Statement of
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Before the Committee on Armed Services
U.S. House of Representatives
Washington, DC
March 11, 2009

Mr. Chairman:

Thank you for this opportunity to testify before the House Committee on Armed Services on security challenges arising from the global financial crisis.

Let me first commend you and your colleagues for holding this hearing. Most of the analysis and commentary on the global economic crisis has focused on the economic consequences. This is understandable, but it is not sufficient. The world does not consist of stovepipes, and what happens in the economic realm affects political and strategic policies and realities alike.

It is also important to say at the outset that this crisis, which began in the housing sector in the United States, is now more than a financial crisis. It is a full-fledged economic crisis. It is also more than an American crisis. It is truly global.

I would add, too, that the crisis is unlike any challenge we have seen in the past. It is qualitatively different than the sort of cyclical downturn that capitalism produces periodically. This crisis promises to be one of great depth, duration, and consequence.

This crisis was not inevitable. It was the result of flawed policies, poor decisions, and questionable behavior. It is important that this point be fully understood lest the conclusion be widely drawn that market economies are to be avoided. The problem lies with the practice of capitalism, not the model. Nevertheless, the perception is otherwise, and one consequence of the economic crisis is that market economies have lost much of their luster and the United States has lost much of its credibility in this realm. It is inconceivable in these circumstances to imagine an American official preaching the virtues of the Washington Consensus. This is unfortunate, as open economies continue to have more to offer the developing world than the alternatives. It also adds to the importance that the U.S. economy get back on track lest a lasting casualty of the crisis be modern capitalism itself.

The impact of the economic crisis will be varied and go far beyond the image of capitalism and the reputation of the United States. Director of National Intelligence Dennis Blair was all too correct when he testified recently that the primary near-term security concern of the United States is the global economic crisis and its geopolitical implications. The crisis will have impact on conditions within states, on the policies of states, on relations between states, and on the thinking of those who run states. I have already alluded to this last

[1] These views are my own and not those of the Council on Foreign Relations, which takes no institutional position on matters of public policy.

consideration. Here I would only add that initial reactions around the world to the crisis appear to have evolved, from some initial gloating at America's expense to resentment of the United States for having spawned this crisis to, increasingly, hopes that the American recovery arrives sooner and proves to be more robust than is predicted. This change of heart is not due to any change of thinking about the United States but rather to increased understanding that the recovery of others will to a significant extent depend on recovery in the United States. In a global world, what happens here affects developments elsewhere and vice versa. Decoupling in either direction is rarely a serious possibility.

The crisis is clearly affecting the developed world, mostly as a result of the centrality of banking-related problems and the high degree of integration that exists among the economies of the developed world. Iceland's government has fallen; others may over time. Many governments (including several in Central and Eastern Europe but outside the Eurozone) will require substantial loans. The economies of Japan, much of Europe, and the United States are all contracting. World economic growth, which averaged 4 to 5 percent over the past decade, will be anemic this year even if it manages to be positive, which is increasingly unlikely. It is worth noting that the most recent World Bank projection predicts negative growth for 2009.

Change of this sort will have consequences. There will likely be fewer resources available for defense and foreign assistance. Reduced availability of resources for defense makes it even more critical that U.S. planners determine priorities. Preparing to fight a large-scale conventional war is arguably not the highest priority given the enormous gap between the relevant military capabilities of the United States and others and the greater likelihood that security-related challenges will come from terrorism and asymmetric warfare. State-capacity building, the sort of activity the United States is doing in Iraq, Afghanistan, and Pakistan, will continue to place a heavy burden on U.S. military and civilian assets. Also remaining highly relevant (and deserving to be a funding priority) will be standoff capabilities designed to destroy targets associated with terrorism and weapons of mass destruction.

Developing states may appear to be better off than wealthier countries at first glance. Their growth on average is down by half from previous years, but still positive. Appearances, however, can be deceptive. This growth is measured from a low base in absolute and relative terms. The reduction in growth in some instances has been dramatic. Developing country exports are down as demand is down in the developed world. Also reduced are aid flows and most importantly investment flows to the developing world. Commodity prices are much lower, a boon to those who rely on imports but a major problem for the many who are dependent on the income from one or two exports.

