institutions, and the overall international mood/ability of the international community to function optimally. An example would be a generalized impulse among countries toward trade protectionism, capital markets protectionism, and to reevaluate effectiveness of and relationships with the existing international institutions if their precepts or rules run contrary to what internal political and social pressures demand (or if the institutions become seen as costly, politically unpopular luxuries.) Tension between regions may also result whether these are along traditional lines (North-South) or emerging lines (the U.S. as capital importer vs. Asia as capital provider). Another set of tensions may result from efforts to remake the international system to respond to the crisis and to what is perceived as a new, mid-crisis or evolving post-crisis balance of power, which is likely to create fault-lines between those who once dominated, led or participated in key institutions and those who feel it is now their right or time to assume new roles. Another set of global tensions may be created as large numbers of countries realign in support of “solutions” or ideological positions they see as likely to promote recovery or a better future and others take opposing views or as groups identify causes of the crisis and perceived bad actors or flawed systems and seek to either lash out at them or to isolate them (either on the merits or for opportunistic reasons). Consequences of the next order may arise as nations are divided over how to respond to some of the geopolitical consequences (including military conflicts) that may be spawned by the crisis.

A Question of Degree: How Bad Might it Get?

That the global economy is in dire straits is no longer open to dispute. In recession for essentially all of 2008, the key questions to ask with regard to how the crisis might drive geopolitics are how bad might it get and how long will it last? While this testimony is not the place for in-depth economic analysis (and while there are a wide range of viewpoints out there), we can settle on some useful guidelines for those whose job it is to anticipate geopolitical risks and prepare for them. First, there is almost no credible set of estimates anticipating an economic rebound before the second half of 2009 and many expect the downturn to last into 2010 and beyond.

Next, the proximate causes for this crisis—the collapse in the U.S. housing market, the subsequent collapse in mortgage-backed securities markets and the resulting meltdown in the international financial system which has destroyed some institutions, weakened many others and created a global liquidity crisis—are far from being resolved. The U.S. government has yet to unveil a program likely to establish a “bottom” in U.S. housing markets, to help mortgage-holders restructure their debt or meet their obligations, or to help banks get “toxic” loans off their balance sheets. Liquidity provided to banks has not made its way into the markets. Major banks like Citibank and Bank of America appear to remain at risk. There is something close to a consensus that most banks continue to under-report their bad assets. Falling housing prices in the U.S. may well have exacerbated the problem by putting many millions more homes “under water.”

And the contraction in the economy and the increases in unemployment to levels not seen for a quarter century are seen as likely triggers of a consumer credit crisis that may produce a second wave of bank failures.

Further, the entire global financial system has sustained a blow that has called into question the viability of many of the world's largest institutions, the viability of the current international regulatory regime and the very structure of finance. In the US, the UK, and around the world, institutions are being partially or substantially nationalized, the day of highly-leveraged, trader-driven "universal banks" deeply involved in derivatives markets and trading for their own accounts is clearly over. A new model with more Glass-Steagall-like restrictions on institutional activities is likely to emerge as are more restrictive regulations. Private equity firms are on the ropes or substantially subdued and the entire industry is bent on preserving capital rather than lending it in order to protect their ratings and their stock prices. Sorting this out will take time and the result will be severely constricted liquidity well into the future. The consequences of this are clear. A new study from the Institute for International Finance projects that net private sector capital flows to the world's emerging markets (recently considered the engines of global growth and "decoupled" from developed world markets) will fall to \$165 billion in 2009. That is one-fifth what flows were in 2007. That is a stunning collapse that will deal a powerful blow to economies in which rapid growth is key to social and political stability.

