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**THE ECONOMIC CONSEQUENCES OF
MR. G.W. BUSH'S FOREIGN POLICY. CAN
THE US AFFORD IT?**

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The economic consequences of Mr. G. W. Bush's foreign policy. Can the US afford it?

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Abstract

Current analyses of the so-called "neoconservative" turn in US foreign policy tend to neglect its economic *requirements* and *consequences*. This is probably due to their long-run and uncertain nature, and yet one expects the foreign policy choices of a global power to be made with a clear understanding of their probable long-run economic costs and sustainability. The economic implications of unilateralism for the US may be complex and may stretch far beyond the accounting of the Afghan and Iraq campaign. The phenomenon that we should examine, if unilateralism is going to be a lasting choice, is a return to huge external borrowing requirement since Reagan's "Star Wars" programme. The paper, intended for a non-economist readership, seeks to ascertain whether the ensuing scenario will be stable and sustainable from two interrelated perspectives. The first one draws together the various possible consequences suggested by standard international economic analysis. The second one is a historical-comparative analysis of the position of the US in the present global economic system *vis-à-vis* the previous experiences of Great Britain before World War I, and the US after World War II.

THE ECONOMIC CONSEQUENCES OF MR. G. W. BUSH'S FOREIGN POLICY. CAN THE US AFFORD IT?

1. Introduction

Substantial agreement exists that the Bush Administration has announced, and is undertaking, a major shift in the international policy of the United States aimed at the unilateral exercise of global power according to an extensive definition of “national interest” and “national security”, inclusive of the establishment of the “world democratic order” by means of armed force. This new strategy is considered to be inspired by the so-called “neoconservative” doctrine, which stresses the right and power of the US to lead the politics of the free world, with no permanent commitments towards, and constraints by, multilateral organizations. What has an economist to say about this new international policy stance of the US?

It is well known to economists, as well as to political scientists of almost all persuasions, that economic and political choices are intimately related. Very generally speaking, the influence of the economy on the political sphere can be traced back to two main factors: *motivations* – whether “need” or “greed” – that induce political choices, and *constraints* that set limits on political choices (Gilpin (2003)). While much debate focuses on the former factor – e.g. control over oil production and other vested interests of major Bush’s supporters – in this paper attention will be drawn to the role of the economy as a constraint on political choices.

According to a well-known definition, economics is the science of allocation of scarce resources to alternative ends in society. This definition concerns more a *method* than a specific matter of analysis, and a method can, in principle at least, be applied to different matters. Indeed, there are many social situations – though not all of them –

where the scarcity of resources with respect to competing ends raises difficult choice problems. In most such cases, the real value added of economics is *negative* and consists in pointing out the expected *implications* of different courses of action, and hence the *limits* to feasible choices. On the other hand, the extent of economic resources and the extent of power are often interrelated, and each may be instrumental to expanding the other. Thus, a politician may use his/her power to relax economic constraints on his/her set of feasible choices; and if political power is considerable, the politician may be tempted to believe that economic constraints are negligible. History, as we shall see, suggests that this belief is groundless even for international “super-powers”. There is, however, a specific dimension of economic constraints that may justify the attitude of politicians to ignore them: namely that these constraints typically unfold over time – technically speaking they are “intertemporal” constraints. As a consequence, they may be difficult to predict and appraise, and, what is more intriguing, the expected horizon of the politician’s political life may be shorter than the time taken for the constraints to materialize. Thus, the unsustainability of seemingly grand and successful political designs may harm society a few generations later, and possibly fall on the shoulders of a different political party.

The so-called “New Political Economics” (see e.g. Persson and Tabellini (1990)), with its distinctive sceptical attitude towards the economic rationality of democracy, views the (self-interested) myopia of policy makers as a major flaw in democratic systems based on predictable majority reversals. Advocates of this view suggest two remedies. The first is “tying governments’ hands” by means of constitutional rules embodying the interests of yet-to-be-born constituencies. The second is exposing governments to the “constituency of markets” too (by e.g. allowing free capital movements) on the grounds that “markets” are particularly skilful in intertemporal calculation and are able to anticipate the effects of right constraints in real time.

All the foregoing considerations contribute to make the economic analysis of the new US international political stance a serious and challenging matter. The US Administration does enjoy political power in the international arena to an unprecedented extent. This power indeed relaxes some economic constraints that other “ordinary”

countries face. On the other hand, the American democratic system is such that majority reversals are frequent and predictable, whereas constitutional protections against governments' short-termism are not particularly strong (they are in fact much weaker than those contained in the EU Maastricht Treaty and Stability and Growth Pact). Nor do super-national regulations of such a nature exist. The exposure of US governments to markets is high, but the faith in markets as far-sighted real-time voters is no longer as great as it used to be. Hence, if one considers whether the new US international policy stance has been tested against its long-run economic feasibility, not only does one realize that the Administration seems to have paid remarkably scant attention to this dimension in the public debate, but one is also led to suspect that little pressure is felt to focus on it¹.

The non-economist reader will find in section 2 a quick guide to the international economic constraints that a country operating in free and integrated world markets faces. The simple indicators presented in section 2 focus on the long-run sustainability of a country's international position. Section 3 will enlarge the picture, providing a few basic insights into the domestic as well as international economic implications of international political choices. The key message is that the feasibility of these choices can be ranked according to their consistency with the long-run sustainability of the ensuing economic implications. These basic principles will be seen in action in section 4, which examines two major historical antecedents when a single country ruled the political-economic world system of capitalist countries, Great Britain from 1870 to 1915 and the US from 1945 to 1973. The purpose of these historical comparisons is to highlight patterns of world political-economic governance which should not and cannot be mechanically applied to the present situation of the US, but can offer better guidance in gauging the long-run feasibility of the neoconservative strategy than mere (unreliable) projections of the costs of wars. This assessment exercise will be presented in section 5, drawing attention to the present world debtor position and international financial phase of the US

¹ The resignation of Paul O'Neill from the Treasury, which seems motivated by most of the concerns raised in this paper, has apparently had no substantial impact on the political-economic line of the Administration.

economy. This position is at odds with successful antecedents and appears highly problematic for the neoconservative programme for two reasons: one is that considerations of international financial stability leave too little room for the large fiscal deficits and external borrowing required by the programme; the other is that high external debt is hardly consistent with the “free-hand”, unconditioned exercise of political will invoked by the neoconservatives. Section 6 will present a few concluding remarks.

2. International economic constraints

In this section I will point out a few concepts that define the basic international economic constraints faced by countries operating in integrated world markets.

Traditionally, the key issue in a long-run perspective is under what conditions each country brings its worldwide transactions in goods and assets into balance, which is known as the “balance-of-payments (BOP) constraint”. Apparently, this is nothing but the worldwide application of the principle of equal exchange which requires any individual (country) to meet payments with receipts. Note, however, that it is the existence of nation-states with monetary sovereignty and different legal tenders – two facts hard to accommodate in the pure theory of value and exchange – that introduces the specific dimension of international economic constraints which we will consider. Indeed, it is monetary sovereigns who directly perceive the BOP constraint, whereas private agents may only face it to the extent that monetary authorities are willing or able to enforce it.² Let me now recall how this responsibility is exerted.

Different legal tenders force private agents to trade them in order to be able to pay for cross-border transactions. The development of international trade requires the parallel development of markets for

² At the individual level, *where* goods are bought and sold, and the *unit of account* in which they are quoted, is, or should be, immaterial. If a household sells labour “at home” but buys goods “abroad” it may well keep its private budget in equilibrium, whereas its country records a BOP disequilibrium.

currencies granting convertibility and efficient exchange-rates quotations (i.e the prices at which currencies are traded against each other).

Table 1. International accounting

Receipts	Payments
Trade (X)	
Exports of goods and services	Imports of goods and services
Incomes and transfers (YF)	
Labour and capital incomes from non-residents	Labour and capital incomes to non-residents
Unilateral transfers and non-market obligations towards non-residents	Unilateral transfers and non-market obligations from non-residents
Capitals (K)	
Sales of assets to non-residents ("capital inflows")	Purchases of assets from non-residents ("capital outflows")
Total supply of foreign currency	Total demand of foreign currency
"Fundamental" balance of payments	

The demand for foreign currency in one country is determined by the sum of external payments, while the supply of the same foreign currency is determined by the sum of external receipts³. Usually, external transactions are recorded under three different categories, as in the table above. The important differences between them will become clear in due course. The net balance between supply of and demand for foreign currency corresponds to the so-called "fundamental" BOP, which is the result of all autonomous international transactions by the private and public sectors other than monetary authorities. In what follows, this will be our measure of BOP.

³ This principle of course applies to the currency of each of a given country's trade partners. For simplicity, I shall consider all external partners to be a single entity with a single currency.

In the short run, the demand for and supply of foreign currency may happen to be different (or equivalently, $BOP \neq 0$). Two different mechanisms may then be triggered. The first is that the monetary authority absorbs excess demand or supply at the current exchange rate by reducing or increasing its own stock of foreign currency reserves or other compensatory items under its control (“fixed exchange-rate regime”). In algebraic form, taking the net balance of each international account,

$$(1) \quad X_t + YF_t + K_t = \Delta OR_t$$

where $\Delta OR_t > 0$ is an increase, and $\Delta OR_t < 0$ a decrease, in official reserves.

