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*Jeffrey E. Garten*

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# The Global Economic Challenge

*Jeffrey E. Garten*

## PRIORITY ATTENTION

AS HE BEGINS a second term, President George W. Bush faces daunting global economic challenges. It will not be easy to meet them successfully, for although some of his administration's policies have been encouraging, many have been deeply flawed. Most important, his administration will have to increase vastly the emphasis it places on international economic policy in general.

For the last four years, global finance, trade, and development, and the cultivation of overseas relationships to advance U.S. interests in these areas, were not given the priority that they generally received in the preceding half-century. During the Cold War, lowering barriers to trade and investment, granting generous foreign aid, and strengthening international economic institutions—all in close cooperation with U.S. allies—were a central part of Washington's fight against communism. After the Soviet Union collapsed, the administrations of George H.W. Bush and Bill Clinton geared much of their foreign and domestic policy to enhancing U.S. competitiveness in global markets and to spreading U.S.-style capitalism abroad. During this time, the United States had intense policy interactions not just with the European Union and Japan, but also increasingly with emerging markets in Latin America, eastern Europe, and Asia.

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It is no mystery why the current President Bush has subordinated global economic issues in the hierarchy of his concerns: since September 11, 2001, combating terrorism and waging war in Afghanistan and Iraq have been the primary lenses through which the administration has viewed nearly every aspect of its foreign policy. There has been little time, interest, or energy for anything else. But even if terrorism

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remains the focus of U.S. foreign policy in the second Bush term, as seems likely, the United States cannot succeed in this fight with a strategy that is predominantly military and that fails to gain foreign help in terms of both people and money. The United States has neither the skills nor the resources to mount adequate postconflict stabilization and reconstruction efforts in the Middle East or

elsewhere entirely on its own. And it certainly does not have the wherewithal to deal single-handedly with the massive longer-term development challenges around the world that must be met if future generations of potential terrorists are to feel they have a less destructive alternative.

The need for a broader foreign policy that focuses more attention on economic growth and development becomes even more urgent when the interests and goals of other nations are taken into account. Washington may be obsessed with fighting terrorism, but economic and social advancement matters more to most other countries. It is on that plane that the United States must build stronger international relationships if it wants other nations to embrace its priorities.

President Bush also must devote more attention to global economic policy in order to strengthen the U.S. domestic economy. Bush has set out an ambitious agenda for his second term that includes tax reform and the partial privatization of Social Security. The president will be better able to gain needed political support for such complex and controversial goals if economic growth and job creation are robust. That depends in part on favorable global conditions, as well as on the direction of U.S. foreign policy. For example, the president will be relying on the persistence of modest interest rates, which means ensuring that foreign money keeps flowing into the United States at the rate of \$600 billion per year. The health of the domestic economy

depends on reasonable oil prices, which means securing adequate supplies and avoiding disruptions abroad. To create enough jobs, the United States will need to expand its exports, and that will require persuading other nations to lower their trade barriers and stimulate internal demand.

The bottom line is that geopolitics and geoeconomics are now deeply intertwined. To more effectively connect them on the policy level, the Bush administration must at least make more of an effort to ask the right questions. Should the United States grant European demands in global trade negotiations in order to induce France and Germany into closer cooperation on the problems of the Middle East? Should Washington use more political and economic leverage in eastern Asia to offset China's growing influence in the region? Should it come up with a more potent mix of political and economic carrots and sticks to persuade Iran and North Korea to engage more seriously in nonproliferation negotiations?

Geopolitics and geoeconomics are converging in other areas as well. President Bush has frequently voiced his commitment to spreading democracy and free markets around the globe. For him, democracy and capitalism have the same goal: human liberation. But the administration needs to reflect on whether simultaneously pushing open politics and open markets is realistic. If U.S. rhetoric is out of step with its behavior, the United States will be seen as hypocritical and purely opportunistic. That is what is happening now. If the Bush administration is so committed to liberty broadly defined, for example, why has it been so timid in criticizing China for its failure to democratize? Why has it remained almost silent as Russia's Prime Minister Vladimir Putin has eliminated political opposition and a free press? Why has it been so skittish about pushing for political openings in Saudi Arabia?

