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Looney, Robert E.

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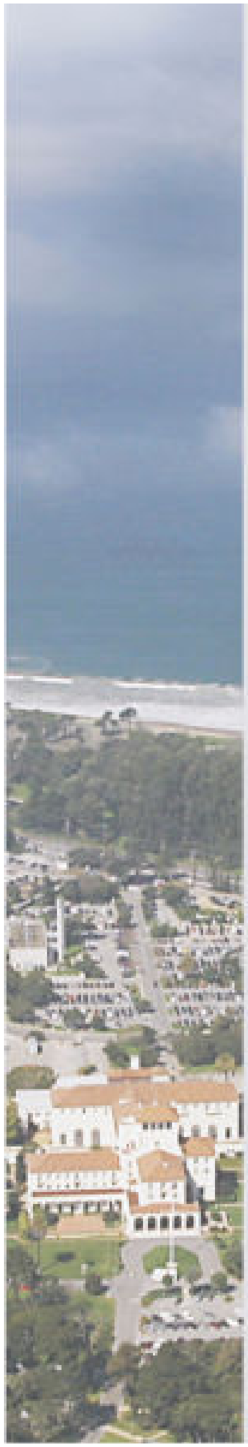

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Security Implications Of The Global Economic Crisis

2011 CCMR Executive Course in Decision Making Naval Postgraduate School

November 3, 2011

Dr. Robert E. Looney
relooney@nps.edu

Monterey, California
WWW.NPS.EDU

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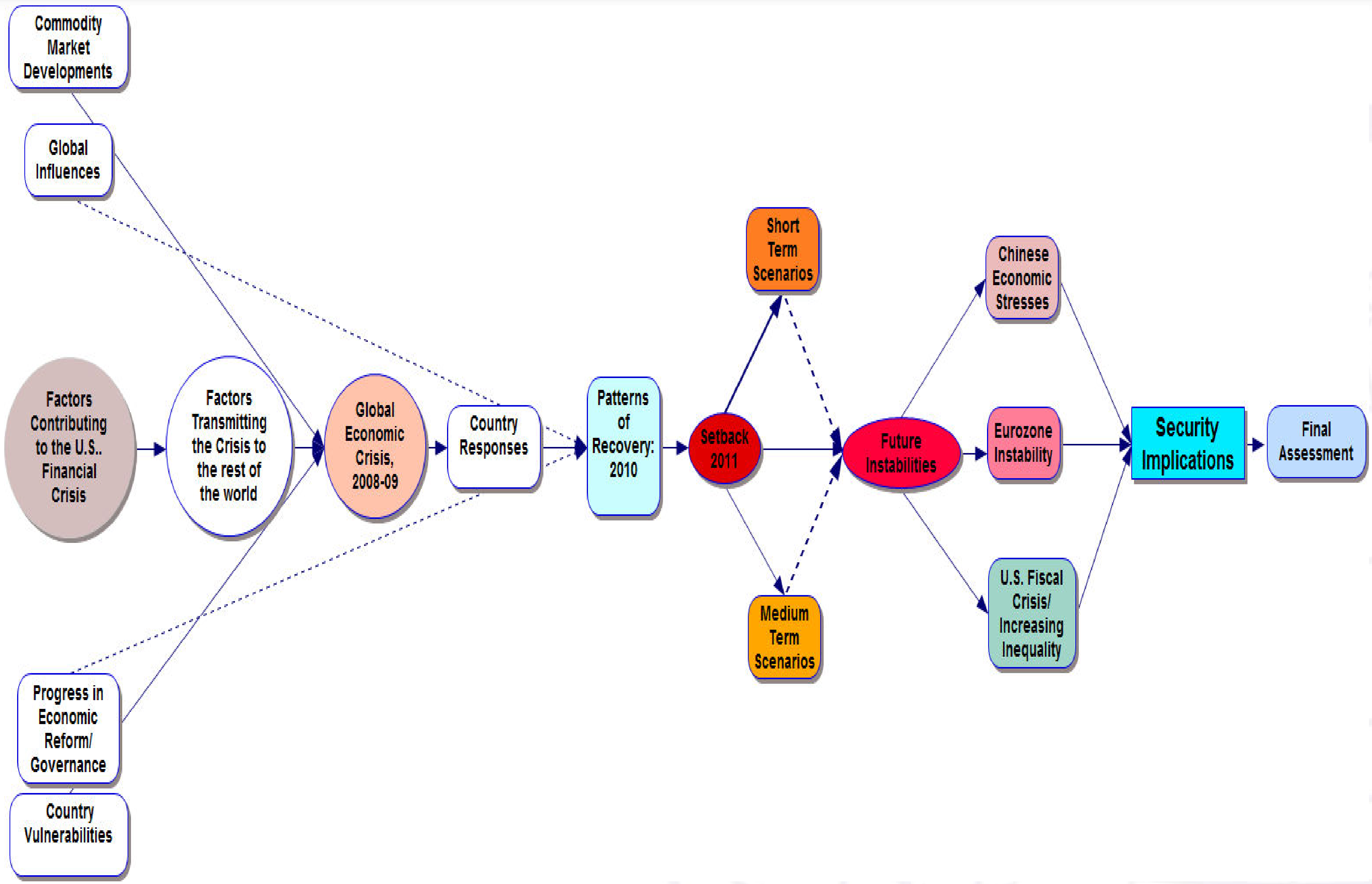
Outline

- **PART I – The Global Economic/Financial Crisis**
  - Factors Leading to the Global Crisis
  - Transmission Mechanisms
  - Patterns of Recovery
  - Current Risks – Increased Pessimism
  - Alternative Scenarios
  - Short/Medium Term Assessments
  - Complicating factors – oil shocks, governance traps
- **PART II – Future Sources of Instability**
  - Eurozone Crisis
  - Chinese Economic Stresses
  - Globalization Stresses – Increased Inequality
  - U.S. Fiscal Crisis
  - Impact on Security/Defense Expenditures
  - Final Assessment

Overview


Commodity Market Developments
Global Influences
Factors Contributing to the U.S.. Financial Crisis
Factors Transmitting the Crisis to the rest of the world
Global Economic Crisis, 2008-09
Country Responses
Progress in Economic Reform/ Governance
Country Vulnerabilities
Patterns of Recovery: 2010
Setback 2011
Short Term Scenarios
Medium Term Scenarios
Future Instabilities
Chinese Economic Stresses
Eurozone Instability
U.S. Fiscal Crisis/ Increasing Inequality
Security Implications
Final Assessment

Economic Crisis and Security Threats

"The global recession is America's primary near-term security concern."

Admiral Blair – Director of National Intelligence

(February 2009)

"The single biggest threat to national security is the national debt."

Admiral Mullen, Chairman of the Joint Chiefs of Staff

(August 2010)

"I have to confess, I paid no attention to this (economics) as a cadet and have done nothing to increase my awareness of economics issues between age 22 and 59. I should have paid attention."

General Dempsey, Chairman of the Joint Chiefs of Staff
(October 2011)

The World Economic Crisis

With regard to the ongoing economic crisis, several generalizations are possible:

- **The current crisis while severe, shares many characteristics and patterns associated with past crisis**
- **Its origins and underlying causes follow a familiar pattern --- with several unique twists**
- **Just when it appeared the crisis was coming to an end in 2010, it has flared up again with the prospects for the next several years, grim for the developed market economies (DMs) and highly uncertain for the emerging market economies (EMs).**

Crisis: Beginnings

- **The Environment:**
  - Long period of easy credit, low interest rates
- **The trigger:**
  - Higher than expected defaults on U.S. subprime mortgage loans (bad banking?)
- **The propagation channel:**
  - From real estate markets
  - to asset-backed securities markets
  - to bank balance sheets
  - to inter-bank funding markets
  - to the broader credit markets
  - to the real economy and
  - across borders.

Crisis: Initial Stages

The early stages of the crisis :

- **Summer 2007 – initial phase**
  - **Subprime mortgage crisis,**
  - **Beginning of collapse of stock exchange**
- **Early 2008 – growing stress in advanced countries**
  - **Systemic crisis of financial intuitions in US**
  - **Economic slowing down in U.S. EU and Japan, but**
  - **Overheating inmost emerging markets (high commodity prices, weak US dollar accelerating inflation**
- **Summer 2008 – breaking point**
  - **Bursting commodity and other bubbles**
  - **Global crisis of financial institutions (bankruptcy of Lehman)**
  - **Recession in developed countries**
- **Fall 2008 – crisis hits emerging market economies.**
  - **Effects of the crisis world-wide and more severe than in past modern recessions – severe because of wide-spread financial institution's holding of bad paper.**

Crisis: Country Responses

- **Not much coordinated activity in responding to crisis, because of incompatible conceptual frameworks for understanding its root causes**
  - U.S. policy makers believe that trade surplus countries pursued policies that created global imbalances – excess savings in China – fixed exchange rate
  - Europeans believed that the root cause of the crisis was excessively deregulated financial systems
  - China feels reserve status of dollar created the imbalances to develop to unsustainable levels
- **Therefore responses not coordinated**
  - Fiscal stimulus in some countries
  - Expansive monetary policy, central bank asset purchases
  - Support (IMF) to vulnerable countries
  - Attempts through WTO at preempting protectionism

Crisis: Transmission and Responses

What is the shock at global level?

Global shock

The following characteristics determine how the global shock creates country effects:

- Level and type of economic and financial integration
- Characteristics and distribution of links with other countries
- Structure of economy
- Policy

What are the transmission mechanisms?

Trade	Private capital flows	Remittances	Aid

The following national characteristics determine the macro effects of the transmission mechanisms:

- Economic/social structures
- Institutions/policies
- Assets, prices, employment
- Access to goods and services

What are the broad macro effects? (effects so far, possible effects)

Growth, investment and employment National and sectoral	Inequality, poverty	Public and private debt

Review of policy responses

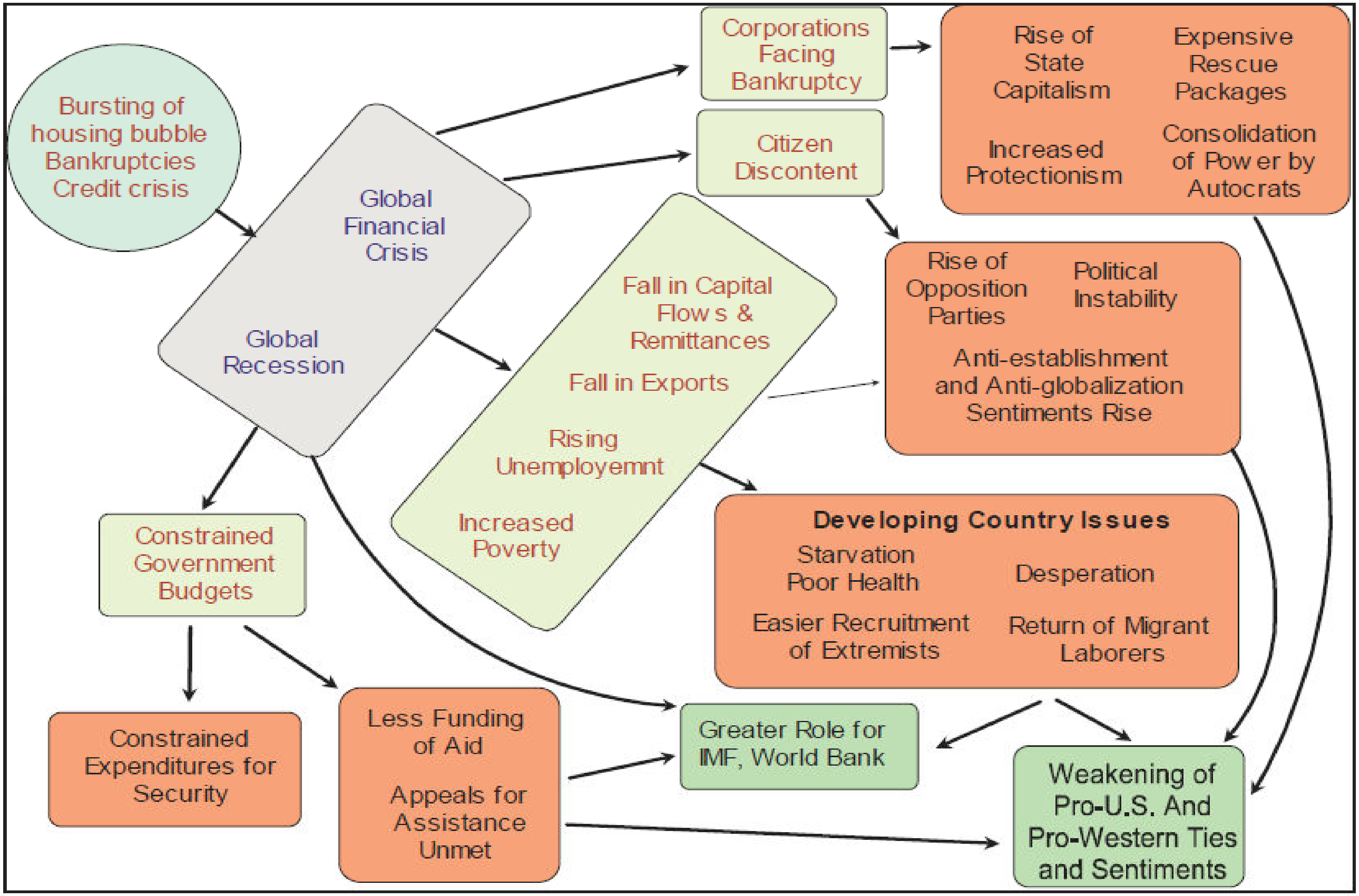
Macroeconomic policies to manage shock (fiscal, monetary, financial)	Social policies to manage shocks	Accelerating normal growth and development policies

Four Early Economic/Security Scenarios

In late 2008, early 2009 four economic crisis/security scenarios were getting considerable attention –

- The Bait Effect – terrorists seeing the U.S. economy melting down calculate that a strike could have a force multiplier because of the already skittish stock market.
- The China Syndrome – Chinese own more than $500 billion in US. Treasury bonds, and billions more in other U.S. debt. While they would not dump them on the market to disrupt the U.S. economy, they have leverage over U.S. decisions on interest rates, exchange rate decisions.
- A Japanese "Lost Decade" – U.S. economy flat in the water for a decade or so – government runs up debt with no stimulating effect on the economy
- The Alternative-Dollar Nightmare – countries refuse to hold dollar reserves. Dollar crashes and U.S economy along with it.
- None happened – Lesson – Much More Stability in Global System than Commonly Believed

Global Financial Crisis: Initial Security Concerns



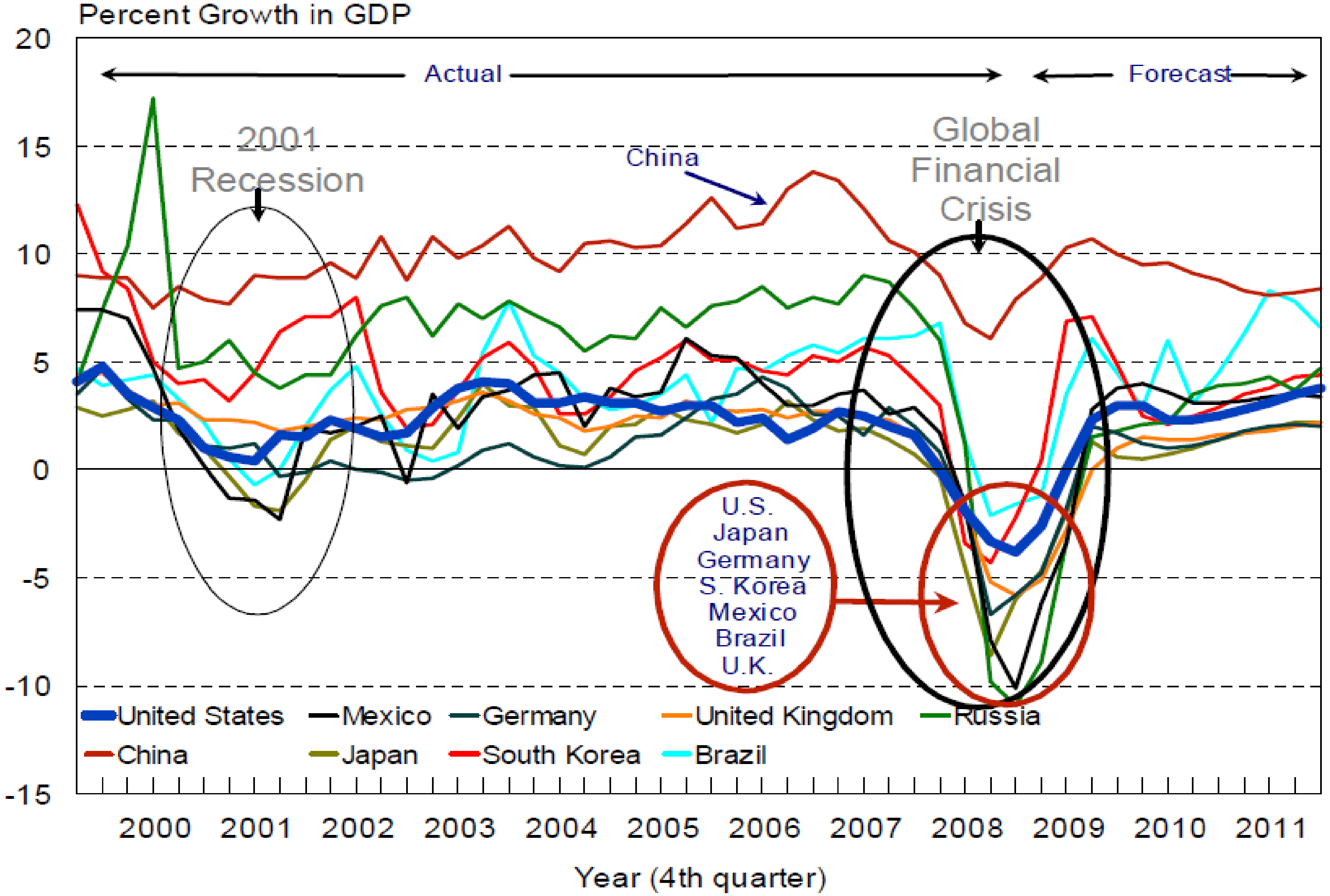
Source: Congressional Research Service

Factors Contributing to Stability

Why didn't the global system collapse when many in late 2008 were predicting its immediate demise?