Alternatively, the monetary authority may let the exchange rate float (“floating exchange-rate regime”), in which case excess demand for foreign currency brings about domestic currency depreciation (the price of foreign currency rises), while excess supply brings about appreciation (the price of foreign currency falls). Exchange-rate adjustments are generally allowed for on the expectation that they will help rebalance international accounts spontaneously. Again using relationship (1),

$$X_t + YF_t + K_t > 0, \Delta OR_t = 0, \Rightarrow \text{appreciation}$$

$$X_t + YF_t + K_t < 0, \Delta OR_t = 0, \Rightarrow \text{depreciation}$$

Yet reserves cannot be increased or decreased, nor can the domestic currency depreciate or appreciate, indefinitely. Hence, whatever the choice of exchange-rate regime, monetary sovereignty in an integrated world economy implies that external payments and receipts are sooner or later brought into balance. Consequently, the usual expression for the BOP constraint is

$$(2) \quad X_t + YF_t + K_t = 0$$

At first sight, this constraint can be fulfilled by various combinations of the various accounts. However, in order to understand the evolution of international payments and the time profile of their constraint, it is necessary to examine the three different categories of international transactions more closely. As can be seen in Table 1, they have quite different economic nature in relation to time.

The *trade account* concerns transactions in goods and services. These may be regarded as having negligible intertemporal repercussions, in the sense that they are performed within their accounting period and give rise to no commitments beyond it. When General Motors sell cars to Europe, these are generally paid for in cash or with negligible delay⁴, and the relationship between the US and the EU is concluded. At the opposite end of the spectrum lie transactions on *capital account*, which by their very nature establish commitments extending into the distant future. If General Motors sell bonds to European savers, the concomitant capital inflow is still recorded as a current US receipt, but the US are also indebted with the EU to the amount of principal and interests. This counterpart of today's financial transaction will show up in tomorrow's payments on incomes account when GM services its debt to EU bond-holders. Of course, the reverse holds for the EU, which records capital outflows today but will receive more foreign incomes tomorrow. Thus, the *incomes account* is largely predetermined by previous foreign assets and liabilities and arises from international market obligations (except for labour incomes, which depend on migration flows and remittances). This account is usually integrated with unilateral transfers and non-market obligations: that is, private and public commitments towards and from non-residents, such as international grants and aid, participations in international institutions, military expenditure abroad. Since trade, incomes and transfer payments result from transactions that do not change assets or liabilities, they can also be aggregated into a single account, the *current account*, as opposed to the capital account, which records transactions which change assets or liabilities. Therefore, the same aggregate balance of receipts and payments, and even a zero total sum of the BOP, may hide marked differences as regards the future evolution of the accounts. There are two principal patterns.

- *The debtor country*

$$(3) \quad X_t < 0, YF_t < 0, K_t > 0$$

⁴ Commercial credit may be extended, but its time-horizon can be considered relatively short with respect to the economic phenomena under examination here.

In this pattern, balance-of-payments equilibrium is the result of trade and incomes deficits *vis-à-vis* capital inflows. The country acts as a debtor since capital inflows imply sales of assets and an increase in liabilities with non-residents, whereas the trade deficit indicates that the country is buying more than it is selling abroad. Because the debtor position stretches over time, also the incomes account tends to turn negative, owing to the debt service payments.

- *The creditor country*

$$(4) \quad X_t > 0, YF_t > 0, K_t < 0$$

This pattern is the reverse of the previous one, in that BOP equilibrium is now the result of trade and incomes surpluses with capital outflows. The three accounts indicate that the country as a whole is lending abroad, hoarding assets towards non-residents, while it is selling more goods than it is buying abroad, with positive incomes gained from foreign assets.

Of course, in spite of the rhetoric of economics and politics, countries are not anthropomorphic entities. Their stance on the international economic stage is the result of many independent choices made by private and public agents. The connection between international accounts and national accounts highlights the economic forces behind a country taking a debtor or creditor position. Given (after tax) gross domestic product Y_b , private domestic consumption C_b , private domestic investment I_b , and the government *deficit* D_t (total public expenditure – total tax revenue), the following identity holds,

$$(5) \quad Y_t - (C_t + I_t + D_t) = X_t$$

where the sum $(C_t + I_t + D_t)$ yields the so-called *domestic real absorption*. Therefore, a trade surplus (deficit) arises as the economy absorbs less (more) goods and services than it produces, the difference being made up by net exports to (imports from) the rest of the world.

The financial counterpart of the previous relationship is crucial. Note, first, that non-zero private investment and public deficit imply that private firms and the government borrow from households. Since $Y_t + YF_t$ yields national income, and the difference $Y_t + YF_t - C_t$ yields private saving S_b , under BOP equilibrium it follows from (5) and (2) that

$$(6) \quad S_t - (I_t + D_t) = X_t + YF_t = -K_t$$

where the sum $(I_t + D_t)$ corresponds to the *domestic financial absorption*.

Let us begin with a debtor country and suppose that initially $YF_t = 0$. As we know from expression (3), this country will display a negative trade account, $X_t < 0$, and a positive capital account, $K_t > 0$. Expression (6) tells us that in this country private saving, which represents the domestic supply of financial resources, falls short of the domestic financial absorption⁵, resulting in a net *external borrowing requirement* covered by capital inflows. As is often said, a debtor country – like any debtor indeed – “lives above its own means” by absorbing *real* and *financial* resources from the rest of the world. By contrast, a creditor country “lives below its own means” by transferring *real* and *financial* resources to the rest of the world, in the sense that private saving exceeds the domestic financial absorption, excess saving is channeled abroad through capital outflows, $K_t < 0$, while the concomitant excess of domestic production is sold abroad and is reflected in a trade surplus, $X_t > 0$.

To conclude this overview of international accounts and constraints, it should be stressed that, on closer inspection, even the previous patterns of BOP equilibrium may well persist for a long time, but they cannot be sustained indefinitely. A critical variable is represented by foreign incomes. The reason is that as long as the capital account is unbalanced, the country as a whole goes on accruing assets or liabilities towards non-residents. Over time, two main consequences arise. The first is that, even though K_t and X_t were to remain constant, YF_t would tend to grow larger and larger, whether positive or negative, thus bringing overall payments out of balance⁶. The second consequence is due to the elementary financial principle whereby no country can rely

⁵ If the government budget is positive, it adds to private saving.

⁶ Consider any country facing a world interest rate r . Its yearly incomes account is r times its outstanding liabilities/assets. The latter are the sum of previous capital inflows/outflows, so that the year incomes account is

$$YF_t = r \Sigma K_t$$

which continues to increase as long as $K_t \neq 0$.

on indefinite net capital inflows or outflows because the acceptance of country-specific assets and liabilities in the world financial markets is limited. These markets tend to obey to portfolio diversification rules focused on *proportions* of country-specific securities related to their return-risk profile⁷.

Take the case of a debtor country. This country's securities should grow year after year in world portfolios, with a rising risk profile. To rebalance portfolios, purchases of these securities are reduced so that K_t falls as YF_t payments grow mechanically. To sustain K_t , financial markets demand a higher interest rate rate or a currency appreciation (see fn. 7); but the former measure accelerates the growth of YF_t payments whereas the latter widens X_t . Therefore, a "mature" debtor country tends spontaneously to display a *growing negative current account* and/or *decreasing capital inflows*, which is not compatible with the BOP constraint. Hence either the debtor develops a positive trade account over time or its position is unsustainable in the long-run, i.e.

$$(7) \quad X_t > 0, YF_t < 0, K_t > 0$$

A creditor country has of course a specular evolution, with positive YF_t payments progressively adding to trade surpluses, so that a *growing positive current account* is typical of a so-called "mature" creditor, or international rentier. However, since to any creditor country there corresponds a debtor country, the limits to the sustainability of debtor positions also set the limits to the sustainability of creditor positions. Hence, if a mature debtor must develop a trade surplus,

⁷ It is worth recalling the simple formula which states that the rate of return to a country-specific security r_i should be

$$r_i = r - \varepsilon_i + p_i$$

where r is the world risk-free rate, ε_i is the expected rate of currency appreciation and p_i is its own country-risk premium. Suppose $r = 5\%$, $p_i = 1\%$ and no expected change in the exchange rate, $\varepsilon_i = 0$. Then, $r_i = 6\%$. Now suppose that $p_i = 2\%$. Consequently, either the country-specific return rate increases up to $r_i = 7\%$ or foreign investors should expect a currency appreciation $\varepsilon_i = 1\%$ (or a combination of the two). The currency appreciation is necessary because it increases the take-home value of interest payments.

sustainability of world payments implies that a mature creditor must accommodate a trade deficit, i.e.

$$(8) \quad X_t < 0, YF_t > 0, K_t < 0$$

It will be observed that, with reference to the patterns of payments (3) and (4), “maturity” implies that the sign of the trade account in the debtor and creditor country is reversed. There are only two ways in which this can be obtained in relation to the exchange-rate regime. Under fixed exchange rates, the debtor country should be able to raise GDP above domestic real absorption (ore equivalently private saving above domestic financial absorption) with the creditor country moving in the opposite direction. If the exchange rate is free to float, the foregoing adjustment can be accomplished by depreciating the debtor country’s currency *vis-à-vis* the creditor country’s. The timing and precision of the co-evolution of debtor and creditor positions is the extremely delicate mechanism underlying world economic and financial stability. An important conceptual consequence is that if “equilibrium” is to be understood in its strict meaning of indefinitely sustainable position, a third pattern of international payments should be introduced.

- *Full equilibrium*

$$(9) \quad X_t = 0, YF_t = 0, K_t = 0$$

This is an ideal benchmark in which all accounts are balanced. The economic meaning and relevance of this pattern is conceptual. Though full equilibrium is hardly observable in practice, it acts as a “gravity centre” around which actual country positions revolve, and, more importantly, it represents the benchmark against which they can be measured and assessed. The unsustainability of creditor-debtor positions can materialize more or less smoothly depending on the growth speed of foreign debt, the country-risk assessment, the level of world interest rates and exchange-rate expectations (see e.g. the formula in fn. 7). Currency crises and BOP crises are typically triggered by sudden reversals of capital inflows as foreign investors abruptly “discover” that the above ingredients are no longer mutually consistent.