The answers are obvious: in each case, stability and economic ties are more important to the Bush administration than real democracy, because the latter carries with it the dangers of radical political change and destabilization. That may in fact be a realistic calculation. But in any case, Washington needs to reconcile the inherent tensions between its geopolitical and its geoeconomic aspirations.

Lastly, the Bush administration must recognize the powerful constraints that global markets could exert on the U.S. economy in the

next few years and prepare to react at home and abroad if a market crisis occurs. History is instructive here. In 1987, Wall Street and its foreign counterparts precipitated a market crisis that eventually put enormous pressure on the Reagan administration and on Congress to rein in spending. When President Clinton came into office, it was Wall Street's discomfort with ballooning fiscal deficits that caused him to renege on his campaign commitments to provide tax rebates for the middle class. Since the mid-1990s, however, the U.S. economy has been consistently stronger than most others, and until just a few years ago its fiscal position was strong as well. The combination of both factors made it seem like international financial constraints on the United States had disappeared.

This situation could easily change in Bush's second term. The president came into office facing a projected \$5 trillion budget surplus over the next decade. Today, the ten-year projection is for a more than \$2 trillion deficit, and that is before spending on any of the new initiatives planned for the second term is taken into account. President Bush has said he will make his tax cuts permanent, adding another \$2 trillion to the deficit over the next decade. He also wants to privatize part of Social Security in a way that could add another \$1 trillion to \$2 trillion in transition costs. He has said his upcoming tax reforms will be revenue neutral, but if the administration's past performance is any guide, they could easily end up leading to even more tax breaks. Moreover, the administration has been weak in controlling spending and resisted imposing strict spending guidelines. With a smaller Democratic opposition in Congress, there is now likely to be even less resistance to these trends. All the while, the United States is relying heavily on foreign investors, particularly Asian central banks that are now buying about a third of all U.S. Treasury obligations, to fund its deficits as well as a good part of net new investment in the United States.

Under these circumstances, the possibility of a financial crisis that forces the Bush administration quickly to reassess its policies cannot be discounted, to say the least. Such a crisis would ensue if foreign lenders were to change their investment patterns, spending more in their own economies or shifting funds to the euro or other assets. Were this to happen, a currency crisis could force the United States to jack up interest rates to make lending and investing more attractive.

That, in turn, could cause a recession. If and when a crisis occurs, the administration will be forced to work with Congress on an emergency fiscal package to show international investors it is taking remedial action, as happened in the Reagan years. Simultaneously, it would be seeking help from foreign governments to support a dollar-rescue operation.

The implications for what could ensue would affect much more than fiscal and monetary policy, and it could scuttle more than Bush's plans for tax and Social Security reform. Budget pressure dictated from abroad could affect the size and composition of the U.S. armed forces and put excruciating pressure on the United States to solicit military help from other countries. It could reduce funds available for everything from homeland defense to education. In sum, the refusal of international investors to support out-of-control U.S. fiscal policies could become the defining event of Bush's second term.

PAST AS PROLOGUE?

GIVEN THE ELECTION RESULTS and the clarity of the president's past behavior, there is nothing to suggest that the new Bush administration's policies will fundamentally change. This goes for the good policies as well as the bad. President Bush will give high priority to concluding the Doha Round of trade negotiations, and he may give renewed attention to a free trade agreement for the western hemisphere. Both would be important accomplishments. He will fight hard for "fast track" legislation in 2005 to renew his trade negotiating authority—although the administration can expect a tough battle, as the political support for free trade is very fragile. He will try to resist pressures to clamp down on increasing imports from China. Bush's free trade credentials are strong, and his continued global leadership in this area will likely continue.

