The Global Financial Crisis: Foreign and Trade Policy Effects

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Summary

The global financial and economic crisis affects all three of the essential national interests of the United States: national security, economic well being, and value projection. Only occasionally does an event of this magnitude occur that generates such daunting challenges yet also opportunities for U.S. policy. The effects of the crisis on foreign policy, trade, and security are so diverse and widespread that, out of necessity, policy responses must range from the highly specific to the broad and ethereal.

This report provides an overview of the major non-financial effects of the global crisis. In some countries, incumbent governments have lost support or authoritarian governments are consolidating power. In certain countries, conditions for citizen discontent or even radicalism are being augmented and market capitalism is being questioned. On the world stage, U.S. leadership is being challenged; money to lend is becoming a critical component of soft power; budgets are tightening and threatening funds for economic assistance and national security; international financial institutions are assuming a higher profile relative to national governments; and shifts in trade flows are raising forces for protectionism. As seen in the G-20 London Summit, the financial crisis also has become a rallying point for anti-globalization groups and anti-government activists. The U.S. Director of National Intelligence, Dennis Blair, has told Congress that instability in countries around the world caused by the global economic crisis and its geopolitical implications, rather than terrorism, is the primary near-term security threat to the United States.

The political and foreign policy effects of the global financial crisis can be divided roughly into the following categories: effects on political leadership, regimes, stability, and spheres of influence; effects on economic philosophies, state capitalism, and trade protectionism; effects on U.S. international leadership and attitudes toward the United States; effects on supranational financial and economic organizations; effects on poverty; and budgetary effects on resources for aid, diplomacy, and defense.

Congress has been active in recognizing and moving toward dealing with the longer-term effects of the crisis, but most of the long-term effects are just developing, and it is yet not clear whether they are temporary jogs in a path or a permanent deviation from post-World War II trends. The response to the effects depends both on “more of the same” (working through existing institutions for diplomacy, aid, trade policy, and security) with incremental changes and at a higher level of intensity, and on new and innovative approaches to cope with problems laid bare by the crisis. As the dust from the onset of the crisis has begun to clear, it is apparent that the world has become more unstable, that much of the blame for the turmoil is being aimed at the United States, that attempted solutions are taking enormous amounts of budgetary resources, and that, if the crisis worsens, it may cause wrenching changes both within the countries most vulnerable and among the big power nations of the world.

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The world now faces the worst financial and economic crisis since the Great Depression. The bursting of the U.S. housing market bubble has sparked a ripple effect that has grown to major proportions and is wreaking havoc on market after market and country after country as it works its way around the world. The sudden loss of trillions of dollars in wealth, the addition of tens of millions of people to the ranks of the unemployed, and historic drops in economic activity have combined to create new challenges for policymakers. While the current focus is on measures to recover from the financial and economic turmoil, the uncertainty and socio-political forces being generated are creating political instability, heightening security risks, and affecting U.S. interests in ways that could hardly have been imagined just a year ago.

This report provides an overview of the major non-financial impact of the global financial and economic crisis—both actual and potential. Although the eventual effects of the crisis are yet to be determined, looking back at the Great Depression, it is clear that a prolonged and widespread economic contraction can lead to major shifts in governments and acts of desperation that can be catastrophic in nature and far reaching in effect. International Monetary Fund Managing Director Dominique Strauss-Kahn recently stated that as the crisis spills over into developing countries, millions will be pushed into poverty and unemployment, and, for many countries, this will be at the roots of social unrest, some threat to democracy, and for some cases may also end in armed conflict.[1]

The forces that determine foreign policy and provide a foundation for the basic paradigms that underlie policy initiatives tend to have a long history and a momentum of their own. Therefore, the ultimate effects of the global financial crisis likely will depend on the length and severity of the global recession. If, as many economic forecasts indicate, the global downturn is U-shaped with a recession that lasts for about two years and recovery beginning in late 2009 or in 2010, the long-term effects are likely to be more of an exacerbation of previously existing trends rather than revolutionary direction-changing events except in particularly dire situations. However, if the global recession takes an L-shape with prolonged contraction and stagnation, much like the Great Depression, the probability rises that changes will be more than mere blips in a continuum but significant turns in the road.

As the crisis has progressed, policymakers have moved from rescues of financial institutions and loosened monetary measures to shoring up manufacturers in the real economy and expansionary fiscal policy. Now the crisis is extending into political and security concerns and is affecting fundamental issues such as basic economic philosophy or the underlying assumptions about the workings of market based economies. Some wonder if a statement by Albert Einstein may not apply here:

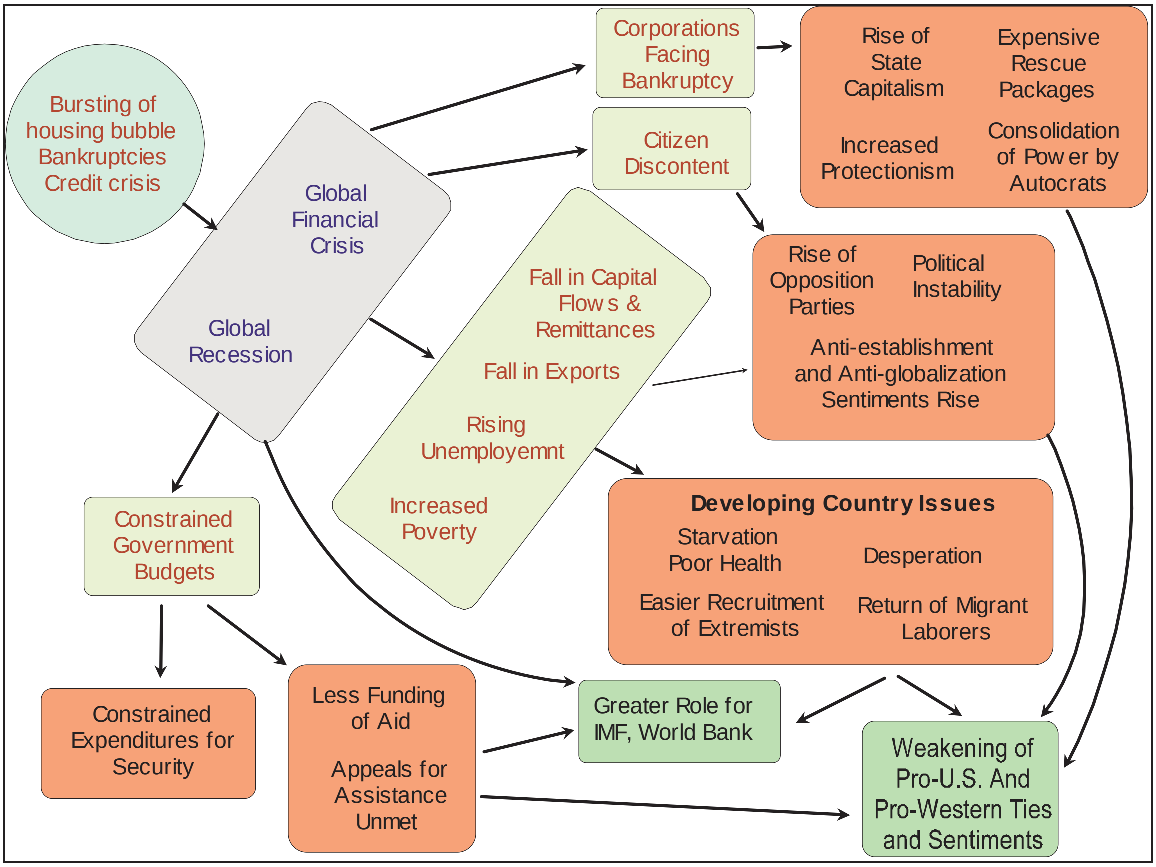
> The significant problems we face today cannot be solved at the same level of thinking we were at when we created them.

As indicated in **Figure 1**, the financial crisis began with a rising default level in subprime mortgages, bankruptcies, an overextension of credit and then a freezing of credit markets, and

[1] Jonathan Lynn, "IMF says clean up banks to tackle dire world crisis," *Reuters*, March 23, 20009, Reuters.com.

excessive financial bets on securitized debt obligations mainly in the United States but also in Europe. This has now grown into a global financial crisis with wildly diverse effects. At first, the crisis was transmitted through the globally interconnected financial system primarily among industrialized countries. As the economies of North America, Europe, and East Asia slowed or dropped into recession, the concomitant drops in commodity prices, international trade flows, and remittances along with tightening credit, and depreciating currencies (relative to the dollar and, in cases, the euro) caused similar contraction in growth in developing and emerging market countries.[2] This, in turn, has caused social and economic effects that pose the foreign policy challenges discussed in this report, and which ultimately can lead to a greater role for international financial institutions and a weakening of pro-United States and pro-Western sentiments and ties.

Figure 1. Actual and Potential Foreign Policy Related Effects of the Global Financial Crisis



Source: Congressional Research Service

Some of the specific effects being created or exacerbated by the financial crisis are shown in **Table 1**. These include changes in the U.S. leadership role and in international relations both among countries and between the United States and other nations. The enhanced role of the International Monetary Fund both as a lender of last resort and coordinator (along with the

[2] For details, see CRS Report RL34742, *The Global Financial Crisis: Analysis and Policy Implications*, coordinated by Dick K. Nanto.

Financial Stability Board) of international financial regulatory reform is particularly notable. Among the fundamental philosophies being affected are the rise of state capitalism, trade protectionism, and doubts about what has been seen as the Western economic model of market-based capitalism. Security issues include rising poverty and conditions that could provide ready recruits for religious extremism in certain countries of Africa and South Asia and budgetary pressures that could constrain security related expenditures. Among the challenges stemming from the economic and financial fallout from the crisis are questions about the primacy of the United States and the role of the dollar as a reserve currency, problems for developing nations caused by diminished inflows of capital and remittances and declining exports and prices for commodities.

Table 1. Actual and Potential Foreign Policy and Security Changes Caused or Exacerbated by the Global Financial Crisis

Category of Change	Actual or Potential Changes
International Relations	Potential effects on the U.S. leadership position in the world
	Enhanced role for the International Monetary Fund, Financial Stability Board, and Multilateral Development Banks
	The rise of China as a player in international financial issues and the co-mingling of U.S. and Chinese financial interests
	Additional pressures on European unity and policy discord between the United States and Germany/France
	Economic and political crises in Eastern Europe and tug-of-war for influence there between Russia and the EU/U.S.
Fundamental Philosophies	Rise of state capitalism and questioning of the Western economic model of deregulated, market-based decisionmaking
	Risk of rising trade protectionism and intensified anti-globalization efforts
	Potential for more authoritarianism in countries such as China and Russia and/or rise in authoritarian models of governance in the developing world
Security	Rising poverty and potential political instability in developing nations providing fertile ground for recruits for religious extremism
	Budgetary pressures in Western nations that could constrain international security and diplomatic efforts
Financial and Economic Fallout	Possible reduced U.S. financial primacy in the world and importance of the dollar as a reserve currency
	Diminished flows of economic assistance, capital, and remittances to developing nations
	For developing nations, declines in export earnings from low prices for commodities and from shrinking world trade

Source: Congressional Research Service.