The role of expectations is critical, as they may, rightly or wrongly, induce a crisis well before actual figures reveal or justify it.

3. Some economics of international politics

Let us now move closer to the central topic of this paper, namely the interaction between the “hard laws of economics” outlined above and a country’s choice of its international political stance. The latter will be considered in a highly simplified and stylized way as a country’s ability to control external political resources. This ability may acquire a variety of nuances, such as “influence”, “leadership”, “hegemony”, “imperialism”, etc. Differences among these forms of the exercise of international power, albeit important, fall outside the scope of this paper. They will instead be examined along a common dimension, that is to say the implications of a given international political stance in terms of a country’s domestic and international economic pattern.

It is well known that a country’s international political status does not come as a ‘free lunch’ or by pure political will. It is the long-run outcome of a complex mixture of historical pre-conditions and political and economic choices. Both private and public economic choices concur to determining a country’s feasible international political stance. For instance, the geographical extent of a country’s political influence is often dictated by the extent of its “national interests”, which in turn depends on the expansion of international trade and finance developed by the private sector. The endeavour to protect national interests is generally accompanied and enforced by the development of the “foreign affairs apparatus” (diplomacy and army), and this in turn implies a consistent path of public expenditure both domestically and abroad. Note that the problem is wider and deeper than the so-called “war finance”, though this may be predominant in some circumstances. Likewise, the so-called “costs of the empire” in terms of direct public expenditure abroad (see the item “transfers and non-market obligations” in Table 1) may be relevant, but it should not be our exclusive concern. As seen above, it is the interaction between the long-run saving and investment choices of the private sector, on the one hand, and the budgetary choices of governments, on the other, that eventually determines the country’s international economic pattern.

Thus, *an international political stance is feasible as long as it is associated with a sustainable international economic pattern of the country.*

A paradigmatic example of modern analysis of the economic implications of international political status is provided by Kindleberger (1976, 1981), who examined the role of the US in the post-World-War-II international order and proposed that it should be defined as one of *international leadership*. Kindleberger pointed out that sheer will, political power, or even command over material and strategic resources are not enough in themselves for a country to become an international leader. The difference lies in the presence of *international responsibility* among the government's objectives. In other words, an international leader must be aware of the external consequences of its actions, must be able to include its partners' benefit among its own targets, and to this effect it must be ready to restrict its set of feasible choices according to its international commitments. This general principle is shared by a variety of other analyses of international power, not only concerning leadership but also hegemony (Kehoane (1980)) or even imperialism (Arrighi (1978)).

The case that Kindleberger took from the economist's tool box is the so-called provision of public goods. Defence is the textbook example of a public good, and it was indeed the key issue in international politics during the 1960s and 1970s. Defence is a public good because everyone benefits from it, but no one in isolation has enough resources or incentives to pay for it, once account is taken of the fact that if any single individual or coalition of individuals pays for defence then it is not possible to exclude from the benefits those who have not contributed. Hence no one will ever pay for defence on a voluntary basis. When the coalition of individuals that we call "the state" exists, the solution to the provision of public goods is compulsory contribution enforced by law and legal sanction – i.e. taxation. In the post-war Western international coalition of states, in the absence of a super-state authority, the solution was a type of informal semi-voluntary exchange. The leader of the coalition would bear the (bulk of the) costs of defence and reap the benefits of leadership. The members of the coalition would enjoy defence with limited loss of sovereignty and minimal waste of resources. Total security supply would be maximized, total defence

expenditure would be minimized. If, drawing on Arrighi's taxonomy (1978), we move from the "informal" to "formal" exercise of international power, such as modern colonialism or imperialism, we find that participation in the exchange is of course no longer voluntary, and the loss of sovereignty and economic resources by subject countries is substantial. Nonetheless, the mother country still faces a number of costly international commitments towards subject countries as well as other countries.

The fact that the exercise of international power imposes a constraint on the leader's or emperor's domestic choices is made clear by another economic textbook story. *Insofar as resources are limited*, any government is confronted by the alternative between producing butter or guns. If more guns are produced to meet international commitments, less butter is left for home taxpayers. Inwardness and pure domestic self-interest are not compatible with the pursuit of high international status. This is a recurrent theme in the culture of international powers, from Rome to Great Britain to the United States. Both the British and the US past experiences teach that international power may postpone the domestic butter-or-guns dilemma but cannot eliminate it in the long-run. As explained in the previous section, one way in which the excess of public expenditure (say guns *and* butter) over net private saving is remedied is by borrowing from abroad. This way out is only possible if there are other countries and/or private agents in the world which are *willing to lend*. Credit-worthiness may be largely supported by international status but it cannot be so indefinitely. Whatever the extent and intensity of the international status of a country, the law of power and strength should give way to the "law of the market", which eventually imposes, sometimes painfully, a reconciliation between domestic economic choices and international political aspirations. (Gilpin (2003))⁸. The USSR, which strived not to be subject to the law of the market, ran up against the butter-guns trade-off rather quickly.

4. Historical antecedents

⁸ Ardant (1976) and Kindleberger (1984) provide vivid historical analyses showing this principle in action during the great European wars in the fifteenth to seventeenth centuries.

The best way to grasp the implications of the general ideas put forward in the previous sections, and to introduce examination of the present situation of the US, is to provide brief sketches of two major historical cases of the economic success and crisis of international powers: Great Britain and the Empire in the second half of the nineteenth century, the US and its world leadership in the thirty years after World War II.

4.1. Great Britain and the Empire, 1850-1914

In the second half of the nineteenth century, Great Britain reached the apogee of her international economic and political power. This status was to a large extent manifest in the formal and direct exercise of power over subject countries in an imperial system mostly located in the Eastern and Southern hemispheres. No less important, however, was a complex nexus of international relations also involving independent countries in the Western hemisphere. The relationship between Britain's international economic and political stance is complex and provides an invaluable lesson on the economic sustainability of international political ambitions.

Great Britain entered her golden age as a leader in industry and trade, and as a world creditor country. In 1850 Britain held 25% – i.e. the largest share – of both world manufactured products and world trade. From 1860 to 1890 London invested some 1.3 billion pounds abroad, at a pace of 65 million a year. Between 1890 and 1914 foreign investment surged to 2.7 billion pounds, averaging 108 million each year. On the eve of World War I the British capital invested abroad amounted to about 4 billion pounds accounting for 45% of total foreign investment by major industrialized countries (Hobsbawm (1968), ch.7). Hobsbawm, like many others, argues that British international economic relations mostly developed independently of political power. If one looks at the geographical composition of foreign investment one indeed finds that up to 1870 territories under direct British control accounted for less than 35% of total investment, the remainder being concentrated in Southern Europe, North America and Latin America. Yet data on new issuances in London in the subsequent three decades

show that the concentration of foreign investment in controlled territories increased sharply, so that by the end of the century its geographical composition between dependent and independent countries was almost balanced (De Cecco (1975), p. 53, Hobsbawm (1968), table 36).

A key institutional aspect of Britain's relations with other independent countries was participation in the international monetary system known as "gold standard". Formally, this was a system with gold as exclusive means of international payment, and currencies quoted in terms of gold, which resulted in mutually fixed exchange rates. The traditional wisdom in the international community was that gold reserves were critical, and that the BOP constraint was binding since payments imbalances would give rise to gold transfers from deficit to surplus countries. Summary data of Britain's international payments are given in Table A1 in the Appendix⁹. From this viewpoint, the most striking feature was that Britain lost her supremacy in industry and trade. From 1850 to 1900 the British economy halved its share of world manufactured goods and never regained a surplus in the merchandise trade balance. The trade account was barely corrected by large remittances from transport services. How could a heavily capital exporting country with a worsening trade account survive the BOP constraint? The key to success was foreign incomes, as can be appreciated from

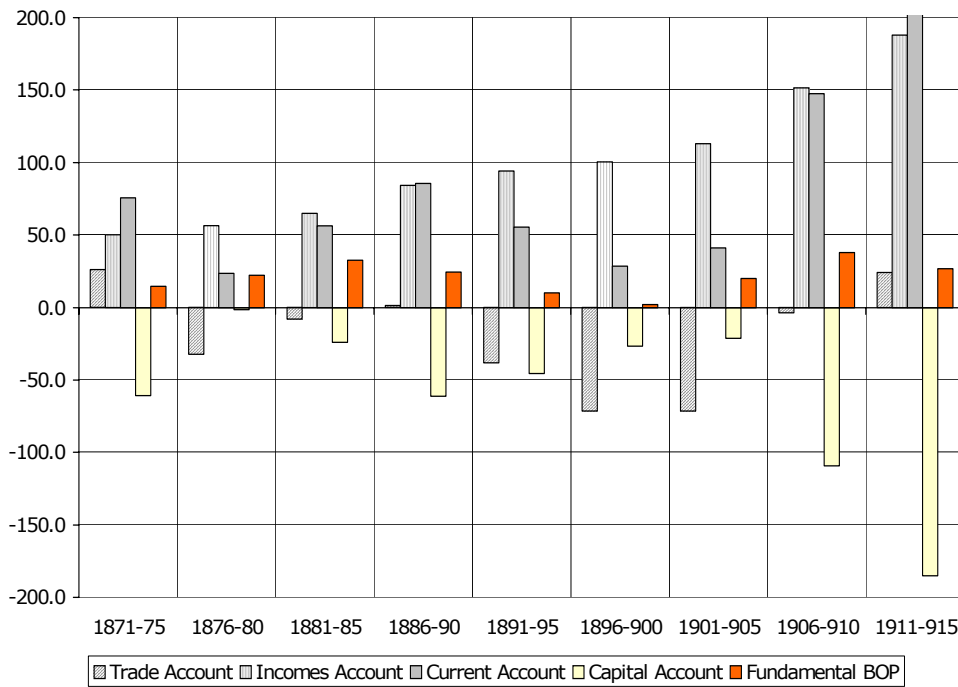
⁹ Owing to a lack of reliable data, the capital account only displays long-run capital movements.