- **Revival did not happen because markets managed to stabilize themselves on their own**
  - Governments learning from the great depression responded quickly through central banks and treasuries
  - The extensive social safety nets across the industrialized world cushioned the pain
- **Global system is simply more resilient than we imagined – three major reinforcing elements producing stability**
  - Spread of great power peace – relatively little friction between major nations – rare in history – true global economy
  - Relatively low rates of inflation – can plan for the future
  - Technological connectivity – information revolution crated a deeply connected global system – most nations have benefitted greatly from the system – cautious about appeals to nationalism or acts that would jeopardize the current system.

Country Patterns



Source: Congressional Research Service. Data and forecasts (January 15, 2010) by IHS Global Insight.

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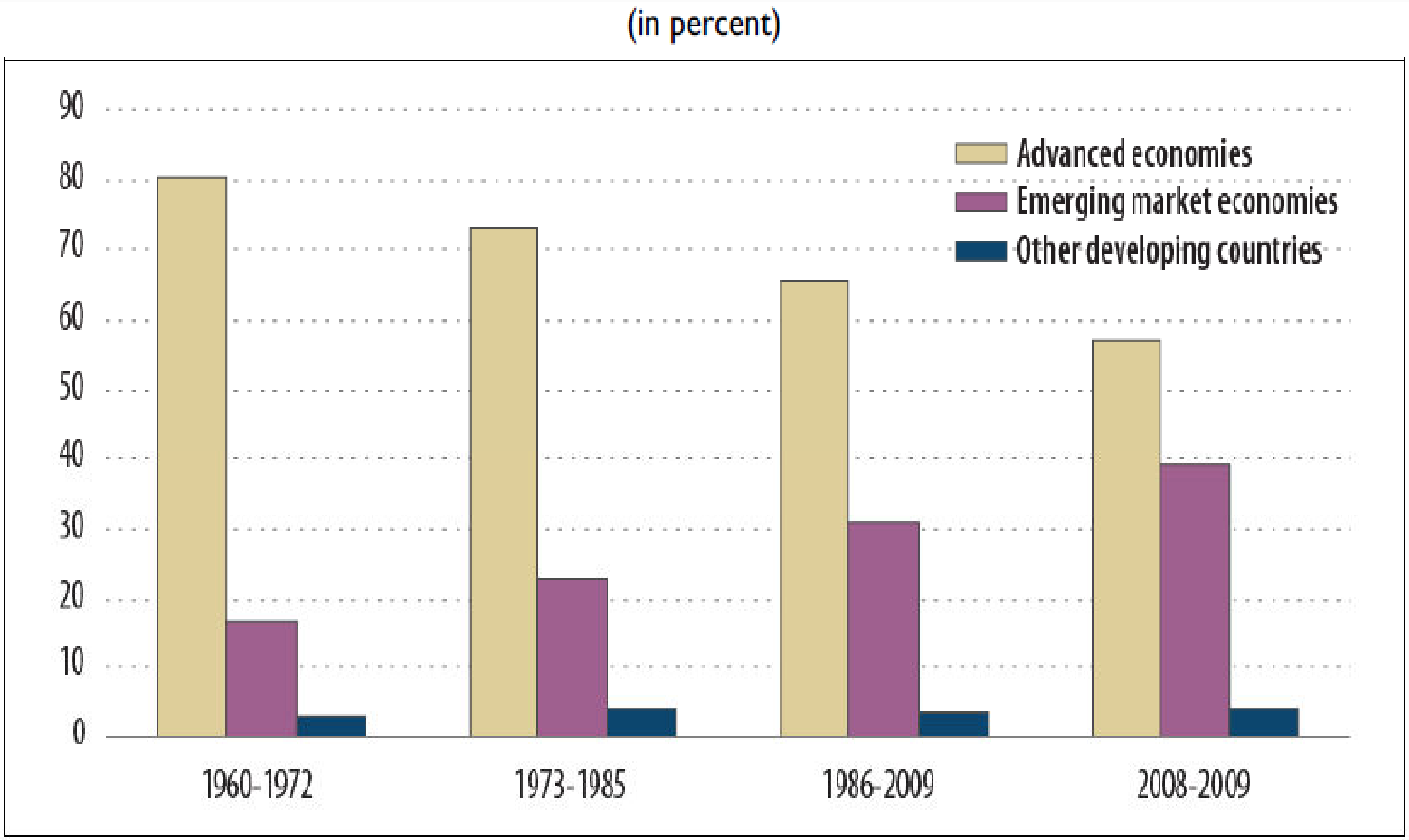
Crisis: Potential U.S. Growth

Under all the standard scenarios, the crisis will have a marked impact on U.S. potential growth:

- **The recession, the rising U.S. debt levels and tighter financial conditions will hurt investment, keeping capital formation well below rates in pre-crisis years**
  - Resulting high and more-persistent-than-usual unemployment will lower potential growth
  - IMF estimates that U..S. potential output will average about 1.5% over the next five years.
  - This compares with an estimated 2.0 percent anticipated average in the absence of the crisis
  - By 2014 the potential output expected to be abut 6 percent below what it would have been in the absence of a crisis
- **Slower U.S. growth will suppress recoveries in key U.S. trading partners.**

Crisis Has Accelerated Changes in World GDP



Source: Brookings Institution, *Emerging Markets*, p. 30.

Notes: World GDP is measured in Purchasing Power Parity (PPP) adjusted dollars.

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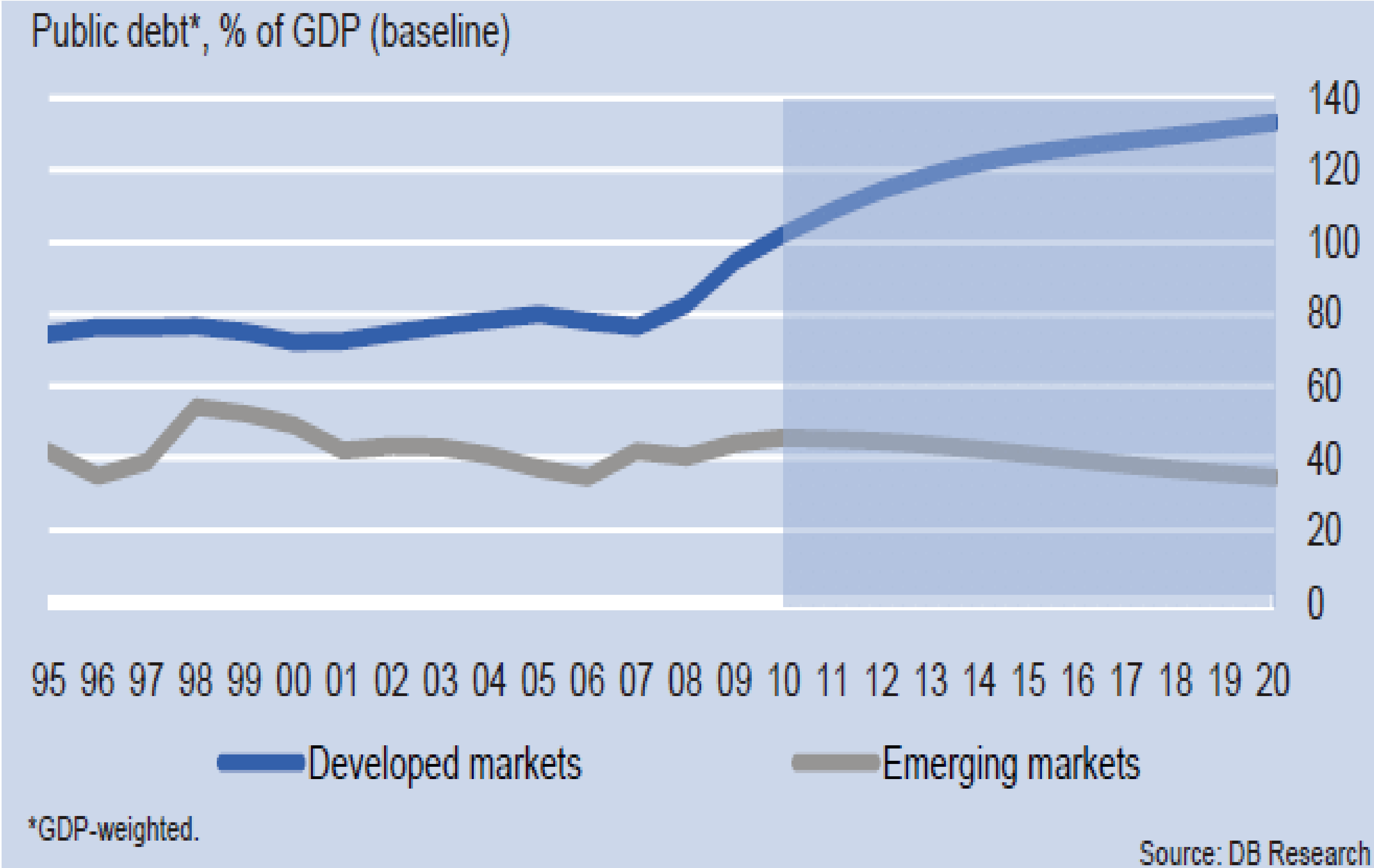
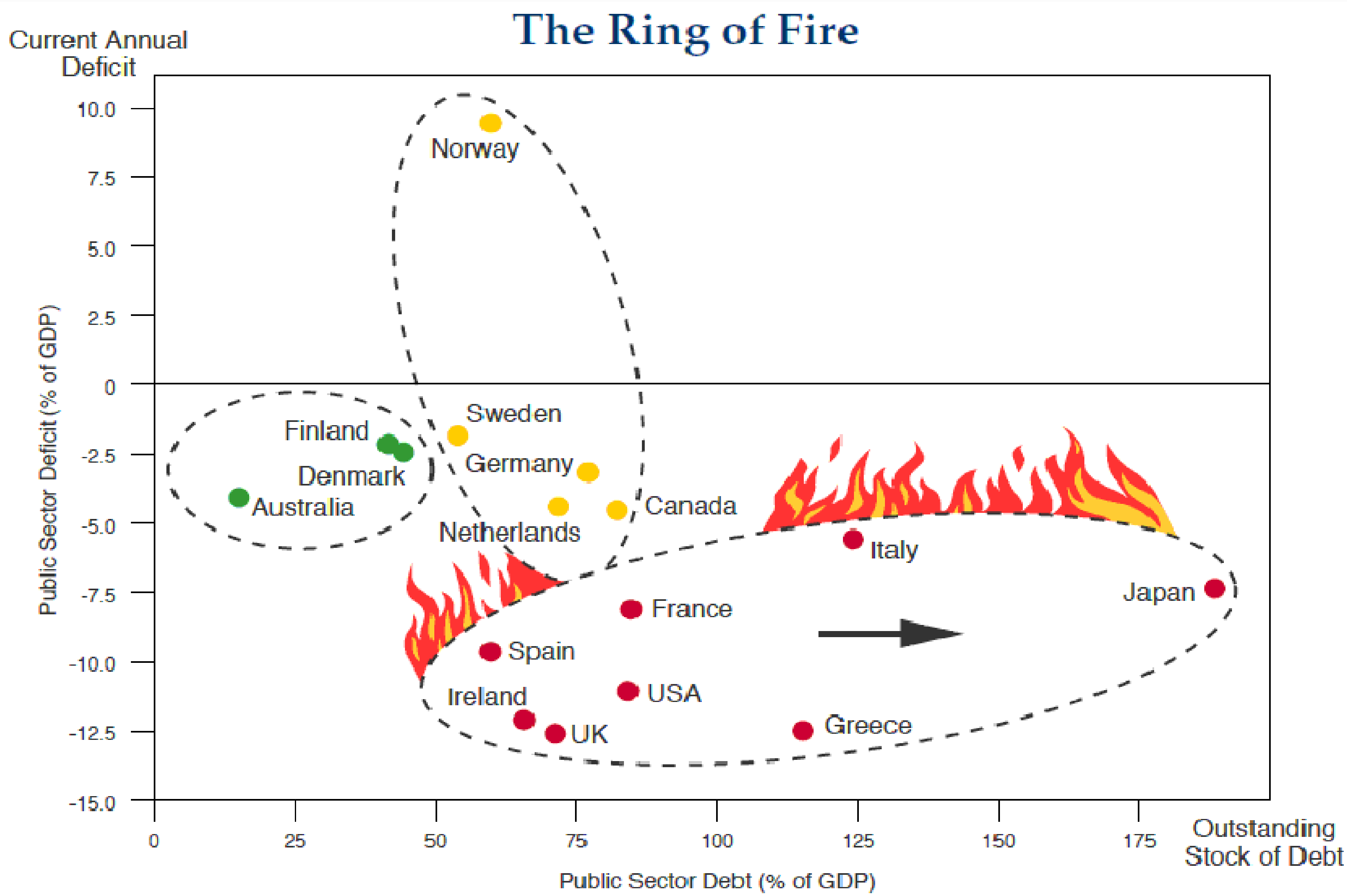
Patterns of Future Pubic Debt



Debt Vulnerability



Source: Reuters EcoWin, SEB X-asset Research.

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Debt Burden and Credit Ratings

Outlook Downgrade

The S&P lowered its outlook on the U.S. government's debt to 'negative' from 'stable.'

	LONG-TERM CREDIT RATINGS	LONG-TERM CREDIT OUTLOOK	GROSS DEBT AS A PERCENTAGE OF GDP, 2010
Japan	AA-	Stable	220.3%
U.S.	**AAA**	**Negative**	**91.6**
Canada	AAA	Stable	84
France	AAA	Stable	81.8
Germany	AAA	Stable	80
U.K.	AAA	Stable	77.2
Brazil	BBB-	Stable	66.1
Spain	AA	Negative	60.1
Norway	AAA	Stable	54.3
Argentina	B	Stable	47.8
Australia	AAA	Stable	22.3
China	AA-	Stable	17.7

Sources: Standard & Poor's (long-term credit); International Monetary Fund (debt)

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2011 -- Increased Pessimism

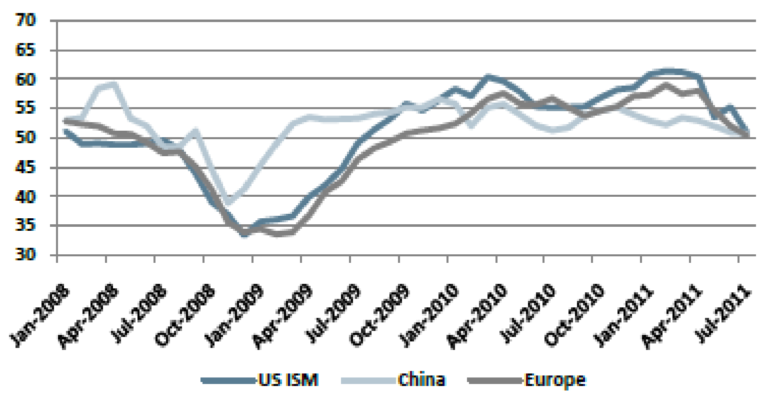
Since early 2011 most forecasting groups have continually downgraded their projected rates of recovery for most areas of the world. Many factors are involved:

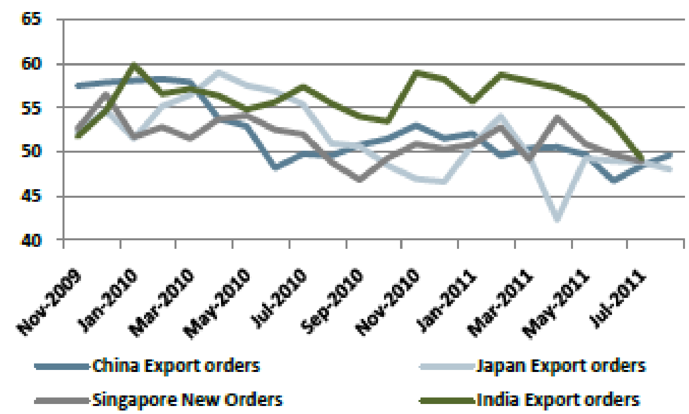
- A lack of resolution of old threats to the recovery (e.g., the EZ crisis)
- The need for deleveraging in DM public sectors
- The double dip in the U.S. housing sector, witch poses risks to wealth, personal consumption, and the balance sheets of financial institutions
- Still-high commodity prices that have dampened consumption and complicated monetary policy in some countries
- Inadequate rebalancing of global demand, adding to excess capacity
- Rising risks of a short-term hit to confidence – markets very nervous

Near-Term Leading Indicators All Down

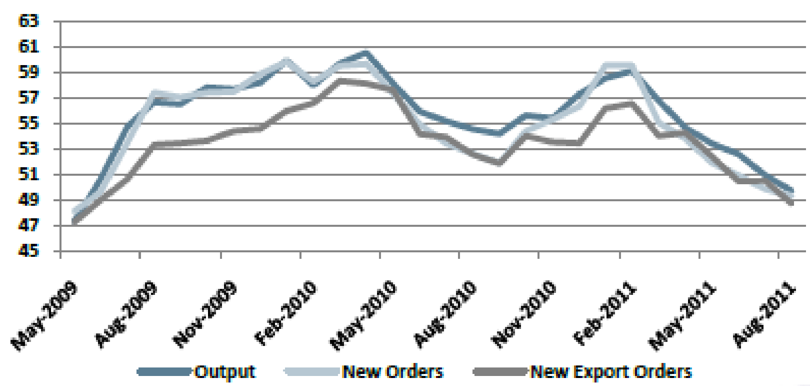
- Global PMIs have fallen significantly, with several at or below the neutral level.
- Forward-looking components (new orders) are underperforming output.
- Inventories are starting to pile up.
- OECD leading indicators point to slowdown in many economies—the business cycle has turned.