The role of Congress in this aspect of the crisis is multifaceted and broad based. As of early 2009, the major policy focus has been on containing the crisis and doing what is necessary to promote recovery and reform in financial markets both in the United States and abroad. Congress has a particular role to play in protecting the national interest; informing the public and managing public expectations; budgeting for economic assistance, diplomacy, and defense; determining trade policy; providing capital for the International Monetary Fund and Multilateral Development Banks and determining their role relative to the U.S. government; and ensuring that the U.S. grand strategy in dealing with the world succeeds. Several committees in both the Senate and House already have held hearings on the foreign policy and security implications of the global financial crisis. [3]

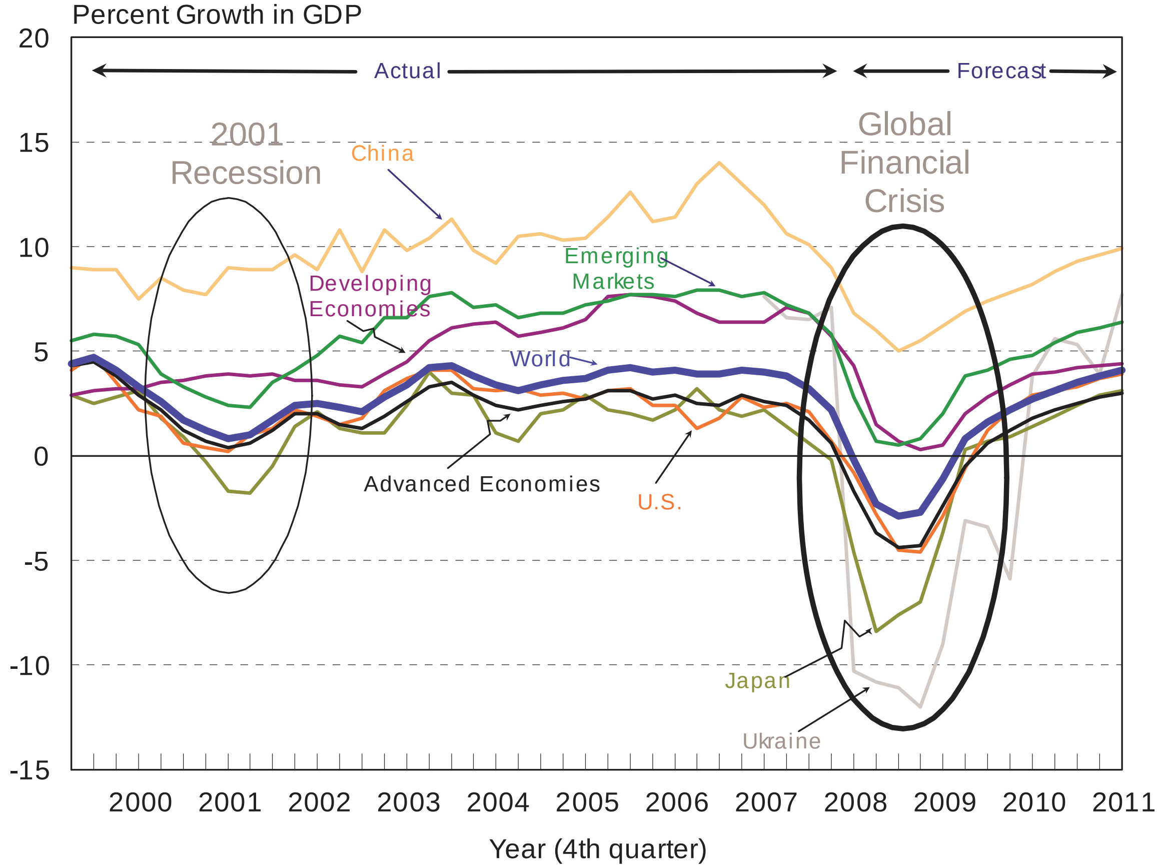
Two Indicators of the Severity of the Crisis: Growth and Trade

How severe is the global financial crisis? On March 19, 2009, the International Monetary Fund projected global economic activity to contract by ½ to 1% in 2009—the first such fall in 60 years. **Figure 2** shows projected growth rates by quarter (annualized) by Global Insight, an econometric forecasting firm. As can be seen, countries of the world are experiencing a simultaneous downturn with the advanced industrialized countries of North America, Europe, and Japan dropping into recession and a significant slowdown in economic growth rates in both developing countries and in emerging markets in Eastern Europe. Particularly noteworthy are the growth rates for China which still is positive but down considerably, and those for Japan (the second largest economy in the world) and Ukraine (an example of a particularly hard-hit economy), both facing severe recessions. These declines in economic activity have combined with trillions of dollars lost in equity markets and a credit squeeze that not only is affecting households and businesses world wide but is putting a damper on the financing of activities such as world trade and oil exploration. The International Labor Organization has noted that after four years of consecutive declines in world unemployment, the number of unemployed persons had increased in 2008 by 14 million. As the crisis continues to spread and job losses mount, worldwide unemployment could increase by at least 38 million by the end of 2009.[4]

[3] U.S. Congress, Senate Committee on Foreign Relations, *Foreign Policy Implications of the Global Economic Crisis*, Hearing, 111th Cong., 1st sess., February 11, 2009 and *Foreign Policy and the Global Economic Crisis*, March 25, 2009. U.S. Congress, Senate Committee on Armed Services, *To receive testimony on the current and future worldwide threats to the national security of the United States*, 111th Cong., 1st sess., March 10, 2009. U.S. Congress, House Committee on Armed Services, *Hearing on Security Challenges Arising from the Global Financial Crisis*, 111th Cong., 1st sess., March 11, 2009. U.S. Congress, House Committee on Foreign Affairs, *U.S. Foreign Economic Policy in the Global Crisis*, 111th Cong., 1st sess., March 12, 2009.

[4] International Labor Organization, International Institute for Labor Studies, *The Financial and Economic Crisis: A Decent Work Response*, Preprint edition, March 2009.

Figure 2. Actual and Forecasted Economic Growth Rates for Country Groups and the United States, Japan, and Ukraine (Annualized Quarterly Changes)

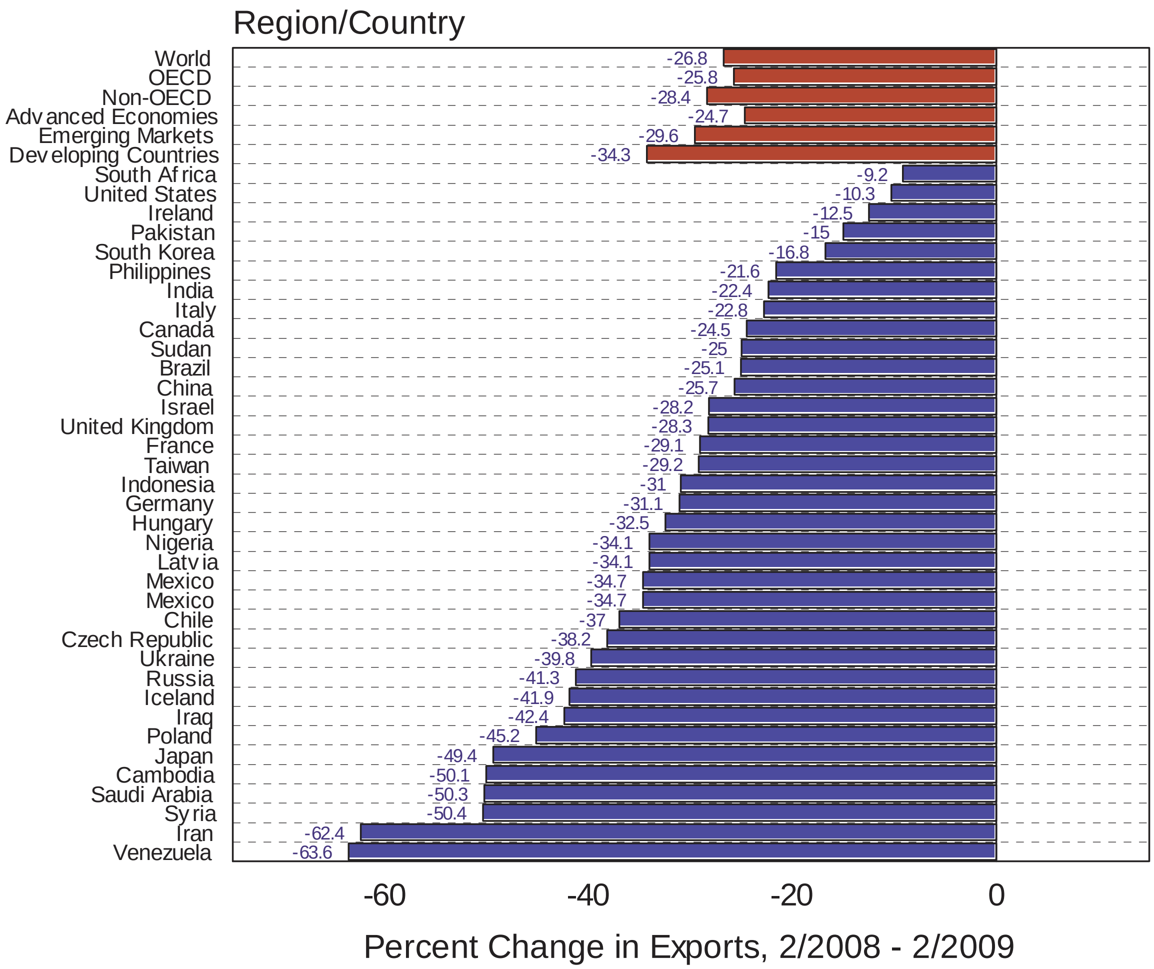


Source: Congressional Research Service with data from Global Insight (March 14, 2009, monthly forecast).

Exports of goods and services provide the main vehicle for countries to generate the foreign exchange necessary to pay for imports and to repay international debt. A deficit in a country's balance of trade also tends to depress the value of its currency which then raises the cost of debt service for governments, businesses, and households that have borrowed in international currencies. This is a particular problem for Eastern European nations whose public and private debt often is denominated in euros or Swiss francs. Also, in many less developed countries, the decline both in volume and price of exports of minerals and agricultural commodities undermines the basic levels of income for large segments of the working poor.

Figure 3 shows estimates of the change in export levels in February 2009 compared with that a year previous. For the world, advanced economies, and emerging markets, exports were estimated to be down about 25% (Japan's were down 49%). For developing countries, however, exports were down by more than a third. Exports were down from 9% to 64% for the other countries indicated. These are historic drops in trade volume. Even though imports also are falling, the shrinking of international trade is adding to the contraction in global economic growth and causing unemployment rates to rise and pushing more people into poverty.

Figure 3. Change in Merchandise Export Levels for Selected Regions and Countries, February 2008-February 2009



Source: CRS, Forecast data from Global Insight (March 14, 2009 forecast).

As the crisis has spread, the adverse macroeconomic effects are reverberating back to further weaken financial institutions, currencies, and equity markets. This is working to exacerbate adverse long-term effects that may affect U.S. foreign policy and, ultimately, U.S. security.