What is more, if growth in the biggest of those markets such as China and India slows as expected, it will have a secondary impact on commodity prices, many of which were driven by the rapid growth of these markets. If that is the case, many other emerging economies which are heavily dependent on commodity prices will suffer serious decreases in exports and reserves of hard currency. Given concerns that many of the financial institutions in these markets do not currently have the ability to meet their financing obligations of \$20 billion a month in 2009 (the IIF study estimates they have only half what they need) this may trigger serious financial market crises in these markets as well as traditional crises associated with the inability to meet government debt obligations due to balance of payments problems. Because most of the world's security hot spots are in the emerging world and in particular in countries that are primarily commodity exporters, this particular secondary wave of financial shocks is likely to have acute geopolitical consequences. That the developed world will be stretched thin paying for their own bailouts makes it less likely that they will be able to provide sufficient aid in the event that an emerging world economic tsunami strikes. (U.S. and other industrialized economies are likely to require second and third tranches due to the aforementioned global shocks as well as problems such as the potential consumer credit crunch and the wave of corporate and financial institution bankruptcy that are predicted for the year ahead. In one estimate, Standard and Poors projects that U.S. "speculative grade" companies at risk of default on their bonds could surpass the previous peak in 1990 and may well hit modern era historic highs of almost 20 percent.)

Of course, it is possible that the pessimistic estimates overstate the problems we will encounter and that recovery will come more quickly, but it would be unwise to count on such an outcome. Further, the severity of the current situation is such that many if not all of the following risks have already been created and/or seriously exacerbated by the crisis as it has unfolded so far. (The IMF projects world economic growth in 2009 will be the lowest since the Second World War, reducing late 2008 estimates by over 2 percent to only .05 percent. Their chief economist said, "We now expect the global

economy to come to a virtual halt.” Most major economies will contract by an average of 2 percent, the first big contraction across this group since the Great Depression. At the same time, the latest set of estimates from the International Labor Organization projects that in its worst case scenario as many as 51 million people worldwide may lose their jobs in 2009, pushing global unemployment to 7.1 percent. The ILO’s most “positive” scenario—only about 18 million new unemployed—was based on the now invalid IMF estimate of 2.2 percent growth. Just as importantly, the ILO estimates that the number of people who work for the most meager wages (less than \$2 a day) may rise to 1.4 billion. This number represents almost half (45 percent) of all those employed in the world. This well illustrates how precarious the social and political situation is likely to be in much of the world.

Near Term Examples of Consequences and Potential Flashpoints

While it is impossible to predict with great accuracy where the pressures of the economic crisis are likely to translate into geopolitical problems, it is possible to offer a series of illustrations of cases in which current conditions make future problems likely. These examples cover not only a range of countries and regions but a range of problems of varying degrees and natures. I will offer the examples using the three categories of potential risks outlined earlier.

Risks Within Nations

Fragile states, countries with current economic or political problems that are likely to be hard-hit by the current crisis dominate this list. One prime example of special resonance for the U.S., cited recently in a Pentagon study, is Mexico. The country faces a host of challenges. One set are associated with the crisis, with decreasing trade flows, decreasing investment flows, decreasing flows in remittances (for the first time since such flows were tracked), and associated challenges meeting budget targets or possibly, meeting debt-service obligations in the future. Another set are associated with declining internal resources, notably the projection of an end to oil revenues within a decade due to the limits of their reserves, dwindling financial and technical resources and the related mismanagement of PEMEX the state-owned oil company. Finally, a third set are associated with the federal government’s gradual loss of control in key provinces where drug cartels and other criminal organizations have stepped in to fill the void. It is these weakened provinces that have led some to draw analogies with Colombia, where the central government lost control of the periphery of the country to the FARC and other rebel groups as part of a 40 year civil war and the expansion of drug cartels in that country. The Mexican example is apt because it underscores that countries can appear to be relatively stable at the center, but in the current circumstances may deteriorate in outlying regions, creating a hybrid weak state-failed state. Naturally, the realization of such a scenario in Mexico is likely to pose multiple challenges for the U.S., including those associated with immigration, the spread of crime across the border, the possibility that criminal avenues into the U.S. might create terrorist avenues into the U.S., deterioration of trade relations or cooperation on border issues, a demand for financial aid and the spread of these problems into other nearby countries such as those of Central America. If the U.S. were to react harshly to the threat, closing the border and confronting the Mexican government, it could lead to a political shift in that country and an alignment of it with other more anti-U.S. elements in the region.