Manufacturing PMIs Converging to Neutral

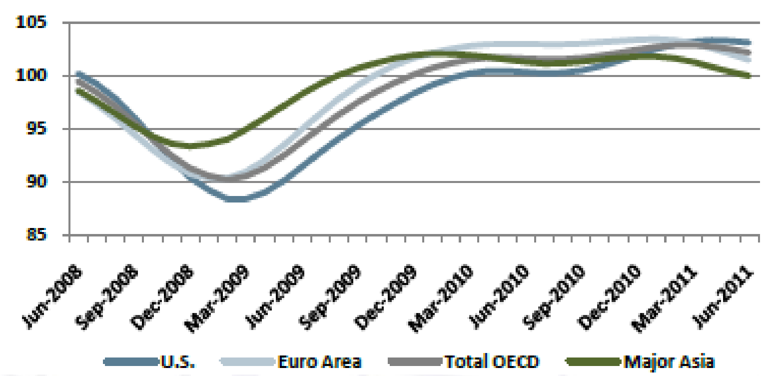




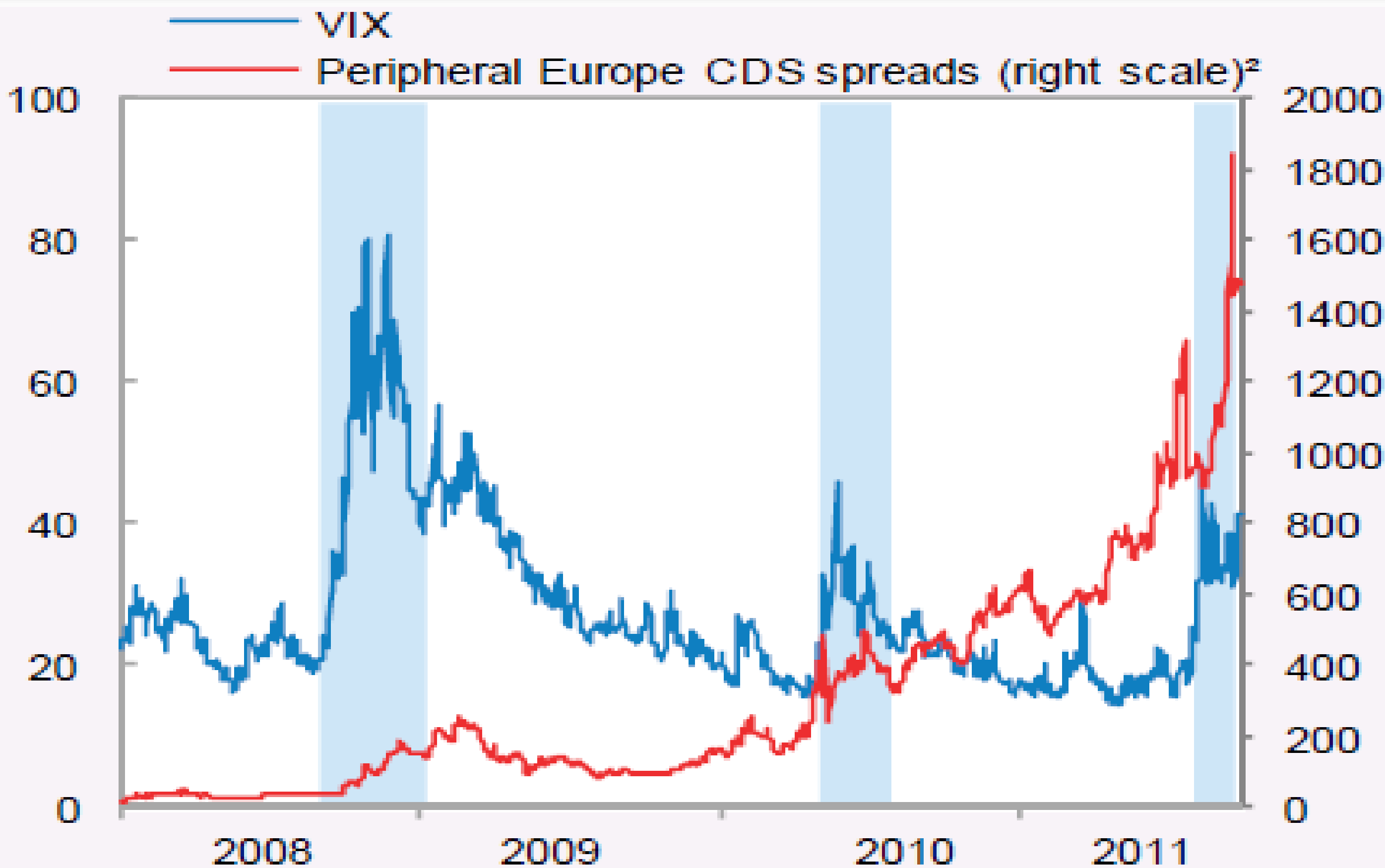
New Orders Decline Signals Weaker Output Ahead (Global)



OECD Leading Indicators Point to Turn in Business Cycle

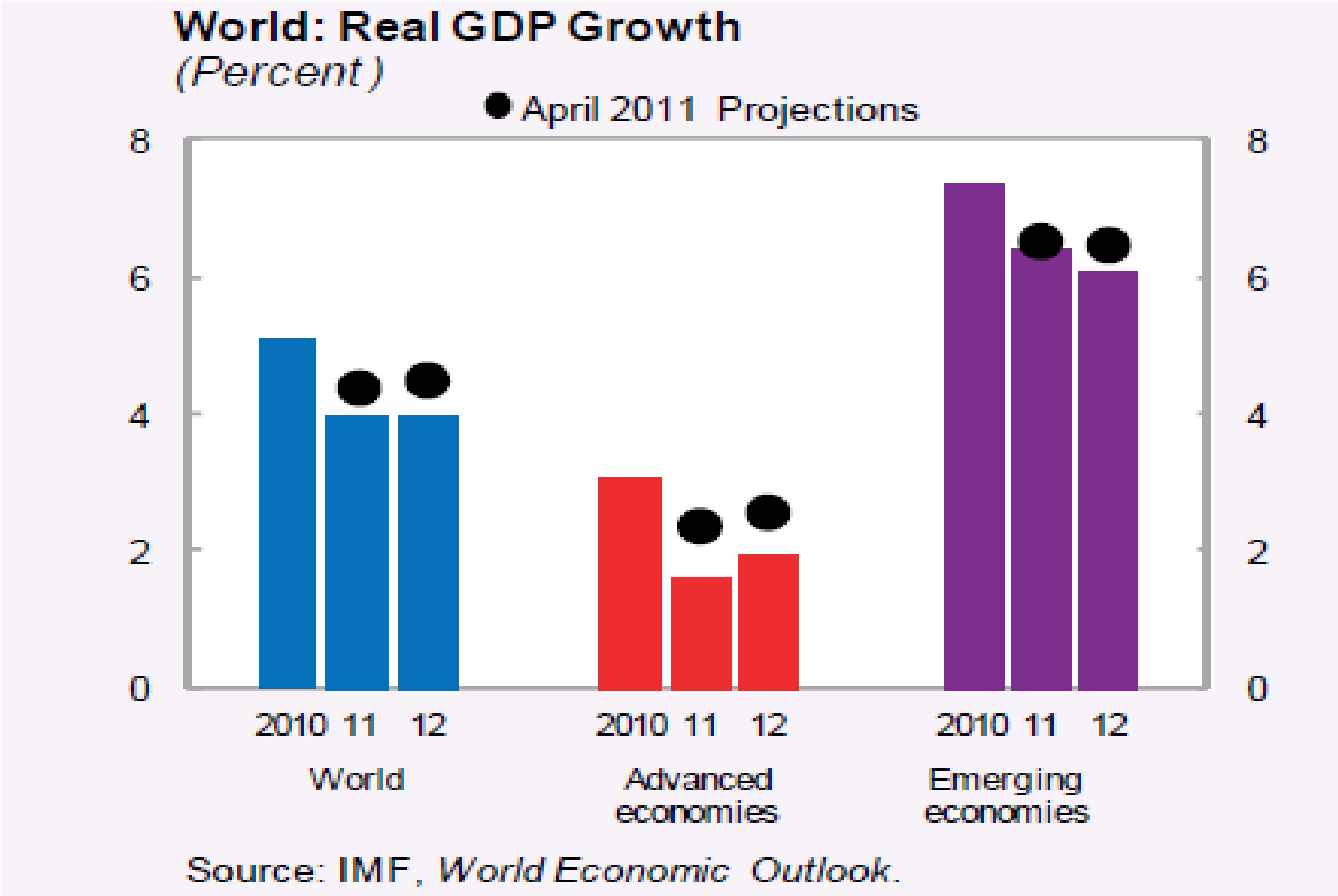


Measures of Global Risk Aversion Up Sharply 2011



Sources: Bloomberg, L.P.; and IMF staff calculations.
¹ Shaded areas correspond to periods of VIX stress.
² Average for Greece, Ireland, Portugal, and Spain.
CDS = Credit default swap; VIX = Chicago Board Options Exchange Market Volatility Index.

Slow-Down in Growth: Advanced Economies



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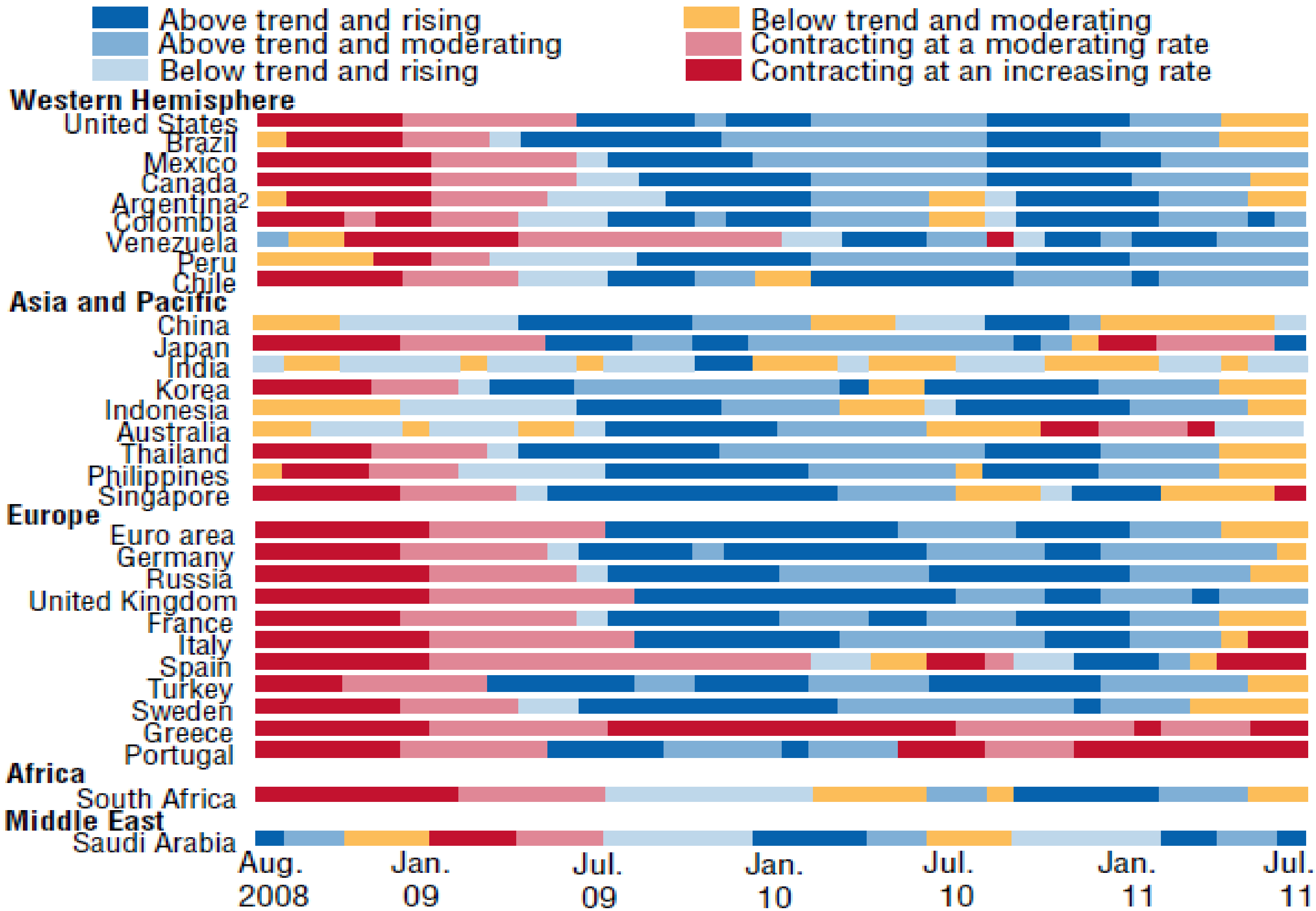
IMF Growth Tracker



