The World Economy: Who Will Lead?

Colonel
Mike Malone
U. S. Air Force

Faculty Research Advisor
Dr. Robert Pirog

The Industrial College of the Armed Forces
National Defense University
Fort McNair, Washington, D.C. 20319-6000
**REPORT DOCUMENTATION PAGE**

**1a. REPORT SECURITY CLASSIFICATION**
Unclassified

**1b. RESTRICTIVE MARKINGS**

**2a. SECURITY CLASSIFICATION AUTHORITY**
N/A

**2b. DECLASSIFICATION/DOWNGRADING SCHEDULE**
N/A

**3. DISTRIBUTION/AVAILABILITY OF REPORT**
Distribution Statement A: Approved for public release; distribution is unlimited.

**4. PERFORMING ORGANIZATION REPORT NUMBER(S)**
NDU-ICAF-93-1394

**5. MONITORING ORGANIZATION REPORT NUMBER(S)**
Same

**6a. NAME OF PERFORMING ORGANIZATION**
Industrial College of the Armed Forces

**6b. OFFICE SYMBOL (if applicable)**
ICAF-FAP

**6c. ADDRESS (City, State, and ZIP Code)**
Fort Lesley J. McNair
Washington, D.C. 20319-6000

**7a. NAME OF MONITORING ORGANIZATION**
National Defense University

**7b. ADDRESS (City, State, and ZIP Code)**
Fort Lesley J. McNair
Washington, D.C. 20319-6000

**8a. NAME OF FUNDING/SPONSORING ORGANIZATION**

**8b. OFFICE SYMBOL (if applicable)**

**8c. ADDRESS (City, State, and ZIP Code)**

**9. PROCUREMENT INSTRUMENT IDENTIFICATION NUMBER**

**10. SOURCE OF FUNDING NUMBERS**

**11. TITLE (Include Security Classification)**
The World Economy: Who Will Lead

**12. PERSONAL AUTHOR(S)**
Mike Malone

**13. TYPE OF REPORT**
Research

**13b. TIME COVERED**
From Aug 92 to Apr 93

**14. DATE OF REPORT (Year, Month, Day)**
April 1993

**15. PAGE COUNT**
24

**16. SUPPLEMENTARY NOTATION**

**17. COSATI CODES**

**18. SUBJECT TERMS (Continue on reverse if necessary and identify by block number)**

**19. ABSTRACT (Continue on reverse if necessary and identify by block number)**

SEE ATTACHED

**DTIC ELECTED**

**DTIC QUALITY INSPECTED** 3

**20. DISTRIBUTION/AVAILABILITY OF ABSTRACT**

**21. ABSTRACT SECURITY CLASSIFICATION**
Unclassified

**22a. NAME OF RESPONSIBLE INDIVIDUAL**
Judy Clark

**22b. TELEPHONE (Include Area Code)**
(202) 475-1889

**22c. OFFICE SYMBOL**
ICAF-FAP
MALONE, Michael J. The World Economy: Who Will Lead? Discusses the current world economic crisis with particular emphasis on the role of leadership. Briefly examines the economies of Germany, Japan, Russia, and the United States and their potential for assuming a world leadership position. Contends that the only country capable of rising to a world economic leadership position is the United States.
DISCLAIMER

This research report represents the views of the author and does not necessarily reflect the official opinion of the Industrial College of the Armed Forces, the National Defense University, or the Department of Defense.

This document is the property of the United States Government and is not to be reproduced in whole or in part for distribution outside the federal executive branch without permission of the Director of Research and Publications, Industrial College of the Armed Forces, Fort Lesley J. McNair, Washington, D.C. 20319-6000.
INTRODUCTION

Who am I? Why am I here?" the very words uttered by Vice Admiral James Stockdale at the vice presidential debate could just as easily describe a nation that is suffering from a collective identity crisis. With the Cold War over, the United States is unsure of its place in the world. And its two major industrial partners, Europe and Japan, are both suffering from a loss of purpose as well.

The numbers are bad enough. Economic growth in the industrial countries crept ahead at a sluggish 1.5 percent in 1992--not enough to keep unemployment from rising. The jobless rate in the countries of the Organization for Economic Cooperation and Development averaged 7.9 percent over the year and was projected to creep up to 8.2 percent in 1993.

But the debilitating problem was less one of production than of psychology. In the United States, in particular, the mood was extraordinarily sour, as Americans developed a gloomy foreboding that their nation was caught up in an inexorable process of economic decline.