Other countries that might fall into this category (and the list is quite long) might include strategically important actors such as Pakistan, Ukraine, Turkey, Egypt, Iran, Russia, Venezuela, Argentina, Indonesia, the Philippines, China, or North Korea. Much of Africa also does. Each case is, of course, different. In Pakistan, it is said no government has ever survived an IMF deal. In other words, the people of the country are so anti-western in their orientation that when governments are compelled due to financial circumstances to turn to international institutions (perceived as western/U.S. dominated) for assistance, it undercuts their political viability. Pakistan has already, late in 2008, come to the brink of financial collapse and there is no reason to assume that the fixes that were put in place by the international community are up to withstanding the additional pressures that might come from a further global deterioration. With the country deeply divided, home to radical jihadist elements, in a permanently tense posture toward India, inextricably tied to the U.S. conflict in Afghanistan (or more properly the U.S. war against the Taliban and Al Qaeda, many of whom have relocated into Waziristan and neighboring regions of Pakistan) and continuing concerns about the security of the country's nuclear arsenal, it is clear that there are few more precarious situations in the world. Economic pressure could topple the Zardari government, create fodder for radical elements seeking to incite political or terrorist action among the people, create a motivation for populists to scapegoat India, or other steps which could produce upheaval, localized conflict or worse.

Ukraine (like a number of other countries in Eastern and Central Europe) has been feeling the downturn and has been at risk of financial default already. It has also felt pressure from its neighbor to the East, Russia, on the issue of payment for (and provision of) natural gas. Should the crisis undercut the current regime, it cannot be ruled out that Vladimir Putin might see the void created as an opportunity either to be filled through the support of a Russia-leaning new leadership in Kiev, or alternatively through more forceful action either akin to another shut off of energy resources leading to a negotiation regarding a different relationship between the countries or something more akin to the confrontation with Georgia. Given dwindling resource export-related revenues (and other problems such as his country's demographic contraction) Putin himself will likely seek ways to distract from the problems and enhance his status as a strong leader. In the past, he has done this through aggression in Chechnya and Georgia and striking a tough, independent, anti-US pose on the international stage.

In the cases of Turkey, Egypt and Iran, economic vulnerability of the current regimes creates the possibility of major shifts in leadership or in the positioning of current leadership that might be problematic. A more fundamentalist government in Turkey, given that country's strategic position, or a more aggressive stance from Turkey regarding either Israel (see the contretemps between the Prime Minister and Israel's Shimon Peres in Davos) or the Kurds (to distract and stir up nationalist feeling) could shift the balance of power in the region in ways that would be most troubling for the U.S. and the West. Iran's case is different. If oil continues to fall and the government is more strapped, it is possible that the current regime may see it as in its interest to stir regional confrontation for both populist reasons and because it may reflate the price of oil. (Alternatively, it may weaken the current regime creating the opportunity for a change and an opening for the U.S.) In Egypt, given the potential for volcanic unrest that could topple the comparatively moderate regime, the issues are similar to those in Turkey.

Venezuela's case is similar to that of Iran. Falling oil prices could undercut Chavez' hold on power and might lead him to seek closer ties with potential partners whose interests do not align with the U.S. (Russia, Iran, Syria, China). It could also trigger confrontation with the U.S. for populist reasons. On the other hand, it may weaken the regime in ways that could, a la Iran, be an opportunity. In other countries on the list economic crisis could topple regimes (all), trigger the rise of extremist elements (Indonesia, Philippines), foment the creation of tension with neighbors to create distraction or increased global bargaining power (North Korea is good example in this case), etc. In the case of China, the reports of tens of thousands of uprisings related to the economic crisis (80,000 in one estimate), significant job losses, massive internal migration of workers, and related factors will put the central government and provincial governments on the defensive, may trigger crack-downs, may trigger bigger protest movements, etc. Further, it should be noted that should instability peak in ways that the international community feels threaten the current order in China, it is not impossible that this in turn could trigger a bigger market sell-off and a possible financial meltdown in that country, which would have global consequences given China's position as the world's third largest economy and one of the principal drivers of global growth over the past decade.