The administration will quietly support a gradual depreciation of the dollar and press for a rising Chinese yuan to enhance U.S. exports and slow imports. There is little choice, given the huge financial imbalances and the lack of viable near-term alternatives to correct them. The dollar will have to decline by another 15 to 20 percent, according to many experts, for the current-account deficit to reach sustainable levels. But the administration will have to proceed

carefully, for if the markets conclude it is too keen to abandon a strong dollar, they could push down its value too fast, necessitating a costly dollar-rescue effort.

Bush will strongly encourage Congress to fund fully its expanded bilateral programs to provide targeted foreign aid and to combat AIDS, both highly worthwhile ventures. He will pursue modest development programs in the Middle East, which may be the best that can be done at this time. He will try to grant legal status to millions of undocumented Mexican workers, also a worthy goal. All these policies constructively continue what was started in the first Bush term. The administration should be commended for its consistency in these areas—although this is the least that ought to be expected from a country with such wealth, power, and interest in the global economy, and one with a history of leading other nations.

Unfortunately, there are other Bush policies that should not be perpetuated—even though they likely will be. Most important, given the current fiscal mess, Bush should not make his tax cuts permanent. Doing so would siphon money that rightfully belongs to future generations, who will either have to endure sky-high tax rates or do without critical government services. The administration says that it will halve the deficit in four years without raising taxes or cutting entitlements, an assertion that rests entirely on a bet that the economy will grow at breakneck speed.

But as the Congressional Budget Office has reported, there is no realistic growth scenario that would generate revenues to meet the enormous unfunded liabilities—upward of \$50 trillion—associated with the upcoming retirement of 75 million baby boomers. Nor can these requirements be met by cutting spending—not when 80 percent of the budget comprises untouchable items such as national security, entitlements, and interest on the debt. In fact, there is no arithmetic solution to the deficit that does not include tax increases or major cutbacks in social programs. Without a change in direction, then, the United States will be stuck on a ruinous fiscal course that will end only with international financial crisis or radical policy changes by future administrations.

The administration's energy policy is similarly unrealistic and ill advised. It relies disproportionately on domestic drilling even though

the United States has less than three percent of global oil reserves, consumes a quarter of the world's oil, and currently imports more than half its petroleum. If this thrust continues, as seems likely given the administration's determination to pass its original energy legislation, the United States will become increasingly reliant on oil from the unstable Middle East. It could be left trying to cope with higher oil prices and insecure supply for years to come.

On health care, the administration has given little indication that it will address the problem of double-digit increases in workers' premiums or take care of the 45 million Americans who are uninsured. The high cost of health care has global economic consequences for the United States: it disadvantages employers whose foreign counterparts operate in countries where governments foot the health care bill. The U.S. health care system is becoming a competitive liability and putting enormous pressure on wages and job security.

If the presidential campaign is any indication, Bush will also continue to neglect the potential long-term employment crisis stemming from increased productivity and outsourcing. He will likely discount the significance of millions of skilled Asian workers, paid about ten percent of a U.S. wage, who are coming on the world market—possibly the most important and disruptive development in the global economy in the first quarter of this century. As in the past, Bush is likely to trust the marketplace to force the necessary adjustments on U.S. industry and workers. In the long term, the president may be right—but at what human cost? And at what cost to the political support for more open trade with the rest of the world?

Also in the category of human capital, Bush is unlikely to rethink fundamentally the post-September 11 policies that are keeping some of the world's great talent from entering or remaining in the United States. Restrictions on visas have been negatively affecting everyone from highly accomplished foreign engineers to some of the world's brightest non-American students. Over time, the cost to the United States will be huge.

Finally, the United States has harmed itself and others by giving short shrift to global economic institutions and multilateral foreign

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Washington has turned its back on half a century of multilateral economic leadership.



assistance programs, thus turning its back on half a century of multi-lateral leadership. The United States and the world have benefited from the way the World Trade Organization (WTO) has handled explosive trade disputes and the way the World Health Organization has dealt with global epidemics. Washington and others gained when the International Monetary Fund helped Brazil avoid a major financial crisis a few years ago and when the World Bank played an effective role in the reconstruction of Bosnia. The United States would also benefit from more, rather than less, international regulation in such areas as accounting standards, corporate governance, international migration, and the safety of trade in food and pharmaceuticals. Moreover, the United States will need a strong international economic framework as an enlarged European Union and countries such as China acquire greater weight in the world economy.

