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# Economic Shocks and Their Implications for International Politics

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# "Economic Shocks and Their Implications for International Politics"

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Abstract

The possible shocks posing the greatest risk for the world economy as of March 2012 include a worsening of the sovereign debt crisis in the Mediterranean members of the euro, contagion to innocent bystanders, a fiscal train-wreck in the United States inflicted by malfunctioning domestic politics, a new oil price shock coming from conflict with Iran, and a hard landing in some emerging markets. This paper offers a whirlwind tour of historical precedents for these possibilities and other shocks as well: (1) financial crises (including sudden stops in the flow of capital to emerging markets, banking/real estate/equity crashes, and sovereign debt crises); (2) episodes currency instability, (3) recessions, and (4) commodity shocks (including sudden increases in oil or food prices). Political causes and effects of the economic shocks are considered and the connections with longer term trends such as the rise and fall of powers. Getting domestic policies right can often do more for a country's international standing than the application of military power. This includes loyalty to one's own ideals, responsible fiscal policy, anticipation of possible shocks, and competent responses to new developments. The record so far this century is not good.

“Economic Shocks and Their Implications for International Politics”

In economists’ lexicon, “shocks” are by definition unpredictable. One can attempt, however, to study past shocks as a guide to future risks, to generalize regarding some of the longer term trends that have been signposted by these economic or financial crises, and to consider implications of the causal interplay of major economic and geopolitical factors for international strategy.

During the five-year period 2003-2007, global perceptions of risk were unusually low, at least as reflected in market pricing of sovereign debt, corporate debt, and options. These perceptions were wrong[1], as the ensuing five years, 2007-2011, have abundantly illustrated. Today, in 2012, nobody doubts that the world faces many possible serious economic and political risks.

Economic shocks come in various forms. This paper offers a catalog of them, with major historical examples, including discussion of how these economic shocks interact with political causes and effects. The list features four categories of economic shocks: (1) financial crises, including sudden stops in the flow of capital to emerging markets, banking/real estate/equity crashes, and sovereign debt crises; (2) episodes of inflation and currency depreciation, (3) recessions, and (4) commodity shocks, including sudden changes in oil prices and food prices. The paper then concludes by considering three major risks facing the world economy as of 2012 and attempting to draw conclusions for the strategy that United States or other major powers should pursue.

## 1. Financial crises

We begin with crises in financial markets.

### 1.1 Sudden stops in capital flows to emerging markets

Crises in lending to developing regions go back to the 19th century, and further. Financial difficulties of the Egyptian Khedive associated with Suez Canal debts, for example, led British forces to occupy the country in 1882. This in turn kicked off the scramble among the European powers to colonize the rest of Africa, which could be described in strategic terms as a shift to a non-cooperative equilibrium.

The last 40 years have seen several cycles of boom and bust in capital flows to developing countries. The first of three big waves began after the 1973 oil shocks and is often described as originating in the “recycling petrodollars” from OPEC countries, via banks in London. It ended abruptly in 1982 with the international debt crisis that

[1] One reason why financial markets systematically under-estimated risk during this period is that, in line with rational expectations methodology, volatilities were based on statistical observation of the recent past (the period of the “Great Moderation”), and in a small set of advanced countries. Tail-risk events such as a decline in US housing prices or insolvency in a euro member country need not have arrived as unpredictable “black swans,” but could have been assigned non-negligible probabilities if the data net had been cast wider across countries and across time.

surfaced first in Mexico and then spread rapidly to the rest of Latin America. The second wave of capital flows began around 1990, was associated with the phrase "emerging markets," took the form of securities transactions rather than just bank loans, and included a wider variety of geographic destinations. Many of the recipient countries were responding to the collapse of the Soviet economic model by newly undertaking liberalization, privatization and opening. This second wave also came to a sudden end with the East Asia crisis, beginning in Thailand in June 1997. One currency after another fell victim to sudden stops in capital inflows. This time, contagion was not confined to a single geographic region but easily jumped oceans, for example from Russia to Brazil in August 1998. The last of the major currencies to fall belonged to Turkey in 2001 and Argentina in 2002. The third wave of capital inflows began around 2003. It was associated with the "carry trade" but now also included the giants China and India.