Political and Foreign Policy Effects of the Crisis

Any event of the magnitude of the global financial crisis generates unanticipated effects and this particular set of events seems to be driving states to adopt policies unprecedented in recent times. The financial crisis can be divided into four overlapping phases, each with a different focus. The first has been to contain the contagion and strengthen financial institutions through various financial packages aimed at restoring balance sheets of financial institutions and confidence in markets. Although the worst of the credit crunch seems to have subsided, the inventory of legacy "toxic" assets still has curtailed the ability of banks to lend and, combined with depressed equity values, is threatening insurance companies, pension funds, and investments held by a large swath of households and institutions across the world. The second phase of the crisis has been to deal with the slowdown and recession in world economies through various stimulus packages and other measures. The third phase has been to change financial regulations and build oversight and a regulatory architecture designed to prevent future crises and correct past abuses of the system. The fourth phase has been to deal with political and foreign policy effects of the crisis.

On February 12, 2009, the U.S. Director of National Intelligence, Dennis Blair, told Congress that instability in countries around the world caused by the global economic crisis and its geopolitical implications, rather than terrorism, is the primary near-term security threat to the United States. In his testimony before Congress, Blair stated that the crisis has already "increased questioning of U.S. stewardship of the global economy" and if it continued to spread and deepen, it would contribute to unrest and imperil some governments. He said that according to their statistical modeling, if economic crises persist over a one-to-two year period, they increase the risk of "regime-threatening instability."[5]

Other countries also have recognized that potential political and security effects of the crisis. On March 6, 2009, the United Kingdom established a new security committee called the National Security Forum and asked it to assess the security implications of the global financial crisis. The 12-member group is to bring together experts on policing, counter-terrorism, intelligence, finance and diplomacy to provide analysis to the UK's national security decision-makers.[6]

The political and foreign policy effects of the global financial crisis can be divided roughly into the following categories:

- effects on political leadership; regimes; perceived countries of influence; and stability, violence, and terrorism;
- effects on economic philosophy, state capitalism, and protectionism;
- effects on U.S. international leadership and attitudes toward the United States;
- effects on supranational financial and economic organizations;
- effects on poverty; and
- budgetary effects on resources for aid, diplomacy, and defense.

Effects on Political Leadership; Regimes; Perceived Countries of Influence; and Stability, Violence, and Terrorism

Political Leadership

Two of the major mechanisms through which the financial crisis works on political leadership and regimes within countries are citizen discontent and the consolidation of power by governments.

[5] Dennis C. Blair, *Annual Threat Assessment of the Intelligence Community for the Senate Select Committee on Intelligence*, Director of National Intelligence, Washington, DC, February 12, 2009. See also, U.S. Senate, Committee on Foreign Relations, "Foreign Policy Implications Of The Global Economic Crisis," Roundtable before the Committee On Foreign Relations, February 11, 2009. Mark Mazzetti, "Global Economy Top Threat to U.S., Spy Chief Says," *The New York Times*, February 13, 2009, Internet edition.

[6] Luke Baker, "UK forms new security body, weighs financial crisis," *Reuters*, March 9, 2009.

Citizen Discontent

The discontent from citizens arises from those who are losing jobs, seeing businesses go bankrupt, losing wealth both in financial and real assets, and facing declining prices for their products. This discontent often results in public opposition to the existing establishment or ruling regime and, in democracies, can lead to their replacement through established electoral processes. One commentator has called this the "Axis of Upheaval"[7] referring to the concept that the substantial increase in unemployment and a painful decline in incomes are likely to cause, or contribute to, political upheavals in countries. While financial crises may not be the only cause of such political instability, they may push conditions to a "tipping point."

For example, on January 26, 2009, in financially beleaguered Iceland, Prime Minister Geir Haarde and his cabinet resigned just three months after the collapse of the country's currency, stock market, and several major banks, and following large outbursts of public protest. [8] On February 20, 2009, Latvia's center-right coalition government collapsed, a victim of the country's growing economic and political turmoil.[9] In Hungary, the country's economic crisis has provided an opportunity for a political comeback for Viktor Orban, the long-standing leader of Hungary's conservative opposition. [10] A similar situation has developed in Japan where Prime Minister Taro Aso's approval rating has dropped to about 10% (in February 2009) apparently because of public discontent with his efforts to rekindle economic growth.[11] His conservative Liberal Democratic Party could well lose control of the government in the next election to an emboldened opposition.[12] Ukraine and Georgia also have been moving into a period of political uncertainty as they sink deeper into economic recession.[13] Public discontent over the adverse effects of the financial crisis also is rising in countries such as Greece, France, the United Kingdom, Ireland, Thailand, Haiti, and China. Some have called this the "European winter of discontent"[14] even though the impact extends far beyond the European continent. This illustrates how the global financial crisis can create chances for opposition leaders, regardless of political philosophy, to put pressure on incumbent governments.

In some cases public discontent may be manifest in extremist movements, particularly in poorer countries where large numbers of unemployed young people may become susceptible to religious radicalism that demonizes Western industrialized society and encourages terrorist activity. (See section on Stability and Violence below.) Although not completely related to the financial crisis, in March 2009 in El Salvador, the left-wing FMLN party of former Marxist guerrillas claimed victory in a hotly contested election.[15] If governments change, moreover, the rising new

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7 This is a reference to G.W. Bush Administration's use of "Axis of Evil" referring to Iran, Iraq, and North Korea. Niall Ferguson, "Introducing the axis of upheaval; The financial crisis is bad enough; but combined with empires in decline and ethnic disintegration, it is a recipe for disaster," *The Times (London)*, March 14, 2009, Internet edition.

8 "Icelandic government falls; asked to stay on," *CNN.com/Europe*, January 26, 2009.

9 David L. Stern, "Latvia's government collapses," *International Herald Tribune*, February 20, Internet edition.

10 Stefan Wagstyl, "Crisis opens door for Hungrian conservatives," *Financial Times*, February 3, 2009, p. 4.

11 Kanoko Matsuyama and Toko Sekiguchi, "Aso Approval Plunges as Japan's Economy Shrinks 12.7%," *Bloomberg.com*, February 16, 2009, Internet edition.

12 Toko Sekiguchi and Sachiko Sakamaki, "Aso's Obama Summit May Be Last as Calls to Quit Grow ," *Bloomberg.com*, February 23, 2009.

13 "Eastern Europe gripped by political instability," *EuActive.com*, February 17, 2009.

14 Adrian Michaels, "Europe's winter of discontent," *The Telegraph*, January 29, 2009, Telegraph.co.uk.

15 Adam Thomson, "El Salvador's left claims victory in historic poll," *FT.com (Financial Times)*, March 16, 2009, Internet edition.

government may play on nationalistic sentiments, particularly if the previous regime is seen as having been too oriented toward international considerations.

Some members of the European Union initially viewed the financial crisis as primarily an American phenomenon. That view has changed as economic activity in the EU has declined at a faster pace than in the United States and public protests against the growing financial and economic turmoil have increased the political stakes for EU governments and their leaders. As one commentator has put it, “As panic grips Cabinet rooms across the Continent, the public is driven to fury.”[16] Of growing concern is the impact the financial crisis and the economic recession are having on the economies of Eastern Europe and prospects for political instability as well as the future course for market reforms. Western European banks are heavily involved in Eastern Europe, and worsening economic conditions there could compound the current problems facing financial institutions in EU member nations.[17]

Consolidating Government Power

The second way that the crisis works on ruling regimes is through the actions of existing governments both to stay in power and to deal with the adverse effects of the crisis. Any crisis generates centrifugal forces that tend to strengthen central government power. Most nations view the current financial crisis as having been created by the financial elite in New York and London in cooperation with increasingly laissez faire governments in the United States and the United Kingdom. During the January 2009 World Economic Forum in Davos, Switzerland, for example, Chinese Premier Wen Jiabao charged that America's voracious appetite for debt and “blind pursuit of profit” had led to the worst recession since the Great Depression.[18] By blaming the industrialized West, particularly the United States, for their economic woes, governments can stoke the fires of nationalism and seek support for themselves.

As nationalist sentiments rise and economic conditions worsen, citizens look to governments as a rescuer of last resort. Political authorities can take actions, ostensibly to counter the effects of the crisis, but often with the result of consolidating their power and preserving their own positions. Authoritarian regimes, in particular, can take even more extreme actions to deal with financial and economic challenges.

In Venezuela, for instance, President Hugo Chavez won a referendum on February 15, 2009, ending the two-term limit on presidential elections, a battle he had previously lost in December 2007. Although the result of a democratic process and not completely attributable to the global financial crisis, this does point to the tightening of Chavez’s power in Venezuela. On February 28, he sent troops to temporarily take over rice processing plants including one owned by the American company Cargill. Falling oil prices have limited the government’s ability to provide compensation for takeovers of private businesses.[19]

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[16] Peter Popham, "The Big Question: How serious is the political unrest on the Continent, and can it be calmed?," *The Independent*, January 30, 2009, Internet edition.

[17] The International Monetary Fund has issued emergency loans to Hungary and Ukraine. The World Bank in a joint effort with the European Bank for Reconstruction and Development and the European Investment Bank announced on February 27, 2009 that they were providing $31 billion over two years to assist ailing banks and businesses in Eastern and Central Europe.

[18] "Furious leaders lash US over economic crisis," *ABC News*, January 29, 2009.

[19] "Chavez orders army to seize Venezuela rice mills," *Reuters* as reported by *MSNBC.com*, February 28, 2009. Deisy (continued...)

In Russia, the impact of the financial crisis has been particularly severe as it faces a decline in global demand for its exports of oil and natural gas and a 71% drop in the price of its petroleum. The crisis has exposed Russia's significant dependence on oil, natural gas, and other commodities. In 2008, oil, natural gas, and other fuels accounted for about 65% of Russia's export revenues. In addition, the Russian government is dependent on taxes on sales of oil and natural gas for more than half of its revenues; Russia has generated budget surpluses since 1998, but it is expected to have a budget deficit in 2009, primarily because of the fall in oil prices.

The fall in world demand for oil also has hit other parts of the Russian economy. As of April 6, 2009, Russia's RTS stock market index had lost nearly 70% of its value from the peak reached on May 19, 2008. From June 2008 to the end of January 2009, the ruble had depreciated by 52% in terms of the dollar and 22% in terms of the euro. This compelled the Central Bank of Russia to intervene to bolster the value of its currency by selling foreign exchange and buying rubles. This caused Russia's official foreign exchange reserves to decline accordingly.

These increasingly difficult economic circumstances in Russia are proving to be a factor in rising nationalism and spreading state capitalism there. Some feel, for example, that Russia has taken advantage of the need to intervene in the economy to counter effects of the financial crisis to make the country a harder, more vertically managed power with state capitalism as the foundation of its industrial sector. This reversing or slowing down of many of the structural economic reforms had been pursued under then President Putin, but as the financial crisis and drop in the price of energy has hit Russia, the Kremlin and now Prime Minister Putin have increased the government's control over critical sectors such as oil, natural gas, and other commodities.