Figure 1. In an “average year”, interests and dividends were by themselves more than enough to compensate for the deficit in goods and services and for foreign investments¹⁰. The current account was consistently positive and tendentially increasing (see table A1 in Appendix). Hence, Britain was able to manage her BOP and maintain her commitment to gold as long as her economy was broadly consistent with the *mature creditor*, or international rentier, pattern discussed above. In parallel, Britain's *mature debtor* countries were able to service their debts thanks to their sales of goods to the mother country.

Since the British BOP was tendentially positive, a stabilizing role was also increasingly played by short-term capital movements in paper sterlings from and to London. Overall, world gold reserves, and the British ones in particular, were unable to keep pace with the growth rate of world trade. As a number of studies have pointed out, the gold standard was in fact turned into a sterling standard, with the British currency being largely used in international transactions and reserves instead of gold (Triffin (1969), Williams (1968), De Cecco (1975)). And as a rentier, Britain offered absolute security to those who came "even from the Moon" (McMillan Report) to deposit in London. Thus, a few basis points of increase in interest rates sufficed to attract enough short-term capitals to rebalance overall payments.

¹⁰ The available data do not allow identification of unilateral transfers in the incomes account. Government transfers were certainly substantial in relation to the imperial apparatus, although administrative costs were partly recovered from local administrations in the Dominions. The aggregate extent of military expenditure will be considered below.

Figure 1. Great Britain's international accounts, 1870-1915 (year averages, millions of pounds)



In a long-run perspective, however, the decline of Britain in international trade and her persistent trade deficits were fatal for the British world order. Its economic erosion was due to a number of deep-lying causes, prominent among which were obsolescence of technology, unfavourable specialization *vis-à-vis* emerging competitors in the free Western world, and import-dependent consumption habits. However, also political-economic macro-factors should be considered.

Hobson's analysis of the British Empire (1902) provided one of the earliest and clearest accounts of the "costs of the empire", first, by dispelling the naive idea that empires are always built in the interest of the nation as a whole, and, second, by pointing out how the growing absorption of public expenditure by the foreign affairs apparatus, *vis-à-vis* a declining GDP capacity, set the British economy on an

unsustainable path. Hobson consistently applied relationship (5) well before its appearance in economic textbooks. According to his data, from 1870 to 1900 public expenditure rose from 61.7 to 128.7 million pounds, with the military share escalating from 31.9% to 53.5%, – i.e. three and a half times in nominal terms and more than four times in real terms¹¹. The increasing costs of international power put the public budget under pressure, eventually forcing Victorian governments to abandon the cornerstones of the liberist tradition by introducing a heavier income taxation system and by resorting to borrowing. Debt financing of the military apparatus rose from almost nil in 1870 to about 50 million pounds before World War I (Hobsbawm (1968), ch. 12). Thus, in modern economic textbooks' terms, the persistent British trade deficits were due to excess domestic real absorption in a vicious circle of upper-class consumption and investment trends sustained by foreign incomes, and of growing excess public expenditure necessary to support the global power that made high consumption, investment and foreign incomes possible.¹²

It is remarkable that this system maintained a high degree of stability, given that its pivot was a chronically dependent country as to real resources. This situation, in fact, raises the question of sustainability: how long can a country live above its means? One stability factor was that Britain was not a debtor but a rentier: the flow of world rent necessary to sustain excess domestic real absorption was, to a great extent, guaranteed. Another factor was the Empire, a two-edged sword by itself. I earlier used the term “vicious circle” to denote the role of military expenditure in the excess absorption mechanism; yet contemporaries would probably view it as a “virtuous circle”. Indeed, as the case of India shows, the Empire also offered a large area of administered and protected trade whereby the mother country was able to secure outlets for her goods and to shelter herself against the threats of free trade with emerging Western competitors.

¹¹ Hobsbawm ((1968), tab.43) reports similar figures. It should be noted that the last quarter of the nineteenth century saw a *decline* of prices in all major industrial countries. In Great Britain the general price index fell by about 25%.

¹² For a more detailed and analytical treatment of this process see Tamborini (1992).

As suggested initially, political power may relax economic constraints or hide them from view. Nonetheless, they eventually become compelling. As is often the case, the alarm bell was rung by a sudden financial crisis. In summer 1914, on the eve of war, the sophisticated network of short-term capitals mastered by the London bankers broke down when, for the first time, London was unable to serve a massive withdrawal of liquid funds in sterling and gold by foreign depositors. Technically, the crisis was overcome in few days, but with hindsight we can say that it marked “the end of an era” (De Cecco (1975), ch. 7). Not only was the pre-war monetary order mortally wounded, but the unsustainability of Great Britain’s international political-economic stance became manifest. And after the war, as Keynes emphatically warned in his pamphlets (1931), the obdurate attempts by British governments to restore the vestiges of the past world order played a major role in destabilizing both the international system and their own country.

4.2. The leadership of the United States after World War II, 1950-1973

One of the most famous interpretations of the inter-war political, economic and financial instability culminated in the 1929 crash and then in the World War is Kindleberger’s major book (1973), the keystone of which is the idea that the collapse of the British world order left a vacuum of political-economic leadership, with no country able to assume the pivotal role that would guarantee an orderly, growth-inducive, network of debtor-creditor positions as well as ensuring the supply of international public goods.

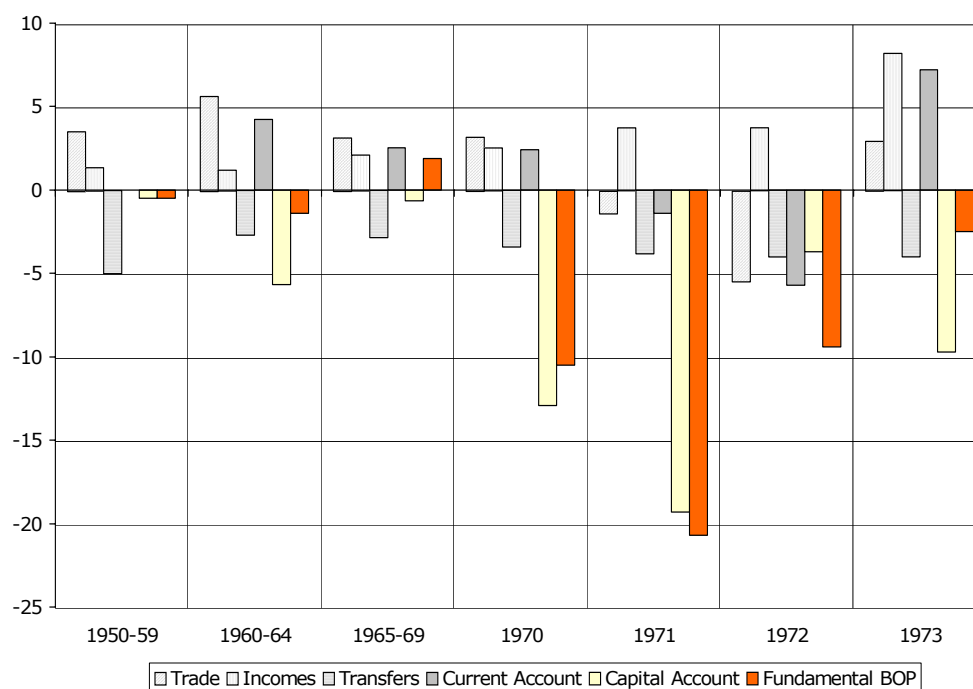
The leading country that presided over the reconstruction of a sustainable world scenario after World War II was the United States. During the 1950s the US took an international economic stance similar to that of Great Britain examined in the previous paragraph – but with some crucial differences. In the aftermath of World War II, like Britain in post-Napoleonic Europe, the US enjoyed a substantial industrial advantage over the rest of the world in terms of fixed capital, infrastructures, production capacity, and financial resources. Absent a formal empire, the role of leader of the victorious Allied Army was quite naturally extended and confirmed in the new confrontation against the

Communist bloc: economic supremacy went hand in hand with political leadership. Again, the new mix of leadership-*cum*-partnership on the Western front was sealed by a “monetary pact” quite similar to the gold-sterling system centered in London one century before: the gold-dollar system of pegged exchange rates devised at Bretton Woods in 1944.

As can be seen from Table A2 in the Appendix, the gold-dollar system, too, was pinpointed by the dominant country as a world creditor, a *young creditor* however (see pattern (4)), with capital outflows averaging 500 million dollars per year *vis-à-vis* trade surpluses of 3.6 billion. Yet, in contrast to the typical creditor-country pattern, the incomes and transfers account was on average *negative* by 3.6 billion. This left a barely positive current account and an average BOP *deficit* of 500 million each year, the seeds of a crucial problem in the US international stance. The available data allow us to distinguish, according to international accounting in Table 1, between incomes, largely due to interests and dividends on foreign investments, and unilateral transfers due to private and public non-market payments and obligations. Foreign incomes were indeed consistent with the creditor-country pattern, showing a yearly *positive* balance of 1.4 billion dollars. Yet they were outweighed by substantial unilateral transfers abroad of 5 billion, two-thirds of which were government payments. These figures are highly indicative of the US growing international military and non-military commitments¹³. In other words, the US economy, as a consequence of domestic excess capacity, was transferring real and financial resources abroad to the benefit of the reconstruction and development of foreign partners, but the compound effect of foreign investments with military and non-military government commitments was too large relative to net export capacity.