There is no shortage of examples of domestic political factors among the causes of these crises. The sudden loss of enthusiasm for Mexican bonds on the part of international investors in 1994, which eventually ended with the peso crisis in December, began early in the year with an uprising in Chiapas and the assassination of the leading presidential candidate Luis Donaldo Colosio. The existence of the sexennial election in Mexico in 1994 may itself have contributed to capital outflows, as investors had by then come to expect an election-year pattern of monetary and fiscal expansion, followed by devaluation and inflation (1976, 1982, and 1988). The timing of elections in Korea in 1997 and Brazil in 1998 also seems to have driven the timing of currency crashes in those countries, as speculators shifted out of the domestic currency in anticipation of post-election devaluations.

Causality also runs the other direction, from currency crises to political change. Sometimes crisis becomes the opportunity to dislodge entrenched autocrats and oligarchs. During the international debt crisis of the 1980s, observers initially feared that prolonged economic austerity in Latin America might set back popular support for social and political reform. What happened after 1982 was the opposite: Almost everywhere in Latin America, the movement toward liberalization and democracy accelerated. To take another example, Indonesian President Suharto had survived political challenges, regional revolts, and environmental disasters, only to see his 32-year rule terminated in 1998 by a currency crisis. Adding to the humiliation was the role played by the International Monetary Fund. Asians to this day have not forgotten or forgiven the photo that was snapped of IMF Managing Director Michel Camdessus standing with crossed arms as Suharto signed the necessary Letter of Intent. But at least the result was progress toward democracy.[2]

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[2] More broadly, part of the rationale behind the creation and longstanding support for the International Financial Institutions (IMF and World Bank) by the United States and others is to help countries that move gradually in the direction of liberalization. Of course economic liberalization and political liberalization are two different things, as Chile under Pinochet or China under Deng memorably illustrated. But the overall lesson, for example from Korea and Taiwan in the 1980s, seems to be that in most cases the achievement of economic success through capitalism eventually leads to democracy. (Zakaria, 2004, argues convincingly that the details of western style democracy should be lower priority in some countries than basic principles such as a free press, human rights and inclusiveness.)

Crisis need not always lead to liberalization of course. The Russian rouble crisis in the same year, which included both devaluation and default, helped bring Vladimir Putin to power in Moscow. This time economic turmoil worked to create political support for strong national leadership, rather than for democracy. Argentina ran through five presidents during the tumultuous years of its currency crisis (1999-2003) and emerged more Peronist than before. Moreover, the severity of the Argentine crisis -- in a country that had done so much over the preceding ten years to adopt the "Washington consensus" model -- substantially slowed down or even reversed the momentum for economic reform in some parts of South America.

### 1.2 Banking/real estate/equity crises

A country does not need to be an international debtor to have a financial crisis. Crashes in domestic stock markets, real estate or banking, or (often) a combination of the three can take place without the presence of international investors. Big bubbles and crashes seem almost a rite of passage for the arrival of a new global economic power. The Dutch tulip mania crashed in 1637 and England's South Seas bubble crashed in 1720. The US stock market crashed in 1929.

Japan's turn came when the equity and real estate bubble of 1987-89 ended in 1990, followed by two decades of economic stagnation. In this case the economic shock marked the end of its ascent as a power that was supposedly due to challenge the United States for global hegemony, rather than the beginning. In reality, even if that financial crisis had been avoided or had been better handled, Japan was in fact never fated to rival the United States in terms of either economic size or power. A substantial slowdown in the growth rate of GDP was inevitable, as Japan's per capita income converged on that of the global frontier and as its population began to decline. But the convergence took the form of a hard landing rather than a soft landing. In any case, the economic crisis in Japan effectively ended the notion that the country had found a superior model of capitalism that others should follow.