Africa, home to the most deadly conflict in the world over the past decade, that in Congo, and a host of other major conflicts, such as those in Somalia and Sudan, and major national calamities like that in Zimbabwe, is likely to find itself a recipient of less aid and attention. Conflict, disease, poverty and instability there are likely to only grow worse in the context of the global crisis. (Remember, if you make 3 dollars a day and you lose a third of your income, the choice is between food and shelter, allowing children to go to school or forcing them to work, etc. Millions will die because of this economic crisis and that will produce not only a great human tragedy but it will depress economies and upset local stability in severe and myriad ways.)

Risks Between Nations

Many of the risks between nations stem from the types of problems cited/illustrated above. So, a weakening of federal control in Mexico is very likely to trigger tensions with the U.S. A crisis in Pakistan will have serious complications for Afghanistan and, should there be instability in Pakistan and a shift toward a more hard-line government, there would be major implications for Pakistani-Indian relations and potentially for Indian financial markets. Should there be an event in which even a tiny portion of the country's nuclear arsenal is put at risk, the implications worldwide are even greater and may require the U.S., China and other countries to step in. (It should be noted—perhaps under the heading of “risks on a global scale”, below--that many of the most vulnerable nuclear facilities in the world are in the emerging world and two-thirds of all nuclear facilities in construction currently are in the emerging world. Thus, should there be a downturn in governments' ability to secure these facilities and a concurrent uptick in radical activity the risks of WMD terror-related breaches will rise substantially.) Russia's potential rationale for intervening in the affairs of Ukraine or other nations in that region was noted, as was the potential for enhanced tensions in the Middle East, were problems in Turkey, Egypt or Iran, for example, to provoke an increase in tensions with Israel, other neighbors, or produce flare-ups among non-state groups that have cross-border components (Sunni-Shiite tension, Kurdish issues, Muslim brotherhood, activities of state-sponsored entities like Hezbollah, ties of entities like Hezbollah to Hamas, etc.) Historically, when countries like Argentina or Indonesia have had serious economic

problems, this has caused contagion in neighboring states, as well (Brazil, in Argentina's case, or the rest of ASEAN in Indonesia's.)

Were China's domestic challenges to force more spending of national reserves to create local jobs or provide emergency economic support of other types, this in turn could lead to a sell-off of Chinese holdings of U.S. Treasuries or at least a policy to purchase fewer such securities. The inability of the U.S. to find debt financing would weaken the country and force it into a position of printing money, fostering inflation, as its only remaining option to meet the financial needs it may associate with the crisis and recovery from it.

This is the first economic crisis of the global era and requires a global response. If we get our recovery plan right, but China gets theirs wrong, we are likely to continue to falter and vice versa. The same holds true for our interdependence with many other significant economies. If we do not rise to the challenges of effective coordination on this front it may foment tension, divisions and further difficulties as individual countries will be seen as the source of enduring problems for others. Here, the failure to do something new and complex and urgent could result in the erosion of relationships and a period in which it is increasingly difficult to act in the multilateral way that most major global problems of today require.

Risks on a Global Scale

If some of the cross-border issues cited above are played out in terms of likely consequences, it raises the possibility of problems spreading to many nations and taking on global or inter-regional scale. One often discussed possibility in this respect is growing protectionism, which not only could have negative economic consequences (as it did during the 1930s) but which also could enhance tensions between nations making cooperation in confronting other challenges more difficult. Protectionism is not just economically self-defeating as it provokes a cycle of action, retaliation and contraction, but it is also diplomatically corrosive. Related concerns have arisen that nations which face capital scarcity are placing pressure on financial institutions to direct available capital flows within their borders. For example, EU Central Bank President Jean-Claude Trichet warned that (per the FT) "the wave of bank bail-outs in Europe and the U.S. could usher in a new era of financial protectionism that could lead to a deeper economic slump." This problem could be exacerbated by the impulse of banks simply to hold on to capital in order to enhance reserves and because there is so little forward visibility in markets. This problem has led observers to wonder whether this downturn might see financial protectionism leading to a drying up of global capital flows akin to what we saw during the Great Depression when trade protectionism crushed global trade flows. Clearly, as noted earlier, reduced availability of capital will only exacerbate problems, particularly in emerging markets which depend on the capital for stabilizing growth. Similarly, the protectionist impulse may lead to the creation of a new round of trade barriers. Two examples here include barriers that come in response to perceptions of currency manipulation (see the current US-China dialogue on this issue) or barriers related to other divides, such as that between developed and developing nations on global warming. If the developed world implements provisions to preserve the climate then there will be great pressure on their governments from effected sectors to impose duties on goods imported from countries with less strict laws or requirements. Again, these impediments to trade flows can inflame relationships. They are also likely to lead