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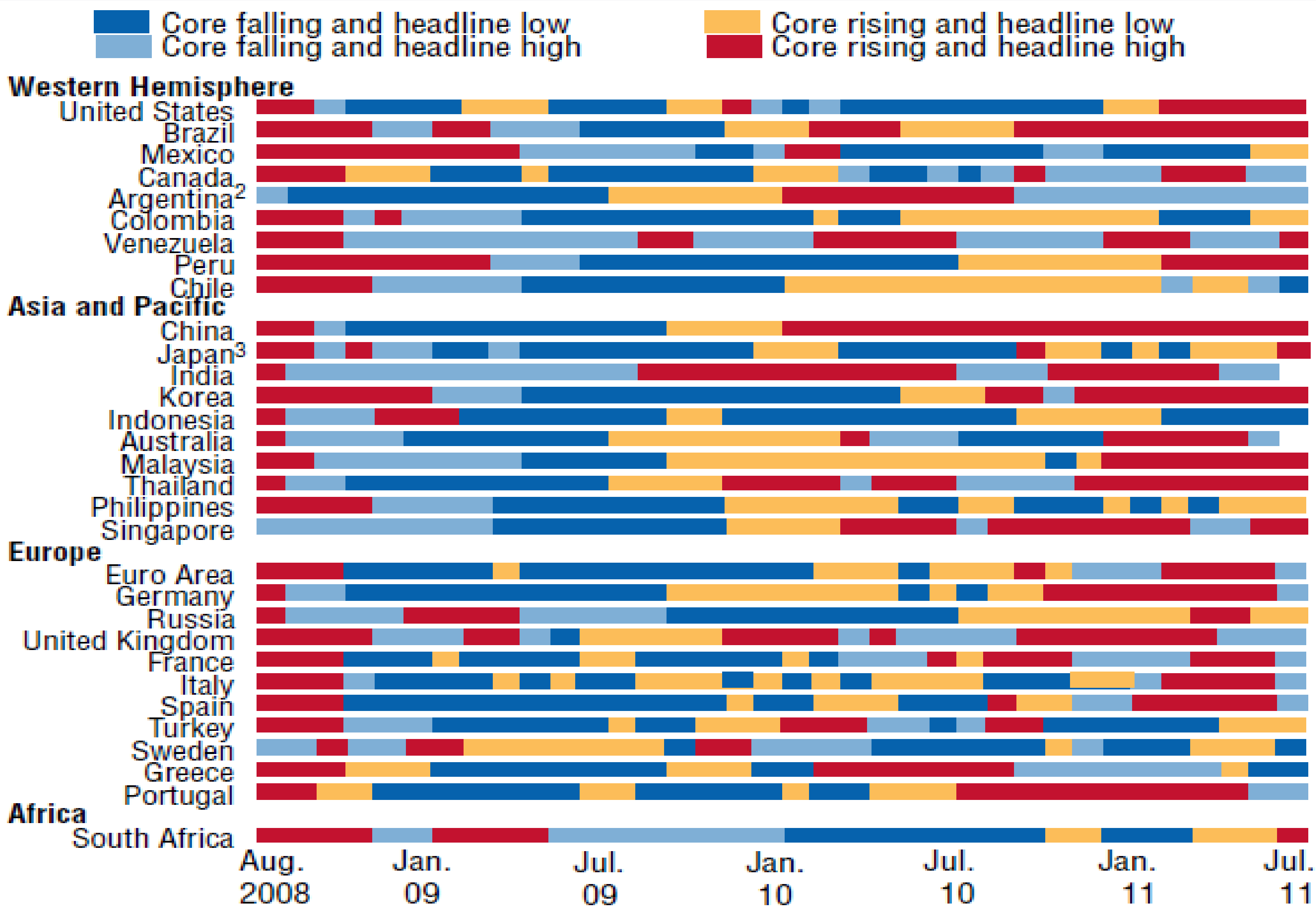
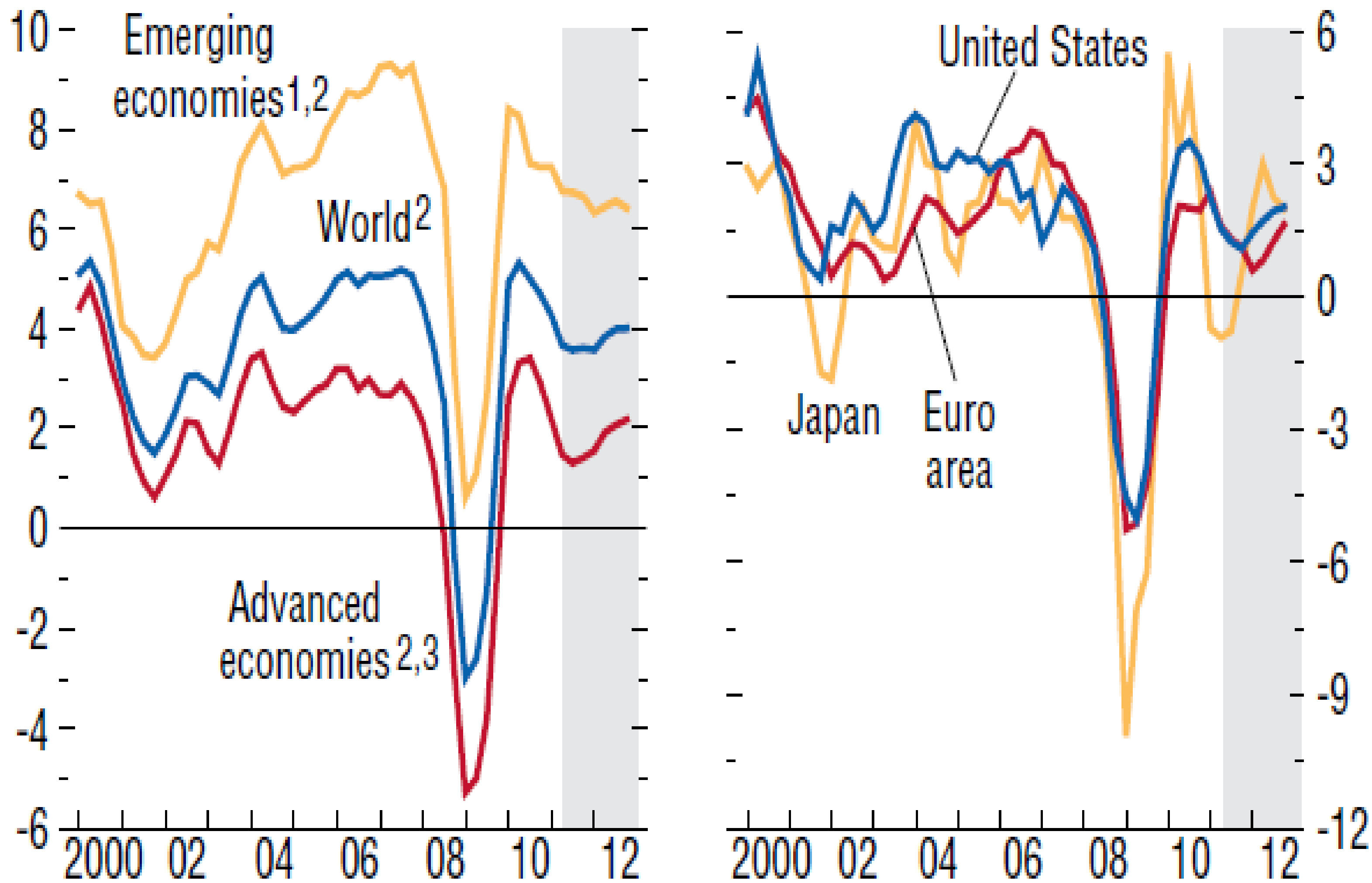
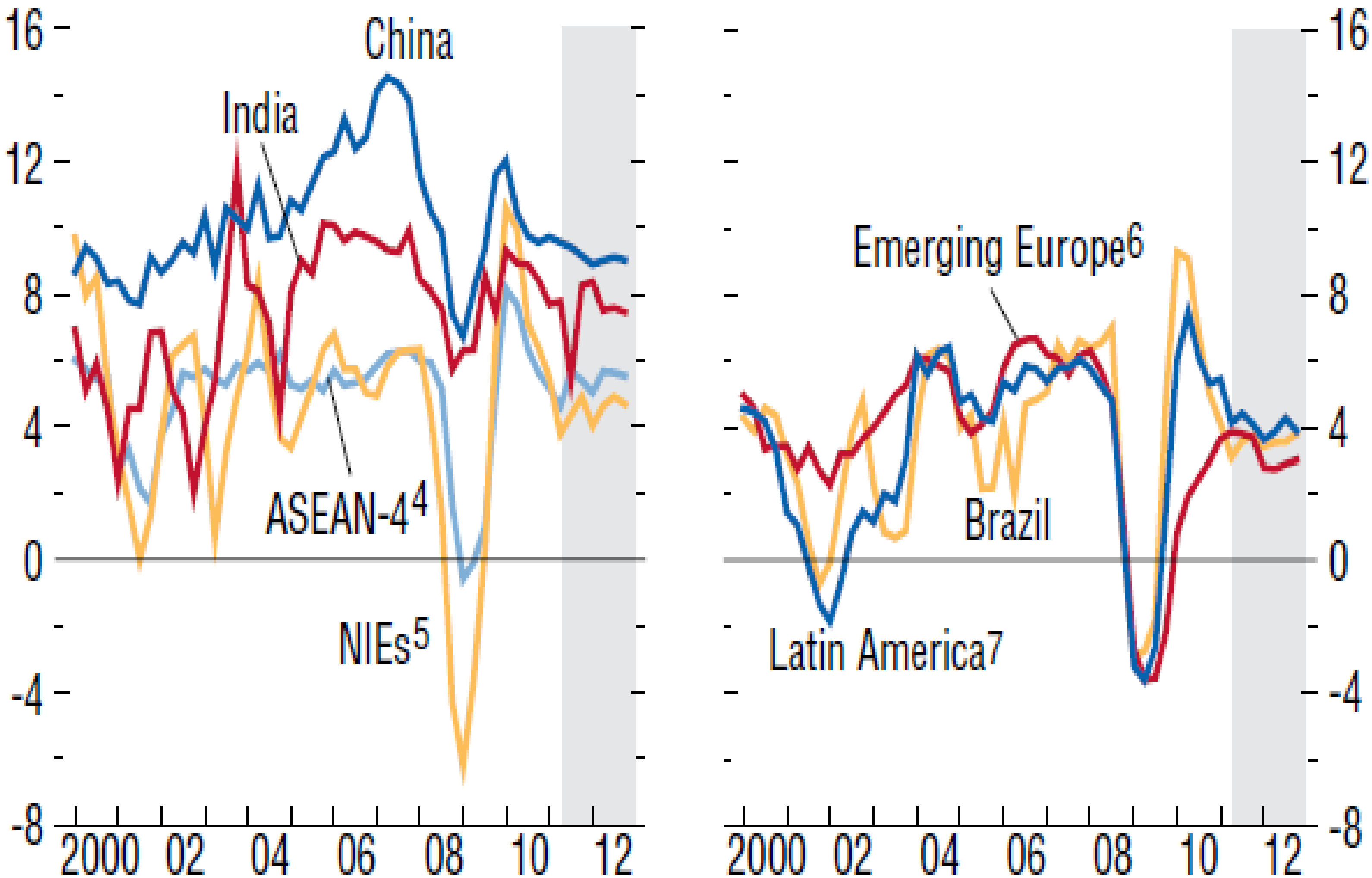
IMF Inflation Tracker



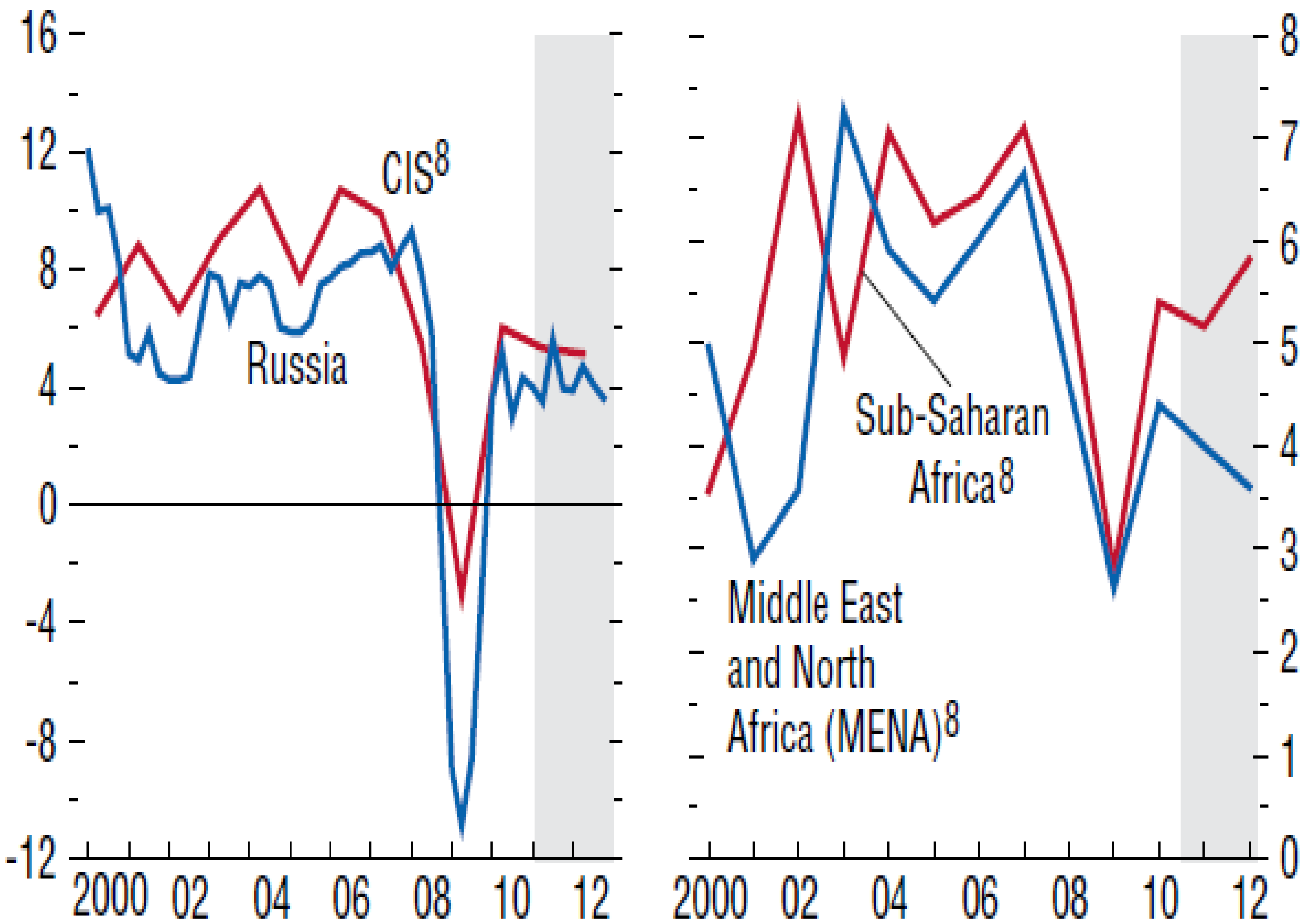
IMF October 2011 Forecast I



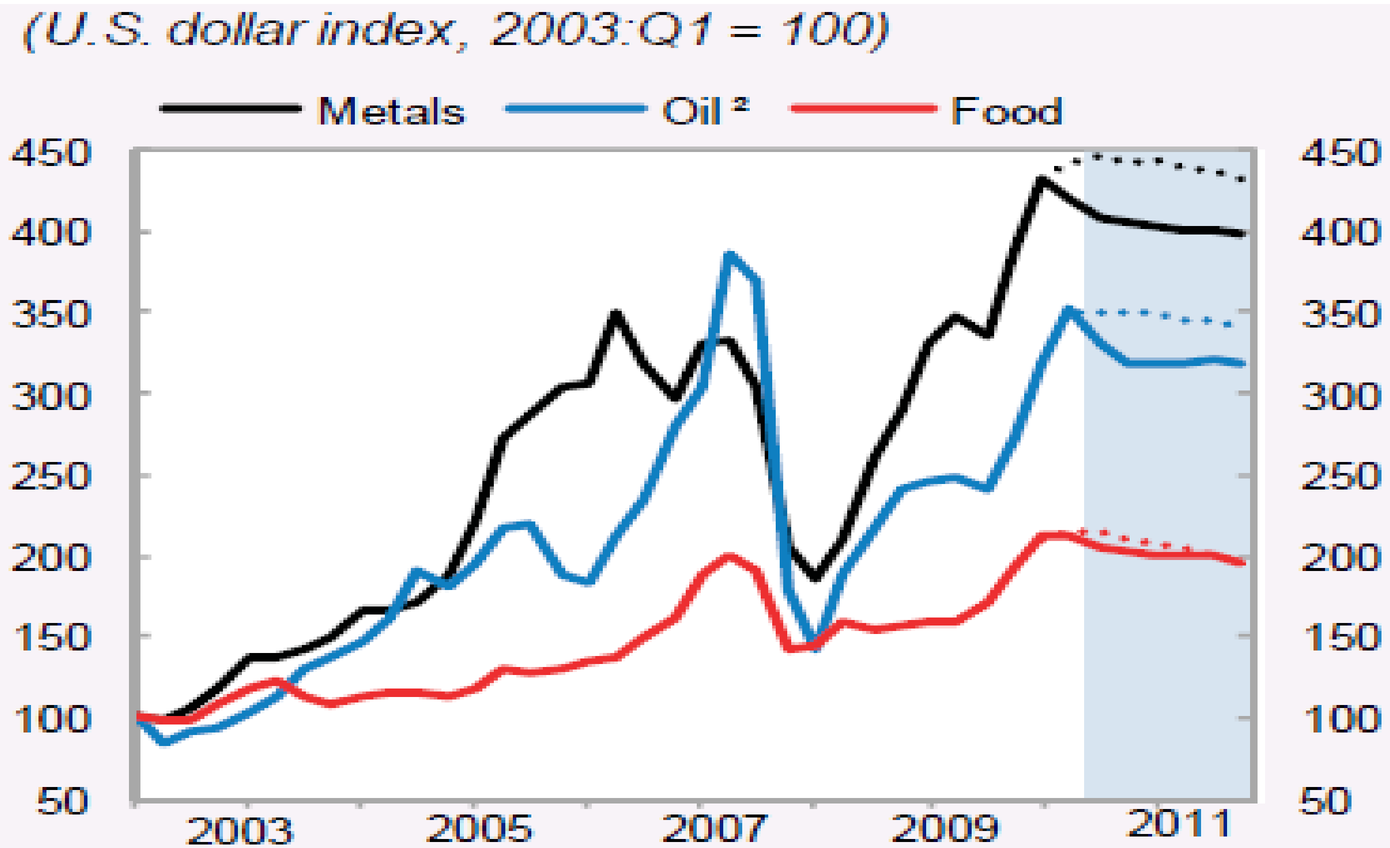
IMF October 2011 Forecast II



IMF October 2011 Forecast III



Commodity Price Changes: April vs. October 2011



Sources: IMF, *World Economic Outlook*; and IMF staff calculations.

[1] Dotted lines represent the projections reported in the April 2011 WEO. Shaded area represents projection period.

[2] Average of West Texas Intermediate, Dated Brent, and Dubai Fateh.

What Has Changed?