Another housing bubble burst in the US in 2006, leading to the sub-prime mortgage crisis of 2007, global financial crisis of 2008 and global recession of 2009. Capping a decade of other unfortunate mis-steps in American policy, both at home and abroad, the crisis undermined the attractiveness of the "American model," in much the way that the Japanese model had lost its attractions in the preceding decade.

The newly arrived great economic power is China, which has accomplished the historic miracle of growing at approximately 10 per cent a year for three decades and is now the world's second biggest economy. The Chinese economy had become overheated by mid-2011, with inflation rising and real estate appreciation reaching bubble status. The question has become whether it is now due for a hard landing, possibly from a housing/banking crash, like other newly arrived powers before it. Steps to cool off the economy, including tightening by the monetary authorities, may have been enough to achieve a soft landing. But China remains vulnerable to big further increases in prices of oil and other raw materials.

### 1.3 Sovereign debt crises in 2010-2012

The greatest single risk facing the world economy in 2012 is the sovereign debt crisis in the euro periphery and the chance that it will spread to other countries. The original primary motivation behind European economic and monetary integration was political, to rule out any future wars in the heart of the continent. Moreover, some expected that the bold establishment of the euro in 1999, a monetary union that has expanded to include 17 European countries, would achieve a powerful bloc to rival the United States. Regardless how one evaluates the various pros and cons of the euro, there is no question that excessive debt and uncompetitiveness has left Greece in dire economic straits, with Portugal and some others not far behind. Leaders of the euro zone have made many mistakes. They could have treated to the eruption of the Greek crisis in late 2010 as a convenient opportunity to establish the right precedent for dealing with overindebtedness of a euromember, sending them to the IMF and if necessary restructuring the debt. Instead they reacted as ostriches with their heads in the sand, with the result that the debt problem got much worse over the next two years. The situation has improved at the time of writing, largely as the result of the appointment of some high-caliber technocrats in November 2011, so that Greece succeeded in rolling over its debt in March. Nevertheless, Greece's debt path remains unsustainable. The euro crisis will soon be back.

Contagion to banks and other countries, which euro leaders have so feared from the beginning of the Greek crisis, has already happened (especially to Ireland and Portugal in 2010). The front lines of the spreading sovereign debt crisis now run through Spain and Italy. The question is whether a renewal of troubles in the Mediterranean countries would spread, not just to Italy, but also France (which has recently been downgraded from AAA status by Standard and Poor's), and then to high-debt countries outside euroland.

Who would be most vulnerable to a new wave of turmoil in sovereign debt markets? In past decades, developing countries were always the most vulnerable to world financial conditions. When US interest rates rose sharply in the early 1980s or in 1994, assets in Latin America were impacted more severely than those in the United States itself. But an historic role reversal occurred subsequent to the currency crises of the late 1990s. Emerging markets took a variety of steps to make themselves less vulnerable to new shocks. The new policies included higher foreign exchange reserve holdings, more flexible exchange rates, less dollar-denominated composition of capital inflows and – perhaps most importantly and unprecedentedly – the wisdom to take advantage of the opportunity of the 2003-07 global boom by strengthening their budget balances and current account balances, even while most industrialized economies failed to do so. All these measures paid off in the global crisis of 2008-09, from which the developing world recovered rapidly.

Debt/GDP ratios among the largest advanced economies are now roughly double the ratios among the largest emerging market countries, and are still on an upward path. The past "debt intolerance" of developing countries, meaning a greater vulnerability to shocks even for the same level of debt, is much diminished. Today some developing countries (or formerly-developing countries) have higher credit ratings and can borrow at lower interest rates than some industrialized economies (or formerly-industrialized economies). Table 1 gives examples of current credit ratings, comparing the two categories of countries that now overlap. Such ratings have not earned a reputation as leading indicators. But the latest rankings confirm judgments of creditworthiness that would have been unimaginable 30 years ago, or in some cases even 15 years ago. France and the US now have a lower credit rating than Singapore; Japan has a lower credit rating than Chile, Spain has a lower credit rating than Korea or China, Italy has a lower rating than Malaysia, South Africa, Brazil, or Thailand; Iceland and Ireland have lower ratings than Colombia; Portugal has a lower rating than Indonesia or the Philippines; and Greece has a lower rating than anyone.