A few countries merit specific mention. One is China. China's economic success over the past few decades constitutes one of history's great examples of poverty eradication. This process, one that has involved the migration of millions of people every year from poor rural areas to cities, will slow considerably. The already large number of domestic political protests in China over such issues as land confiscation, corruption, environmental degradation, and public health, is likely to grow. Absent renewed robust economic growth, the chances are high that the government will react by clamping down even more on the population lest economic frustration lead to meaningful political unrest.

Russia is in a different position, one characteristic of countries dependent on raw material exports for much of their wealth. The Russian economy is contracting after a period of boom. As is the case with China, this suggests the likely assertion of greater political control. But Russia is not as fully integrated as China is with the world economy. There is thus a greater (although impossible to quantify) chance that Russia's leaders will turn to the time-honored resort of manufacturing an overseas crisis to divert attention than will China's.

The same holds true for Iran and Venezuela, two countries that are heavily reliant on energy exports and whose foreign policies have been counterproductive (to say the least) from the U.S. perspective. But at the same time, it is possible that one or both will pull in their horns. Venezuela is already showing some signs of this, with its more welcoming stance toward international oil companies. This may well be simply a tactical adjustment to immediate needs. And at least in principle, Iran's government might find it more difficult to make the case to its own people for its continued pursuit of a nuclear weapons option if the Iranian people understood that it was costing them dearly with respect to their standard of living.

Iraq is another oil producing country whose wealth is closely associated with the price of oil. Here the effects are sure to be unwanted. There is the danger that disorder will increase as unemployment rises, prospects for sharing revenue shrink, and the ability of the central government to dispense cash to build broad national support diminishes. In light of the multiple challenges already facing the United States, the last thing the Obama administration needs is the specter of an unravelling Iraq.

Two other countries are worth highlighting. One is Pakistan. Pakistan's economic performance is down sharply for many reasons, including a decrease in both foreign investment in the country and exports from Pakistan to other countries. Pakistan has little margin for error; the possibility that it could fail is all too real. The worsened economic situation makes governing all that much more difficult. The consequences of a failed Pakistan for the global struggle against terrorism, for attempts to prevent further nuclear proliferation, for the effort to promote stability in Afghanistan, and for India's future are difficult to exaggerate. North Korea is a second nuclear-armed state whose stability is worsened by the economic crisis. At issue is the extent to which South Korea (along with China and Japan) can provide resources to the North to help stave off collapse.

Another serious consequence of the global economic crisis, one that affects both developed and developing countries, is the reality that protectionism is on the rise. One realm is trade; some seventeen of the twenty governments set to meet in London early next month have increased barriers to trade since they met late last year. Negotiated free trade agreements with Colombia, Panama, and South Korea continue to languish in the U.S. Congress. The president lacks the Trade Promotion Authority essential for the negotiation of complex, multilateral trade accords. Prospects for a Doha round global trade pact appear remote. The volume of world trade is down for the first time in decades.

The economic but also strategic costs of this trend are high. Trade is a major source of political as well as economic integration; one reason China acts as responsibly as it does in the political sphere is because of its need to export its products lest potentially destabilizing unemployment jump sharply. Trade has other virtues as well. More than anything else, trade is a principal engine of global economic growth. The completion of the Doha round might be worth as much as $500 billion to the world in expanded economic activity. One-fourth of this expanded output would occur in the United States. This is the purest form of stimulus. For the United States, exports are a source of millions of relatively high-paying jobs; imports are anti-inflationary and spur innovation. Alas, the economic crisis will make it difficult if not impossible to conclude new trade pacts and to gain the requisite domestic support for them. Economic nationalism is on the rise, and when this happens, the will and the ability of political leaders to support policies that are perceived to hurt large numbers of their citizens (but which in reality help many more) invariably goes down. What is more, the economic crisis may also make it more difficult to reach agreement on a global climate change pact when representatives of most of the world's countries gather in Copenhagen late this year. Developed and developing countries alike will resist commitments that appear to or in fact do sacrifice near-term economic growth for long-term environmental benefit.

