



# BACKGROUND

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## Finance and National Security: Five Fundamental Facts

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As Washington prepares a \$1 trillion bailout for shaky financial institutions on Wall Street, many Americans are worried about repercussions on Main Street. High unemployment and home foreclosures already have Americans up at night. The financial meltdown is not helping the insomnia. However, what too many American policymakers fail to realize is that our financial health is not merely a question of economic prosperity. It is a question of national security. The United States remains an economic powerhouse with plenty of financial cards to play, but in order to stay ahead of the competition we must first understand what international finance looks like in the 21<sup>st</sup> century. Here are five fundamental facts about the intersection of finance and foreign affairs that will help us achieve that understanding.

**1.) Setting the Stage: Skyrocketing Debt Under the Bush Administration.** When George W. Bush took office in 2001, U.S. debt stood at \$5.6 trillion dollars, and was shrinking. He has since raised the official debt limit at least a half dozen times. If he succeeds at raising the ceiling once again to make room for his bailout plan, U.S. debt will have approximately doubled since he took office, from \$5.6 trillion to \$11.3 trillion. Federal debt as a percentage of GDP has jumped from 58% in 2000 to 65.5% in 2007. To put that number in everyday terms, U.S. government debt has reached the staggering total of nearly \$455,000 per American household. Nor will our new debt produce a clear return on investment. While going into debt to bolster infrastructure, education, or research and development can produce tangible benefits in the near

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future, neither the \$1 trillion debt created by the Wall Street bailout nor the \$800 billion debt created by the wars in Iraq and Afghanistan will have a similar financial reward down the road.

As debt has grown, the United States has become increasingly reliant on foreign countries – including China, Russia, and Middle East oil producers – to finance the U.S. government. In other words, thanks to the reckless borrow-and-spend policies of recent years, we are no longer master of our own house. The keys to America’s financial future are now held by foreign central banks of China, Japan, Russia and other countries. This is the source of the financial challenges we now face.

**2.) The Rise of Government Investors: Sovereign Wealth Funds.** A sovereign wealth fund (SWF) is a state-owned investment fund. Although SWFs have existed for decades, they have grown substantially in recent years, and are estimated to control about \$3 trillion worth of assets worldwide. On the positive side, SWFs are excellent sources of cash that have contributed to global growth and stability. By purchasing assets that had recently lost value,

SWFs helped shore up the U.S. economy during the mortgage crisis and the collapse of Bear Stearns in early 2008. SWFs in authoritarian countries – such as China, Singapore, and Kuwait – may even increase accountability, transparency, and democratization, as citizens demand their governments spend their money wisely.

However, unlike private-owned investment funds, SWFs are controlled by governments that may have political motivations. Critics fear that SWFs controlled by countries such as China and Russia will use their investment funds to gain economic and political leverage over the United States. Although the potential for financial mischief certainly exists, the threat should not be overestimated. A given SWF would have to invest tremendous resources into crucial U.S. industries simultaneously to give itself serious leverage over the United States – an unlikely scenario indeed. The task for U.S. policymakers is to remain vigilant in preventing SWFs from investing too heavily in critical sectors of the U.S. economy, while avoiding alarmist policies that discourage legitimate activities and prevent SWFs from investing to create a stronger U.S. economy. The U.S. Committee on Foreign Investments in the United States (CFIUS) and the Foreign Investment and National Security Act of 2007 (FINSA) already provide a rigorous review process for evaluating investments by foreign governments. Unless antagonistic SWFs begin causing financial mischief, which has not occurred yet, CFIUS/FINSA should be more than enough to keep America safe.

### 3.) Controlling Currency: Central Bank Reserves.

For all the well-publicized fears of SWFs, which control about \$3 trillion worth of assets, government-owned central bank reserves exceed \$7 trillion. Through central bank reserves, savvy governments have the power to affect currency markets in significant ways. China is a prime example. China's central bank has financed American debt by purchasing nearly \$500 billion worth of U.S. Treasury securities. This artificially depreciates Chinese currency relative to the dollar, making Chinese exports more competitive and leaving U.S. exports less competitive. It also hamstring U.S. foreign policy. If we challenge Chinese interests or criticize Chinese behavior, China can threaten to sell off or quit purchasing U.S. assets, which could wreak financial havoc in the U.S. economy. The current bailout plan, which will clock in at about \$1 trillion, deepens the deep hole we are already in. The \$1 trillion will be raised by selling U.S. securities, many of which will be purchased by foreign countries such as China. Our diplomatic clout is thus \$1 trillion weaker.