The implication is that the biggest vulnerabilities to sovereign debt shocks now lie not among emerging market countries, but among the advanced countries. Contagion from the euro crisis could hit the United Kingdom, Japan, or the United States, all three of which now have worrisome debt levels.

The United States is in a unique position. On the one hand, ever since the dollar overtook the British pound in the period 1914-1945, the United States has had the advantage of exorbitant privilege. Surprisingly, a 40-year trend of deficits and depreciation have done little to diminish the dollar's status as leading international currency and nothing to diminish the ability of the US Treasury to borrow at low interest rates. But this could change. Serious mistakes by American authorities, some of them in reaction to the terrorist attacks of September 11, 2001, have accelerated the decline in the US international standing (including aggressive increases in the structural budget deficit during the years 2003-07 and the occupation of Iraq). The imperial overstretch of which Paul Kennedy (1989) warned was premature, but could now come to pass. Dysfunctional government continues in Washington. In the summer of 2011, the needless standoff between the two political parties over debt ceiling legislation seemed to confirm that no self-correcting mechanisms were in place to constrain the damage that could be inflicted by reckless politicians. It led to the loss of the AAA rating on US debt for the first time, though so far there has been no diminution of global investors' willingness to hold US Treasury securities.

## 2 Instability in Currency Value

### 2.1 Hyperinflation

When a government has difficulty financing its spending, currency crash and default are not the only extreme outcomes that are possible. Another possible way that desperate episodes of excessive debt can end is hyperinflation. The 20$^{th}$ century saw three waves of hyperinflations, scattered among governments that had lost the ability to finance their spending but who retained control over a printing press. The first wave followed the end of World War I, another followed the end of the World War II, and a third (loosely speaking) followed the end of the Cold War. Perhaps the most famous of them all was Germany's hyperinflation of 1921-23. That hyperinflation is often attributed in part to the imposition on the vanquished side of reparation obligations that were greater than it could meet, and is often blamed in turn for undermining the democratic Weimar Republic.

There are no hyperinflations underway in the world today nor is there a substantial danger of one developing in a major country this decade.

### 2.2 Inflation and the value of the dollar

The 40-year trend in the value of the dollar has been downward. The classic dollar crisis came in the 1970s. President Lyndon Johnson in the 1960s increased spending rapidly on both the war in Vietnam and domestic programs, and was initially unwilling to raise taxes to pay for it (a pattern that President George W. Bush later repeated). The resulting budget deficits were accommodated by easy monetary policy and led to rising inflation, a declining trade balance, and a widening deficit in the overall balance of payments. The situation continued under President Richard Nixon, exacerbated by the Federal Reserve, and came to a head with the devaluations of the dollar in 1971 and 1973. In 1979, facing a renewed crisis in the value of the dollar in terms of both goods and foreign currency, President Jimmy Carter appointed Paul Volcker chairman, with the assignment of tightening monetary policy severely— supposedly anathema to liberals— in order to defeat inflation. Volcker duly accomplished the deed.

### 2.3 International currency status

Dollar crises such as those of the 1970s are mainly noteworthy for signaling the longer term trend. The US dollar has generally been on a gradual downward trend for forty years. This is true whether one focuses on the share of the dollar as an international currency (with the exception of the 1990s) or the foreign exchange value of the dollar (with the exception of 1980-85 and 1995-2000).

Predictions of twenty years ago that the mark or the yen could overtake the dollar as leading international currency proved completely wrong. Analogous predictions more recently for the euro or, currently, the renminbi are also, at a minimum, premature. Nevertheless, the dollar's international standing does appear to be on a long-term negative trend, even if the alternative turns out to be a multi-currency world rather than displacement by any single rival. A new view suggests that the loss of dollar primacy, when it comes, could happen suddenly.[3] Would the loss of dollar dominance imply a loss of US political hegemony?