Perceived Countries of Influence

As the financial crisis spreads to emerging and developing nations, many of these countries are facing gargantuan financial problems that they are unable to resolve themselves. They have turned to outside assistance from sources such as Russia, the European Union, China, and the International Monetary Fund. Whether such assistance is extended or not may affect strategic and political relations with the nations in question. In Eastern Europe, in particular, there appears to be a tug of war developing between the European Union and Russia for the long-term allegiances of Eastern European states.[20] The situation in Ukraine illustrates the problem. After being rebuffed by the IMF for additional financing, Ukraine Prime Minister Yulia Tymoshenko said that she had sent letters requesting financial aid to the United States, the European Union, China, Japan, and Russia. She also noted that Russia had responded with a positive reply, although Moscow has yet to announce a decision.[21] (Eventually, Ukraine accepted an IMF loan and has agreed to its rather stringent conditions [such as increasing its retirement age].)

(...continued)

Buitrago, "Venezuela sees no further Cargill takeovers," *Reuters*, March 6, 2009.

[20] "EU, Russia quietly battle for Eastern Europe influence," *EurActiv.com*, February 11, 2009.

[21] Office of mass media relations of the Cabinet of Ministers of Ukraine Secretariat , *Yulia Tymoshenko: Ukraine carries on successful negotiations with many countries of the world on giving credit to cover deficit of State Budget*, Government Portal, Riga, Ukraine, February 7, 2009. Yekaterina Trofimova, "Russia Seen as Cash Cow," *Utro.ru (in Russian)*, March 4, 2009, Translated by Open Source Center, document CEP20090304009003 . "Ukrainian Speaker Says Borrowing From Russia Would Be Advisable," *ITAR-TASS*, March 11, 2009.

In April 2009, OAO Surgutneftegaz, a Russian oil company close to the Kremlin, announced that it had acquired a 21% stake in Hungary's national energy company. This sparked criticism that Moscow was exploiting the financial crisis by parlaying its energy resources into greater economic influence in Eastern Europe.[22]

In one case, the financial crisis may help in moving a country away from Russia and toward the West. On January 12, 2009, the IMF approved a 15-month Stand-By Arrangement of $2.46 billion for Belarus. Belarus also had unsuccessfully approached Russia for a $3 billion currency swap arrangement and then asked for a $2 billion bank loan guaranteed by the Russian government. Some assert that Belarus has set up a "bidding war" between the East and West for influence there.[23]

"Checkbook diplomacy" (using economic assistance to gain political advantage), in many cases has returned only mixed results. However, public memories of events during times of crisis tend to linger. In Thailand and other Southeast Asian countries, perceptions persisted that the United States had been slow in lending support during the 1997-98 Asian financial crisis and were only partly assuaged years later through the outpouring of U.S. assistance to Southeast Asian nations following the 2004 Indian Ocean Tsunami.[24]

A Dutch think-tank also has been following the security impact of the financial crisis. It has been particularly interested in a possible power shift from the West to the East because of China's rising financial power.[25] The London Economist puts the situation in these terms:

> China's prime minister, Wen Jiabao, no longer sticks to the script that China is a humble player in world affairs that wants to focus on it own economic development. He talks of China as a "great power" and worries about America's profligate spending endangering his $1 trillion nest egg there. ...Already a big idea has spread far beyond China: that geopolitics is now a bipolar affair, with America and China the only two that matter.[26]

The financial crisis also is providing an opportunity for cash-rich China to secure critical supplies of minerals and raw materials.[27] Although China's quest for food, fuel, and ores is not new and Chinese companies are backing out of some deals, Chinese companies are among the few with cash on hand to do deals in the current recessionary economic conditions. In February 2009, China reached a long-term deal to lend $25 billion to two Russian energy companies in exchange for an expanded supply of Russian oil. China Minmetals Corporation also had offered roughly $1.7 billion to buy Australia's OZ Minerals Ltd., and Aluminum Corp. of China announced a planned $19.5 billion investment in Australia's mining giant Rio Tinto.[28] The financial crisis

[22] Guy Chazan and Gregory L. White, "Russian oil company buys stake in Hungary's MOL—Purchase reinforces concerns Kremlin is extending reach," *The Wall Street Journal Asia*, April 1, 2009, p. M2.

[23] Yuriy Humber, "Lukashenko Eases Grip on Belarus Amid Crisis," *The St. Petersburg Times (Russia)*, April 3, 2009, Reproduced in Dow Jones Factiva.

[24] Meetings with opinion leaders in Indonesia by Dick Nanto in February 2008.

[25] Valentina Pop, "European NATO members at odds over strategic priorities," *EUuobserver.com*, March 27, 2009.

[26] "How China sees the world," *The Economist*, March 21, 2009, pp. 13, 27-29.

[27] For an analysis of China's trade and investments as part of its soft power, see CRS Report RL34620, *Comparing Global Influence: China's and U.S. Diplomacy, Foreign Aid, Trade, and Investment in the Developing World*, coordinated by Thomas Lum.

[28] David Winning, Shai Oster, and Alex Wilson, "China, Russia Strike $25 Billion Oil Pact ," *The Wall Street Journal, Asia*, Internet Edition, February 18, 2009.

apparently has made companies facing falling demand eager to secure cash and more amenable to overtures by Chinese companies. While locking up such supplies of raw materials may not translate into political allegiances, they constitute a strong link in supply chain ties that tend to bind economies together. [29]

China also has entered into currency swap arrangements totaling 650 billion Chinese yuan ($95 billion) with South Korea, Hong Kong, Malaysia, Indonesia, Belarus and Argentina. Under the swap arrangements, those countries could swap a foreign currency for yuan that can be used to settle trade with China.[30]

The financial crisis also has been buffeting the sense of unity among the eurozone nations. There has been some speculation on a potential break-up of the eurozone, a development that could affect European security. The issue revolves around the troubles that Ireland and southern members of the single currency arrangement (Portugal, Spain, Italy, and Greece) have had in selling bonds and stabilizing their growing budget deficits.[31] At the same time, the financial crisis and the accompanying economic downturn have battered the currencies of many of the non-eurozone countries, especially in Central and Eastern Europe. As a result, many of these countries have become more interested in joining the perceived safety of the eurozone and have pressed the eurozone members to relax the rules on entry into the euro area. These actions are straining relations with the larger, more prosperous economies of the eurozone and the European Union who hold a skeptical view of any rapid expansion in eurozone membership. For some of the aspiring economies, however, opposition within the euro area to their membership is especially embittering, because the recession is undermining their ability to meet the rigid requirements for membership in the eurozone set by the more prosperous economies, who, they argue, are to blame for originating the crisis.

Stability, Violence, and Terrorism

Citizen discontent, the consolidation of government power, and effects on international relations relate to economic and political stability both within and among countries. Stability, in and of itself, is not an overriding foreign policy goal,[32] but no one likes to deal with surprises, particularly those that can threaten U.S. interests. If change happens, U.S. foreign policy analysts would like to be able to predict it and prepare for the consequences. The National Intelligence Council in its November 2008 report forecasting global trends to 2025, noted that economic volatility introduces a major risk factor to political stability. Historians and social scientists have discovered a strong correlation between rapid economic change—both positive and negative—and political instability. The Council cited the massive dislocation and economic volatility introduced by the end of the “first” globalization in 1914-1918 that helped lay the groundwork for the rise of protectionism in the 1920s and 1930, and then to World War II that, in turn, unleashed

[29] Valentina Pop, "European NATO members at odds over strategic priorities," *Euobserver.com* , March 27, 2009, Open Source Center article No. EUP20090327319002.

[30] Denis McMahon and Aaron Back, "PBOC Eyes More Currency Swaps To Up Trade In Crisis," *Wall Street Journal*, March 31, 2009, Mobile edition.

[31] Valentina Pop, "European NATO members at odds over strategic priorities," *Euobserver.com* , March 27, 2009, Open Source Center article No. EUP20090327319002.

[32] For a discussion of stability as a goal, see Ralph Peters, "Stability, America's Enemy," *Parameters*, 2001/2002, Winter, pp. 5-20.

a long series of national and ethnic conflicts that reverberates today.[33] One thing that could be said about stability, is that instability generally favors a rising power or opposition forces. For a dominant power, instability may pose a risk to its hegemony.

For U.S. businesses operating overseas, stability is essential for smooth operations. Obtaining government approvals, building manufacturing facilities, expanding service networks, maintaining a labor force, and shipping components and final products all are threatened by political, financial, and economic instability. Also, political instability may bring a rise in crime, traffic in illegal drugs and counterfeit products, kidnappings, and other illicit activity.

The financial crisis also may worsen problems that already have escalated in recent years. In particular, violence by drug cartels and crime syndicates seems to be on the rise in various countries. Mexico is a case in point. Rising violence in Mexico is forcing American companies to change their operating procedures and shipping routes, and to tighten security for their employees.[34] Mexican President Felipe Calderon has rejected U.S. concerns that Mexico is losing control of its territory to drug cartels and called "absolutely false" the idea that Mexico is in danger of becoming a failed state if the violence continues. However, in 2008, 6,290 people were killed in drug violence[35] and government officials say the drug war and economic crisis are starting to feed off each other. The violence discourages foreign investment and tourism while rising unemployment could nudge more youths to join the drug cartels. Lower growth also could leave Mexico with less cash to spend on the drug war, which cost $6.4 billion over 2007 and 2008.[36]

Even in China, where rates of violent crime have traditionally been low, there reportedly has been an increase in kidnappings for ransom since the onset of the economic slowdown and an overall rise in security issues for multinational companies, particularly from laid-off workers. Desperation over unemployment seems to be the primary cause of this increasing threat.[37]

Political instability and poverty also can provide an incubator for extremism. The financial crisis may not be the primary cause of ideologically driven terrorism, but the worsening of economic conditions and rising joblessness among young people provide better recruitment opportunities for extremist terrorist groups. Militants thrive in places of political instability and lack of strong central governmental control. The global financial crisis threatens to create more such places. Countries of concern may include Pakistan, Bangladesh, Yemen, Nigeria, Sudan, Somalia, and Egypt. As one analyst has stated,

> No matter how cohesive and determined a terrorist organization, it needs a supportive environment in which to flourish. That means a location that provides a steady stream of funds and recruits and the support (or at least acceptance) of the local population. ... As more people lose their jobs, their homes, and opportunities for prosperity—in emerging market

33 National Intelligence Council, *Global Trends 2025: A Transformed World*, NIC 2008-003, Washington, DC, November 2008, p. 5.

34 "Foreign Companies React To Mexico Violence," *Associated Press, reported by CBS News*, February 24, 2009, Internet edition.

35 "Mexico Drug Violence May Be Reaching Peak," *CBS/Associated Press*, February 26, 2009, Internet edition.