to the unraveling of global trade talks and a possible new set of challenges to the effectiveness and legitimacy of the WTO.

Similarly, the advent of the crisis has already seen a number of nations seeking to use it as a justification to “reseat the global head table”, to move away from the leadership structure of the international community that is largely a vestige of the post-World War II environment and to move toward one more suited to the current environment. The rise of the BRICs has coincided with an effort among the leaders of Brazil, Russia, India and China to assume greater roles within a variety of organizations ranging from a potential successor to the G8 to a revised permanent structure to the UN Security Council to changed ownership structures at multilateral financial institutions. Other major emerging powers (such as the other members of the G20...given a leadership role in addressing the financial crisis through the November 15 summit in Washington) will seek the same. These aspirations will cause tensions on several levels. First, some leaders, like Putin and Wen Jiabao at the recent Davos meeting...and French, German, Iranian, Venezuelan, Chinese, Japanese and other politicians during the Fall phases of the crisis...will cite the U.S. (or the West) as the cause of the problems, use this to create new divisions and alliances, and seek to use it to undermine the credibility of the U.S. and the system we have long advanced. Next, rising powers will inevitably seek to displace some nations that have traditionally held leadership roles but may not in the future. Next, different leadership means different priorities and the transition may undercut the effectiveness of multilateral institutions at precisely the moment they are needed most.

Finally, growing tensions and unrest are likely to feed transnational threats from terrorism, to proliferation of weapons of mass destruction, and to the expansion of global criminal networks. Migration caused by the crisis may lead to the spread of disease, ethnic conflict and the creation of new extra-legal networks that will be difficult to track and contain. Further, as nations turn inward to address domestic problems and as their resources dwindle, the attention devoted to international institutions, the funds directed to those institutions and thereby their effectiveness are all likely to decline.

A Note on Medium to Long Term Examples of Consequences

While the request was that this testimony focus on relatively near-term threats, it is important to note other significant threats that may have a longer time horizon. These include but are in no way limited to:

- Threats associated with opportunity costs of the current crisis. In other words if we are directing resources and attention to the current problem, we may be ignoring other important issues. In the case of the U.S., for example, this may be failing to bring our fiscal house in order or address the long-term debilitating costs of an inefficient health care system, or it may mean (as it may in many other countries) failing to devote sufficient attention to issues like global warming which in turn may have devastating long-term consequences. Similarly, funds for addressing issues like global poverty, development, or the containment of disease will dry up and the long-term consequences of an erosion of programs in these areas may be prolonged poverty, stalled growth, a generation without education, and consequent impacts on stability.