The decline in the pound during the first half of the 20th century was clearly part of a larger pattern whereby the United Kingdom lost its economic pre-eminence, colonies, military power, and other trappings of international hegemony. As some of us wonder whether the United States might now have embarked on a path of "imperial over-reach," following the British Empire down a road of widening federal budget deficits and ambitious military adventures in the Muslim world, the fate of the pound is perhaps a useful caution. The Suez crisis of 1956 is frequently recalled as the occasion on which Britain was forced under US pressure to abandon its remaining imperial designs, but the important role played by a simultaneous run on the pound is often forgotten.[4]

Over the last four decades, US allies were willing to pay a financial price to support American leadership of the international economy, because they correctly saw it to be in their interests. In the 1960s, Germany was willing to offset the expenses of stationing U.S. troops on bases there so as to save the United States from a balance of payments deficit. In the 1980s, the U.S. military was charged less to station troops in high-rent Japan than if they had been based at home. In 1991, Saudi Arabia, Kuwait, and a number of other countries were willing to pay for the financial cost of the war against Iraq, thus temporarily wiping out the U.S. current account deficit. Repeatedly the Bank of Japan, among other central banks, was willing to buy dollars to prevent the U.S. currency

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[3] Eichengreen (2011). I am still in the gradualist camp (Frankel, 2011).
[4] E.g., Boughton (2001). "The US refused to allow the IMF to give emergency loans to Britain unless it called off the invasion" – *The Economist*, 7/29/06, p. 24.

from depreciating (late 1960s, early 1970s, late 1980s). After 2001 the hegemon lost some of its claim to legitimacy in the eyes of many. Next time the US asks other central banks to bail out the dollar, will they be as willing to do so as Europe was in the 1960s, or as Japan was in the late 1980s? Unlikely.

## 3. Recessions

Our third category of shocks is downturns in economic activity. Some recessions result primarily from financial crises (such as 2008-09) and some from supply shocks (such as 1974-75). Garden variety recessions result from a fall in demand, including from contractionary monetary or fiscal policy.

### 3.1 Monetary and fiscal contraction

The great disinflation of the 1980s, for example, was the deliberate response of monetary policy (led by Paul Volcker at the U.S. Federal Reserve, but also by UK Prime Minister Margaret Thatcher and others) to the acceleration of prices in the preceding decade. The current recessions in Mediterranean countries are largely the result of fiscal contractions, although the austerity in Greece and Portugal was an inescapable element of the response to the deep sovereign debt holes that they had dug for themselves by 2009.

Sometimes monetary or fiscal austerity is overdone, an expression of excessive fears of inflation or debt. Winston Churchill's decision in 1925 to return Britain to the gold standard at the pre-war parity, exacerbated by fiscal contraction in 1931, needlessly insured years of depression. In the United States, premature monetary and fiscal tightening in 1937 needlessly sent a newly recovering American economy right back into recession. The danger is that the United Kingdom, Germany and other major countries are repeating the same mistakes today.

### 3.2 Trade wars

Another great policy mistake of the interwar period was protectionism. America's Smoot-Hawley tariff enacted in 1930 was soon copied by others. The collapse of global trade left everyone worse off. The world divided up into separate economic blocs, presumably facilitating the drift toward World War II.

Fears that the great recession of 2008-09 would induce an analogous protectionist surge do not seem to have been realized. Whatever trade barriers were adopted appear mild in comparison to the recessions of 1980-82 and 1990-91, let alone the Great Depression. The existence of the World Trade Organization helps explain the difference. And despite much talk of the rise of "state capitalism" in the aftermath of the global financial crisis, the long-term trend still seems to be in the direction of market capitalism.

Still, one should not take the benefits of the trading system for granted. If American politicians followed through on their threats to apply (WTO-illegal) tariffs against China in protest over the latter's exchange rate undervaluation, for example, it could indeed trigger a new trade war.