36 Catherine Bremer, "ANALYSIS-Mexico drug war, economy hobble Calderon's ambitions," *Reuters*, April 6, 2009.

37 Stratfor Global Intelligence, *An Uptick in Violent Crime*, China Security Memo, February 19, 2009.

> countries or even within minority communities inside developed states—it becomes easier for local militants to find volunteers.[38]

The global financial crisis also is causing mass deportations or voluntary exodus by many immigrant workers who no longer can find employment abroad. As these workers return to their home countries, they may join the many already unemployed and become targets for recruitment by militant groups and insurgent movements. For example, most of the Gulf Cooperation Council states rely heavily on foreign labor in their construction and oil industries. Many of these workers are from Pakistan, India, Bangladesh, and the Philippines. Dubai's labor ministry reportedly has been cancelling 1,500 work permits per day since late October 2008.[39]

In February 2009, the Chairman of the Joint Chiefs of Staff, Admiral Mike Mullen outlined what he thinks about the future and evolution of the U.S. military stated that the world's financial crisis has to be taken into consideration as well. Mullen noted that poor economic states may become future targets for terrorism. He also added that U.S. defense may be affected by budget cuts, possibly shifting mission focuses.[40] As noted above, on March 23, 2009, IMF Managing Director Dominique Strauss-Kahn said the world is in a dire economic crisis that will push millions into poverty and unemployment, risking social unrest and even war and that urgent action is required.[41]

The rising unemployment problem is exacerbated by declining remittances from workers overseas, a critical component of household income in many poorer countries. The global financial crisis not only has reduced export income and inflows of investment capital in many developing nations, but as demand shrinks for foreign labor in more industrialized economies, the money sent to home countries also may decline. In 2008, remittances from foreign workers accounted for an estimated $305 billion in flows to developing countries.[42] For many countries, this is greater than inflows of aid and foreign investment funds combined. The countries that rely on remittances for at least one-fifth of their income include such post-conflict and conflict-prone nations as Lebanon, Burundi, Liberia, Kyrgyzstan, Tajikistan, Afghanistan, Bosnia, Moldova and Haiti.[43]

In Latin America, currencies, stock markets, and output are down broadly by one-third to one-half from a year earlier. Unemployment is also on the rise. While most countries in the region are likely to ride out the economic contraction, many are watching Argentina to see if it again ends up defaulting on its foreign debts, thereby raising the specter of a social breakdown. Financially, the country is extremely fragile and already is experiencing protests. This could present a challenge to U.S. policy and status, given that Argentines often blame the United States for many of their economic problems.

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38 Ian Bremmer, "Call: Global recession = more terrorism," *Foreign Policy*, March 4, 2009, pp. Internet edition, ForeignPolicy.com.

39 Stratfor, *Gulf States: Labor Policies, Financial Crisis and Security Concerns*, Analysis, February 24, 2009.

40 Michael J. Carden, *Military Adapts to Special Operations Mission, Mullen Says* , American Forces Press Service, February 12, 2009.

41 *IMF says clean up banks to tackle dire world crisis*, Reuters, March 23, 2009.

42 "Remittances, Trickle-down economics," *The Economist (London)*, February 21, 2009, p. 76.

43 Donald Steinberg, "First Lehman Brothers, Next Liberia?," *The Globalist*, by the International Crisis Group, January 26, 2009. Stratfor, *Watch List for Remittance Flows*, Analysis, February 4, 2009.

The precipitous drop in the price of oil, moreover, holds important implications for countries such as Mexico, Venezuela, and other petroleum exporters, who were counting on oil revenues to fund activities considered to be essential to their interests. The oil-producing Andean countries of Ecuador and Bolivia also tend to be financially fragile and have left-leaning governments. While moderating oil prices may be a positive development for the U.S. consumer and for the U.S. balance of trade, such price declines also may cause political instability in certain of these petroleum exporting countries. The concomitant drop in prices of commodities such as rubber, copper ore, iron ore, beef, rice, coffee, and tea also carries serious consequences for exporter countries in Africa, Latin America, and Asia.[44]

The decline in oil prices may be particularly troubling in oil-dependent Yemen, a country with a large population of unemployed young people and a history of support for militant Islamic groups. Also, in Pakistan, a particular security problem exacerbated by the financial crisis could be developing. The IMF has approved a $7.6 billion loan package for Pakistan, but the country faces serious economic problems at a time when it is dealing with challenges from suspected Al Qaeda and Taliban sympathizers, when citizen objections are rising to U.S. missile strikes on suspected terrorist targets in Pakistan and the country faces a budget shortfall that may curtail the ability of the government to continue its counterterror operations.[45] The Iraqi government also depends heavily on revenues from exports of oil. Such revenues finance about 95% of the government's budget.

Effects on Economic Philosophies, State Capitalism, and Protectionism

Economic Philosophies

The global financial crisis may have ended what some call the period of economic neoliberalism that began with President Ronald Reagan and British Prime Minister Margaret Thatcher. This economic philosophy already was being disparaged in many Latin American countries. Some also have asserted that the crisis has effectually ended the Washington Consensus, the economic strictures often prescribed for Latin American countries in financial trouble.[46] The Washington Consensus included fiscal discipline, liberalization of trade and direct investment flows, privatization, deregulation, and flexible exchange rates.[47] While the elements of the Washington Consensus and neoliberalism do not overlap completely, the underlying premise of each was that market-based, rather than government-based, economic decisionmaking along with fiscal discipline can lead to higher rates of economic growth and greater prosperity for nations. Budget deficits and their borrowing requirements, in particular, had to be controlled because they caused inflation and economic instability and crowded out private economic activity.

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[44] Johnston, Tim. "Asia Nations Join to Prop Up Prices," *Washington Post*, November 1, 2008, p. A10. "Record Fall in NZ Commodity Price Gauge," *The National Business Review*, November 5, 2008.

[45] Joby Warrick, "Experts See Security Risks in Downturn, Global Financial Crisis May Fuel Instability and Weaken U.S. Defenses," *Washington Post*, November 15, 2008. p. A01. Bokhari, Farhan, "Pakistan's War On Terror Hits Roadblock, Global Economic Crisis Prompts Military To Consider Spending Cutbacks," CBS News (online version), October 28, 2008.

[46] Kevin Gallagher , "The death of the Washington consensus?," *Guardian.co.uk*, October 13, 2008.

[47] Center for International Development at Harvard University, Global Trade Negotiations Home Page, *Washington Consensus*, Updated April 2003.

Now, however, many countries (including the United States in some respects) seem to be turning toward large budget deficits, increased trade protectionism, restrictions on capital flows, government ownership of companies, and tighter regulation of financial markets and players. After the global financial crisis has passed, the basic structure of market-based capitalism and liberalized international trade are likely to survive, but countries today seem to be turning more toward viewing economic policies through a strategic lens and some question whether the costs of neoliberal economic policies being manifest by the financial crisis are worth their benefits. Of course, coping with the crisis can be viewed as a case of expediency overriding values rather than a shift in philosophy. As one analyst has noted about financial crises: as each crisis arrives, policy makers express ritual shock, then proceed to break every rule in the book. The alternative is unthinkable. When the worst is passed, participants renounce crisis apostasy and pledge to hold firm next time.[48]

At the January 2009 World Economic Forum in Davos, Switzerland, the question was raised whether the rules and values that were in place to safeguard the capitalist system have failed or whether the system itself is in need of an overhaul. Most Forum panelists agreed that, while the financial system needs to be fixed, the solution is not excessive regulation that stifles innovation and free enterprise. Former British Prime Minister Tony Blair, for example, argued that "the free enterprise system as a whole has not failed. The financial system has failed." He noted that the financial system was originally there to serve the wider economy and the wider economy to serve the wider society. According to him, the financial system was not meant to be an end in itself.[49] One commentator may have captured the essence of the issue with this comment, "Capitalism isn't the enemy, and it isn't the savior. It is simply a system fueled by human creativity but vulnerable to human weaknesses such as greed."[50]

State Capitalism

Increased government ownership and direction of enterprises and investment funds has been called state capitalism[51] or public-sector capitalism. The formal term for government takeovers of companies or assets is "nationalization," although in most cases, the current cases differ from past cases of nationalizations by communist or socialist governments. Those essentially amounted to expropriation in which governments would seize private sector assets without fully compensating owners. Most industrialized market-oriented economies of the world are taking over firms as part of rescue packages (out of expediency) with the major goal of providing support to the financial or other sectors of the economy and not to shift the basic structure of the economy away from capitalism. It is probably not the case, as some have postulated, that "we are all socialists now,"[52] but increased government ownership and management of business assets brings a new dimension to the interaction between policy and business activity.

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[48] Gelpern, Anna. "Emergency Rules," *The Record* (Bergen-Hackensack, NJ), September 26, 2008.

[49] Tony Blair , Stephen Green , Indra Nooyi , and Shimon Peres , *The Values behind Market Capitalism*, The World Economic Forum, January 28, 2009.

[50] Cynthia Tucker, "Capitalism no foe; just keep an eye on it," *Atlanta Journal Constitution*, March 29, 2009, Internet edition.

[51] State capitalism also may refer to economic activities by states (e.g., New York) within the United States. Most state investment, however, tends to be unrelated to foreign policy (except for state pension funds that may eschew investing in certain countries because of human rights considerations).

[52] E.J. Dionne, Jr, "Stuck Between Stations," *The New Republic*, March 30, 2009, Internet edition.

A challenge for the United States is to balance its own free-market economic philosophy with the fact that it is now a major owner or player in businesses that it has rescued because of the financial crisis. Compared with formerly socialist countries, U.S. state capitalism is small in scale, but the challenges of government management and the potential to sway business decisions because of political considerations are similar.

With respect to foreign policy, one danger of state ownership of businesses is that governments may exploit state-owned or state-invested enterprises for international political gains.[53] Nationalizations also pose risks for businesses that have invested in foreign countries. Governments could take over their operations without sufficient compensation. A related issue is that government ownership may cause companies to become less efficient and unable to compete as well in the global marketplace over the long-term. Governments may not have the expertise or manpower to successfully manage or make quick decisions at nationalized firms. Government ownership of companies, moreover, may induce companies to take actions in response to popular pressure rather than to market forces. This may lead to inefficiencies and further uncertainties about economies.

Some examples of increasing state capitalism include the following. Iceland has nationalized all its major banks, and the UK has taken a 68% share of the Royal Bank of Scotland.[54] The United States has taken control over Fannie Mae and Freddie Mac and has substantial input into the operations of AIG, Citigroup, General Motors, and Chrysler.[55] Germany has approved a law letting the government nationalize banks.[56] Loans being extended to private businesses as well as capital injections into financial institutions also are coming with strings attached. Whether the strings are limits on executive compensation, fuel economy standards, pressures on banks to lend more domestically, or other specific performance requirements, governments now have greater voice in the operation of many corporations.

In countries such as Russia, where histories of command economics predispose the government toward state ownership of the means of production, the shift toward state capitalism already was developing before the financial crisis and has continued to develop. National oil companies, other state-owned enterprises, and sovereign wealth funds have brought politicians and political bureaucrats into economic decision-making on a scale not seen since the before the market reforms that followed the end of the Cold War.[57] Although not totally attributable to the financial crisis, the line between the state-owned Gazprom and the Russian state can be quite thin. Under former President Putin, Gazprom reportedly became an instrument for centralizing authority, buying up opposition television stations and newspapers.[58] In a poll taken in Russia asking what socio-economic system the respondent favors, 58% favored the old Soviet system of state planning and distribution, while 28% favored one based on private property and market relations,

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[53] Douglas Rediker and Heidi Crebo-Rediker, "Don't Pick on Sovereign Wealth," *The Wall Street Journal Europe*, July 17, 2008, p. 12.