¹³ Military expenditures abroad averaged at 2.1 billion dollars per year with a fivefold increase in the decade (see Argy (1984), table 3.1).

Figure 2. The United States' international payments, 1950-73 (billions of dollars)



As shown by Table A2 and Figure 2, the 1960s replicated the same pattern in a context of apparent domestic and world stable growth. In reality, in the first half of the decade the fundamental imbalance of US payments dramatically deteriorated, falling to -1.4 billion dollars per year in spite of further improvement in external trade and a positive current account. The BOP deficits were boosted by an upsurge of foreign investments and other capital outflows *vis-à-vis* an insufficient current account. A critical component of the current account was the rigidity of unilateral transfers. Either a cut in foreign investments and unilateral transfers or a cut in domestic absorption to improve foreign trade were necessary¹⁴. None of these corrections took

¹⁴ The incidence and importance of unilateral transfers in US international payments revived research on a “minor” point of BOP theory, the so-called

place. Quite the contrary: unlike Imperial Britain, the US economy was set on a path of declining and tendentially *negative* current account inconsistent with its role as world investor. Nonetheless, apart from minor disturbances, it was only at the end of the 1960s that the gold-dollar system's crisis was fully understood by markets and governments. The survival of this system for more than twenty years in spite of the pivot country's unsustainable international stance was a variation on the theme of the economic benefits of international power that we have already met in the gold-sterling system.

The solution to the "guns *vs.* butter" dilemma adopted by the US in the 1950s and 1960s was another international transposition of the classical economic theory of the state: *seignorage*. Besides levying taxes, the state also has the monopolistic power to print money: indeed, printing money is the alternative means to pay for public expenditures. The US was able to practise seignorage worldwide thanks to the special status of the dollar as world means of payment and reserve. No foreign recipient of dollars would put the Federal Reserve under pressure to convert dollars back into other currencies or gold. Seignorage was one of the benefits of leadership that compensated the leader for the costs of providing defence for all, and at the same time it allowed the exchange-rate system to survive. In fact, as Argy (1984) stresses, in the 1950s the world overflow of dollars was probably "demand driven" as the fast growth of international trade generated demand for means of payments in excess of gold supply, and "dollar shortage" was one of the troubles of the time. However, this was no longer the case in the 1960s. Robert Triffin predicted ten years in advance the collapse of the international monetary system brought about by excess US seignorage, i.e. the unsustainable growth of paper dollars in the world relative to the US gold stock (Triffin, 1960). Dollar balances held by non-residents were short-term liabilities of the Fed, which should stand ready to convert them into gold on call. The mounting threat to the convertibility commitment is highlighted by two figures: in 1959 short-term liabilities amounted to 19.4 billion dollars and were 1:1 with gold reserves, in

"transfer problem" concerning whether BOP adjustment mechanisms exist such that a country can honour unilateral transfers: see e.g. Machlup (1963, 1969), Johnson (1956, 1975, 1976), Kindleberger (1968).

1971 they amounted to 67.8 billions, more than 6 times the value of gold reserves.

The inconsistency between the international political order based on the US leadership and what are now called the "underlying economic fundamentals" exploded in the second half of the 1960s on three fronts: the erosion of trade surpluses, the Vietnam War with the concomitant flood of dollars in the world markets, and the domestic economic downturn of 1968-69. These three developments raised conflicting objectives: sustainability of international commitments would call for a (strong) monetary-fiscal restrictive policy mix domestically, but recovery of the domestic economy would push in the opposite direction. The first objective was (mildly) pursued in the mid-1960s¹⁵, whereas the second one prevailed in the 1968-69 recession. This change of attitude was read by dollar-holders worldwide as the death certificate of the convertibility commitment, and indeed huge BOP deficits opened up in 1970 and 1971 (-10.5 and -20.7 billion dollars, respectively). Speculative attacks against the dollar were triggered. The official breakdown of the Bretton Woods Agreements occurred in August 1971 with a subsequent official devaluation of the dollar by 7.9%. In 1972 the US economy recovered, yet in February 1973 a further 10% devaluation was necessary, which in fact brought the trade account back to surplus and reduced the BOP deficit. In November, however, the first oil crisis broke out and definitively disrupted the post-war political-economic order.

Overall, in spite of similarities in favourable factors (supremacy in industry and trade, world creditor position, gold-based fixed-exchange-rate "monetary pact") and in unfavourable ones (growing external-internal conflicting targets and long-run unsustainability of the BOP constraint) the US leadership model proved to be weaker and shorter-lived than the British imperial system. As a matter of fact, the latter was undermined by the slow erosion of the British world rent, but never was there substantial world payments imbalances. By contrast, the US proved unable, or unwilling, to correct the structural imbalance in her international payments, and blatantly resorted to seignorage

¹⁵ The temporary recovery of the BOP reported in Figure 2 was largely due to monetary restrictions raising short-term interest rates and attracting short-term capital inflows (see also Table A2 in Appendix).

regardless of the “monetary pact”. To return to Kindleberger’s definition of international leadership, we may conclude that the US broke the rule that a leader must be ready to give priority to international commitments over domestic concerns. Indeed, the end of the coalition pact on which the post-war political-economic order rested was declared as early as 1968 by Charles De Gaulle and his central banker Jacques Rueff, when they announced that the privileges enjoyed by the US thanks to the international role of the dollar were “extravagant” and “no longer acceptable”.

5. Global power and global finance

The US retreated from international commitments and organized exercise of power after the events described in the previous section. Not surprisingly, neoconservatives are extremely critical of the lack of a grand view and of the piecemeal approach in foreign affairs of the 1970s, for which they indict Richard Nixon and Henry Kissinger, let alone subsequent Administrations. This criticism seems unaware of the collapse of the economic conditions underlying the US leadership, and of the advent of conditions unfavourable to any other possible design of global governance. It is worth focusing on one of these conditions, which the neoconservative view seems unable to fully comprehend: *in a capitalist system, the exercise of international political power, no matter how large, is never fully unconstrained*. I stressed at the outset that a country’s international political stance is feasible as long as it is consistent with a sustainable international economic pattern. Both the historical experiences examined above have shown that, although the extent of international power may relax economic constraints, they are nonetheless binding in the long run. This is unavoidable if *international power is to be exerted within a frame of free market relationships with partners*.

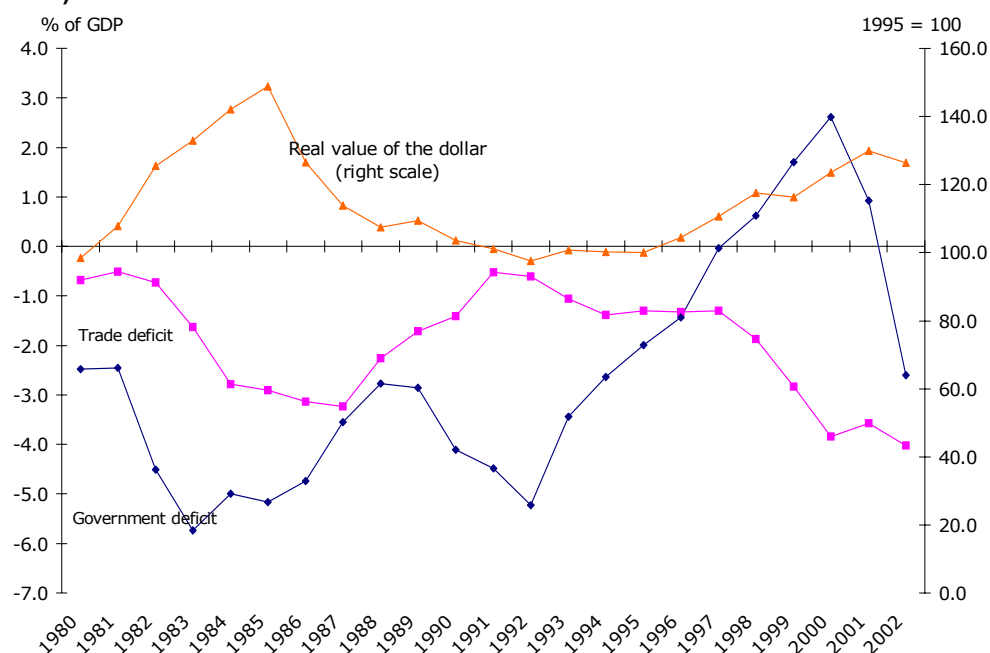
This general principle has been gaining further cogency in the last two decades: on the doctrinal side thanks to the advent of the so-called “New Political Economics”, which advocates that governments be subject to the “market constituency” as the safeguard of the economic rationality of their choices (a conservative doctrine itself, by the way); and on the economic side as a consequence of the general phenomenon

of market globalization. Compared to the early post-war decades, when limits and controls on international transactions were much stricter and the driving capacity of markets by politics much stronger, nowadays the market conditioning of international political choices is likely to be strengthened. In short, global power has to come to terms with global finance.

Prior to the open endorsement of the neconservative doctrine by G. W. Bush, the US had already experienced the implications of financial globalization for international politics with the “Star Wars” programme under the Reagan Administration. President Reagan took office in 1981 and his economic programme was based on dismantling market protections and limitations, on the one hand, and on strong fiscal expansion through low taxes and high strategic expenditure, on the other. High strategic (military and non-military) expenditure also reflected an international political choice to restore the US to its role as world leader in the final attack against the Communist bloc. The rationale of the “Star Wars” programme was essentially to raise the cost of mutual deterrence so enormously as to shatter the USSR economy. In our metaphor, the “butter *vs.* guns” alternative would have strangled the USSR, whereas the US economy would have enjoyed “more butter and more guns”. Was this design accomplished? Who actually paid for the “Star Wars” programme? The answers to these questions provide a clear exemplification of the principles put forward so far.