## 4. Commodity shocks

Our final category of shocks is sudden changes in world market conditions for basic commodities, including oil, minerals, and agricultural products. Sudden increases in oil prices in 1973 and 1979 -- which resulted, respectively, from the Arab oil embargo and the fall of the Shah of Iran -- are conventionally blamed for the serious global recessions that followed each of them. Oil prices may also have caused the 1990-91 recession that followed Iraq's invasion of Kuwait. Economists do not all agree on the causal relationships. On the one hand, some have generalized to say that virtually all recessions since 1950 can be attributed to exogenous oil shocks. On the other hand, others have argued that even the classic oil price rises of the 1970s were not in fact exogenous, but rather were symptoms of deeper underlying trends (either the loss to local governments of oilfields that had previously been controlled by western oil companies, or US monetary expansion). Similarly, the rapid increases in oil prices during the decade 2000-2011 have variously been attributed to the "peak oil hypothesis;" rapid growth of China, India and other industrializing economies; easy monetary policy; and geopolitical uncertainty in the Middle East.

Most of the big swings in oil prices over the last forty years have been accompanied by similar swings in the prices of other fuel products, minerals, and agricultural commodities. Sector-specific factors mostly wash out in these aggregate correlations. For example, American ethanol subsidies could explain the 2010-11 increase in grain prices – as could Russian fires, Canadian floods or Australian droughts – but they would not explain the simultaneous increase in oil prices. A harsh winter could explain a rise in oil prices but not an increase in mineral prices. The strong upward price trend of the last decade, with spikes in 2008 and 2011, has been so widely dispersed across commodities that the cause must be macroeconomic. That primarily means rapid economic growth, especially in China and other developing countries where industrialization is intensive in commodity inputs. Another contributing macroeconomic factor is low real interest rates globally.

Oil is not the only commodity with geopolitical significance. Tight world market conditions for basic foodstuffs – sometimes exacerbated by misguided attempts at the national level to fight price volatility through export controls or price controls – can lead to political unrest. There is a history of grain shortages leading to riots in North Africa, for example, and grain prices may again have been a contributing factor to the Arab Spring of 2011.

## 5. Four Risks in the Coming Year, and Policy Implications

Let us consider the most serious economic risks currently facing the global economy and the policy implications of each, viewed in light of our whirlwind review of historical precedents for economic shocks and their political ramifications. To identify a particular economic risk as serious is to not to predict that it will in fact materialize with probability above 51% in any given year. It is, rather, to assert that the probability is non-negligible (say, above 10%), that its consequences would be serious, and that policy contingencies can usefully be pre-meditated.

1. **Euro crisis**. The highest-probability of the economic "shocks" is a default by Greece within the next year or so, probably around the date when it has eliminated its

primary budget deficit, perhaps followed by Portugal. Possibly by that time provisioning and ring-fencing will have proceeded far enough to insulate banks and governments in the rest of Europe. More likely, sovereign debt contagion would spread. Notwithstanding the tremendous achievements of emerging markets in improving their creditworthiness and reducing their economic vulnerability, the contagion could still hit some of them, such as Turkey. Alternatively, it could spread to the UK, US, and Japan.

Regardless which direction the sovereign debt crisis spreads, the broad outlines of the policy response should be the same, almost certainly with heavy involvement of the International Monetary Fund: a three-way combination of multilateral support, serious policy conditionality, and Private Sector Involvement. For all the criticisms that the IMF has sustained over the last couple of decades, it and other multilateral financial institutions remain the most effective way of responding to international debt crises. Northern Europeans will have to put in extra money when it is Southern Europe that needs rescuing, just as the United States did in 1994 when it was Mexico that needed rescuing or Japan in 1997 when it was Korea that needed rescuing. But the temptation to think that the regional power can do it alone, without the IMF, is a dangerous mirage. Bilateral politics, often driven by historical grievances or ethnic linkages, are too likely to upset the delicate balance between funding and conditionality, which is the forte of the IMF.