#### SECOND-TERM OPPORTUNITIES

GIVEN THAT the landscape of policies for 2005 is more or less set, the biggest opportunities for making progress in the international economic sphere may come not from dealing with any one issue but from creating more effective forums for analysis and decision-making. These forums should be designed to widen the frame of reference for what goes into decisions and to inject some more long-term perspective into the decisions themselves.

In its first term, the Bush administration was weak when it came to the formulation of international economic policy. Of course, it had a National Security Council (NSC) and a National Economic Council (NEC), both of which were supposed to coordinate a wide range of policies. But in practice, these mechanisms do not appear to have been very effective when it came to integrating foreign policy and economic policy. There were no clear administration leaders, as Treasury Secretary James Baker was in the second Reagan administration. There were no powerful White House economic coordinators, as Robert Rubin was when he headed up President Clinton's NEC. The usually powerful lead agency, the Treasury, appeared weak. The State Department often seemed cut out of decision-making. There was little coordination among the broader set of departments—Agriculture,

Commerce, Homeland Security, Justice, and Labor—that have real interests and important views to contribute when it comes to the global economy.

In its second term, the Bush administration could and should do much better on coordination, given the blurring of lines between foreign and domestic policy and the importance of having geopolitics and geoeconomics reinforce one another. Without a strong coordinating mechanism, big decisions are unlikely to take into account all the right information, analysis, and judgments, because they are more apt to be made by a few people in the back room reflecting narrow interests. This situation also makes it difficult to devise strategies that endure. Moreover, whether the United States is pressing countries to allow genetically modified foods, to change their approach to the protection of intellectual property, or to clamp down on money laundering, the need for Washington to better coordinate foreign policy and economic policy is growing every day.

Ideally, the NSC should be reorganized to incorporate a substantial staff that deals with international economic issues, reporting to an NSC economic deputy. An alternative is an NEC that not only includes most of the cabinet agencies, but is also headed by a powerful director who is close to the president and who has clout on a par with the director of the NSC. Either would work, and either would be better than what is in place now.

Beyond that, Washington must reorganize the global economic management system, such as it is. There was a time when the G-8 group of highly industrialized nations plus Russia might have been the “ruling directorate” for the world economy. But the group is now widely seen as ineffective, and its annual heads-of-state meeting has become little more than a media extravaganza for whichever country is the host.

Of course, the world economy cannot be governed like a global organization, a hierarchy with clear lines of authority and chains of command. But a carefully selected group of nations must set an agenda for the future and mobilize resources to implement that agenda. This group should give guidance to the growing array of international economic institutions and react to episodic crises. If it is to have credibility, this group ought to reflect the distribution of power and interests in the world.

No such group exists today. Canada and Italy are part of the G-8, but China, India, and Brazil are not. The G-8 includes no country that even purports to represent the Islamic world or the continent of Africa. With the rise of big emerging markets and the increasing clout they are showing in trade negotiations and global finance, and with the growing importance of recognizing diverse cultures, the time is ripe to move toward a broader membership. Politically, it would not be easy to do. But it would be nowhere near as difficult as reorganizing the UN Security Council, which, unlike the G-8, is bound by a legal charter. The initiative could come from the United

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The longer Bush neglects international economic policy, the more difficult the challenges will become.

States as early as the upcoming G-8 summit this summer—which means that the diplomacy to get there should begin now.