First of all, the Reagan fiscal programme produced a sequence of large deficits escalating from 2.1% of GDP in 1981 to 5.2% in 1985 to return to 2.8% in 1988 (see Table 2). In the eight years of the two Reagan Administrations, defence expenditure rose constantly from 157 billion dollars in 1981 to 290 in 1988, and it reached the historical peace-time peak of 6.2% of GDP in 1986. As explained in section 2, the international impact of the government budget can be viewed in real as well as financial terms. In real terms, it adds to the domestic absorption of resources of the private sector and hence co-determines the trade balance with the rest of the world (relation (5)). Since the private sector’s absorption was almost in balance or in surplus, the US experienced the so-called “twin deficits” phenomenon – that is, trade deficits *vis-à-vis* government deficits – as can be seen in Figure 3.

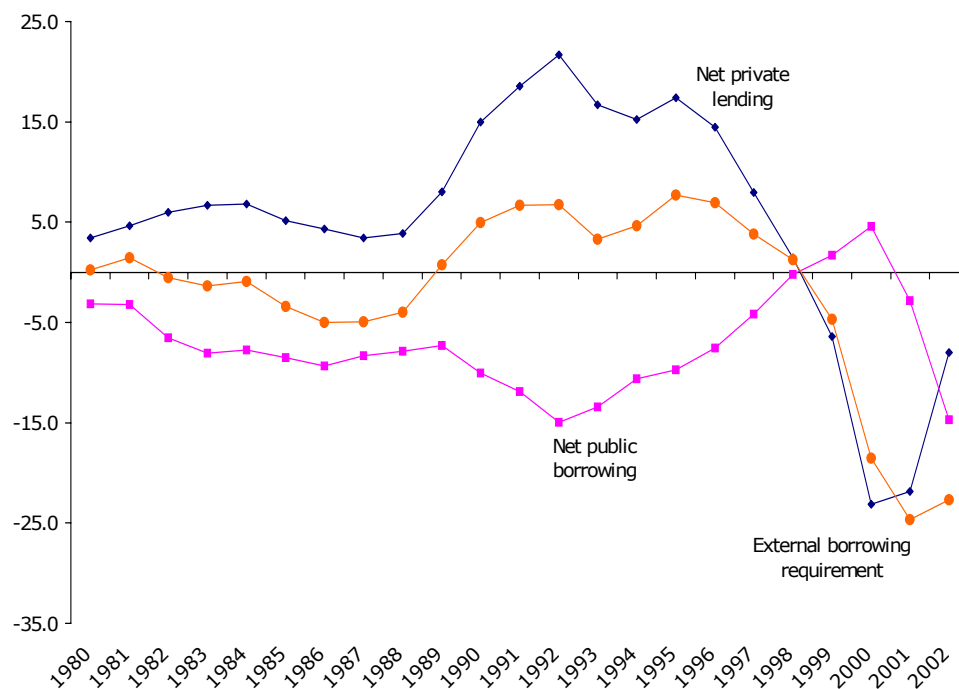
Figure 3. US “twin deficits” and the real value of the dollar, 1980-02 (% of GDP)



In financial terms, as shown by relationship (6), fiscal deficits matter because they determine the borrowing requirement of the public sector; given net lending or borrowing (the saving-investment balance) of the private sector, the difference should result in net lending or borrowing with the rest of the world.

Figure 4 reproduces the US financial accounts from 1981-88. The public sector borrowing requirement rose from 3.1 of GDP in 1981 to 9.3 in 1986. In spite of a sustained net lending capacity of the private sector (excess of private saving over private investment) amounting to around 5% of GDP, the consequence was an increasing external borrowing requirement which peaked at 5% of GDP in 1986.

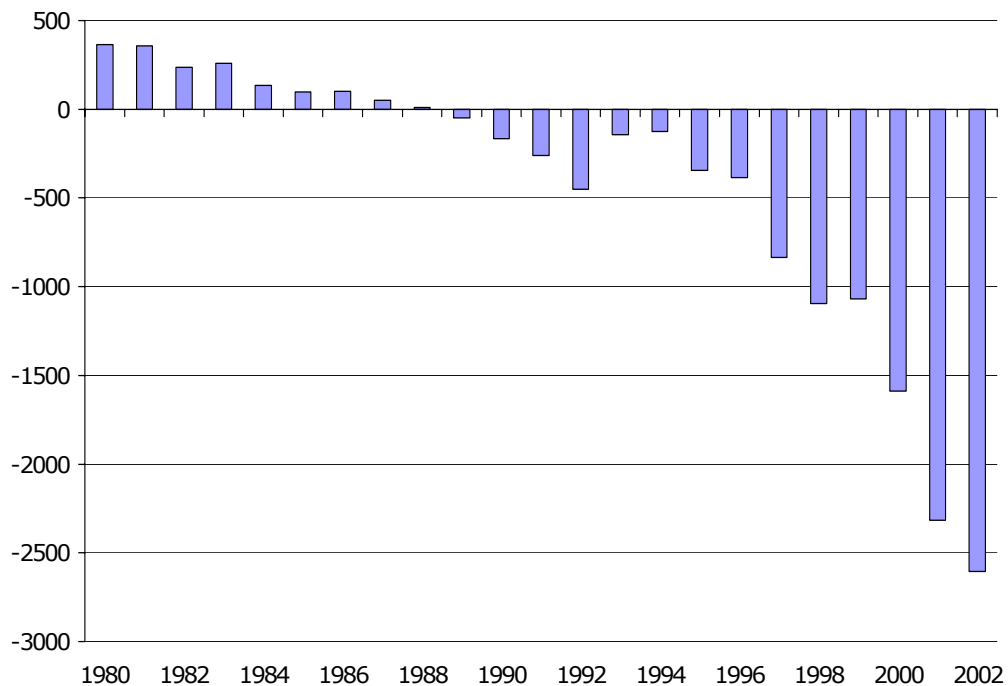
Figure 4. US financial accounts, 1980-02 (% of GDP)



These real and financial tendencies set in motion by the US fiscal policy were eventually reflected in international accounts (see table A3 in the Appendix). Thus, the most striking feature of the first attempt to return to global power after the crisis of the 1970s, in the new context of global finance and floating exchange rates, was that *the US had to take a typical world debtor position*. In fact, trade deficits were covered by huge capital inflows, with a constant trend of unilateral transfers barely compensated by declining foreign incomes. Foreign incomes were declining as a consequence of the growing foreign debt service generated by external borrowing and by high interest rates paid by US Treasury bonds. The US had net foreign assets of 356 billion dollars in 1980,

which were reduced to 10.4 in 1988, and then turned into net liabilities from 1989 onwards (see Figure 5).

Figure 5. US Net Foreign Position, 1980-2002 (billions of dollars)



The interesting question raised by the Reagan parable is whether the world political-economic leader can be a debtor. The lesson may be relevant to Bush as well. Recourse to global debt by the Reagan Administration was an alternative to seignorage¹⁶ in the attempt to by-

¹⁶ An important element in the picture is monetary policy. The new President of the Federal Reserve appointed by Reagan, Paul Volker, launched a U turn in monetary policy towards neo-monetarist principles. The growth rate of the money stock as a means to curb inflation became the pivot of the Fed's policy. Volker introduced severe monetary restriction in 1981, which resulted in a slowdown of inflation with a sharp recession in 1982 (-2.1% of GDP). Subsequently, this strict adherence to the monetarist doctrine was relaxed, but

pass the domestic “butter vs. guns” trade-off by inducing partners to share the military effort. Yet, as stressed by Kindleberger ((1984), chs. 12, 16), it is a recurrent faulty idea that the best financial policy to pay for wars is debt, on the illusion that this dispenses with the need to raise taxes. Debt is only a means to shift higher taxes, or lower non-military expenditures, to the future: “[recourse to] debt is irrelevant to the question as to whether the country [can], or [cannot] pay for the war”, and to this effect “one has to take into account repercussions throughout the system (Kindleberger (1984), p.172)). The system, for a global player, is the world. As explained in section 2, a world debtor has to pay higher interest rates and/or appreciate its currency in order to induce foreign lenders to accommodate increasing shares of its liabilities in their portfolios. From 1981 to 1985 the US recorded the most dramatic peace-time increase in nominal and real interest rates. In the same period, the dollar appreciated by 51.2% in real terms *vis-à-vis* the US trading partners’ currencies. The other side of the coin was that high interest rates worsened the income account, while the strong dollar worsened the trade account, thereby widening the external borrowing requirement in a vicious circle. As to lenders, the world expansionary effect of US trade deficits was outweighed by the contractionary effect of financial resources absorption and high interest rates. The overall negative impact of the new US international stance was felt both in Europe, which experienced a twin spike in interest rates and unemployment (Fitoussi and Phelps (1988)), and in the developing countries, which were no longer able to meet their external dollar-denominated debt services (Strange (1998))¹⁷.

The blatant financial unsustainability of the “Star Wars” programme on the one hand, and its negative effects on the partner economies on the other, disrupted the US new international stance in a handful of years. In June and October 1985 two meetings of the major

the Fed ceased to be a lender of last resort for the government, which was forced to finance budget deficits by issuing debt.