[54] Landon Thomas Jr., "Nationalized in all but name: U.S. move echoes U.K. share of RBS ," *International Herald Tribune*, February 24, 2009, Internet edition.

[55] CRS Report RS22950, *Fannie Mae and Freddie Mac in Conservatorship*, by Mark Jickling; CRS Report RL34730, *Troubled Asset Relief Program: Legislation and Treasury Implementation*, by Baird Webel and Edward V. Murphy; Binyamin Appelbaum, "Government to Take Bigger Stake in Citigroup," *Washington Post*, February 27, 2009.

[56] "Germany approves law on bank nationalization," *Welt Online*, February 18, 2009.

[57] Ian Bremmer and Nouriel Roubini, "Expect the World Economy to Suffer Through 2009 ," *The Wall Street Journal*, January 23, 2009, p. A15.

[58] Andrew E. Kramer, "Gazprom," *The New York Times*, January 20, 2009.

and 14% responded that it was hard to say. The polling center indicated that the growth of "anti-bourgeois" sentiments can be explained by the financial crisis.[59]

Trade Protectionism

For many, the global financial and economic crisis has confirmed existing anti-globalization sentiments and is being reflected in opposition to more liberalized trade.[60] Under the dislocation caused by the financial crisis, many countries are attempting to curtail imports or impose other restrictions on trade. At both the G-20 Leaders' Summit and the meetings of finance ministers and central bank governors, participants agreed to fight all forms of protectionism and maintain open trade.[61] However, in March 2009, World Trade Organization Director-General Pascal Lamy stated that members of the WTO were showing a "worrying tendency toward increased trade protectionism as a result of the deepening global economic crisis." He indicated that the WTO had identified 85 verified trade measures imposed by 23 countries between September 2008 and March 2009. The large majority were trade-restrictive, although some were in the direction of trade liberalization. The largest number of measures were imposed by India, most of them trade restrictive (duty hikes, import bans introduction of licensing requirements, antidumping actions, etc.) and some nonrestrictive (removal of export duties). Others that the WTO reported as having imposed a large number of new trade measures were the EU, China, Indonesia, Argentina, and Russia. The report also identified a further 14 non-verified trade measures imposed by 12 countries between September 2008 and March 2009 (with the information largely gleaned from press reports). Lamy stated that a "pattern is beginning to emerge of increases in import licensing, import tariffs and surcharges, and trade remedies to support industries that have faced difficulties early on in this crisis." There also has been an increase in initiations of antidumping investigations.[62]

The overt forms of protectionism or beggar-thy-neighbor policies are limited by rules countries have agreed to as members of the WTO. However, there is ample scope for increases in trade barriers that are consistent with WTO rules and obligations, including increases in applied tariffs to higher bound levels. If all WTO members raised their currently applied tariffs to today's WTO bound rates, tariffs worldwide would double. The WTO has said that such increases in trade barriers could cause world trade to shrink by up to 8% and reduce global welfare by up to $350 billion.[63]

WTO rules also allow countries to impose countervailing duties on unfairly subsidized imports or to take antidumping measures against imports being sold at less than fair value. Certain sectors also are excluded from trade agreements for national security or other reasons. Moreover, there are opportunities to favor domestic producers at the expense of foreign producers through

[59] "Russians reject American-style capitalism more than ever," *Washington Post paid supplement, Russia Now*, March 25, 2009, p. H4.

[60] See CRS Report R40461, *The Global Economic Downturn and Protectionism*, by Raymond J. Ahearn.

[61] The Group of Twenty (G-20) Finance Ministers and Central Bank Governors , *Declaration and action plan from the Washington Summit*, November 15, 2009, http://www.g20.org. G-20, Meeting of Finance Ministers and Central Bank Governors, United Kingdom, 14 March 2009, Communiqué, March 14, 2009.

[62] "WTO Chief Cites 'Significant Slippage' Toward Protectionism Since Late January ," *International Trade Daily (The Bureau of National Affairs, Inc.)*, March 30, 2009.

[63] Pascal Lamy, *Protectionism cannot be 'smart', Lamy tells Australian think-tank*, World Trade Organization, WTO NEWS: SPEECHES—DG PASCAL LAMY, March 2, 2009.

industry-specific relief or subsidy programs, broad fiscal stimulus programs, buy-domestic provisions, or currency depreciation.

Almost any government intervention into economic activity affects international trade and capital flows. Since government intervention generally is influenced by political considerations and may involve tax dollars, it usually favors domestic constituencies at the expense of foreign constituencies. A danger in the process of recovering from the global financial crisis is that countries may try to capture a larger share of a declining volume of international trade rather than attempt to induce recovery in trade flows by helping their macroeconomies return to health. Government assistance packages also could result in a form of "creeping protectionism." At what point do government loans and assistance become an unfair subsidy under international trade rules? Also, would a government rescue a company and then stand by while it succumbs later to import competition? Governments also may turn toward "managed trade" as occurred in the 1980s in response to the oil shock of the 1970s. Managed trade was not an increase of tariff rates to reduce imports but rather the imposition of import-reducing measures such as "voluntary export restraints" or local-content requirements.[64] Imports also can be restricted through various other non-tariff measures, such as standards and technical regulations (including sanitary and phytosanitary measures).

China, for example, has announced plans to provide subsidies to various industries (such as steel and motor vehicles) and to boost export tax rebates. Also, despite calls for it to allow its currency to appreciate, the Chinese government has kept its exchange rate relatively stable since mid-2008 arguably to help its export industries. This ended a period beginning in 2005 in which China had allowed its currency to appreciate by about 20% against the dollar.

A concern among developing nations is that a type of "financial protectionism" may rise. The combination of the global economic slowdown, fragile banking and securities sectors, tighter lending standards, increased capital reserve requirements, plus government pressures on banks to lend more domestically rather than overseas may shrink the amount of capital available for emerging and developing nations. Some are wondering if the U.S. Treasury, in borrowing to finance the growing U.S. budget deficit, could crowd out borrowers from countries also seeking to cover their deficits. Also of concern to countries such as Vietnam, China, and other exporters of foreign brand name exports is that private flows of investment capital may decline as producers face rising inventories and excess production capacity. Why build another factory when existing ones sit idle?

In the United States, Members of Congress are called on to balance constituent pressures for relief from imports against the increased integration of the United States in the global economy. This has combined with increased public skepticism about the benefits of free trade and globalization. The "Buy American" provision in the February 2009 stimulus package[65] has been characterized by some as a step down the slippery slope leading to protectionism and a sign, worrying to many, that the United States may not be a leader of the free-trade initiatives in the

[64] Fredrik Erixon and Razeen Sally, *Protectionism is on the rise*, European Centre for International Political Economy, Brussels, Belgium, February 16, 2009, posted on VoxEU.org.

[65] H.R. 1 (P.L. 111-5) Sec. 1605 provides that none of the funds appropriated or otherwise made available by the act may be used for a project for the construction, alteration, maintenance, or repair of a public building or public work unless all of the iron, steel, and manufactured goods used in the project are produced in the United States provided that such action would not be inconsistent with the public interest, such products are not produced in the United States, and would not increase the cost of the overall project by more than 25%.

years ahead. The European Union has raised questions about whether its provisions are compatible with U.S. international trade commitments[66] even though the provision applies only to steel, iron, and manufactured goods used in construction projects and language was included that the provision "shall be applied in a manner consistent with United States obligations under international agreements."[67] The criticism from other nations of this provision appears to be based on both its presumed effects and the fear that even a relatively small "Buy American" provision at this time could set a precedent that could open the floodgates and provide the excuse for a cycle of "creeping protectionism" by other nations.

On March 31, 2009, just prior to the G-20 London Leaders' Summit, the Obama Administration issued an interim rule implementing the "Buy American" provisions in the economic stimulus package that was consistent with existing U.S. practice. The interim rule imposed no new restrictions in terms of the origin of products that are eligible to be purchased by the federal government for procurement projects. It upheld that the manufacturing of all iron or steel used in federal projects funded by the stimulus bill must take place in the United States, except for metallurgical processes involving refinement of steel additives. The new rule also established no requirements on the origin of components or subcomponents used in construction materials, so long as the manufacture of the construction material occurs in the United States. It also exempted from the "Buy American" provision all 38 countries that have signed the World Trade Organization's Government Procurement Agreement and 47 least-developed countries.[68]

Many analysts note that the relationship between government procurement and the world trading system has always been tenuous. The national treatment provisions of the 1947 General Agreement on Tariffs and Trade (GATT)(Article III(8)) excluded government procurement from its obligations entirely. However, as the government share of GDP grew in the postwar period, especially in countries where industry sectors such as airlines and steel were nationalized, some GATT members came to believe that the trading system needed to place government procurement practices under certain disciplines. The Tokyo Round negotiations, which concluded in 1979, contained several plurilateral codes including an Agreement on Government Procurement, which members could join voluntarily. The Uruguay Round Agreements creating the WTO renegotiated these codes in areas such as antidumping and subsidies and converted them into mandatory agreements, which became prerequisites for membership in the WTO. However, the Agreement on Government Procurement (AGP) remained a plurilateral agreement open to WTO members. Many developing countries such as China, India, and Brazil have not joined the AGP.[69]

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[66] "EU Raises New Questions on Compatibility of U.S. 'Buy America' Provisions with GPA," *International Trade Daily (Bureau of National Affairs, Inc.)*, March 30, 2009.

[67] "Europe Warns against 'Buy American' Clause," *Spiegel Online International*, February 3, 2009, Internet edition.

[68] Department of Defense (DoD), General Services Administration, "Federal Acquisition Regulation; FAR Case 2009-008, American Recovery and Reinvestment Act of 2009 (the Recovery Act)—Buy American Requirements for Construction Material," 74 *Federal Register* , March 31, 2009, pp. 14623-14633.

[69] The Agreement on Government Procurement (AGP) commits signatories to practice the principles of national treatment and non-discrimination in the laws, regulations, practices, and procedures concerning government procurement. The agreement provides procedures to ensure transparency, including detailed operating rules on the procurement process of the signatory, a challenge procedure by which a rejected bid can be independently and impartially reviewed, and recourse to the World Trade Organization dispute settlement provisions. However, AGP only applies to the sectors and the procurement agencies that the government includes in its schedule of national commitments. This schedule lists the national and sub-national agencies as well as other entities that will participate, exceptions within those units, and the threshold- value for including contracts.