Downside risks dominate in DMs

- **The lingering EZ periphery debt crisis and a major political economy problem preventing its solution have returned to the fore**
- **The U.S. at stall speed with still high consumer debt implies the need for stimulus, but political issues and the debt downgrade have contributed to policies that accentuate unnecessary and harmful fiscal drag**
- **Even as temporary shocks (Japan supply-chain disruptions, oil price spike) wane, underlying growth is weak.**
- **Net effect since June:**
  - Weak DM performance greatly reduces chance of strong global growth
  - DM weakness puts greater pressure on China/EMs. It raises the risk of a crash rather than a slow burn.

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Fear Factor

These elements combine to create a fear factor that is depressing world-wide expectations for growth.

- **Sequencing matters – falling commodity prices are not yet benefitting consumers, but are already curbing growth and financial flows in producer economies**
  - The Gulf States, Russia and Brazil will growth this year but not at peak rates,
- **Other BRIC countries are also experiencing difficulties**
  - India, still struggling to contain near double-digit inflation, also expects growth to drop.
  - China is also looking vulnerable – facing major policy decisions
- **Europe's immediate neighborhood looks fragile and even explosive in parts.**
  - North Africa is still unsettled and Turkey could suffer from financial contagion given its need for capital inflows.
  - Indebted emerging Europe is restive

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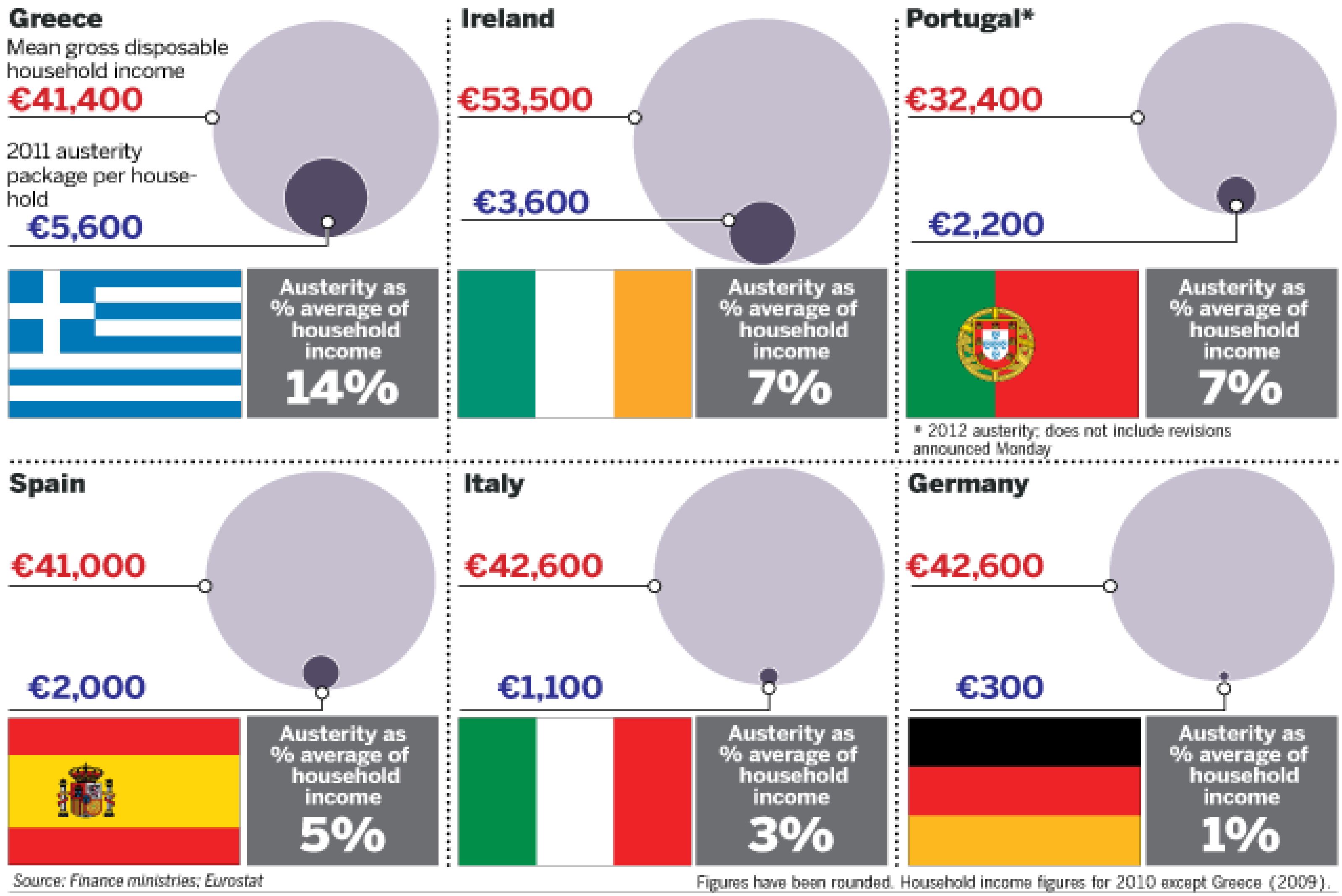
EZ 2011 Austerity Packages



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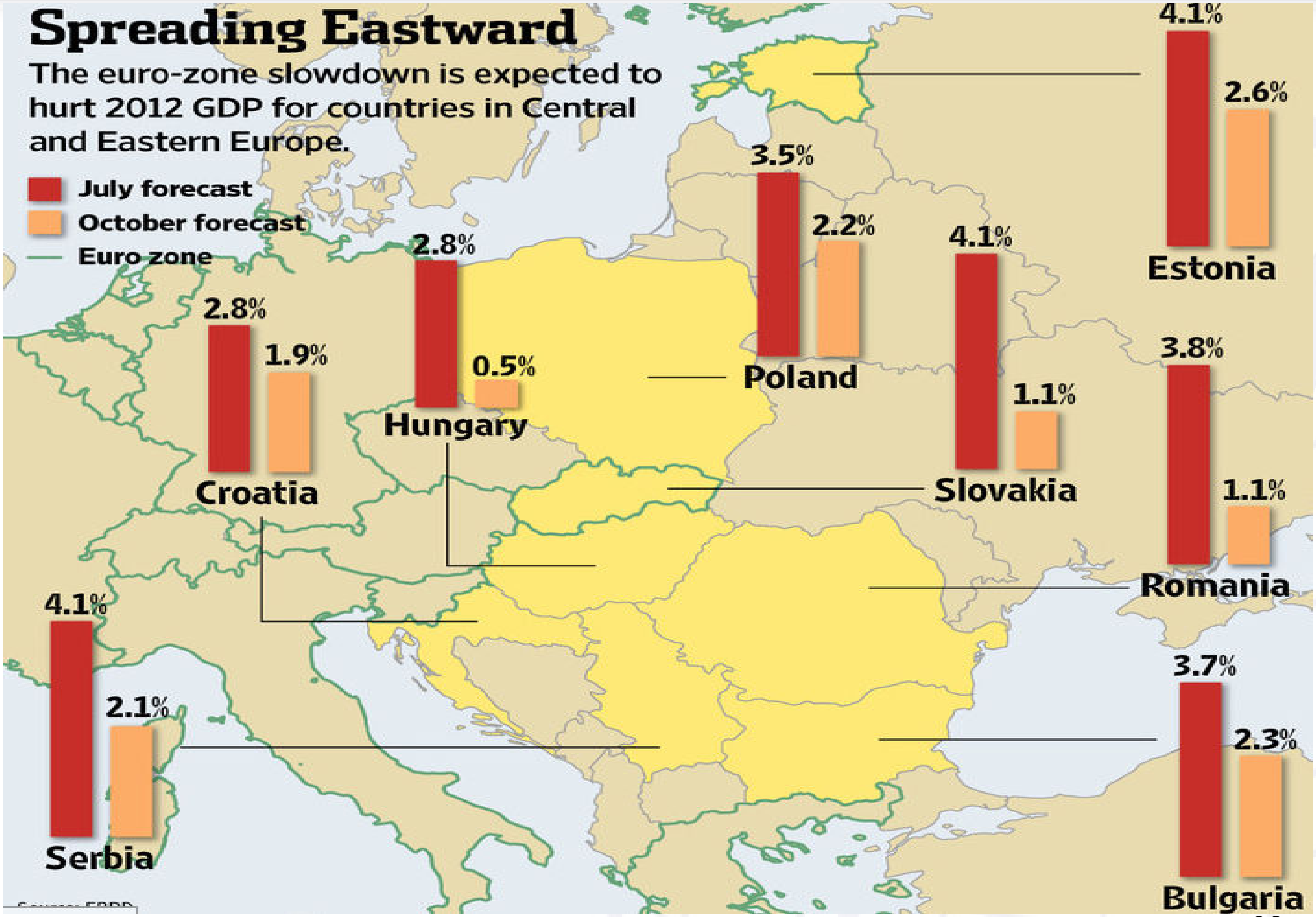
Slow-Down in Eastern Europe



Alternative Scenarios

There are several possible scenarios for the global economy.

- **Benign – Global growth picks up again before end of year Commodity prices stabilize and weaker inflation relieves pressure on consumers and central banks**
  - This boosts confidence in governments' ability to manage their debts and encourages a rally in global equity markets
- **Muddling Through – Economic activity remains subdued despite falling commodity prices and inflation.**
  - The debt crisis escalates in the euro-area periphery and banking system sucking in Italy and requiring further fundraising by the European Financial Stability Facility (EFSF) and IMF.
- **Double-Dip Recession – Growth slackens markedly in leading emerging market economies and the developed world slips back into recession.**
  - Commodity prices tumble and threat of deflation reappears in some countries. Tensions over sovereign debt and austerity policies cause panic in bond and equity markets creating a dash to safe haven cash and gold.

Short-Term Assessment

Probably of stagnation or double dip scenario is higher (60%) than before (15-20% in the spring and 30-40% in July), as negative macroeconomic surprises and faltering confidence continue to show up in the data

- The slowdown is more than a soft patch, and policy makers (particularly in DMs) will find themselves without policy bullets or unwilling to use the ones they have
- Possible triggers include policy mistakes (or inadequate policy responses) or a major financing shock stemming from disorderly default by sovereigns or a systemic financial crisis
- The recovery remains policy dependent in DMs that are relying on ZIRP and withdrawing from fiscal stimulus packages.
- If DMs were to experience sharp demand destruction, EMs would suffer as real economic and financial links exacerbate the ongoing slowdown, though most (especially in Asia and Latin America) have policy space for stimulus.
- Emerging Europe requires more balance sheet repair and retains less policy space.

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Medium Term Assessment

In the medium term (five year horizon) a weak U-Shaped recovery amid balance sheet repair is the most likely scenario

- However given the macroeconomic deterioration, the political impasse in the United States and continued uncertainty in the EZ, the risk of falling into a protracted recession with inadequate policy responses is high (45%).
- As gradual deleveraging continues, investors will search for yield to maximize real returns, bringing capital to Ems as well as commodities, and adding to EM monetary trilemmas
- Regulatory changes encourage the buildup of leverage outside investment banks (in the shadow banking system) and in EMs with space to borrow more.
- Although EMs like Brazil and Turkey still have low overall outstanding credit, debt-service costs could dampen consumption
- Slow policy normalizaion will plant the seeds in the next crisis in EMs and EMs.

Possible Perfect Storm

Several coincident stresses raise short- and medium-term risks

- **Amid U.S. cyclical slowdown, political gridlock stands in the way of necessary stimulus and reforms to deal with underlying vulnerabilities (e.g., the housing market).**
- **EZ policy makers are running out of time. Despite more significant moves from the European Commission/ECB, debt levels are still too high, raising the risk of a country exiting in the medium term.**
- **The end of the Chinese investment bubble is a medium term (post-2013) risk, but DM recession could bring the risks forward. The end of China's investment and lending binge will weigh on domestic and global growth.**
- **Global rebalancing has been insufficient . Excess capacity could derail investment**
- **Governance Traps may halt growth in one or more Ems at a critical juncture – around per capita income $10,000 to $15,000.**
- **Sudden and prolonged spike in oil prices -- Middle East conflict, terrorist attack on oil infrastructure could halt a major ripple effect.**

Part II Future Issues

- **Likely Areas of Crisis/Instability**
  - Eurozone Sovereign and Banking
  - Chinese Economic Stresses
- **Unrest Due to Globalization Stresses**
  - Unemployment Increased Inequality
- **Budgetary Stress – Security Expenditures**
  - U.S. Fiscal Crisis
- **Final Assessment**

Concern over Europe's Future

Report of the Reflection Group on EU's Future

- **The report offers a pessimistic diagnosis of the problems facing the EU. Key challenges include:**
  - The global economic and financial crisis – impact on the Eurozone and Euro
  - Ageing populations
  - Downward pressure on costs and wages
  - Climate change and increasing energy dependence
  - An eastward shift in the global distribution of production and savings and
  - The Union's lack of international clout
- **The report calls for the EU to become an assertive global actor to avoid sliding into marginalization, becoming an increasingly irrelevant western peninsula of the Asian continent.**
- **It highlights the gap between the EU's capacities as a global economic actor and its lack of a common vision and voice in foreign policy.**

EMU Dilemmas

Low competitiveness in the GIIPS countries presents a major dilemma and questions about the future of the Euro

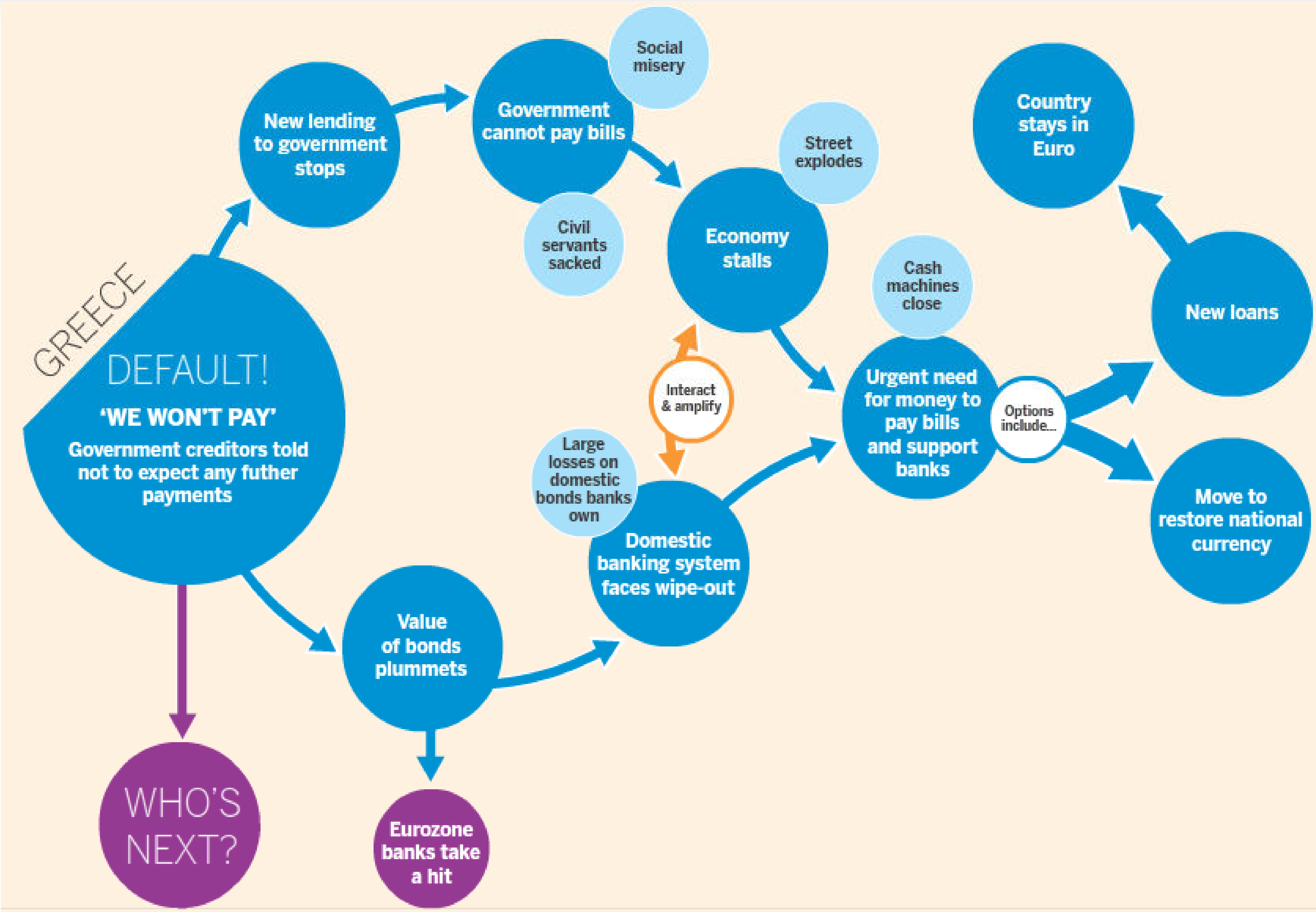
- **The usual fix, devaluation is not an option**
- **Must compete by pushing wages down – very unpopular**
- **Offered a choice between austerity and quitting the euro, voters would choose to leave monetary system**
- **Wage cuts might not work anyway**
  - If try to force wages down it means deflation and deflation increases the burden of their already sizeable debts
  - Because of the debt-deflation pincer, uncompetitive and indebted countries must choose between default and leaving the euro.
- **Greece with high-debts, and in a high wage trap will stay in only if other countries assume most of its debts. Europe together with the IMF can do this for Greece**
- **Moral hazard problem. Bailed out investors will assume they can lend freely to other big spenders.**
- **What happens if a country larger than Greece falls in the same trap? By bailing out Greece, Europe may have only postponed the inevitable.**