¹⁷ Remember that, by contrast, in the post-war period US international *lending* and trade deficits, albeit structurally unbalanced, played a crucial role in recovering and sustaining world economic activity in a context of monetary stability, to the general benefit of partners.

industrialized countries “talked the dollar down”, thereby putting an end to the world lending-to-America frenzy and, at the same time, to the tale that America could do by herself. The legacy of Reagan’s global war finance experiment was the devastating third-world debt crisis of 1982-85 and, as a final *coup de theatre*, the Wall Street crash of October 1989.

The numerous analogies between Reagan’s and G.W. Bush’s global war finance programmes are evident. Both have taken place in a context of weak domestic economy, fiscal expansionary policies and large reliance on external debt. While aware of the pitfalls of historical analogies as guidance to future developments, it is nonetheless worth examining in greater detail the initial conditions of the two programmes. This task is helped by Table 2, which summarizes a few selected economic indicators of the two Administrations *vis-à-vis* the previous Administration.

Table 2. Reagan and G.W. Bush Administrations. Selected indicators

	Defence % total exp.	Defence % GDP	Budget % GDP	Debt % GDP	Foreign % total	GDP growth
Reagan						
Prev. Adm. ¹	23.1	4.4	-2.2	27.2	19.2	3.4
Prev. year	22.7	4.8	-2.5	26.6	17.6	-0.2
1981	23.2	5.1	-2.5	26.6	16.5	2.5
1982	24.8	5.7	-4.5	30.6	15.1	-2.1
1983	26.0	6.0	-5.7	33.5	14.2	4.3
1984	26.7	5.8	-5.0	35.3	15.0	7.3
1985	26.7	6.1	-5.2	38.3	14.1	3.8
1986	27.6	6.2	-4.7	41.1	14.5	3.4
1987	28.1	6.0	-3.5	41.6	15.3	3.4
1988	27.3	5.7	-2.8	41.4	17.3	4.2
Bush						
Prev. Adm. ¹	16.4	3.1	1.2	41.4	32.5	4.2
Prev. Year	16.5	3.0	2.6	35.0	30.3	3.8
2001	16.4	3.0	0.9	33.9	31.0	0.3
2002	17.3	3.4	-2.6	35.1	33.2	2.5
2003	17.6	3.5	-3.7	37.3	n.a.	2.5

¹Four year average

Table 2 (cont.d).

	Inflation	Long int. rate	REER ¹	Trade account % GDP	NFA ² % GDP
Reagan					
Prev. Adm. ¹	7.9	8.6	101.7	-1.1	16.2
Prev. year	9.2	10.8	98.4	-0.7	13.2
1981	5.1	12.9	107.9	-0.5	11.5
1982	5.7	12.2	125.5	-0.7	7.3
1983	6.0	10.8	132.9	-1.6	7.4
1984	5.8	12.0	142.1	-2.8	3.4
1985	6.1	10.8	148.8	-2.9	2.3
1986	6.2	8.1	126.5	-3.1	2.3
1987	6.0	8.7	113.9	-3.2	1.1
1988	5.7	9.0	107.5	-2.3	0.2
Bush					
Prev. Adm. ¹	1.7	5.8	117.0	-2.5	-12.8
Prev. Year	2.1	5.5	123.6	-3.8	-16.3
2001	2.4	5.3	129.9	-3.6	-23.1
2002	1.1	5.2	126.4	-4.0	-25.1
2003	1.9	4.8	n.a.	n.a.	n.a.

¹Four year average²Real effective exchange rate (1995 = 100)³Net Foreign Assets

Source: *Economic Report of the President*, Washington D.C., 2003; IMF, *International Financial Statistics*, CD-Rom.

To begin with, let us point out possibly *more favourable* conditions. First and foremost, Bush has inherited healthier public finances than Reagan: the overall budget was in surplus in 2000, public debt was diminishing, and defence expenditure was relatively low, in relation both to total expenditure and to GDP. These conditions allow greater room for manoeuvre than that available to the Reagan Administration. The impact of Bush's military programme seems at the moment to be less dramatic than Reagan's: even in 2003, the year of the Iraq war, defence expenditure (380 billion dollars) is estimated to reach 17.6% of total expenditure and 3.5% of GDP,¹⁸ well below the peaks of 28% and 6%, respectively, in 1986-87. The overall budget deficit is expected to be 3.7% of GDP in 2003 and between 4.5 and 5% in 2004, whereas it reached 5.7% in 1983.

However, military and strategic expenditure during the Reagan Administration was almost entirely channelled to domestic research and investment aims, whereas the Bush Administration's programme is far more complex and ambitious. It implies not only funding the domestic strategic apparatus, but also engaging in external military operations as well as non-military aids and transfers, the cost of which is not completely reflected in the defence budget and is still largely to be determined. Projections are extremely volatile and unreliable. As an example, prior to the Iraq war, the economist William Nordhaus¹⁹ estimated that the military and non-military federal costs of the operation might range from 121 of 1595 billion dollars, depending on the length and difficulty of the war and post-war operations. The Administration itself has announced a target for the defence budget of 451 billion dollars in 2007, with total expenditure amounting to 2144 billion dollars from 2002 to 2007. Assuming a 5% yearly increase in nominal GDP, the US would end up with defence expenditure absorbing about 5% of GDP in 2007, a figure in line with its order of magnitude in the 1980s. Overall, one may expect that the fiscal impact of the Bush programme will eventually be comparable with that of Reagan's.

¹⁸ In 1991-92, after the first Iraq war, defence reached 21.8% of total expenditure and 4.8% of GDP.

¹⁹ *New York Review of Books*, December 5, 2002.

Let us now turn to a list of *less favourable* conditions than those faced by the Reagan Administration. These essentially affect the US borrowing capacity, and hence the long-term sustainability of the neoconservative programme. In this respect, Bush has inherited an international financial position of the country that was much harder, *for his own purposes*, than that inherited by Reagan. First of all, in 1980 the US had net claims towards the rest of world of 378.7 billion dollars; at the end of the 1990s the US was one of the world's largest debtors, with net liabilities amounting to 1588.7 billion dollars, 16.3% of GDP (see Figure 5). The US financial and international accounts in the second half of the 1990s displayed a pattern similar to that of the 1980s (see Figure 3 and Figure4) except that the driving force was not government deficits but the longest private investment and consumption cycles in post-war history. The private saving-investment balance has been shrinking since 1995 and has turned to negative since 1998. With back-paddling government deficits, massive external borrowing has nonetheless been necessary to sustain the "new economy" investment bubble. High expected returns on stocks and capital inflows have set the dollar on a robust appreciation path; parallely, the trade account, after the recovery of the late 1980s, has pointed again towards larger and larger deficits, reaching the post-war record of 375 billion dollars (3.8% of GDP) in 2000. Large interest payments owed to foreign investors have added to trade imbalances to produce the concomitant current-account negative record of 421.3 billion dollars (4.3% of GDP). In the first three years of the Bush Administration, these tendencies have worsened further, with the government budget again taking the lead of financial imbalances. Thus, the neoconservative programme not only hinges on a *replica* of Reagan's idea of global war finance, but it also presumes that the replicant can be a massive world debtor with yawning current-account deficits.

The forces that can play against a world debtor maintaining the role of world power for a long time have already been discussed. As the foregoing analysis shows, from this viewpoint the Bush Administration has much *less* room for future manoeuvre than the Reagan Administration. International financial markets and policy-makers have already set in motion the adjustment process of the US external position required by a *mature debtor*. The Fed keeps interest rates low, capital inflows are slowing down, and the dollar is depreciating to the

effect of correcting the current-account imbalances. At the same time, the domestic absorption of real as well as financial resources should be reduced, which requires less consumption, more saving and balanced fiscal budgets. Thus, the US economy is now being driven through the same phase that *followed* the Reagan era in the late 1980s and early 1990s: that is, the adjustment process that had to be managed by Bush sr. (see Figure 3 and Figure 4). Viewed in this perspective of financial phases, Bush jr.'s policy is, literally, "anachronistic".

It is highly unlikely that the mature-debtor phase of the US economy can be inverted, and any attempt to move in that direction would be fraught with danger to international stability. As after 1985, the "must" of world markets and policy-makers is now the so-called "soft landing" of the dollar. That is to say, depreciation of the dollar, reduction of capital inflows and improvement of the current account must be carefully tuned so that the mutual adjustment of the three variables occurs gently and smoothly. Along this path, little room is left for fiscal deficits. It is true that public debt is less than 15% of overall US foreign liabilities (but more than 30% of it is held abroad). Nonetheless, given the general tendency to reduce dollar-denominated assets in world portfolios, large loans to Washington would require a sharp increase in interest rates or, alternatively, massive monetization of federal deficits by the Fed – i.e. seignorage once again. The first alternative is precluded by three considerations. 1) High interest rates would create recessionary conditions and would defeat the effect of tax cuts which are the hallmark of Bush's programme. 2) They would produce a fall in stock prices, which on the one hand would amplify recessionary conditions while on the other might trigger capital flights and attacks against the dollar. 3) They would also reduce the value of US T-bonds in world portfolios, and massive foreign sales of T-bonds would soon make financial and monetary policy in Washington unmanageable.

The alternative to high interest rates represented by seignorage encounters no less serious obstacles. 1) Systematic monetization of fiscal deficits is nowadays strictly inhibited by central banking doctrines. Though the Fed has a tradition of pragmatism and flexibility, this policy would represent a U turn in its strategy and reputation, setting the clock back to the 1960s and 1970s, when, as explained previously, pro-

seignorage US monetary policy was seen as one of the causes of the collapse of the world monetary system. 2) Consequently, fast growing money supply dictated by fiscal deficits would hardly be consistent with the “soft landing” strategy. Financial markets might read pro-seignorage monetary policy as signalling that fiscal policy is unsustainable and react by selling T-bonds and speculating against the dollar.