For the United States to both support the inclusion of government procurement in trade negotiations yet also place certain "Buy American" restrictions on its own procurement policies illustrates the ambivalence that it, like many nations, feels toward opening government procurement policies to the same disciplines that govern other commerce. Alone among the Tokyo Round codes, the AGP was not converted into a mandatory agreement in the WTO. The political nature of government procurement may account for this ambivalence. First, the underlying rationale of the WTO system is to increase economic efficiency through freer trade. However, government procurement decisions may not depend on economic considerations. Governments use purchasing decisions to achieve domestic policy goals, such as to provide economic stimulus or the promotion of specific local industry sectors or social groups. Because taxpayer dollars are involved, however, for many there is a political imperative that money be spent locally. As one commentator summed up the dilemma, "Countries that feel themselves to be competitive in supplying goods have an incentive to improve market access, but few countries seem willing to give up the ability to discriminate in favor of either domestic providers or regional partners."[70]

Effects on U.S. Leadership and Attitudes Toward the United States

Another issue raised by the global financial crisis has been the role of the United States on the world stage, the U.S. leadership position relative to other countries, and U.S. credibility. These are largely intangible qualities that depend partly on the effectiveness of current U.S. leaders but also depend on a host of other factors such as the relative military and economic might of the United States (including the role of the U.S. dollar and American market in the global economy), attitudes and perceptions abroad, actions by other nations, and the skillful use of all aspects of U.S. power. As the global financial crisis has progressed, a world-wide perception has developed that the lack of oversight and regulation by the United States was a major contributor to the crisis and has imposed huge costs both on investors and "innocent bystanders" abroad. This has been added to existing discontent in many countries with the situation in Iraq and other U.S. policies and may work to reduce the ability of Washington to lead in finding solutions to both the current financial crisis and other issues.

The financial crisis appears to have had a dual effect on perceptions of the United States as a world leader. On one hand, U.S. policy is seen as key to financial and economic recovery and in reforming the international financial system. The crisis has reminded the world that the United States is a central node in the network of financial and trade linkages that encircle the globe. Despite efforts to diversify economic and financial ties, most economies remain closely linked to the United States. Prospects for recovery from the crisis would be quite dim without U.S. policy initiatives and U.S. leadership. On the other hand, the crisis itself is perceived by some as weakening the U.S. position in the world and providing an opportunity for other nations to adjust the global balance of power away from the United States and toward Europe, China, Russia, and India. The fact that the G-20, not the G-7, [71] has become the international coordinating body for resolving the global financial crisis indicates that countries such as China, Russia, India, and Brazil have taken a seat at the head table along with the advanced industrial nations of North America, Europe, and Japan.

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[70] John H. Barton, et. al., *Evolution of the Trade Regime* (Princeton, NJ: Princeton University Press, c2006), p. 119.

[71] The G-7 includes Canada, France, Germany, Italy, Japan, United Kingdom, and the United States. The G-8 is the G-7 plus Russia. The G-20 adds Argentina, Australia, Brazil, China, India, Indonesia, Mexico, Saudi Arabia, South Africa, South Korea, and Turkey.

During the early months of the crisis, European leaders (particularly British Prime Minister Gordon Brown, French President Nicolas Sarkozy, and German Chancellor Angela Merkel) played a major leadership role in coordinating policies and convening meetings in which immediate rescue actions as well as principles for solutions and proposed policies were addressed. The end-of-term status of President George W. Bush may have contributed to this situation, and President Obama made his international debut at the April 2009 London Leader's Summit. It appears that other nations are according the Obama Administration room for a "fresh start."

The global financial crisis also has enabled countries with large currency reserves, such as China and Japan, to assume higher profiles in world financial circles. Americans are unaccustomed to being lectured to by Chinese officials, but on several occasions Chinese officials have publicly blamed the United States for causing the current crisis. Many contend that the crisis has undermined U.S. credibility on economic issues and may make it harder for Washington to induce China to continue to reform its economy, especially its financial system. In addition, Chinese officials have expressed strong dissatisfaction over suggestions by some U.S. analysts that China's economic policies (such as its large purchases of U.S. debt securities) were a contributing factor to the U.S. subprime mortgage bubble.[72] For the Obama Administration and Congress, bilateral relations with Beijing are likely to be a challenge and require close attention and skill in managing communications and relations with the Chinese leadership. At the London Summit, President Obama accepted an invitation to visit China in the second half of 2009.[73]

China's large holdings of U.S. Treasury securities ($696 billion as of December 2008) pose a dilemma for U.S. policymakers. On one hand, Chinese purchases of U.S. debt have helped fund the U.S. budget deficit and has helped keep U.S. interest rates relatively low. However, much of the approximately $2 trillion in stimulus spending, troubled asset recovery, capital injections, mortgage restructuring and other U.S. programs will likely be financed by additional borrowing. China, which is the world's largest holder of foreign exchange reserves (at nearly $2 trillion), will likely be a major purchaser of this new debt. When Secretary of State Hillary Clinton visited China in February 2009, she expressed her appreciation for the Chinese government's continuing confidence in the U.S. Treasury securities.[74] Many analysts have warned that increased Chinese ownership of U.S. debt could enhance its political leverage over the United States. For example, China could threaten to suspend or limit future purchases of U.S. Treasury securities or threaten to liquidate its current holdings, which could further undermine the U.S. economy. Such action, however, could also reduce the value of China's investments, not only in U.S. Treasury securities, but in other financial instruments and in the U.S. economy.

China's presence at the multilateral negotiating table also could complicate the process of policymaking. China's policymakers have a strong domestic focus, and the country has a relatively short history of cooperating with international bodies in consensus decision-making. At the United Nations, China has used its Security Council veto power to block some U.S. and

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[72] U.S. Joint Economic Committee, "Chinese FX Interventions Caused international Imbalances, Contributed to U.S. Housing Bubble," by Robert O'Quinn. March 2008; Wang Yu, *The U.S. is the Cause of the Financial Crisis. China Cannot Be Blamed* , Xinhuanet, China, translated By Eugene Tan, and Edited by Louis Standish, printed in Watching America, http://watchingamerica.com/News/18092/zhang-jianhua-us-is-cause-of-financial-crisis-putting-responsibility-on-china-cannot-be-justified/.

[73] "Obama accepts invitations to visit China, Russia," *Associated Press*, April 1, 2009.

[74] Hillary Rodham Clinton, *Toward a Deeper and Broader Relationship With China, Remarks With Chinese Foreign Minister Yang Jiechi* , Beijing, China, U.S. Department of State, February 21, 2009.

European initiatives. China's own financial regulatory system is still developing, and its stances on global financial oversight and regulation are only in the process of being formed. But China clearly seeks a voice in the discussion. In 2009, Zhou Xiaochuan, the governor of the People's Bank of China (China's central bank), proposed reforming the international monetary system by replacing the dollar as a reserve currency.[75] China's financial weight could provide the potential for it to play the United States off against others, including Europe and Japan, in multilateral discussions of financial regulation. This could make finding a consensus more difficult at the G-20 level. China also is actively seeking to take a larger role in activities of the IMF and other multilateral financial institutions.

As for Japan, it is lending $100 billion to the International Monetary Fund and has been active in moves to create an Asian Monetary Fund and other monetary arrangements in Asia to counter the effects of currency crises. [76] This is despite the fact that the Japanese economy is in recession, the government is deeply indebted, and the country seems to be losing international financial and political clout to China.

The financial crisis and flight to dollar assets for safety also have revived discussion of the role of the U.S. dollar as a reserve currency. The international role of the dollar not only allows the United States to run trade deficits without the currency depreciation faced by most other nations, but the international role of the dollar is a factor in U.S. global influence. Russia's Prime Minister Putin has called over-reliance on the dollar "dangerous" and has proposed the development of multiple, regional reserve currencies in addition to the dollar.[77] Joseph Stiglitz, a Nobel laureate in economics, has advocated the development of a global reserve currency based on a basket of currencies to reflect the multi-polar world of today.[78] China also has joined the voices arguing for a creation of a new currency to eventually replace the dollar as the world's standard.[79] Although such proposals are far from being implemented, a decline in use of the dollar as a reserve currency could make it more difficult for the United States to finance its budget and trade deficits, and if the value of the dollar fell, this would reduce the buying power of U.S. companies investing abroad and the purchasing power in other countries of U.S. budgeted funds for diplomacy, aid, security operations, and other foreign activities.

The recession in the United States and elsewhere also may hamper efforts to reach agreement on international issues such as climate change. A new climate change agreement may require sacrifice, and the willingness of either Americans or others to make sacrifices in the current environment (and our ability to convince China, India, and others to do so) may limit the range of possible outcomes.

In addition, U.S. trade and foreign investments are key components of American soft power. At a time when U.S. policymakers are turning toward the use of soft power (or what is sometimes termed "smart power"[80]), if U.S. companies are perceived as reducing their overseas business

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[75] Zhou Xiaochuan, *Reform the International Monetary System*, Peoples' Bank of China, March 26, 2009, pbc.gov.cn available at [http://news.xinhuanet.com/english/2009-03/26/content_11074507.htm].

[76] Ulrich Volz, "Asian Monetary Fund, Take Two," *Far Eastern Economic Review*, June 18, 2008, Internet edition; "IMF close to finalizing $100 bil. loan from Japan: Strauss-Kahn ," *Kyodo News*, February 2, 2009.

[77] "Putin Speaks at Davos," *The Wall Street Journal*, January 28, 20009, online version.

[78] Joseph Stiglitz, "Europe's leaders can seize this opportunity to fill the leadership gap," *The Daily Telegraph*, November 11, 2008, p. 7.

[79] Andrew Batson, "China Takes Aim at Dollar ," *The Wall Street Journal*, March 29, 2009, Internet edition.

[80] Luigi R. Einaudi, *U.S. Smart Power in the Americas: 2009 and Beyond*, Institute for National Strategic Studies, (continued...)

activities because of the global financial crisis, this could cause a drop in perceived U.S. importance in overseas business communities and could also lower U.S. diplomatic interest in countries of lesser importance to U.S. businesses.

Effects on Supranational Financial and Economic Organizations

The financial crisis has brought international financial organizations and institutions into the spotlight. The issue here is threefold. First is how much sovereignty to yield to the International Monetary Fund, Financial Supervisory Board, Bank for International Settlements or other such organizations in devising macroprudential regulations for the world financial system that would identify signs of problems that could engulf entire economies. For example, how much authority should the IMF have to compel countries to implement policies to reduce the risk of a systemic financial failure? A second aspect of the issue deals with how much additional capital member countries should provide to the IMF, World Bank, and other global lenders. The third aspect is governance of the institutions. Given the increasing role of China, India, and other new members of the G-20 in the financial crisis, should they also have a commensurately larger role in the governance of the international financial institutions?

The economic crisis has highlighted the inter-connected nature of the global financial system and the rapidity with which a financial crisis in one country crosses borders and spreads across manufacturing, retailing, and other sectors. It also has raised the importance of having an international early warning system and some institution that can assess systemic risk occurring across countries and across financial sectors and take measures to stem world financial problems before they become too costly and reach the catastrophic level. It has become apparent that remedial and recovery measures, both on macroeconomic and microeconomic levels, need to be coordinated. On the macroeconomic level, one country can "free ride" on a stimulus package by another economy through increased demand for its exports. On the microeconomic level, the forces of international competition drive business activity away from overregulated or high-cost financial centers. If, for example, financial institutions in New York are more restricted than those in London, financial deals may simply migrate from the United States to the U.K.