What, then, should be done to limit the adverse strategic effects of an economic crisis that is certain to get worse and persist for some time?

The United States – the Obama administration and the Congress – should resist protectionism. "Buy America" provisions in the stimulus legislation will increase costs to American consumers and all but make certain that other countries will follow suit, thereby reducing the prospects for American firms to sell abroad. More American jobs are likely to be sacrificed than preserved. Increased protectionism will also dilute the strategic benefits that stem from trade and its ability to contribute to international stability by giving governments a stake in stability. Similar arguments hold as to why "lend national" provisions are counterproductive. Bringing countries into the world trading system (best done through WTO accession) makes strategic sense, too, as it gives them a stake in maintaining order at the same time it opens government decision-making to greater degrees of transparency.

Recession cannot become this country's energy policy or a reason not to decrease U.S. consumption of oil, imported or otherwise. Lower prices will dilute any economic incentive to consume less oil. Regulatory policy will be the principal means of discouraging demand and encouraging the development of alternative energy sources and technologies. Reduced demand is essential for strategic reasons (so as not to leave the United States highly dependent on imports and so that countries such as Russia, Venezuela, and Iran do not benefit from dollar inflows), for environmental reasons, and for economic reasons, i.e., not to increase the U.S. balance of payments deficit. The goal should be to use this moment of temporarily-reduced prices to decrease the chances we as a country again find ourselves in a world of high energy prices once the recession recedes.

The United States should work with other developed and reserve-rich countries to increase the capacity of the IMF to assist governments in need of temporary loans. Current capacity falls short of what is and will be needed.

It would be helpful if aid budgets were not victims of the economic crisis. Aid is needed on a large scale not just for humanitarian reasons (to fight disease, etc.) but also to build the human capital that is the foundation of economic development. Aid will also be a necessary substitute in the short and medium run for investment. Absent such flows we are likely to see greater misery and an increased number of failing or failed states.

The upcoming G-20 summit in London provides an opportunity to adopt or encourage some useful measures in many of these realms. It is essential that others, including Europe and Japan, take steps to stimulate their economies. It is equally important, though, that guidelines be promulgated so that stimulus programs do not become a convenient mechanism for unwarranted subsidies and "buy national" provisions that are simply protectionist measures by another name. The London meeting is also an opportunity to increase IMF capacity, to generate commitments to provide aid to developing countries, and to agree on at least some regulatory principles for national banking and financial systems. There is not time, however, to try to rebuild the architecture of the international economic system, solve the problems caused by countries that run chronic surpluses, or revamp the system of exchange rates.

Let me close with two final thoughts. Much of this hearing and statement is focused on the question of the consequences of the economic crisis for global security. But it is important to keep in mind that the relationship is not only one way. Developments in the political world can and will have an effect on the global economy. Imagine for a second the economic consequences of, say, a Taiwan crisis or fighting between India and Pakistan or an armed confrontation with Iran over its nuclear ambitions. This last possibility is the most worrying in the near term and underscores the importance of trying to negotiate limits on Iran's enrichment program lest the United States be confronted with the unsavory option of either living with an Iranian near or actual nuclear weapons capability or mounting a preventive military strike that, whatever it accomplished, would be sure to trigger a wider crisis that could well lead to energy prices several times their current level.

Finally, getting through this economic crisis should not be confused with restoring prolonged calm in the markets or sustainable growth. Enormous stimulus measures here at home coupled with equally unprecedented increases in the current account deficit and national debt make it all but certain that down the road the United States will confront not just renewed inflation but quite possibly a dollar crisis as well. At some point central banks and other holders of dollars will have secnd thoughts about continuing to add to their dollar holdings, currently larger than ever given the desire for a safe harbor. Ongoing U.S. requirements for debt financing, however, will likely mean that interest rates would need to be raised, something that could choke off a recovery. This underscores the importance of limiting stimulus packages to what is truly essential to reviving economic activity and to taking other measures (such as entitlement reform and the already discussed steps to reduce oil use) lest the current crisis give way to another one.

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