It seems fair to conclude that the smooth correction of the US mature debtor position now in progress sets fiscal policy on a narrow path, probably too narrow for the global war finance operations required by the neoconservative programme. Moreover, since politics has not completely disappeared from the stage of world finance, it should also be borne in mind that a substantial share of the US T-bonds circulating in the world is bought and held by institutional investors in Japan, China and “old Europe”, that is to say countries which are quite moderately favourable to, or openly against, Bush’s foreign policy. Thus, in spite of the neoconservative ostentation of unilateralism, the new US international political stance should to some extent rely upon the financial benevolence of its opponents.

6. Concluding remarks

Current analyses of the neoconservative turn in US foreign policy tend to neglect its economic requirements and consequences. This is probably due to their long-run and uncertain nature, which stretches far beyond the accounting of the Afghan and Iraq campaigns. Yet one expects the foreign policy choices of a global power to be made with a clear understanding of their probable long-run economic costs and of their sustainability.

The assessment of these economic implications presented in this paper has focused on the long-run sustainability of international political choices as determined by the ensuing international economic pattern of the country. The success of candidates to world governance in a frame of free market relations does not only depend on the extent of their political will or power. The fiscal counterpart of governments’ foreign policy interacts with the private sector’s saving and investment choices, co-determining the evolution of external trade and of external

borrowing or lending. Comparison with the historical experiences of world governance of pre-World-War-I Britain and post-World-War-II America has shown that financial sustainability of borrowing or lending positions is a crucial factor in the long run, and that no international political stance can withstand the “hard laws of markets” for long.

We have seen that those systems of world governance remained sustainable as long as 1) both countries were world creditors, 2) their international commitments were contained within not too large fiscal imbalances, 3) their international economic positions were beneficial to their partners as well. America was still world creditor when President Reagan launched his global war finance venture, which however transformed the Americans into world debtors. The intrinsic fragility of that (comparatively) short-lived experience lay in the violation of all three previous successful conditions. President Bush’s fiscal counterpart of his foreign policy looks very similar to Reagan’s, with the major inconvenience that he took office when the country was already the largest world debtor. As a consequence, Bush’s policy mix is confronted by two extremely difficult hurdles on international economic grounds. The first is that the US, in spite of the rhetoric of uncompromised unilateralism, is a country under external financial dependence, with the opponents of its foreign policy in possession of most of the financial means. The second is that, as a matter of fact, international financial markets and policy-makers (Fed included) are already driving the US economy along an adjustment path where little room is left for the large global war finance operations required by the neoconservative programme.

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Appendix

Table A1. Great Britain's international payments, 1870-1915 (millions of pounds; selected items, year averages)

	1871-75	1876-80	1881-85	1886-90	1891-95	1901-05	1906-10	1911-15
TRADE ACCOUNT (a)	25.6	-32.6	-8.3	1.2	-38.5	-71.8	-3.9	23.8
Merchandise, net	-19.3	-78.9	-56.4	-44.3	-84.4	-115.0	-79.1	-61.3
Services, net	44.9	46.3	48.1	45.5	45.9	43.2	75.2	85.1
INCOMES ACCOUNT (a)	50.0	56.3	64.8	84.2	94.0	113.0	151.4	188.0
CAPITAL ACCOUNT								
Foreign investments (b)	-61.0	-1.7	-23.9	-61.1	-45.6	-21.3	-109.5	-185.0
Source: (a) De Cecco (1975), (b) Feis (1930)								

Table A2. United States' international payments, 1959-73 (billions of dollars)

	1950-59 (a)	1960-64 (a)	1965-69	1970	1971	1972	1973
1. TRADE ACCOUNT	3.6	5.7	3.2	3.2	-1.4	-5.5	3.0
Merchandise, net	...	5.4	2.6	2.6	-2.3	-6.4	0.9
Services, net	...	0.3	0.5	0.6	0.9	0.9	2.1
2. INCOMES & TRANSFERS ACC.	-3.6	-1.5	-0.7	-0.8	0.0	-0.2	4.2
Incomes	1.4	1.2	2.2	2.6	3.8	3.8	8.2
Unilateral Transfers	-5.0	-2.7	-2.8	-3.4	-3.8	-4.0	-4.0
3. CURRENT ACCOUNT (1+2)	0.0	4.2	2.5	2.4	-1.4	-5.7	7.2
4. CAPITAL ACCOUNT	-0.5	-5.7	-0.7	-12.9	-19.3	-3.7	-9.7
Foreign investments	...	-4.3	-3.8	-6.4	-9.1	-6.2	-6.9
Short term capitals	...	-1.3	3.2	-6.5	-10.2	2.5	-2.8
5. FUNDAMENTAL BOP (3+4)	-0.5	-1.4	1.9	-10.5	-20.7	-9.4	-2.5
(a) year average							
Source: IMF, <i>International Financial Statistics</i> , Washington DC, CD-Rom Database							

Table A3. United States' international payments and net foreign position, 1980-90 (billions of dollars)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990
1. TRADE ACC.	-18.9	-15.7	-23.5	-57.1	-108.3	-121.1	-138.5	-151.7	-114.7	-93.1	-80.9
Merchandise, net	-25.5	-28.0	-36.5	-67.1	-112.5	-122.2	-144.6	-159.2	-126.6	-117.0	-110.3
Services, net	6.6	12.4	13.0	10.0	4.2	1.1	6.1	7.6	12.0	23.92	29.41
2. INCOMES & TRANS. ACC.	22.1	24.9	20.3	21.3	17.9	4.8	0.2	0.9	5.1	-6.0	-4.7
Incomes	29.6	32.4	29.2	30.8	30.0	19.8	15.5	14.3	18.7	19.8	28.56
Unilateral Transf.	-7.5	-7.5	-8.9	-9.5	-12.1	-15.0	-15.3	-13.4	-13.6	-25.8	-33.2
3. CURRENT ACCOUNT (1+2)	3.2	9.2	-3.3	-35.8	-90.4	-116.3	-138.4	-150.8	-109.6	-99.2	-85.5
4. CAPITAL ACC.	-20.7	-26.0	-25.0	23.0	80.8	105.2	118.0	160.2	143.9	74.8	62.4
Foreign invest.	8.3	31.0	23.0	4.5	37.4	74.5	92.9	85.1	101.1	98.44	4.53
Short term cap.	-29.0	-57.0	-48.0	18.5	43.4	30.7	25.0	75.1	42.8	-23.61	57.91
5. FUNDAMENTAL BOP (3+4)	-17.6	-16.7	-28.3	-12.8	-9.6	-11.1	-20.4	9.4	34.3	-24.3	-23.1
6. NET FOREIGN POSITION	365.5	356.1	235.9	257.4	134.1	96.9	100.8	50.5	10.5	-47.0	-164.5
Assets	755.4	820.1	961.0	1129.7	1127.1	1302.7	1594.7	1758.7	2008.4	2350.2	2294.1
Liabilities	389.9	464.0	725.1	872.3	993.0	1205.8	1493.9	1708.2	1997.9	2397.2	2458.6

Source: IMF, *International Financial Statistics*, Washington DC, CD-Rom Database

Table A4. United States' international payments and net foreign position, 1991-2002 (billions of dollars)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
1. TRADE ACC.	-31.2	-38.2	-69.2	-97.2	-95.1	-102.8	-107.1	-163.1	-261.2	-375.4	-357.8	-418.0
Merchandise, net	-75.7	-95.1	-130.6	-163.8	-172.3	-189.1	-196.2	-244.7	-343.7	-449.8	-424.1	-479.4
Services, net	44.51	56.94	61.38	66.57	77.26	86.26	89.11	81.6	82.5	74.41	66.3	61.34
2. INCOMES & TRANS. ACC.	30.4	-10.4	-14.1	-22.2	-11.0	-15.0	-21.7	-42.3	-34.5	-36.9	-37.0	-64.1
Incomes	24.13	23.31	24.33	17.08	25.07	24.54	20.68	6.92	17.11	19.61	10.69	-3.97
Unilateral Transf.	6.3	-33.7	-38.4	-39.3	-36.1	-39.5	-42.3	-49.2	-51.6	-56.5	-47.7	-60.1
3. CURRENT ACCOUNT (1+2)	-0.8	-48.6	-83.3	-119.4	-106.1	-117.8	-128.7	-205.4	-295.7	-412.3	-394.8	-482.2
4. CAPITAL ACC.	40.6	92.3	82.9	124.6	95.9	130.5	220.2	82.5	227.8	456.6	420.5	531.7
Foreign invest.	-2.86	-5.65	-67.82	45.05	46.86	177.5	214.9	99.76	233.8	460.1	372.0	339.0
Short term cap.	43.49	97.99	150.7	79.55	49.05	-47.05	5.28	-17.25	-6.05	-3.52	48.44	192.6
5. FUNDAMENTAL BOP (3+4)	39.8	43.7	-0.3	5.2	-10.2	12.7	91.5	-122.9	-67.9	44.4	25.7	49.5
6. NET FOREIGN POSITION	-260.8	-452.3	-144.3	-123.7	-343.3	-386.5	-835.2	-1094.	-1068.	-1588.	-2314.	-2605.
Assets	2470.6	2466.5	3091.4	3326.7	3930.3	4631.3	5379.1	6174.5	7390.5	7393.7	6891.3	6473.6
Liabilities	2731.5	2918.8	3235.7	3450.4	4273.6	5017.8	6214.3	7268.6	8459.2	8981.8	9205.5	9078.7

Source: IMF, *International Financial Statistics*, Washington DC, CD-Rom Database

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