Eurozone Political Economy Problem

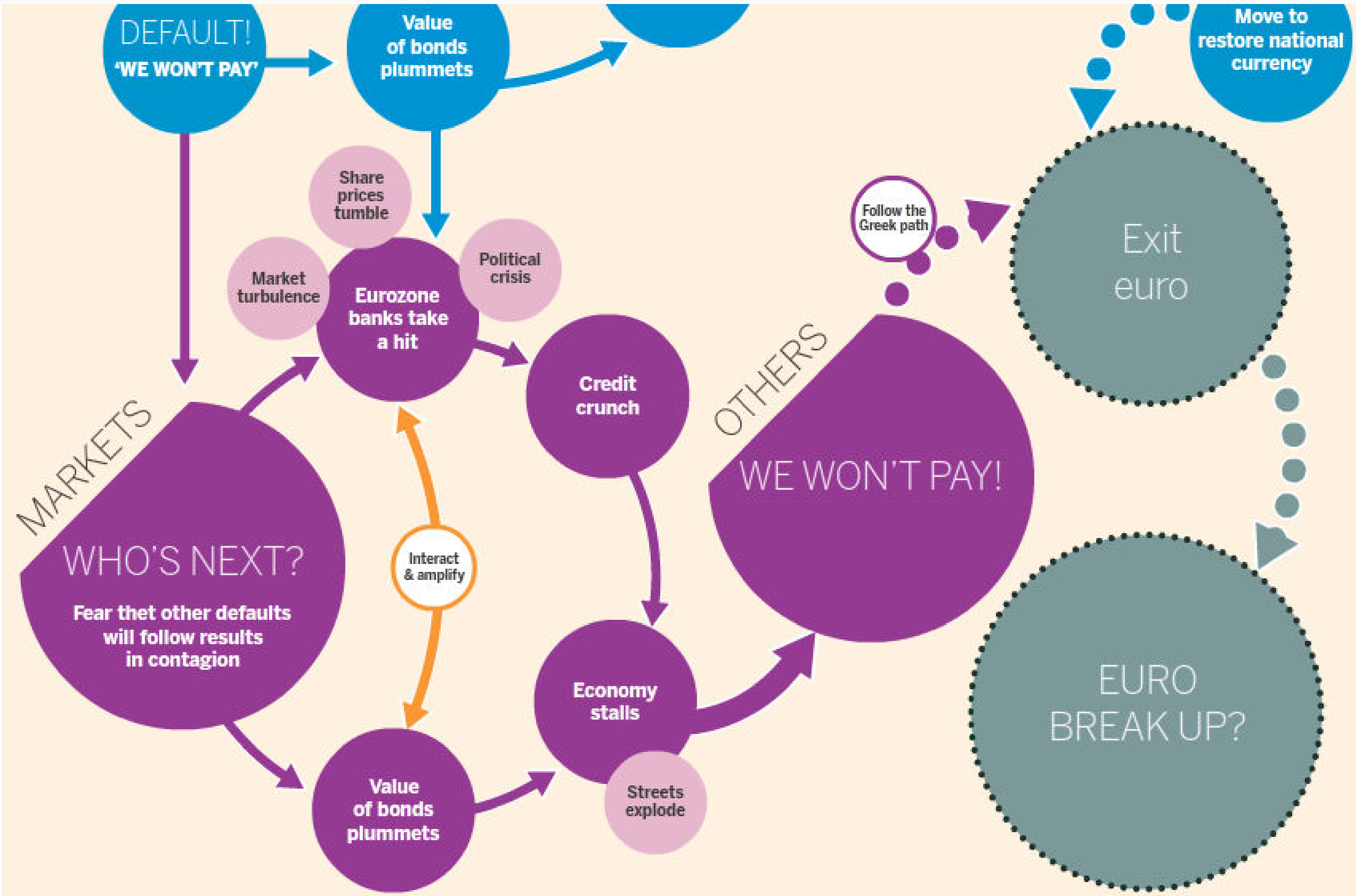
Could the Eurozone Break Up? Possible over a Five-Year Horizon

- **The current "muddle through" approach to the EZ crisis is not a stable disequilibrium; rather it is an unstable disequilibrium**
- **Either the member states move from this disequilibrium towards a broader fiscal, economic and poltical union that resolves the fundamental problems of divergence (both economically and fiscally and in terms of competiveness) within the union … or**
- **The system will move first toward disorderly debt workouts and eventually breakup, with the weaker members departing. Over a five year horizon, the odds of a breakup are about 40%.**

What Happens When a Country Defaults? I



What Happens When a Country Defaults? II



RGE EZ Scenario Analysis

	In 2011	Beyond
Large-Scale ECB Intervention	40%	20%
More PSI in Greece and Beyond	30%	60%
Supersize EFSF/ESM	20%	40%
Eurobonds	10%	40%
Greek/Portuguese Exit	10%	40%

- Developments in the EZ periphery have deteriorated even more than we previously anticipated, forcing European policy makers to take more extensive efforts, including debt restructuring similar to what RGE advocated.
- In the short term, a “muddle through” scenario is likely, but risks to confidence are very high. Debt levels are still too high to finance.
- In the medium to long term, there are greater chances of either a disorderly outcome or deeper integration.

China: Crisis Lessons

The Chinese government has drawn some important conclusions from the economic crisis:

- **The U.S. has ceased to be a model for China's economic reforms – this has both economic and political consequences.**
- **The crisis has confirmed the government's belief that the state should have a major role in the economy**
- **China is trying to reduce its dependence on Western consumer markets**
- **China will reduce economic imbalances but only slowly and on its own terms.**
- **This last factor in particular has helped heat-up the long-standing friction with the U.S.**

China-US Economic Frictions

- **Disagreement between the two countries runs deep**
  - For three decades the US has granted China access to its consumer markets – enabled China to build up massive manufacturing capacity and export revenues
  - Chinese have gained competitiveness not only through abundance of cheap labor but also by pegging their currency, the yuan to the US. Dollar at a weak rate
  - Exchange rate policy gives Chinese goods an advantage over its competitors – including U.S. producers
- **The crisis has compounded tensions**
  - The global economic crisis left China with massive foreign exchange reserves from years of trade surpluses
  - China continues to grow rapidly while the US suffers from prolonged unemployment of around 10% and a weakened manufacturing sector
  - Hence US has begun to pressure China more aggressively to open up its markets to U.S. goods and remove its fixed exchange rate advantage.
  - China argues trade surpluses arise from other reasons

China's Future

- **Key questions for Chinese future scenarios:**
  - Can China implement internal reforms to further its development?
  - How will China's relationship with the rest of the world affect its development and shape the global context?
- **A number of factors will influence how these questions are answered in the next several decades:**
  - The intent of China's leadership and its ability to sustain the implementation of decisions made
  - The economic policy choices made, including the degree of liberalization and openness
  - The extent to which social stability can be maintained and popular expectations managed.
  - The reaction of other global actors to China's rise, and the broader geopolitical situation.

Changing Center of World Economy

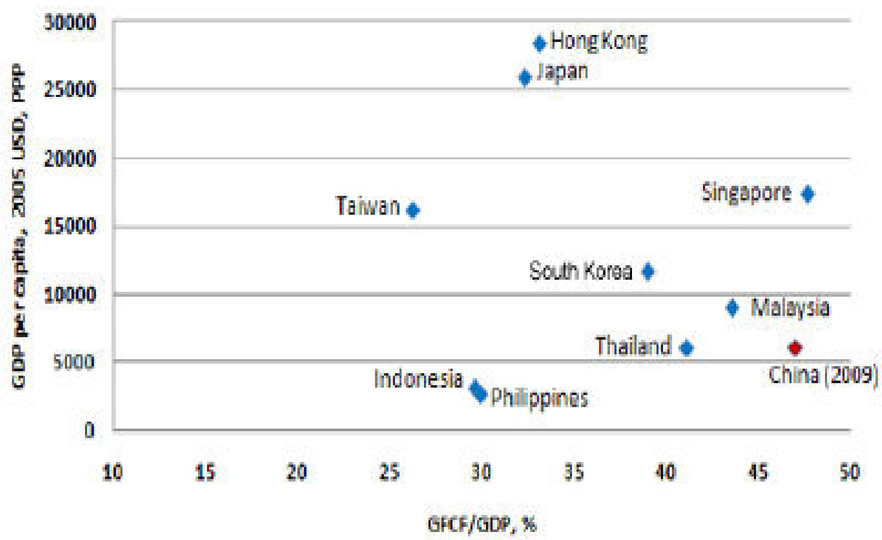
Black Dots: 1980-2007; Red Dots: Projected 2011-2049

Chinese Slowdown Likely

Country	Peak Year	Growth Before	Growth After
Hong Kong	1997	4.9	1.3
Indonesia	1996	7.1	0.4
Malaysia	1995	9.3	5.0
Thailand	1995	9.0	0.6
South Korea	1991	9.7	7.3
Japan	1990	5.1	1.5
Singapore	1984	8.7	5.8
Philippines	1983	4.6	0.0

Source: National Statistics, Gapminder, RGE
Note: Average growth rates five years before/after, %, y/y

- While investment/GDP has peaked, growth has slowed.
- A current account surplus and financial repression will prevent a liquidity crisis, but not domestic banking problems.
- Investment is continuing to drive growth in 2011, raising the risk of future problems.



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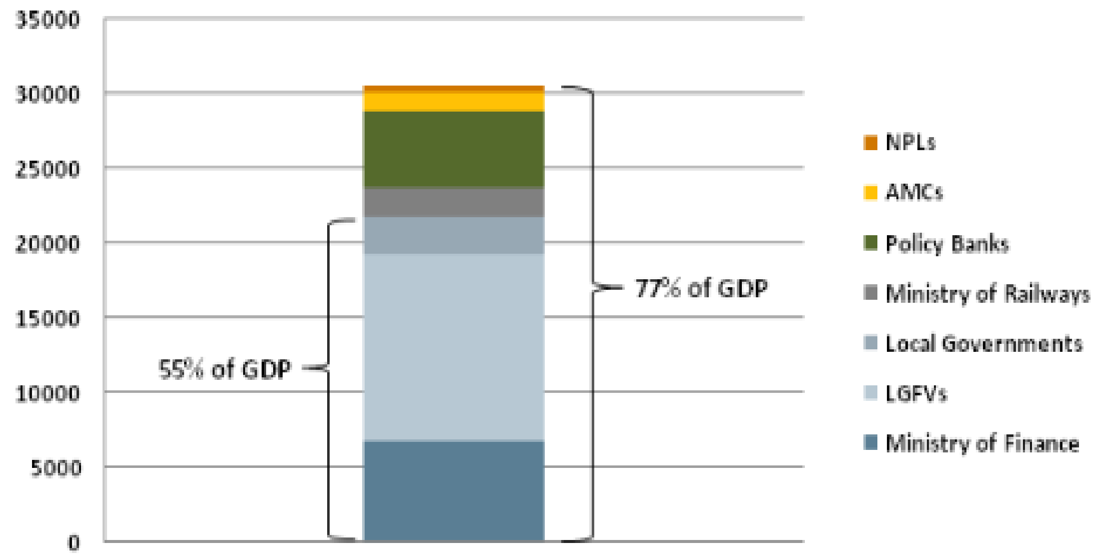
No Drastic Slowdown Before 2013

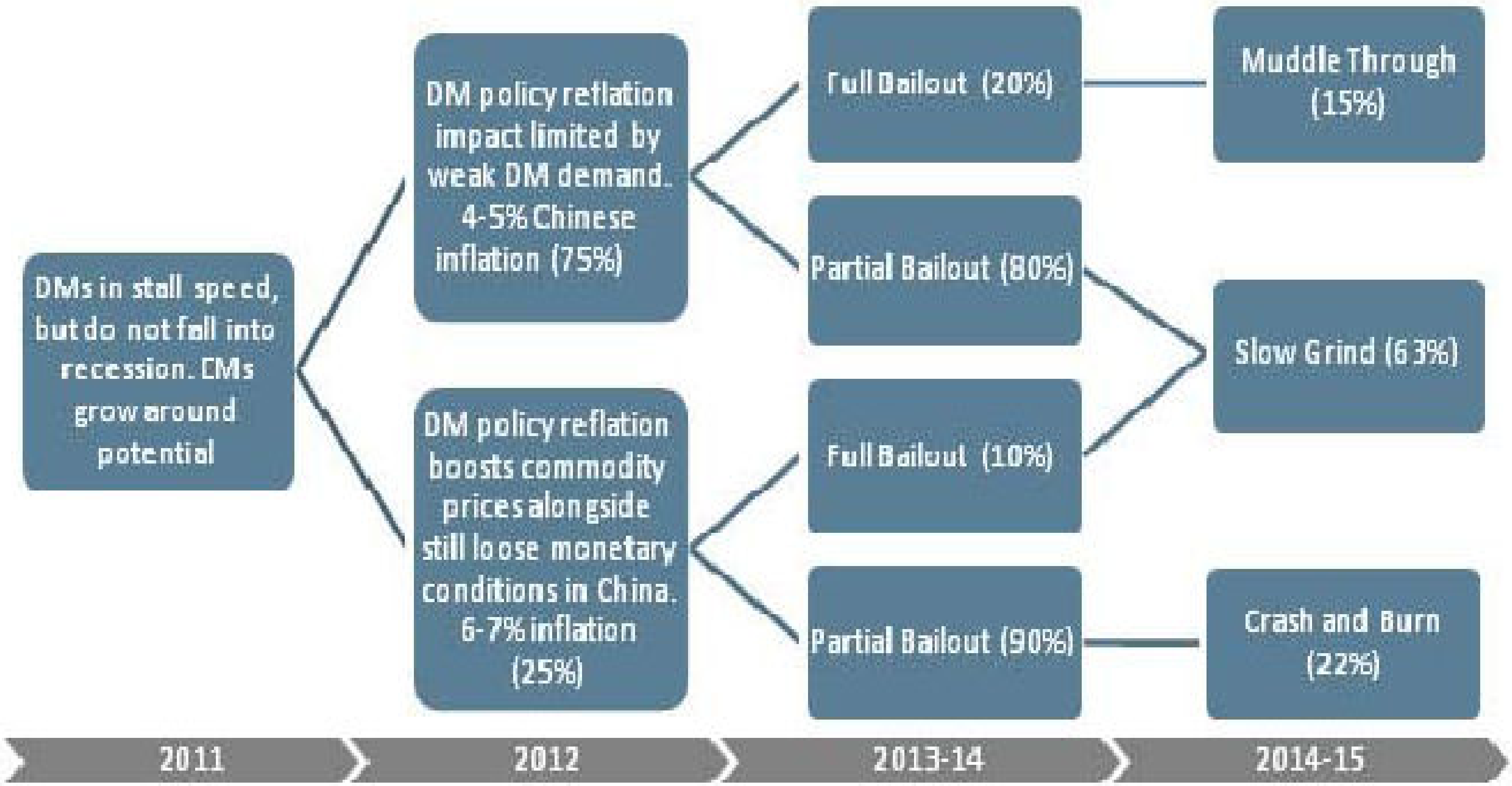
- The 2012-13 political cycle encourages policy makers to be extremely risk-averse. GDP growth is still the key metric for promotion.
- The political cycle will encourage more lending in H2 2011, taking local government debts to RMB19 trillion by the end of 2012 from RMB15 trillion at the end of 2010.
- Up to 30% of these may eventually turn into nonperforming loans (NPLs).
- Given the tenor of loans, we assume the problem loans will really begin hitting balance sheets in 2013.
- It takes time for loans to be classified as NPLs, and banks had a 230% coverage ratio at end-Q1—sufficient to get through 2012 with government support.