In his book, "Head to Head," Mr Thurow's premise fits into
this perception. He must agree with the 66 percent of the voters that NBC polled who said that the United States was "in a state of decline." Most said that they feared the next generation of Americans would not live as well as the current one. And 72 percent rated Japan as a stronger economic power than the United States. But the most stunning measure of America's pessimism came when respondents were asked to rank America's relative economic power: only 17 percent believed the United States was the world's leading economic power, and an astonishing 43 percent believe it is not even in the top tier.

To be sure, these perceptions are not justified by the facts. By almost any measure that makes sense, the United States continues to lead the world in economic output, productivity and living standards.

But perception is reality. And it was these sorts of perceptions that shaped political and economic developments for the United States and its allies in 1992, along with Mr Thurow's mind. Uncertain of it's own standing in the world, the United States was in no position to meet the need for global leadership in either trade or finance.

While the world is currently in a economic mess, I disagree with those who believe that no country is less prepared to lead into the twenty-first century than the United States. To make
this point we must first attempt to understand what the world economy is undergoing, and especially how the United States, Japan, Germany, and Russia are dealing with their own problems and what the outlook for their future is.

JAPAN

Since the end of the second world war, Japan has been rebuilding its economy. It had the luxury of doing this with the political, financial, and military support of the United States. The result was that the Japanese built and improved upon the best economic system that existed in the world. At the same time the United States was providing for Japan's defense. This protection allowed the Japanese, well ahead of Mr. Clinton, to say "its the economy stupid!" They increased their savings rate and invested it into their growing economy. It also allowed the Japanese to focus not on the unstable world, with all it's military threats, but on their economy. We have seen the results - Japan is the Pacific Rim's most developed country. Its growth since World War II has been remarkable. At the start of the 80's, just one Japanese bank ranked among the top ten banks in the world. By the end of the 80's, Japan had captured all ten of the world's top banking slots. At the same time Japan was continuing to increase its overseas investments and was the world's largest net
exporter of capital.

In every aspect Japan was beginning to assume the role of a world leader. Then it appears that its massive growth reached its limits. In 1992 the Japanese finally experienced the unpleasant side of the world economy. In the past, the growth-addicted Japanese had used the word recession whenever their torrid expansion rate slowed below 3 percent. But last year a true Western-style recession hit, shrinking the national economy by 1.6 percent in the second quarter.

In an effort at self-delusion, Japan's economic planning agency continued to predict 3.5 percent economic growth in 1992 right through the end of the year, but almost everyone recognized the projection to be far from reality.

So what is left now is a country, much like our own, in a state of self-doubt, and in no position to step up to a leadership role in the world.

GERMANY

The United States and Japan were not alone in their angst over their places in the post Cold War world. Germany was suffering through an even more severe trauma, driven by its
determination to integrate its east and west. The cost and difficulty of the undertaking proved to be far greater than the Germans had ever expected, with an estimated 170 billion deutsche marks transformed from west to east over the course of the year. Much of that cost was financed through public borrowing, with the deficit rising to more than three percent of the nation's output.

When we talk of Germany we really need to include all of Europe in the equation. The future of Europe is up in the air. Will the countries of the region remain as independent sovereign nations or will the dream of 1992 continue on and reach fruition with the total integration of the European Community with one currency and one governing body?

Of the changes that are occurring in Europe, some are subtle; many are irresistible; all of them are deep. With the goal of the concentration of political and economic power in Brussels and Berlin, national votes will mean less and less, regional affairs more and more. What we are witnessing beneath the surface is a new and revolutionary experiment in transnational federalism. While Eastern Europe returns to a nineteenth-century order, Western Europe looks more and more like the fifteenth: an area of regional semi-states, where political sovereignty is inchoate and rival areas compete for economic power. Europe is struggling to come to consensus on a number of
important matters, ranging from trade to peacekeeping efforts in
the Balkans. It could contain more surprises—and have a huge
impact. But one thing that's for sure is that Germany, or
Europe, is not able to take the world's leadership role into the
twenty-first century.

THE GREAT UNKNOWN

RUSSIA AND EASTERN EUROPE

The jury is still out as to the future of the old Soviet
Union. In one corner, some economists tell us that economic shock
therapy is destroying the achievements of Soviet
industrialization and the Soviet welfare system, since the market
is an American importation, unsuited to Russian culture. Some,
echoing the Russian Civic Union of industrial managers,
explicitly conclude that the West should drop Yeltsin for the
"centrist" Arkadi Volski, a Civic Union leader.