Many economists argue China is unlikely to take any such action, because dumping U.S. dollars would negatively impact the Chinese economy. Often described as the “nuclear option,” China could cause tremendous pain in the United States by ridding itself of dollars, but it would also cause such pain in China that Chinese leaders would be loath to go through with it. Yet this argument ignores the array of options that exist between the status quo and the nuclear option. If the U.S. decides to push China on human rights, China only needs to threaten to sell off a small percentage of its dollar holdings to force foreign policymakers in the United States to change their tune. Moreover, for some issues—such as the status of Taiwan—the Chinese government might be willing to accept a significant degree of pain to achieve its objectives. The degree of leverage China has over U.S. foreign policy may be unclear, but the leverage exists. To diffuse the threat, American policymakers must continue trying to persuade China that appreciating its own currency is in its own best interest. Americans must also make a fundamental choice. If we continue to finance our wars and our entitlements programs through borrowing, foreign governments will continue to develop leverage against the United States. If we are unwilling to accept such leverage, we must either pay for our wars and entitlements ourselves, or learn to spend less and expect less from our government.

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**4.) The Marriage of Profit and Politics: State-Owned Enterprises.** When governments own corporations, corporations can work for political influence as well as profit. Russia's Gazprom is a perfect model for how a profit seeking company can also exercise political power. After securing a majority stake in Gazprom in 2005, the Russian government has frequently wielded the “energy weapon” in its relations with European countries. For example, Gazprom abruptly halted shipments of natural gas to Ukraine in 2006. Although Gazprom cited a pricing dispute as the rationale, the “Orange Revolution” in 2005 brought a pro-Western government to power that sought to move Ukraine out of Russia's sphere of influence. The natural gas cutoff is seen by many as Russia's punishment for Ukrainian impunity.

The repercussions of the cutoff, however, went beyond Ukraine. The European continent as a whole rely on Russia for 25% of its natural gas, and 80% of the natural gas Europe acquires from Russia crosses through Ukraine. Halting the flow of natural gas to Ukraine caused energy shortages throughout Europe, effectively punishing the entire continent for Russia's disagreement with Ukraine. In mid-2008, one day after the United States and the Czech Republic signed a pact for the development of a missile defense shield in Eastern Europe, Russia halted oil deliveries to the Czech Republic. Although Russia's action did not deter the Czech government from following through on its commitment, there's no guarantee that other countries will be cowed by Russian threats in the future.

Gazprom is a potent foreign policy weapon for Russia because it threatens to throw a wrench in relations between Europe and the United States. When Russia and the United States disagree, Europe's ability to side with the U.S. is limited by its Russian-supplied energy needs. U.S. policymakers must pay close attention to the development of state-owned enterprises, and ensure that crucial sectors in the U.S. economy do not become as dependent on state-run companies as Europe is on Gazprom. Working to help our allies in Europe and elsewhere break their dependence on hostile government-owned businesses must also become a foreign policy priority.

**5.) Competing for Creativity: Threats and Opportunities in Finance.** China has begun offering loans with "no strings attached" to developing countries, allowing them to sidestep the conditionality of loans provided by Western institutions and ignore human rights issues or the importance of development. Venezuela is using its oil wealth to refinance other countries' debt to the International Monetary Fund, buying friends at the expense of the U.S. and Europe. These are both demonstrations of public actors using financial tools in creative ways to win hearts, convince minds, and influence countries. China and Venezuela illustrate how the financialization of foreign policy can undercut U.S. policy goals. Boggled down in Iraq and Afghanistan, the United States has failed to counter new finance threats, just as it has failed to capitalize on new finance opportunities. U.S. leaders should work to reverse that trend in the years to come.

### **Panic Not**

America's financial challenges will not disappear overnight; neither will America's economic power. Central reserve banks and state-owned corporations may give other governments new policy tools, but their influence

remains at the margins of U.S. foreign policy. To date, they have been powerless to thwart America's major foreign policy initiatives. With proper vigilance, there is no reason why that should change.

Yet vigilance comes only after awareness. U.S. leaders have not been quick to recognize the new connections between finance and national security, and consequently have failed to act. Although the United States remains strong economically, our recent fiscal policies have given foreign countries unprecedented influence over the U.S. government. To keep America prosperous and safe from foreign meddling, we must learn from the mistakes of the past. No nation can remain powerful without deep pockets and a robust economy, as military power starts with economic strength. As General David Petraeus put it, "money is ammunition." Borrowing money from foreign governments puts ammunition in the wrong hands. The time to reverse that trend is now.

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