The major international organizations dealing with the financial crisis include the International Monetary Fund, the Financial Stability Forum, the Bank for International Settlements, the World Bank, and the G-20. Several other organizations also play a role in coordinating policy among nations. Some leaders have called for a Bretton Woods II agreement that would remake the international financial architecture that was created in 1944 centered around the IMF and World Bank.[81] Some of the questions being addressed include whether the major role of the IMF should be informational, advisory, and technical, or should it have enforcement authority? For example, if the IMF finds that a country is teetering on the brink of a financial crisis, what can and should it do proactively to lessen the risk that the crisis actually occurs? Any public action could be the trigger that would start such a crisis, but quietly discussing the issue with national authorities without any enforcement authority is rarely sufficient to spur corrective actions that may be politically unpopular. Also, should any enforcement be done through a dispute resolution process, through rules similar to those that the European Union requires of its members, or should the IMF

(...continued)

National Defense University, Presented at a conference U.S. Smart Power In The Americas: 2009 And Beyond at the Center for Strategic and International Studies, Washington, DC, February 11, 2008.

[81] Gerstenzang, James. "Bush will Meet with G-20 After Election," *Los Angeles Times*, October 23, 2008.

or other international institution be ceded oversight and regulatory authority by national governments?[82]

The IMF, Financial Stability Forum (now Financial Stability Board), and the Bank for International Settlements already have made recommendations for changes in regulations for member nations. Each is contributing to the G-20 process to devise policies for nations to adopt. Countries, however, have been slow to implement regulatory changes previously recommended. Traditionally, the U.S. Treasury and other financial regulatory agencies, not the State Department, interface with these international financial organizations. As can be seen with the global financial crisis, however, financial foreign policy can have as large an impact on international relations and world stability as traditional political and security policies.

At the London Summit of the G-20, the leaders agreed to boost the IMF's reserves to around $500 billion through bilateral borrowing from members and also from borrowing in world financial markets (much as the World Bank already does). There appears to be consensus that the IMF lacks the necessary financial resources to tackle the problems of struggling countries, with particular concern about Eastern Europe. The G-20 leaders also agreed to provide the World Bank and other regional development banks with extra funds.

Effects on Poverty

In a February 2009 commentary, Dominique Strauss-Kahn, Managing Director of the IMF, noted that during the financial turmoil attention has been focused on the advanced and emerging-market economies that are most immediately affected, but, in his opinion, the impact on poor countries is far more severe. [83] He pointed out that weak global growth is shrinking export markets, and many commodity prices are plunging. The combination of tighter credit conditions in the advanced economies and dimmer economic prospects in low-income countries is reducing investment flows, while workers' remittances, which now eclipse aid as the largest financial flows to many low-income countries, also are falling.

Even though the poorest countries in the world, many in sub-Saharan Africa, are less integrated into global capital markets than the advanced industrial nations or emerging economies in Eastern Europe, the global economic crisis is affecting standards of living and is expected to lead to higher levels of global poverty. Many argue that the impact on poverty also may be most felt in the large, middle-income countries such as China and India, the world’s two most populous nations, and not just in the least developed countries. Over the past two decades, the largest gains in raising people out of poverty have been made in these two countries. For several years China has averaged economic growth rates of 10% or higher, while India has grown at 8% or more per year. The World Bank estimates each one percentage point drop in world economic growth could trap another 20 million people in poverty. [84] In 2008, global growth was an estimated 2.5%. For

[82] For further information on the IMF, see CRS Report RS22976, *The Global Financial Crisis: The Role of the International Monetary Fund (IMF)*, by Martin A. Weiss

[83] Dominique Strauss-Kahn, *The World Must Not Forget Africa During This Crisis*, A Commentary by Dominique Strauss-Kahn, Managing Director, International Monetary Fund, February 10, 2009.

[84] “Global Financial Crisis: Responding Today, Securing Tomorrow,” Background Paper prepared by the World Bank Group, G20 Summit on Financial Markets and the World Economy Washington, D.C., November 15, 2008. http://web.worldbank.org/WBSITE/EXTERNAL/NEWS/0,,contentMDK:21972885~pagePK:64257043~piPK:437376~theSitePK:4607,00.html

2009, growth is expected to drop by three percentage points or more.[85] In February 2009, China reported that about 20 million of the nation's 130 million migrant workers already had become unemployed.[86]

The impact of the global crisis is transmitted to the poorest countries through several channels. These include:

- Declining exports. In Pakistan, for example, textile exports fell by 4.1% year-on-year in December 2008. The textile sector represents approximately two-thirds of Pakistan's total export revenues.
- Declining commodity prices. Because many of the poorest countries are heavily dependent on a few primary export commodities, rapid swings in commodity prices can wreak havoc on their domestic economy. Yemen, for example, announced in January that it would have to decrease public expenditures by 50% because of the financial crisis and the lower government revenues from its oil exports.
- Migration and remittances. The combination of slow growth rates, job losses, and the rising cost of living in advanced countries has led to fewer economic migrants from developing countries and lower levels of remittances. This could have major effects in countries which provide large numbers of migrant workers, including Mexico, Guatemala, El Salvador, India, Bangladesh, and the Philippines. The volume of remittances soared over the past decade, but recent data show significant deceleration since the beginning of the current crisis, with Latin America and Caribbean the hardest hit. The Inter-American Development Bank calculates that remittances to the Latin American and Caribbean region declined by 1.7% between 2007 and 2008.
- Lower levels of foreign assistance. Research from previous incidences of economic crisis suggests that foreign aid from developed to poor countries is likely to decrease.
- Diminished capital flows. Although some progress has been made in developing capital markets in poor countries, they are still perceived as risky. Global credit has tightened across the world, especially among the developing countries. This has lead to a sharp contraction in capital flows to developing countries as well as restrictions on the availability of trade finance. The inability of developing country governments to raise money on international capital markets will likely have a sharp impact on government budgets, reducing the amount available for poverty reduction programs.

Once the global recession is past, estimates of declines in long-term poverty are encouraging. Over the medium term, economic growth rates may still be higher than they were in the 1990s due to macroeconomic policy improvements and structural reforms such as privatization and

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85 International Monetary Fund, *Global Economic Slump Challenges Policies*, World Economic Outlook Update, January 28, 2009.

86 Keith Bradsher, "China's Unemployment Swells as Exports Falter," *The New York Times*, February 6, 2009, Internet edition.

regulatory initiatives within developing countries.[87] This depends, however, on how quickly and fully the world economy can recover.

Budgetary Effects on Resources for Aid, Diplomacy, and Defense

The decline in government tax revenues caused by the slowdown in economic activity and the stimulus programs and automatic economic stabilizers (increased spending for unemployment compensation and welfare) are increasing competition within countries for scarce budget funds and affecting decisions about the allocation of national resources. Budget battles, already intense, have become even more heated as the global financial crisis has spread.[88] This could result in fewer resources available for foreign assistance, diplomacy, and defense.[89]

A policy brief by the United Nations Conference on Trade and Development on flows of official development assistance (ODA) stated the following:

> The current recession, and some of the stimulus measures being introduced to combat it, is compounding budget deficits and budget reallocations in many donor countries. ODA is a soft target in such situations; during past banking crises, it has dipped anywhere from 20% to 40%. A recent study found that the crises affecting Finland, Japan, Norway and Sweden in the 1980s-1990s were all followed by a substantial decline in foreign aid, ranging from 10% in Norway to 62% in Finland. Furthermore, ODA levels tend to recover very slowly–in Sweden's and Norway's case, six-to-nine years after the trough, according to the same study. Finnish and Japanese aid flows, meanwhile, have yet to return to their pre-crisis peaks. Given the depth of today's crisis, the recovery period is likely to be similarly long.[90]

In the United States, official development assistance to poorer nations and other programs aimed at alleviating poverty now are competing for funding in a budget deep in deficit.[91] The large expenditures to provide stimulus to the U.S. economy could clash with some early foreign policy priorities of the new Administration. President Obama and top officials in his Administration—including Secretary of State Clinton and Secretary of Defense Gates—have pledged to increase the capacity of civilian foreign policy institutions and levels of U.S. foreign assistance. Early pledges have included: a 25% increase in Foreign Service staffing; doubling of U.S. foreign assistance spending to $50 billion by 2012 (or slower increases if the current economic crisis continues); and increased funds for global health programs.

Although some efficiencies may be found in revamping foreign policy-related programs and/or improving policy coordination, one incoming State Department official emphasized outright that "we will need additional resources" to achieve foreign policy goals.[92] Financial constraints could impose difficult choices between foreign policy priorities—for example, between boosting levels

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[87] Ibid, p. 49.

[88] Jim Snyder, "Budget battles loom as Obama team heads to Hill," *The Hill*, March 1, 2009.

[89] See, for example, Richard Haass, *Statement of Richard N. Haass, President of the Council on Foreign Relations, Before the Committee on Armed Services, U.S. House of Representatives*, Washington, DC, March 11, 2009.

[90] United Nations Conference on Trade and Development, *Keeping ODA afloat: no stone unturned*, UNCTAD Policy Brief, No. 7, March 2009.

[91] For details of the FY2009 appropriation, see CRS Report RL34552, *State, Foreign Operations, and Related Programs: FY2009 Appropriations*, by Susan B. Epstein and Kennon H. Nakamura.

[92] Testimony of Jacob Lew, U.S. Deputy Secretary of State nominee, U.S. Senate Committee on Foreign Relations, January 22, 2009.

of non-military aid to Afghanistan and increasing global health programs–or changes to planned levels of increases across the board. The global reach of the economic downturn further complicates the resource problem, as it both limits what other countries can do to address common international challenges and potentially exacerbates the scale of need in conflict areas and the developing world.

The budget constraint also could affect the resolution of issues such as the North Korean (DPRK) nuclear threat. Under agreed-upon requirements under the Six Party Talks, if the DPRK complies with its commitments, the United States is to provide more energy and other assistance. In addition, Japan and South Korea, two countries hit hard by the financial crisis, would have to budget funds for aid to North Korea.[93]

U.S. defense expenditures also face similar budget debates.[94] Addressing U.S. security needs under the financial crisis is beyond the purview of this report, but one analysis indicates that the security threat from the crisis is likely to manifest itself in several distinctive ways.

- It will create major pressures on the defense budget, most notably acquisition—that is, the procurement and research and development accounts.
- It will likely result in a contraction of defense spending, and therefore operations as well and modernization, on the part of key allies and friends.
- It could prompt nations that are ambivalent about their relationship with the United States, most notably China and Russia, to act in ways that are deleterious to American interests.
- It could prompt even more hostile behavior on the part of nations such as Iran and Venezuela that already bear deep antipathy toward the United States.
- It could further destabilize states that are already vulnerable to internal unrest.
- It could spur further international criminal behavior that could undermine internal American security.[95]

[93] See CRS Report R40095, *Assistance to North Korea*, by Mark E. Manyin and Mary Beth Nikitin; CRS Report RL33567, *Korea-U.S. Relations: Issues for Congress*, by Larry A. Niksch.

[94] For information on the FY2009 defense authorization, see CRS Report RL34473, *Defense: FY2009 Authorization and Appropriations*, by Pat Towell, Stephen Daggett, and Amy Belasco.

[95] U.S. Congress, House Committee on Armed Services, *Hearing on Security Challenges Arising from the Global Financial Crisis*, Statement by Dov S. Zakheim, "Security Challenges Arising From the Global Economic Crisis," 111th Cong., 1st sess., March 11, 2009.

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