In another corner, some assert that shock therapy was
"fatal," a "fraud," only aggravated by Yeltsin's accumulated
"errors." The result is a ruined economy, an impoverished
population, a disintegrated state and impending descent into
nationalist reaction. What policy follows from this is not
specified, but presumably it is the nihilistic abandonment of
Russia to her fate.

For the real culprit in this, Martin Malia, a professor of
history at the University of California, Berkeley states that apocalypse is Russia's "political culture," compounded of autocracy above and servility below, which has made her an eternally hopeless case, whether white or red--and now red, white and blue.

The real question, however, is not whether the Yeltsin reforms can "succeed"--of course Russia does not yet have an effective market democracy--but how good are the results thus far. The Soviet Union was not Franco's Spain or Pinochet's Chile, where a market, private property and civil society existed beneath a despotism whose end sufficed for democracy to emerge. The Soviet Union was totalitarian: everything--from politics to the economy to culture--was absorbed into the Party-state. Gorbachev's perestroika showed that such a total system cannot be reformed piecemeal: it ends in total collapse, leaving behind a total problem. And to climb out from under the wreckage, everything has to be done at once, thus creating an impossible situation where everything, logically, has to be done first.

Yeltsin did not have the choice of carrying out separate democratic political reform, a liberal economic reform and building a Russia distinct from the Soviet Union. He had to take the gamble of attempting all at once. This took him beyond reform to revolution--but revolution of an unprecedented sort. Earlier Western revolutions were by breakthrough, as when an already
formed English Parliament or the dynamic French Third Estate cracked the outworn shell of royal power. But the anti-Communist revolutions of 1989-91 were by implosion, with the shell of the Party-state simply disintegrating, leaving no viable institutions for the successor democracy to build on.

In such a situation, circumstances impose priorities. Thus after the August 1991 failed coup, Yeltsin began with partial political reform. By December this had precipitated the problem of the Union and Russian identity. So it was only in January 1992 that he was able to launch economic reform--while at the same time juggling the still-unresolved political and national issues.

And this brings up the matter on which democracy's success depends above all: the economy and the fortunes of shock therapy.

To be sure, Yeltsin's first year has been the worst one yet in Russia's long-running economic crisis: the gross national product dropped around 20 percent, and industrial production 50 percent; prices rose 2000 percent while inflation was running at a monthly rate of 25 percent to 30 percent; and the ruble was down to 450 to the dollar from 135 in June. Only 40 percent of taxes were being collected, and the government lost control of the money supply, with a deficit of 1.5 trillion rubles.
This economic decline began under Brezhnev; it had assumed crisis proportions by 1989 under Gorbachev; and it had become a free-fall by 1991. If this process accelerated in 1992, this was, partly, because of the collapse of both the external and internal Soviet empires and the disruption of trade. But, above all, the decline was due to the salutary reduction of military procurement by around 80 percent from the previous year, which accounts for most of the production fall. Far from being the cause of the deepening debacle, shock therapy was the first serious attempt to do something about it.

In theory, there are two economic options for the exit from communism: the revolutionary way of shock therapy and the evolutionary way of gradual transition. Gorbachev's perestroika was an approximation of the second way. He never intended to go over to the market and private property. But the result of his half-measures, such as enterprise autonomy, was to disrupt the State run economy, which at least kept production going, without creating a market. So the democrats concluded that a clean break with the old order alone could salvage the economy.

And this was the pattern in all post-Communist countries. Poland, after the failure of the Jaruzelski-Rakowski perestroika, was the first to try a "big bang" of liberalization, in January 1990; but all Eastern European countries (with the partial exception of Hungary) attempted one or another variant of a
cold-turkey cure. In East Germany this took the bruising form of unification with the West; in the Czech republic, of Vaclav Klaus's carefully calibrated liberalization-cum-privatization.

The only way that Russia can come out of this nightmare alive is with help from the west. Without that help the old conservatives will rise to power and turn the country inward once again, this time producing a more dangerous situation that had existed before the breakup of the Soviet Union and its attempt at capitalism. Now you will have a bankrupted, starving, and frustrated country searching for its place in the world order with a huge military might to impose its will on others to take what it wants.

UNITED STATES

America is the preeminent power today. Its economy is still the world's most productive. Militarily it is the world's only superpower. The people of the world admire our democratic political system and free-trade economy. Nevertheless, while we find reasons to celebrate our foreign policy, we find ourselves threatened at home: by recession, crises in our cities, in our education and health care systems, persistent budget and trade deficits, and a growing sense of political paralysis.
Domestic problems have made the American public ambivalent about the US role in the world. Americans are proud of their country's international leadership, but they worry about its burdens.