- This period of crisis is likely, as noted above, to correspond to a remaking of the international system. Change is likely to be required not only in areas pertaining to the crisis (fixing multilateral banks, creating global regulatory regimes and perhaps authorities) but it is also likely to be required within the UN, within the NPT, within the WTO and in new groups such as that which will be required once a global climate agreement is reached. If these institutions are born of tension, undercapitalized, conflict laden, or developed precipitously in response to the crisis, the international system/order will suffer and it may take years to recover. Also, fault-lines may be institutionalized within these institutions as they have been within others in the past (see complaints re: North-South, East-West issues in the IFIs or the UN).
- If capital flows dry up and capital sources shift, so too will power. Much US power in the past several decades has been related to our role as the leading capital market/resource in the world and to the position of the dollar as the unassailable reserve currency of the world. If we have less capital available here, if other currencies take away our share in reserves worldwide, we will become weaker. Similarly, other countries might emerge with a better position in the balance of geoeconomic power (if China is, for example, able to maintain their reserves or once the recovery begins oil prices rise precipitously and oil rich nations once again build up their sovereign wealth). If not exactly destabilizing, it does change the equation by which stability may be achieved.
- In this tensions will come to existing alliances and new alliances may be formed around positions associated with the crisis or with conflicts that may emerge from the crisis.
- The costs of “bail-outs” and crisis related measures will create fiscal burdens for the U.S. and other countries that will limit their resources and therefore their policy options for many years to come and which may ultimately compel the U.S. and these other countries to cut spending in areas like defense, foreign aid and other categories associated with our international roles and influence.
- Finally, while I do not subscribe to the notion that this is the beginning of the end for capitalism or for U.S. global leadership, it is virtually certain that the formulas offered during the past 25 years (“leave it to the markets”, the Washington Consensus, etc.) will be challenged in unprecedented ways. Change is inevitable. “European” or “Asian” versions of capitalism may gain traction. America may see other nations rise in relative power. It is very unlikely that the global balance of power at the conclusion of this crisis will be precisely what it was at its onset.

Implications for the United States

For the U.S., these threats and likely changes ensure that the next years will be extraordinarily challenging. Our national economy is the wellspring of our strength and is a critical engine of the global economy. To remain strong and a force for good internationally, we must restore vitality to that economy. However, if we spend too much to do that we may create fiscal burdens that handcuff us in the future and thus undercut the objective of preserving/restoring our strength and influence. We must make domestic problems a priority, but if we fall into the trap of allowing such an approach to open the door to traditional or new forms of protectionism, we will hurt ourselves both at home and abroad. We must recognize that multilateralism and burden-sharing are key to our ability to achieve our goals in a time of resource constraints, but that to do so successfully will involve understanding and accepting a new order with all the disruptions and changes that may require. We must rise to meet the most urgent security threats with sufficient force but we must also recognize the fragility of the global situation increases the likelihood that miscalculations will cause problems to spread and multiply. We must focus squarely on the critical issues of today without losing sight of the great long-term challenges that also require our attention. We will need to lead in the creation of a new global institutional system at precisely the time many of our basic beliefs are in question (and at a time when our international standing is still damaged from missteps of the past decade.)

Each challenge is great and virtually all carry with them other contradictory or complicating challenges. As a result we cannot help but see the period ahead as one that is fraught with dangers. That said, it is also one that contains considerable opportunity. The Depression and World War II produced tragedy and mayhem...and then led to the creation of the international system that has served the world well in many ways for the past sixty years. We stand at a point where nations are truly compelled to work together better, recognize their interdependency more clearly, and share in the shaping of a common vision for the planet. The sheer range of the potential risks we collectively face can lead us to turn inward or it can motivate us to lead in the shaping of a new more stable, more just international system. We will be judged as a generation and perhaps ultimately as a country by the choices we make.

Conclusions: Top Priorities and Recommendations

A crisis such as this one produces such a welter of challenges that a form of policy triage is required. While there is often a misconception in the U.S. government that we can...and perhaps worse, that we should...be dealing with every issue confronting us in the world, the reality is that not only is that not possible, it's less possible today than at any time in the recent past. Two on-going wars and the severity of the domestic consequences of the economic crisis at home explain that point irrefutably.