The Chinese Government's Contingent Liabilities in 2010 (RMB, billions)



Source: Ministry of Finance, Ministry of Railways, People's Bank of China, ADB, RGE estimates

Chinese Scenarios: Overview



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Chinese Medium-Term Scenarios

	Muddle Through (15%)	Slow Grind (63%)	Crash and Burn (22%)
Global Imbalances	Gradual global rebalancing higher Chinese inflation/ investment	Rebalancing slows on weak Chinese demand/cheaper exports	Global imbalances widen, insufficient global demand
Global Inflation/ Commodity Prices	China becomes an inflationary force in goods market, remains largest incremental buyer in most commodity markets	Disinflationary pressure on goods prices increases, less incremental commodity demand	China becomes a severe global deflationary force from goods dumping and weaker commodity demand
DM Growth	Some relief from deleveraging/deflation, but growth still anemic at best	Weak growth, easing of commodity prices provides some offset	Stall speed/extremely weak growth with high probability of recession
EM Growth	Commodity exporters continue to benefit, growth boost is netted out by higher commodity prices for importers	Commodity exporters slow on weaker demand, commodity importers benefit slightly from lower prices	Recessionary impulses in commodity exporters, commodity importers suffer more modest slowdown
RMB/USD	RMB appreciates	Pressures on RMB balanced	RMB weakens
Chinese Growth	6-8%	4-6%	3-5%

2011 World – Wide Instability

- **Economic factors underlie many of the various 2011 protests:**
  - Arab Spring uprising and revolts
  - Riots in England against pension cuts, higher tuition fees
  - Israeli middle class protesting high housing prices and the squeeze from inflation
  - Chilean students concerned abut education and jobs
  - Vandalism of "fat cat" cars in Germany
  - Greeks demonstrating against fiscal austerity
  - India's movement against corruption
  - Deadly riots in china's globally integrated eastern provinces in reaction to corruption, inequality and illegal land seizures
  - Occupy Wall Street movement across U. S.
- **Protests don't have a single unified theme, but express in different ways concerns of the working and middle classes about their economic futures**

Common Causes of Protest

- **Some common causes of these protests are:**
  - Serious economic and financial insecurity and malaise among blue and white collar workers with the recent global financial crisis leading to a very weak recovery in advanced economies
  - High rates of unemployment and underemployment in advanced and emerging economies
  - A lack of skills and skills-mismatch preventing young people and workers from competing in a more globalized world economy
  - Resentment against corruption, including "legalized forms" such as interest grouping using financial power of lobbying to pursue their narrow interests
  - Poverty, insecurity, anger and hopelessness about the future and a desire for greater social justice;
  - A sharp increase in income and wealth inequality in advanced economies and even fast growing emerging markets
- **Many observers attribute capitalism and the recent acceleration in globalization as the root cause of these development**

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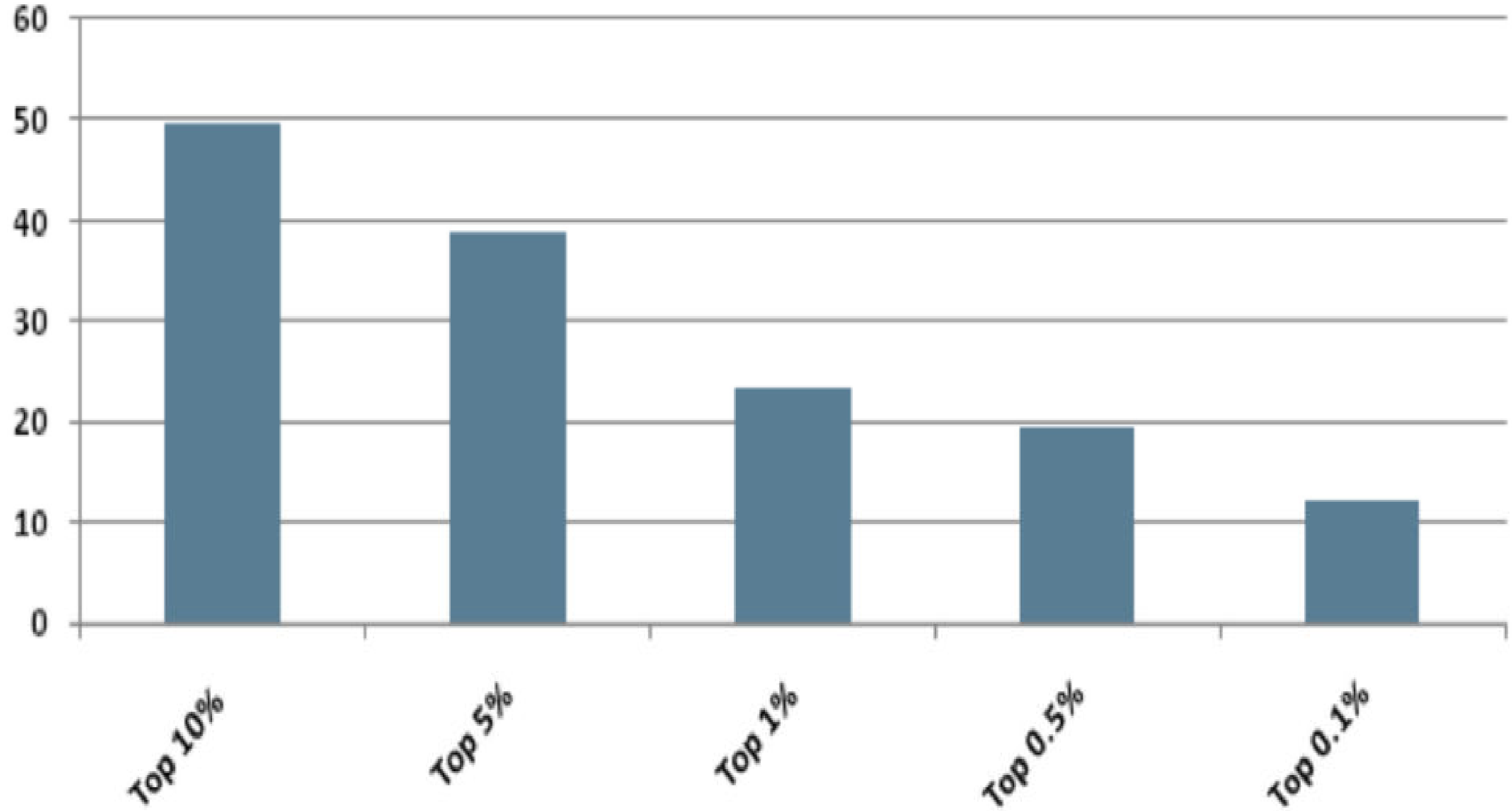
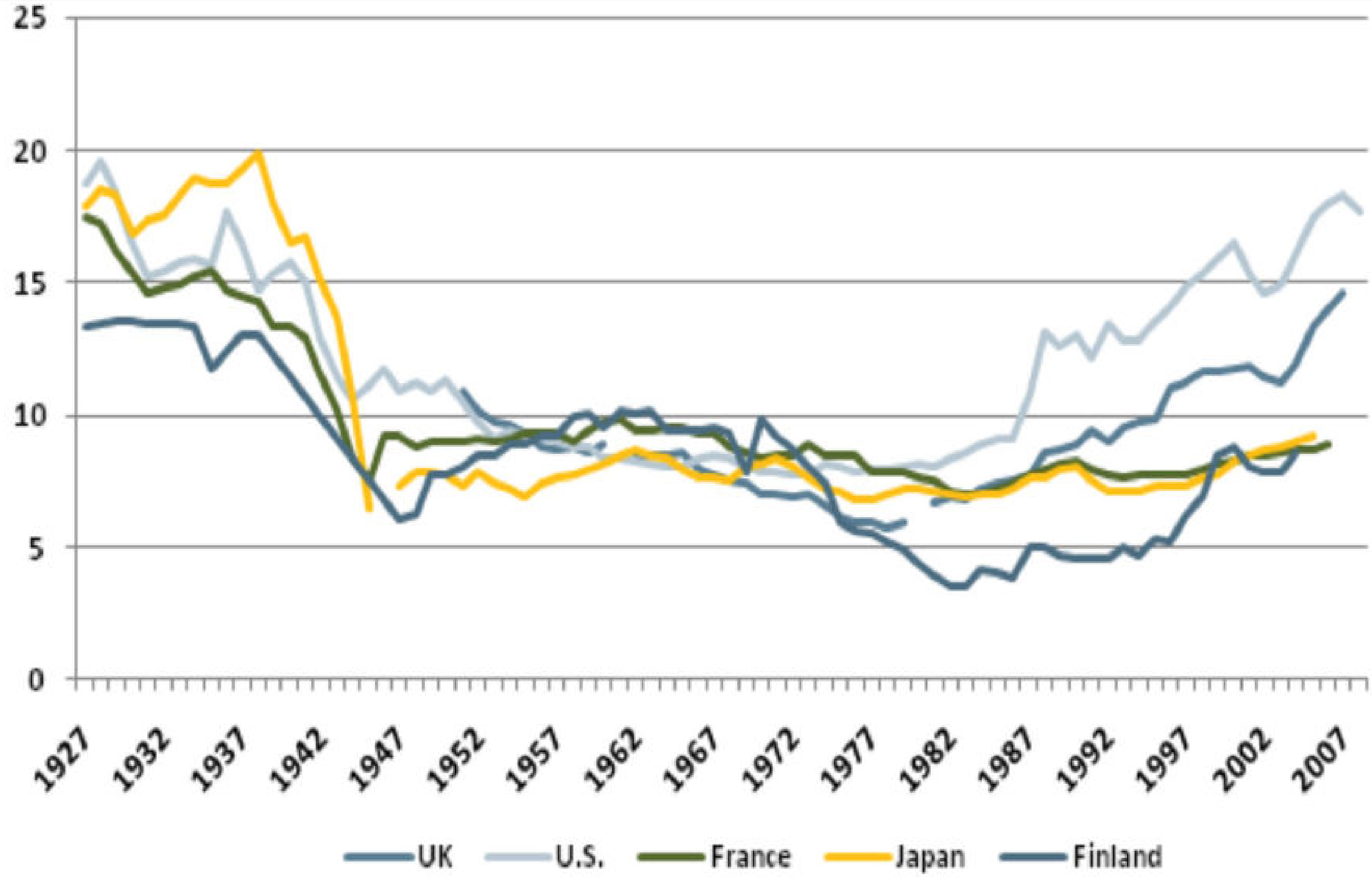
Income Inequality in U.S.



Source: Paris School of Economics

Note: % share of total income including capital gains

Income Share of Top 1%



Source: Paris School of Economics

Inequality and Its Ramifications

- **The recent increases in inequality are complex and cannot be attributed to one factor. Causes include:**
  - The addition of 2.5 billion workers from China and India and another billion of other EM populations to the global labor force – reducing the jobs and wages of unskilled blue collar and of off-shorable white collar workers in advanced economies
  - Skill based technological change – big gaps developing in incomes between college graduates and non-college workers
  - Winner take all effects – globalization creates winners and losers. Recent winners have been capital and skilled workers in traded goods sectors. With competition and limited productivity growth in non-traded areas little wage growth.
- **By 2010 the share of income of the top 15 by income was 23% having risen from 10% two decades earlier**
- **The top 5% control about 75% of financial wealth.**
- **Instability arises because the political ramifications of these developments are hard to predict – Populist governments? increased protectionism? Trade wars? Resource nationalizations? Internal conflicts?**

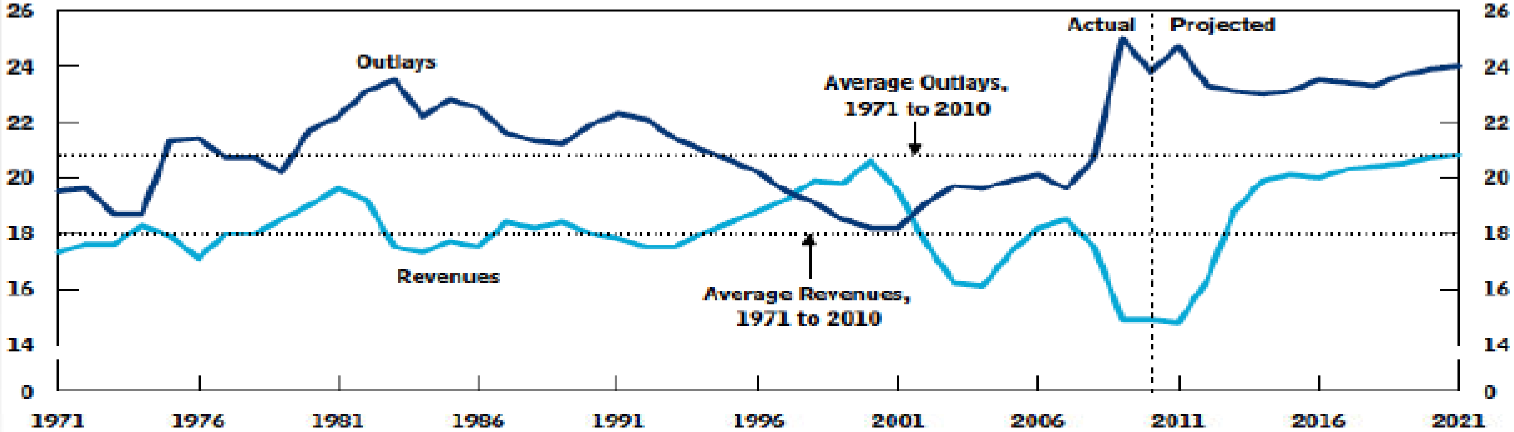
U. S. Fiscal Outlook

- **After the debt ceiling conflict, further fiscal stimulus are unlikely at a time when the economy may be moving towards a recession.**
- **Only when it is clear the economy is in another downturn and it is too late to avoid one, the discussion abut stimulating the economy fiscally might resume**
- **Effective fiscal stimulus in the form of a jobs program, comprehensive support to stabilize the housing sector or infrastructure spending is less likely than some form of tax-based stimulus that comes with a lower multiplier.**
- **A credible commitment to long-term fiscal consolidation needs to be made immediately; however front-loading the fiscal austerity does not make sense as the resulting fiscal drag would exacerbate the downturn. The current path of policy is the exact opposite of optimal.**
- **The necessary primary adjustment to prevent an eventual fiscal train wreck in the U.S. is 5.4% of GDP. Some fiscal adjustment will have to occur on revenue side.**

CBO Budget Estimates

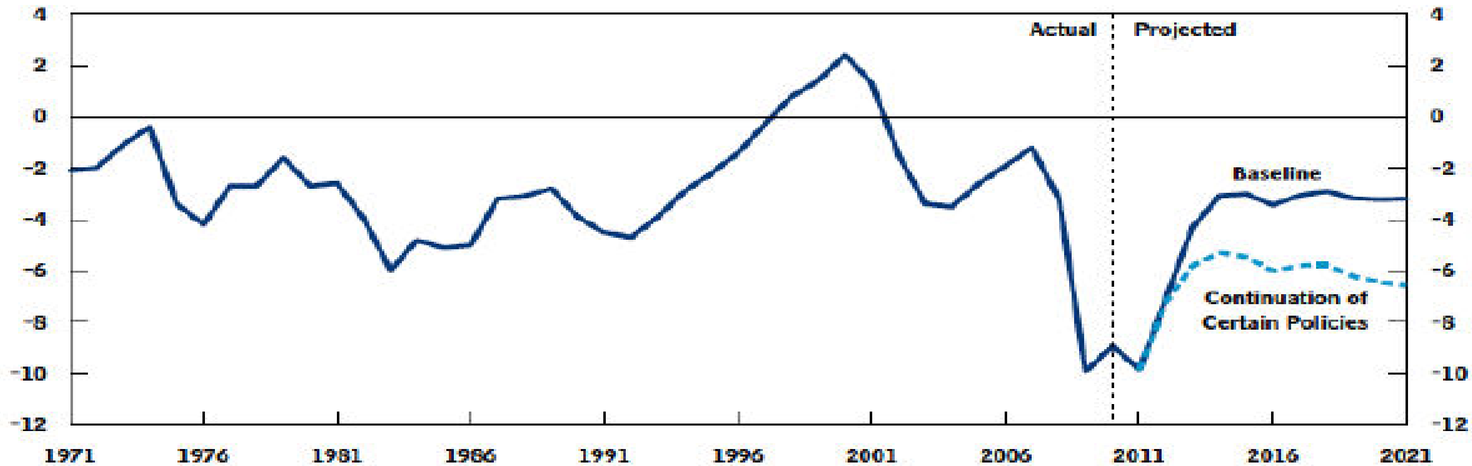
Total Revenues and Outlays

(Percentage of gross domestic product)



Source: Congressional Budget Office. (Figure corrected on February 15, 2011.)

(Percentage of gross domestic product)



Source: Congressional Budget Office.

Crisis Impact on Defense Spending

Global financial crisis and the subsequent recession in most European countries has created a new dynamic for defense spending

- **Even before the crisis punishing demands of operations on armed forces revealed shortfalls in capabilities**
- **In addition the cost of new equipment was rising at a rate of 5-10% per year.**
- **As both trends continue, European governments now struggling to control public deficits have launched a series of austerity measures across the board.**
- **In the overall scheme of government priorities, defense spending has become discretionary and many defense ministers have already been asked to make do with less money**
- **Two basic options in light of these developments**
  - Accept that reduced financial resources will lead to reduced capabilities
  - Use the budget crunch as an opportunity to do things differently

Defense and Austerity

- **Most elements of defense policy are likely to experience major changes.**
  - UK government has suggested defense expenditures might be cut between 10% and 25% over the next few years
  - France is considering cuts of $2.6-$6.6 billion over the next three years.
  - Germany – Finance Ministry has demanded reductions totaling 4.3 billion Euros for the period 2011-14.
  - Italy and Span have slashed budgets as have a range of smaller EU member states.
- **So far these cuts have not been coordinated on the European level which increases the likelihood that an overall reduction of European capability will be the result**
  - In late July 2010 France and Germany were first countries to announce coordinated discussions about cuts.