To remedy these problems President Clinton is urging the major industrial nations to work together for lower interest rates, and work harder in a unified effort for global economic growth.

He has stated, "It is time for us to do our best to exercise leadership among the major financial powers to improve our coordination on behalf of global economic growth. We simply cannot afford to work at cross purposes with the other major industrial democracies. Our major partners must work harder and more closely with us to reduce interest rates, stimulate investment, reduce structural barriers to trade and to restore robust global growth."

He called on the other G7 nations to "work with us" to promote global growth. "The world can't grow if America is in recession, but it will be difficult for us to grow coming out of this recovery unless we can spark a new round of growth in Europe and Japan. We have got to try," he said.

Clinton also said industrial nations must examine the
"institutions we use to chart our way in the global economy," and decide whether to "modify" them or create others. He did not specify those institutions.

If the United States fails in its recovery attempt it will have a lasting effect on the rest of the world.

If all of this is to happen a major issue for the United States concerns the degree to which it will be willing to depart from market principles in promoting its international economic position. If the United States sets out to dominate world economic matters, there is a real question as to how long Germany and Japan will continue to acquiesce in subordinating their policies to Washington. The Gulf war left deep scars in both countries--especially in Japan--where many felt their economic contribution entitled them to genuine consultation. Continuation of these alliances will require big changes in the way Washington has long done business with its friends, changes that few Americans will readily accept.

If the United States fails to rise to the call for leadership, both Germany and Japanese may be willing to try. Each country has risen to a position of economic power and stands ready to shape the world economy. As we have seen, the problem is that both of these countries are experiencing economic problems of their own, and they are feared by their neighbors.
In the case of Germany, it has been pushing for the unification of Europe for the past twenty years. Its stated goal is a united Europe that can trade on an equal basis with other large countries or trade blocks. The problem is two fold; First it's recent reunification has cost it dearly, and second, the people of Europe aren't sure if they want to trust their future to German domination and leadership.

In the Pacific Rim, Japan and not China, will be the expansionist threat. To counter this a United States-Chinese strategic partnership is necessary to contain not so much Russia, as previously believed, but rather an economically dominant Tokyo. The fact that Japan has been a stable democracy and an all-important capitalist trading partner since 1945, and that the Communist regime in Beijing had just gotten through crushing the Chinese students' model of the Statue of Liberty under tank treads, counts for less than their underlying power positions in the global system.

Today, the United States represents a giant "neutral" power that most countries are willing to rely upon. I say neutral because these countries don't fear our intentions. Most countries do not want to be left to their own protection, or even worse to the protection of the Japanese or Germans. While most East Asian countries are modeling much of their economic policies after the
Japanese, and Europeans after the Germans, both fear the potential for Japanese and or German expansion if the US were to withdraw from the area and create a power vacuum. They fear these powerful countries imposing their will upon the rest of the region, initially economically and possibly politically or militarily.

WHAT WE CAN'T DO

If we totally disengage a gradual economic downturn due to isolationism will occur. I fear that this will feed the fears of those on the left and lay rise to expansionist policies by the areas strongest.

We in the United States will suffer immensely from disengagement. First, our economic well being would suffer at home, bringing a decline in our standard of living. Next, we would have a new threat to deal with, that of an economic giant that wants to impose its economic will, first upon the less fortunate countries, and then through economic wars upon us. It wouldn't take long for the American people to get tired of this and demand action. What kind of action is unknown.

THE FUTURE

16
Economic and Political conditions conspired to make 1992 a bad year for global economic management. Recession, election and a number of one-time problems contributed to the tendency in the United states, Europe and Japan to look inward. Because those conditions are temporary, there is reason to expect improvement.

But there is also a fundamental question about the future that the United States and its allies must answer. It was posed eloquently by World Bank economist Lawrence Summers in his presentation to President Clinton's economic conference. "The Cold War is the third war to have ended in this century," Summers said. "After World War I, there was no leadership. Nations turned inward. There was no effort to rehabilitate and reintegrate the vanquished power. There followed twenty years of stagnation, depression and ultimately the Second World War. After World War II, things were very different. The United States led. The world economy grew together. Enlightened policies--the Marshall Plan--sought to rehabilitate and reintegrate the vanquished powers. And there followed the best 40 years of economic growth in the history of the world.