As a consequence, it is important that we recognize the top threats associated with the crisis and address those. Based upon the preceding discussion, the greatest threats associated with the crisis are as follows:

--The Economic and Political Constraints Placed on the United States

The greatest sea change associated with the crisis may be as a result of the decisions by American policymakers over the past decade that will effectively place the country in fiscal handcuffs for the foreseeable future. We will be dependent on foreign creditors such as China, now the largest of the countries to which the U.S. is beholden. As we

saw for the first time during the Fannie Mae-Freddie Mac crisis last fall, this can mean having Chinese borrowers call U.S. policymakers and bully them into positions to protect the value of China's holdings, with the leverage being the threat of a move away from the dollar by China's investors. Long-term inflation is another risk of our current deficit-building policy tack, especially if foreign investors have a diminished appetite for U.S. dollar denominated assets. Ultimately, these pressures will lead to budget cuts and given the heavy demands of health care and other entitlements in an aging nation, this will certainly and unavoidably lead to cuts in U.S. defense spending. If the process of defense budgeting and acquisitions does not become more efficient and the concept of how our military is structured is not dramatically rethought, this can only weaken the U.S. (Although that is not the only possible outcome.) In addition, in such circumstances, American soft-power will suffer dramatically as the checkbook diplomacy of the past will simply no longer be affordable or politically palatable. Finally, an economically wounded U.S. will be preoccupied at home and less inclined to risks abroad. In short, while the U.S. will remain the world's preeminent power, this power may well be more limited than in the recent past, which may be perceived as an opportunity by our rivals and enemies.

--The Economic and Political Constraints Placed on the EU, China and Other Potentially Stabilizing Actors

The same kind of issues with which the U.S. will grapple will dominate the attentions of political leaders in countries with whom we have close alliances and with others that are large enough to be stabilizing forces regionally or even farther afield. In the past week, the Economist magazine has noted the first rumblings of questions about the viability of an EU that cannot effectively act together to manage the crisis. China, while possessing more cash than any other country in the world, may feel obligated to spend more of that cash to maintain stability at home...more even than currently committed if, as widely thought, Chinese growth estimates remain over-optimistic. This weakening of the great powers can only be seen as creating something of a void in the world's less stable regions suggesting a period during which political brushfires may be expected to break out more frequently than in the past when major power intervention kept a lid on conflicts.

--The Crisis of Confidence in Institutions Worldwide and the Threats to the International System

As noted earlier, the economic crisis is also very much a crisis of confidence in our leading institutions. If this in turn leads to countries stepping back from the international system or to a failure to muster the political will to recast the international system to better meet the challenges of the current era, another major set of stabilizing forces could be put at risk and ultimately recede or disappear. While we might expect the crisis to produce a stronger international system, this may come only after a resurgence of economic and political nationalism and real resource constraints undercut efforts at multilateral reform. Almost inevitably however, it should also be noted that when changes do occur, a new leadership structure—reflected in the shift from the G8 to the G20 as the central steering mechanism for response to this crisis—will be put into place and the U.S. will be forced to adapt its worldview and its diplomacy to adjust to this new reality.

--The Exacerbation of Critical Threats Associated with Proliferation of Weapons of Mass Destruction

The proliferation of weapons of mass destruction remains the greatest threat to global security that we face. While there is no direct linkage between the economic crisis and the technical aspects of proliferation per se, the crisis could well lead to a recruitment bonanza for anti-U.S. non-state actors, greater tensions with hostile nations seeking to lash out at the U.S. as a means of distracting from economic despair at home, reduced resources for sufficient security to prevent proliferation, and the creation of more failed states which become homes to terrorists and criminal organizations that can play a role in WMD proliferation due to their lack of functioning institutional structures.

--The Consequences of Protracted Crisis for the World's Weakest States

These consequences include mass starvation, disease, tribal conflict, and warfare as we historically have seen in the most deprived parts of the world. In Africa, where such unhappiness is a seemingly permanent condition, further instability may intersect in troubling ways with the world's growing recognition of the importance of resources found in the region. In fact, as in the case of WMD proliferation, deterioration in the weakest states may blend with growing resource competition to create a particularly dangerous cocktail.

--The Threats to Weak and Weakened States Directly Impacting U.S. National Interests

As we prioritize threats, we clearly must reserve a special place atop our lists for countries where collapse will produce an immediate impact on the U.S. This could be countries that are nearby that can produce waves of unwanted immigration in a crisis or which can be the source for growing criminal activities that spill into our borders. (Mexico and Haiti immediately come to mind.) Or they can be countries that produce resources on which we are heavily dependent. (Here the greater Middle East and Central Asia top the list.)