The need to strengthen rather than bypass the IMF, World Bank, and other multilateral institutions has a corollary. Assignment of greater weight to China and other major emerging markets economies in the institutions of multilateral governance must move out of dead-end communiqués and into reality. The establishment of the G-20 leaders' summit, which in April 2009 helped formulate the macroeconomic policy response to the global recession, was an important first step. The reallocation of IMF quota weights has been more incremental. The process for choosing the heads of the IMF and World Bank has not been opened up. If there is a new and more virulent outbreak of the euro's sovereign debt crisis, the major emerging market countries can and should play an important role in the policy response, but only under terms that are in their interest. They should be given more influence in the decision-making and a better rate of return than they are currently getting on the foreign exchange reserves that they hold in the form of US Treasury securities.

2. **Domestic US gridlock**

With or without the euro crisis, the United States is capable, via a malfunctioning political process, of fiscal self-destruction as serious as what Europe has inflicted on itself. What is needed is a countercyclical fiscal policy, one that takes advantage of periods of economic expansion to strengthen the budget balance and periods of high unemployment to relax the constraints – in other words, what Chile, China, Indonesia, Korea, and other Emerging Market Economies did over the last business cycle, but the opposite of the thinking used by politicians in U.S., U.K., and much of euro land. This requires taking steps today to lock in a return to fiscal responsibility in the long-term, without the immediate short-term spending cuts that could bring back recession.

In the case of the United States, a serious obstacle to fiscal responsibility is the belief on the part of some of those who call themselves fiscal conservatives that eliminating the US budget deficit is urgent but that it can be accomplished primarily by cutting non-defense discretionary spending (foreign aid is a favorite target, the cost of which poll respondents overestimate more than tenfold), while cutting taxes at the same time. The truth, arithmetically, is that if one could eliminate every penny of US non-defense discretionary spending, it would only eliminate half the budget deficit, let alone free up any revenue for tax cuts. A return to fiscal discipline must entail sacrifice that is widely shared: slowing the growth in domestic spending (e.g., farm subsidies), military spending (e.g., weapons systems that the Pentagon does not even want), social security (e.g., raising the retirement age), and Medicare (e.g., discouraging needless hospital procedures) and also raising tax revenue (including eliminating distortionary "tax expenditures" that subsidize oil depletion, mortgage debt and gold-plated health insurance).

All of those measures are very difficult politically. The second-best option, for the next few years, is to do nothing. Far worse would be futile attempts to pursue fiscal discipline via cuts in domestic spending alone. Worse still would be a partisan game of chicken like the summer of 2011 when congressmen deliberately flirt with US default. Such a crisis, possibly marked by the long-feared "hard landing" of the dollar, could simultaneously unleash a new global financial crisis and accelerate the long-term decline of US power.

3. **Commodity price shocks**

Commodity price increases need not be bad news. If they come as a result of strong growth in the world economy, they are basically good news. Even then, of course, they can have dangerous side effects that require attention. A new round of increases in the prices of basic foodstuffs could again destabilize fragile governments in North Africa or the Middle East, for example. Of maximum concern at the time of writing, however, is a new increase in oil prices that has taken place in early 2012.

This latest oil price rise is different from those of 2008 or 2011. It is happening without similar increases in prices of other fuels, minerals or agricultural products. (Indeed, natural gas prices are strongly down.) The obvious explanation is conflict between the West and Iran over its nuclear program. "Conflict" here includes both the direct effects of the multilateral boycott of Iranian oil and the prospective effects of military conflict, including the much-touted scenario of attacks on oil tankers in the Strait of Hormuz. Although western countries have not been as vulnerable to doublings in the world oil price over the last decade as they were in the 1970s, a serious impairment of access to oil in the Persian [Arabian] Gulf would surely rank as one of the major risks facing the world economy. Certainly most people believe that dependence on oil is one of the major reasons why the United States has long had a greater military presence in the region than in many other parts of the world.