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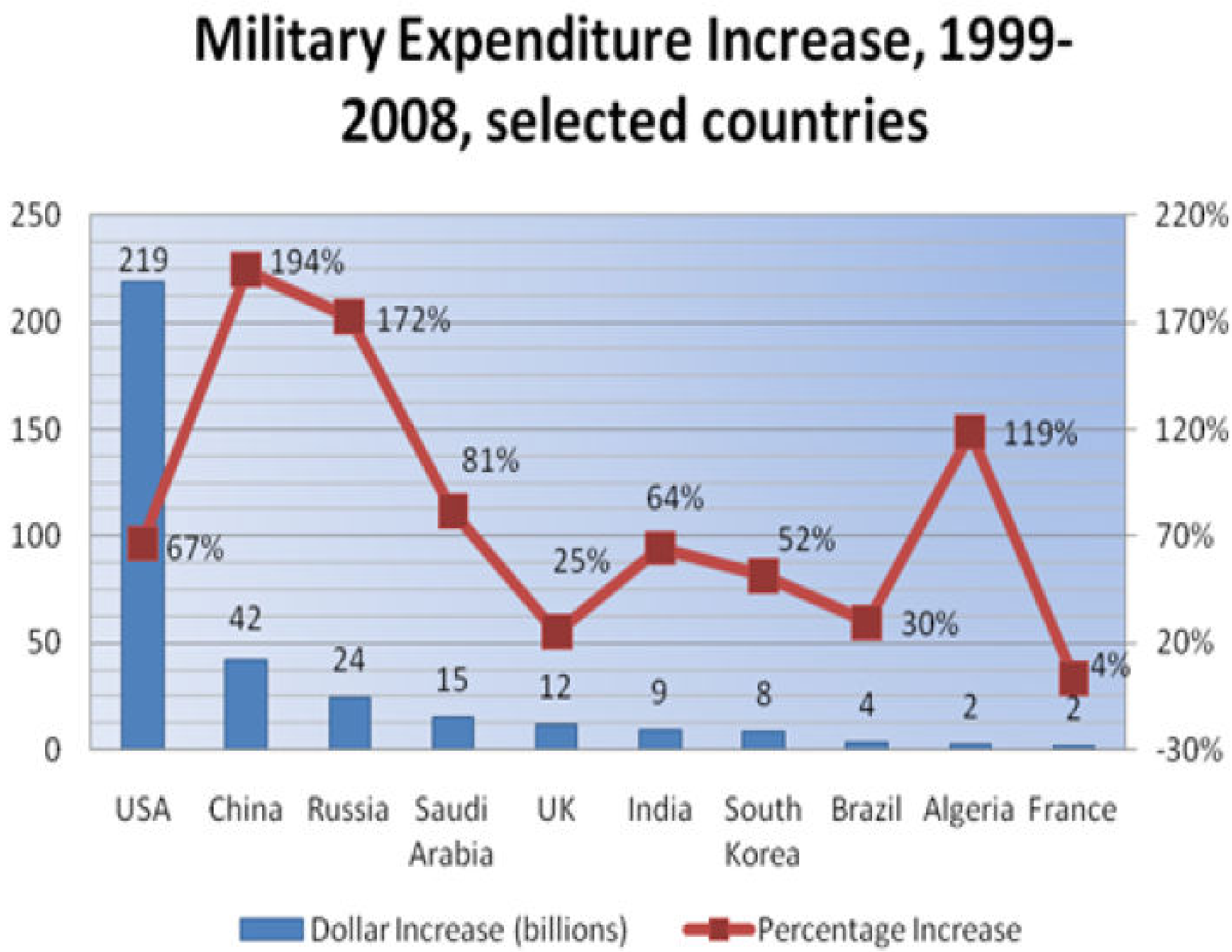
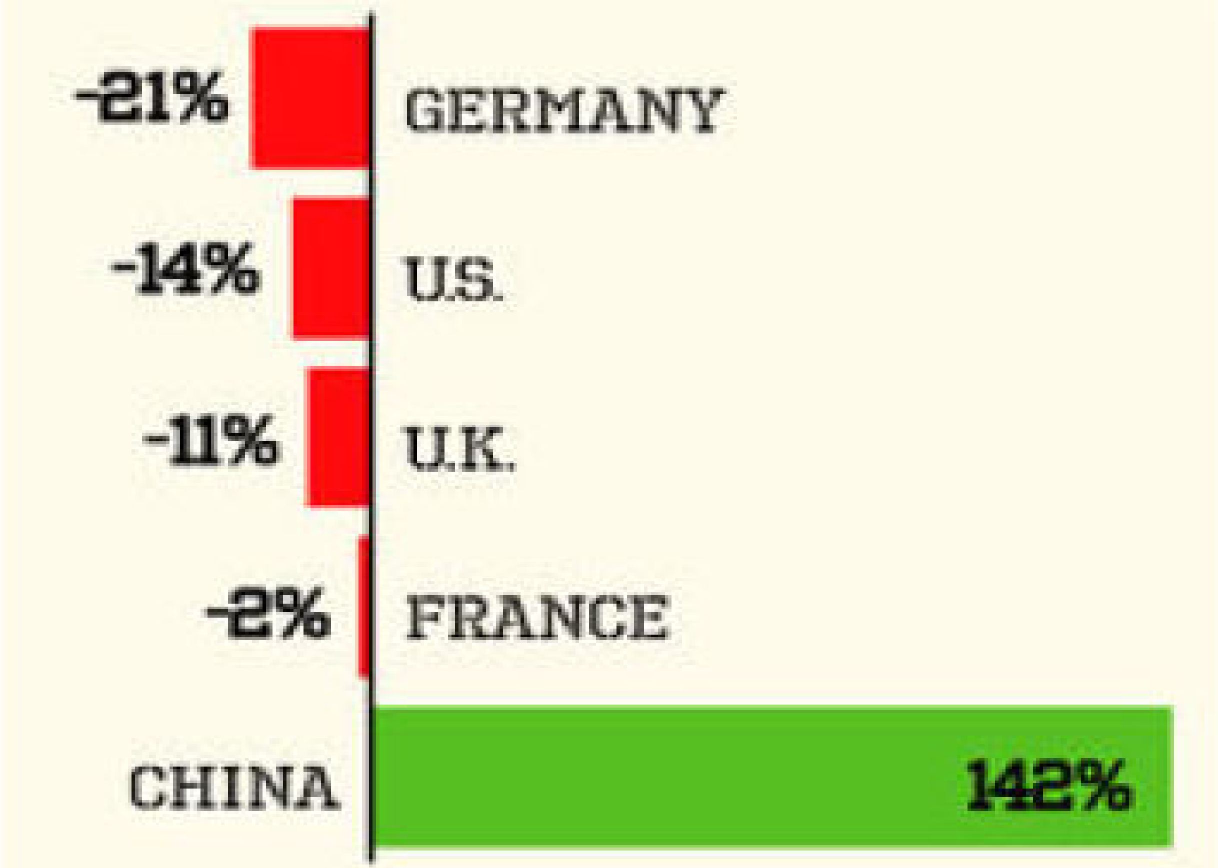
Patterns of Military Expenditures



Potential competitors, such as China and Russia, almost doubled their spending on defense in recent years.

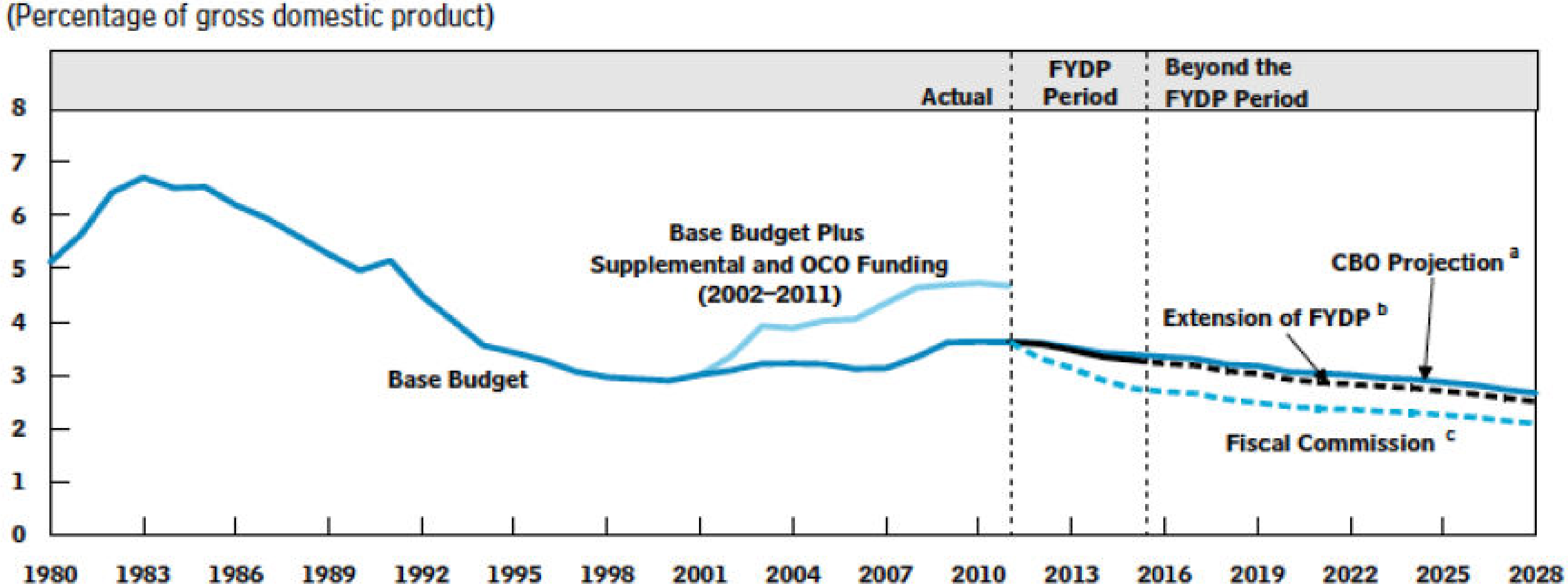
These increases were tied to the dramatic economic growth during this period (not pictured).

Projected Changes in Defense Budgets: 2010-2015



Note: Adjusted for inflation
Source: IHS Jane's Defense Budgets

CBO Defense Budget Estimates



Source: Congressional Budget Office.

Notes: Base-budget data include supplemental funding prior to 2002. Additional funding for overseas contingency operations (OCO) may be requested in 2011.

FYDP = Future Years Defense Program; FYDP period = 2011 to 2015, the years for which the Department of Defense's (DoD's) plans are fully specified.

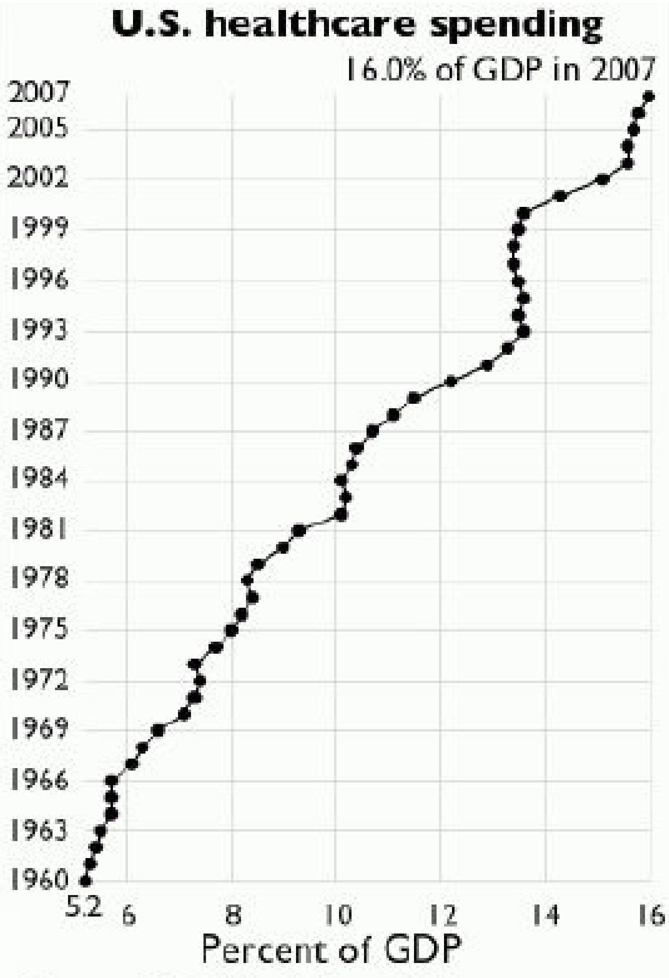
a. The CBO projection of the base budget incorporates costs that are consistent with DoD's past experience.

b. The extension of the FYDP extends DoD's plans and uses DoD's estimates of costs if they available and cost factors based on the broader U.S. economy if estimates by DoD are not available.

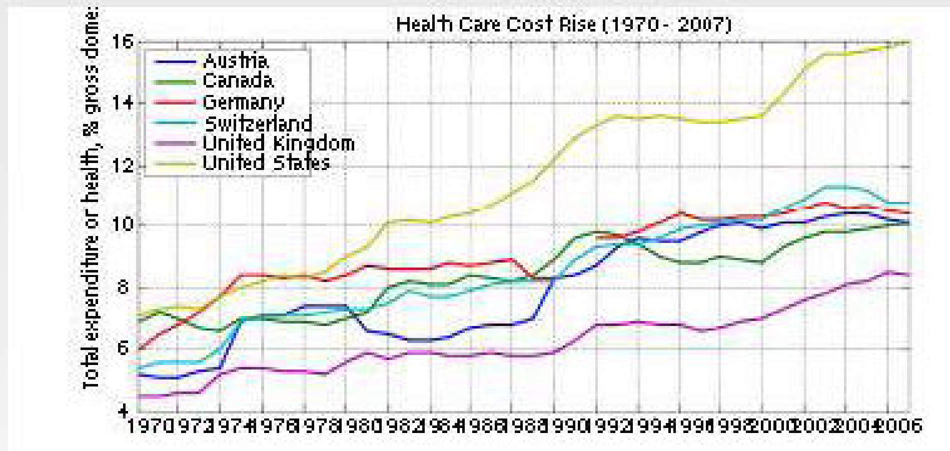
c. Proposal from the National Committee on Fiscal Responsibility and Reform, *The Moment of Truth* (December 2010).

CBO, *Long Term Implications of 2011 Future Years Defense Program*, February 2011, p. 7

Is Health Care the Worst Threat to U.S. National Security?



Source: OECD Health Data 2009.



Despite the most severe economic downturn in 80 years, healthcare spending in the U.S. rose an estimated 5.7 percent to $2.5 trillion in 2009, according to Medicare's actuaries.

The percentage of the GDP spent on healthcare jumped to 17.3 percent from 16.2 percent in 2008-the largest one-year increase since 1960. At the current rate of growth, healthcare costs are predicted to nearly double to $4.5 trillion in 2019. At that point, they will account for 19.3 percent-almost a fifth-of our GDP.

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The Special Joint Committee

U.S. Legislation passed on August 2, 2011 sets up a Special Joint Committee that must identify $1.5 trillion additional deficit reductions by the end of 2011

- **If the Congress does not support its proposals, this would trigger automatic deficit reductions of $1.2 trillion to defense and non-defense programs equally by 2013**
  - The Special Joint committee must address the cuts that should be made in U.S. national security efforts by November 23, 2011 by a simple majority vote
  - The Congress must complete up or down votes by December 23, 2011
- **If the Special Joint Committee's recommendations are not accepted, the bill would trigger massive cuts that would apply to a broad national security category, including the Department of Defense**
- **It also sets annual caps in budget authority for this security category of $546 billion if the Special Joint Committee's recommendations are not past into law or are vetoes, and requires OMB to enforce them.**

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Implications for U.S. Security

One key outcome of the Crisis – Lower Growth and Higher debt – <u>Greater Threat to Security than Concerns at Start of Crisis</u>

- **Financial constraints will play a considerable role in structuring U.S. policy in the foreseeable future**
- **When debt levels reach 90% or more of GDP, the U.S. may find that its rate of growth slows by 1% per year (ring of fire diagram)**
- **The fiscal squeeze that the U.S. and other advanced economies may experience can have the ability to crowd out discretionary spending – defense budgets under considerable stress.**
- **As a result the ability for advanced countries such as the U.S. to spend increasing shares of GDP on defense and security may ---- even to respond to threats may be extremely limited.**
- **In the longer term the U.S. is likely to find that its traditional allies are declining in relative economic and military strength.**
- **Similarly, the U.S. will find it has to deal more and more with countries that it traditionally has not had shared common interests**

Summing Up

Key Points

- **The global economy has been significantly affected by the financial crisis**
- **Emerging economies will outpace the growth of the advanced economies. This disparity in growth has only been exacerbated by the financial crisis**
- **If commodity prices increase over the next several years it would further reduce slow DMs and perhaps some EMs**
- **Debt will rise and revenues will fall for the governments of advanced economies while emerging economies will be more fiscally sound**
- **U.S. and other DM countries will most likely experience a lower rate economic growth than it has in the past creating greater fiscal stresses**
- **The fiscal stress in the advanced economies may significantly reduce defense expenditures and other discretionary items.**

The End

- **Questions?**
- **Thank You ---**