What would this enlarged and more representative body achieve for the United States? At a time when the Bush administration has been seen as caring primarily about combating terrorism, Washington's move to create a more effective forum for global economic

growth and development would signal serious broader interest in the world. At a time when the administration has been accused of being suspicious of multilateral structures, this would be a chance to change at least part of that perception. By supporting membership for countries such as China, Brazil, India, South Africa, and Turkey, the administration would be demonstrating an understanding of some of the big changes sweeping over the world that it has been neglecting.

There is a critical agenda for an enlarged group to advance. What reforms or new directions for institutions such as the World Bank are required to enhance the global development effort? How should the work of the WTO be integrated with considerations of environmental protection, labor standards, and human rights? What can be done to make more progress toward the UN Millennium Development Goals for 2015? What economic transformations can propel the Middle East into the twenty-first century with a modicum of hope for the millions who now live in utter despair?

Another initiative that could pay large dividends would be for President Bush to open up channels to a wide variety of leaders outside

the administration who could have powerful influence on America's role in the world for years to come. Not only would the president benefit enormously from listening to a more diverse range of opinion, but there are also many challenges that the United States faces in the world economy that go well beyond the capacity of this administration, or any other, to deal with on its own. Moreover, there are a number of big issues, some of which have been referred to in this article, that cry out for discussion but that have so far been ignored by U.S. leaders. As a result, the political foundations for some of the most important U.S. policies are based on far less systematic thought than they should be.

It would be a statesmanlike act for President Bush to convene informal discussions on these issues by senators, members of Congress, governors, mayors, generals, executives, scientists, academics, and leaders of foundations and other nonprofit organizations. True, the president does not have a reputation for reaching out in this way, but it just could be that in a second term, with his last election behind him, he would mount more of an effort to get the best out of the best.

Suppose such a group met at Camp David on occasional weekends. An issue to start the discussions could be the crucial challenges of globalization facing the United States in the decades ahead. The consensus on the costs and benefits of globalization is more fragile than it has been in a long time. How should U.S. leaders deal with this? Will the the United States be able to compete with skilled and relatively inexpensive workers in China and India without either a major reduction in its real average wage or large-scale unemployment? To what degree does the United States need a new kind of social safety net? What would it look like, and how would it be financed? Where does the president's vision for an "ownership society" fit into that? And how can Americans be properly educated to understand this new world in which change and disruption come so quickly and so painfully to so many?

Building bridges to a broader leadership group could begin the process of clarifying where the United States ought to be heading in the global economy in the first quarter of this century. It might also help to heal the political divide that has been widening in this country since the Clinton administration.

MOVING QUICKLY

THE BUSH ADMINISTRATION has very little time if it is to change the pattern of its first term and devote adequate attention to international economic policy. Certain dynamics characterize the second term of any administration. There is significant turnover of the best people, fatigue among those who stay, and, after the midterm election, a wholesale exodus of more talent. In addition, global economic issues could soon be crowded out by both a pressing foreign policy agenda (Iraq, Iran, North Korea, the Israeli-Palestinian conflict) and a set of high-profile domestic initiatives (Social Security reform, tax reform, Supreme Court nominations).

At the same time, the currents of globalization are moving fast, and the longer the administration subordinates international economic policy, the more difficult the subsequent challenges will become. For example, global financial markets are growing at exponential rates, and the risks inherent in them are becoming infinitely more difficult for policymakers to understand. Between April 2001 and April 2004, daily global turnover in traditional foreign exchange markets increased 57 percent to \$1.9 trillion, while the daily turnover of complex derivatives grew by 77 percent to \$1.2 trillion.

The rise of China and India, the problem of Europe's competitiveness, the unrest in Islamic society around the world, the imminence of aging as a major global issue, the growth of complex corporate supply chains that straddle the globe, the spread of infectious diseases across borders—these are just some of the other trends that accelerated during the first Bush administration. At some point, the absence of an involvement commensurate with U.S. power and U.S. interests will take its toll on the United States and the world. If the Bush administration recognizes what the global economy is about, if it understands the links to foreign and domestic policy, if it cares enough about the United States' long-term foreign policy and economic interests, then it will move quickly to change its pattern of neglect. 🌐