"Energy security" is a slippery concept. For one thing, strategists (whether American or Chinese) sometimes focus too much on the geographical source of their particular country's oil purchases, and not enough on the fact that a fall in global supply would have roughly the same effect on prices regardless of bilateral relationships. For another thing, subsidies to domestic depletion of oil reserves in the name of keeping oil prices low or in the name of energy independence can have the opposite effect in the long run, by encouraging consumption and depleting domestic reserves ("Drain America First"). A true policy for energy independence would keep the domestic price at relatively high levels, conserve domestic reserves, encourage alternative energy sources, and reduce oil consumption.

4. **Hard landing in some emerging markets**

Given the historical cycle, the possibility of new crises in some emerging markets. must go on the list of risks we face today. These economies have experienced seven years of strong growth, with a remarkably brief interruption in 2008-09, but by 2011 some of them had reached a state of overheating. The trigger for hard landing could be contagion from the ongoing euro crisis or as the result of an oil shock,. Turkey is especially vulnerable, with a current account deficit equal to 10% of GDP. A hard landing in China would have especially big implications. For example, it would probably be transmitted to South American countries that have been exporting raw materials to China.

## Concluding thoughts

As Joe Nye (2004) famously argues, military power is not the only sort of power that a country can use to achieve its aims; economic power and soft power are just as important. The West won the Cold War because people in most parts of the world eventually found the American style of life – with prosperity, free markets, human rights, electoral democracy, and a dynamic culture – a more attractive model than the Soviet style of life, at least as much as by military competition.[5] Conversely the international standing of the United States is diminished by such failures as the 2007 US sub-prime mortgage crisis and the global recession that followed[6], or the limitations to American style electoral democracy that were revealed in 2000, or the occupation of Iraq and related debacles in panicked reaction to the shock of September 11, 2001 (including the holding -- and even torture -- of prisoners without trial, contrary to law).

Getting domestic policies right can often do more for a country's international standing than military power, especially if the latter is applied unilaterally and rashly. The record so far this century is not good. Europe shot itself in one foot by ignoring fiscal constraints during the 2003-07 expansion and is now shooting itself in the other foot by applying fiscal austerity when unemployment is high. The United States has made similar mistakes, without the excuse of having to coordinate across 17 parliaments (the euro members). Huge tax cuts and expansion spending (military and domestic alike)

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[5] In the debate over the meaning of geo-economics (Baru, 2012), I thus take the view of Kennedy (1987), that economic success has throughout history been a primary determinant of political and military dominance, rather than the view of Luttwak (1990), which is apparently that this a new phenomenon that arose with the end of the cold war.

[6] The "crony capitalism" that US authorities had lectured Asia about in the late 1990s turned out to be equally a problem in the United States, in light of the crashes of 2000-01 and 2007-09. (Rajan and Zingales, 2004; Johnson, 2009).

during a period of economic growth has left the country with excessive debt and feeling constrained to withdraw fiscal stimulus during a period of high unemployment. This is procyclical or destabilizing fiscal policy. Meanwhile the United States has also sacrificed much of its good reputation for competence, idealism, and global leadership, by mistakes in such areas as financial institutions, military interventions, and human rights. China makes few claims in these areas; perhaps it thereby at least avoids charges of hypocrisy.

One hopes that we can get more of our policies right in the coming decade than we did in the last decade. This includes anticipating future risks and providing for them ahead of time, as well as rising to the challenge of whatever new unexpected shocks come along.

**Table 1: Selected country credit ratings, Standard and Poor's, Feb. 2012**
**(local currency bonds)**

| Rating | "Advanced" countries | (Formerly) "Developing" countries |
|---|---|---|
| AAA | Germany, UK | Singapore |
| AA+ | US, France | |
| AA | Belgium | Chile |
| AA- | Japan | China |
| A+ | | Korea |
| A | Spain | Malaysia, South Africa |
| A- | | Brazil, Thailand, Botswana |
| BBB+ | Italy | Colombia |
| BBB- | Iceland, Ireland | India |
| BB+ | | Indonesia, Philippines |
| BB | Portugal | Costa Rica, Jordan |
| B | | Burkina Faso |
| CC | Greece | |

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