"Now, the Cold War is over. Will the unhappy post-World War I experience play out or will the happier post-World War II experience play out? That is the question that will be answered in the next four years."
The leadership of this country must make it obvious to the public that world economic leadership is essential to our economic well being. If we don't, and we turn our back on the world, it is likely to turn it's back on us, leaving us the worse off.

Only the United States is in a position to lead. Events of 1992 made clear that it may be a decade--or even decades--before Europe has sorted out its internal problems and can turn it's attention to world affairs. And Japan's economic problems have set that nation back even further on its long road to assuming a global leadership role.

Sure there is a lot of work to be done before the United States can move strongly to take the leadership role; the deficit must be cut by a large reduction in government programs, much more than the token now (with the exception of defense); investment must be inspired, and this investment must take on a long range look; and government must enter into an alliance with business to promote it on a truly global level. But the United States can lead only if it sees itself as a leader. As long as Americans view themselves as being in a state of decline, or a second tier power, they will not provide support for the kinds of policies necessary to keep the world economic and financial systems strong. As president, Mr. Clinton must first restore the confidence of Americans in their own country and its economic
abilities. He must give the nation a new identity to replace the one it lost with the end of the Cold War. Only then can he expect to provide the economic leadership that the world desperately needs.

Trust is an integral part of the calculus of a nation's national security policy. What is especially troublesome about the present trend in relations is that this commodity is in extremely short supply and seems to be dwindling with each passing year. We must establish a strategic policy that establishes trust with our allies while enhancing US interests.

The first way we can do this is to put down these regional free trade agreements that we are currently hot on and practice what we preach - that of worldwide free trade under the GATT principles. The east and the west see themselves shut out by the NAFTA. The only result can be more regional trade blocks that try to wield more power than the others. This can only lead to more worldwide economic destabilization and a further lack of trust among nonaligned countries. So instead of having NATO and the Warsaw Pack you will have the NAFTA countries vs the EC vs APEC. To support a truly worldwide free trade system would only enhance worldwide trust, and at the same time open new markets to American business. To successfully implement this idea we must understand that it's a two way street - we must open our markets to their trade as well as theirs to our's. Our current idea of
free trade is one sided - ours.

Time is critical. The world is calling for our help. We must rise to the occasion and establish a clear strategic policy towards worldwide economic growth that will not only keep it safe but stimulate its economies thus enhancing our own.

Thought for the day

CHINA

China is the oldest continuous major civilization in the world and one of two wildcards in this game. To put it in an economic perspective its 1.1 BILLION people have a per capita income of approximately $1,000, some argue as low as $300. In 1949 Chairman Mao established a communist regime in China. Thirty years later, Deng Xiaoping introduced the primitive beginnings of market mechanisms. With each day that passes this country moves slowly, and I emphasize slowly, toward a "free enterprise" society. The thing that just jumps out about China is that in recent years, its GNP growth has averaged nearly 10% a year - one of the highest in the world.

As the world knows, China's long march toward freedom hit a impasse three years ago. In fact it was on June 3rd and 4th of 1989, that government troops attacked unarmed students who were
demanding greater democracy. Today the situation is still uncertain. Most favored nation status for China is a big debate issue with the congress. But the long-term course appears to be set. China cannot go back and it cannot stay where it is. It must move to a more market-focused economy. Consider it a large train struggling up a steep hill. With our help it will reach the top of the hill faster and with our engineer onboard to steer its course. Without our help it will still reach the top of the hill, only to gain speed as it comes down the hill possibly colliding with United States interests on the way. A great giant has now been awakened, and we must deal with it and help to shape its economic might before it shapes ours.
WORKS CITED


Welch, Wilford H. "Regional Powerhouses Reshape World." WorldPaper Nov. 1991: 3


Landrey, Wilbur G. "European Unity on Track but Far from Fruition." St. Petersburg Times (St. Petersburg, Fla.) June 28, 1992: 1A+

Malia, Martin. "Yeltsin's plan for survival." The New Republic February 2, 1993


Wright, Frank. "The Soviet People: Their Troubled Future." Star Tribune (Minneapolis, Minn.) Oct. 6, 1991: 1A+


Welch, Wilford H. "Regional Powerhouses Reshape World." WorldPaper Nov. 1991: 3


Vita, Matthew. "G-7 Leaders Go Home Asking: Why Bother?" Palm Beach Post (W. Palm Beach, Fla.) July 9, 1992: 1A+