With regard to these priority concerns, the principal recommendations that can be made to this committee are:

--Be Strategic About Marshalling and Maintaining U.S. Resources (Fiscal Restraint and Rethinking Defense Budgeting)

We are realizing almost too late that attentiveness to the structural integrity and wellsprings of growth within the U.S. economy must always be our primary national security concern. Ensuring that recovery happens as quickly as possible and then that we aggressively seek the kind of fiscal balance that reduces foreign dependencies is key. This will however, inevitably mean raising U.S. taxes and cutting spending...including defense spending. The development of a new paradigm for the structure and asset allocation approach to our defense establishment is key here. We can no longer afford the redundancies, the waste or the outmoded "a third, a third and a third" spending habits of the past.

--Maximize the Means of Leveraging U.S. Power (Maintaining Critical Institutions and Alliances)

We must lead in the reform of global institutions. Whether it is in the area of financial regulation or emergency economic intervention, containing proliferation or combating climate change, fostering development or ensuring fair trade, peacekeeping or managing global resources, institutional reform, renovation or rethinking is urgently needed. Unless the U.S. leads this process, spends the necessary capital to ensure the relevance of global financial institutions, invests the necessary political capital to create organizations that can truly manage global challenges, others will not follow and we will all suffer the dire effects of the ensuing institutional void. This will require communicating effectively to the American people that in the post-crisis world the more effective burden sharing that strong international institutions can bring must be a key to a new U.S. foreign policy. It will also require persuading some of our historic allies that a new leadership structure for the global system is needed. The move from the G8 to the G20 is encouraging but we shall soon conclude that the G20 is too large and unwieldy and we will have to formulate a smaller group including at least the U.S., the EU, Japan, China, India and Brazil.

--Lead a Coordinated, Proactive Global Effort to Reduce, Eliminate or Contain Threats (Beginning with Economic Threats)

The preceding point is meaningless if we do not then use the institutions we have to meet the challenges we face. First, we must produce and coordinate the unprecedented global effort that will be needed to deal with the first truly global recession. Next, we will have to install the financial mechanisms to ensure such crises do not occur again in the future. But we cannot afford to be distracted from the other urgent global security challenges we face, notably containing the proliferation of weapons of mass destruction and combating climate change.

--Maintain a Credible Deterrent against Bad Actors

We cannot allow a U.S. weakened by economic crisis and division over an unpopular war in Iraq to be seen as a nation drifting from what my co-panelist Richard Haass once called the "Reluctant Sherriff" to becoming the "Absent Sherriff." There will remain issues that require our intervention and the use of force or the credible threat of the use of force and we should not underestimate the factors that will make such a stance difficult in the immediate future. But absent a real sense that the U.S. might under certain circumstances intervene we will have a very difficult time indeed dealing with the greatest security threats we face such as those in Iran, Pakistan and North Korea.

--Recognize the Likelihood of Crises Emerging Beyond the Iraq and Afghanistan-Pakistan Conflicts that Currently Preoccupy the U.S.

The purpose of this hearing, I believe, has been to underscore this point. We must closely monitor vulnerable regions of the world and anticipate that crises will emerge that have not dominated or even maintained much of our attention in the recent past. Whether these are in Mexico, in Central and Eastern Europe, in Africa or in Central Asia, they will come and we must be nimble and ready to respond.

--Fight the Temptation to Turn Inward at Home and Abroad

We remain the indispensable nation even as other rising powers, such as China, are emerging as indispensable to our future. If America turns inwards and away from engagement internationally, we guarantee a world that is less stable, more hostile, and home to a spreading wave of human tragedies that we can ill afford. Even in a crisis, we must invest in our vital institutions, recognizing that now is a time for greater vigilance and strength, even as economic pressures might lead some to take a step back and disconnect.

This calls for political vision and leadership. Hearings such as this one are a constructive, timely and much needed step in that direction.

Thank you for the opportunity to submit this testimony to the committee today and, of course, I would be happy to answer any questions you may have.