NATIONAL WAR COLLEGE
WASHINGTON, DC

FUNDAMENTALS OF STATECRAFT

ECONOMICS FOR STRATEGISTS

SUPPLEMENT TO CORE COURSE 5611

SYLLABUS
ACADEMIC YEAR 1999-2000 v.1.2 5/4/99

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Economics for Strategists
Course Overview

INTRODUCTION

This short course is supplemental to the National War College core curriculum. Its inclusion in the study program reflects the growing significance of economics in global security matters. The course responds to the need expressed by previous NWC students to have a better understanding of the economic dimensions of geopolitical and strategic issues.

The course is designed to help the national security strategist understand better the economic forces at work at the national and global levels. It will cover basic concepts: the market, supply and demand, gross domestic product, fiscal and monetary policy, exchange rates and the dynamics of the world economy. This is a basic tools course, designed to help you appreciate the significance of today's economic headlines and tomorrow's national security consequences.

Economic power has always been a significant force in geopolitical affairs. As the world grows more interdependent, economic power has come to occupy center stage, along with military power, as a principal source of political influence. A country's economic condition bears heavily on the force and effectiveness of national power. Therefore, stable economic growth – stimulated by high rates of savings and investment, adequate infrastructure and human resource development – is requisite to national security.

In the post-Cold War era, economics has been at the heart of many of the issues confronting the world. Many analysts assert that it was economics that ultimately defeated Communism. The ability of the powerful U.S. economy to outspend and out-innovate brought about the ultimate collapse of the former Soviet Union.

Two other examples in the 1990s illustrate how fundamentally economic issues can bring about the mobilization of U.S. military forces. The Persian Gulf War resulted from Iraq's seizure of oil-rich Kuwait and the implicit and immediate threat to the even more petro-endowed country of Saudi Arabia. This threat was unacceptable to the oil-dependent nations of the world -- especially the U.S. In a very different circumstance, thousands of poor Haitians, devoid of economic hope, saw relatively little risk in taking to flimsy boats in the hope of reaching a dreamland of opportunity in Florida. While U.S. vital interests in democracy and human rights in Haiti were questioned by some, few failed to grasp the urgency of the immigration issue.

More recently, much attention has been focused on the economic crises affecting the Asian Tigers of Korea, Thailand and Indonesia, as well as the

severe problems experienced by Japan. These pose serious threats to the continued economic well-being of Americans.

On the domestic scene, it is clear what most quickly rivets the attention of the American people. Politicians learned in 1992 that "It's the economy, stupid!" As Ross Perot said, "It's that simple." Unemployment, inflation, large deficits, etc. very effectively galvanize the attention and emotions of the American people and their political representatives — elected or not.

The objective of the NWC curriculum is to make you an effective senior strategist. To become this, you must understand the nature and extent of the ways in which economics affects the world at the start of the new millennium.

SCOPE AND OBJECTIVES

Understanding economics is not difficult. It is highly probable that you already understand more about economics and how it affects the world than you may think.

This seven-unit course will seek to provide the basic economic concepts, terminology and principles you will need to learn and participate more effectively during the other elements of the core course curriculum. Because this course is designed to facilitate your role as a national security strategist, it emphasizes macroeconomics (the behavior of entire economies) over microeconomics (what occurs in individual decision-making units).

We will do everything possible to keep the language and the numbers in this course easy to understand. Because Economics for Strategists includes only seven meetings, discussion of multiple, in-depth examples of the principles studied is not possible. Such discussions, as well as the application of the economic tools of statecraft, will take place throughout the NWC core curriculum and electives.

The **overall objectives of this course** are to:

1. Provide students with a basic understanding of the economic principles and tools sufficient to enable them to analyze and develop national security strategy and policy.

2. Enable students to assess the economic aspects of international affairs issues.

The **specific objectives of the course** are to provide a basic understanding of:

1. How market economies function.

2. How market economies grow.

3. The problems (such as unemployment and inflation) encountered by market economies.

4. The means available (e.g. fiscal and monetary policy) to address the problems of economies.

5. International trade: the role it performs and its operating mechanisms (e.g. exchange rates, tariffs, quotas).

6. Dysfunctional economies: underdevelopment and crisis.

A major objective this course will be to explain the strategic/policy relevance of all the subjects and how they relate to other components of the NWC core curriculum.

During the academic year, several economic themes will be discussed often. These themes highlight the convergence of economics and security and can help weave economics into your understanding of national security strategy and policy-making.

Theme 1: The central role of a nation's economic performance in maintaining and projecting national power.

Theme 2: The growing interdependence of the global economic environment and the impact of this interdependence on national power.

Theme 3: The increased global predominance of the market system and free enterprise.

Theme 4: The persistence of global poverty and increasing income disparity.

STUDENT REQUIREMENTS

This course will be comprised of seven 90-minute classes. Note the use of the word "classes." Course sessions will be more in the traditional undergraduate faculty-taught classroom style than in the usual seminar style that is more the norm at NWC.

There will be two primary texts for this course. They are *Economics: Principles and Policies,* by William J. Baumol and Alan S. Blinder, and *Economics Explained,* by Robert L. Heilbroner and Lester C. Thurow. Supplementary readings will also be assigned.

The Baumol and Blinder book **[IMPORTANT: SEE NOTE BELOW[1]]** is a standard college text. It makes excellent use of modern editorial techniques to facilitate the learning process. Key points are printed in blue; important definitions are highlighted in the margins. At the end of each chapter there is a concise summary of the key points and terms that have been addressed.

The Heilbroner and Thurow book provides a very readable, more applied, context of the topics being discussed. It should help facilitate your understanding of the subject matter.

WinTAG, a software program, accompanies the Baumol and Blinder text. It offers a quick, useful, almost entertaining means to reinforce your learning experience. The program is intuitive, which means you do not have to spend time learning how to use it. You will find WinTAG at the economics location on the NWC website.

Time invested during this course in gaining a basic understanding of economics will pay dividends in your ability to acquire and apply the tools of the strategist that you will develop in the subsequent NWC program.

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[1] Because of its very high cost, students **<u>will not</u>** be able to keep the Baumol and Blinder text book. Accordingly, please do not make any marks in the book as it will be used by students in future years.

Topic 1

Introduction – Market Systems

"Hell hath no fury as a vested interest masquerading as a moral principle." –Anon

Friday
21 August 1998
0830-1000 (IS)

OVERVIEW

The material wants of people are virtually unlimited; while the supply of the resources (human, natural or financial) to meet them is limited. Economics is the social science concerned with the allocation of these scarce resources so that they best fulfill our needs.

By way of introduction, this session will explore some of the reasons why a senior strategist – military or civilian – should make a special effort to understand the basics of economics. Included in the discussion will be the various roles that economics plays in strategy and policy formulation and the relationship between economic strength and national power (See also Course 1, Topic 1).

The history of modern economics can probably be traced back at least as far as the 16th century. As you will read in the assignment for today, a market system essentially "is one in which economic activities are left to men and women freely responding to the opportunities and discouragements of the marketplace, not to the established routines of tradition or the dictates of someone's command." Because it is concerned with the efficient management of scarce resources, much of the study of economics is about choice. Most of us make these choices every day. How will I spend my money? What job should I take? Should I buy a push mower or a lawn tractor? On the national level, the stereotypical question asked is whether the nation should spend its "scarce" resources on guns or butter.

In looking at how the notion of a market economy has evolved, we will consider the observations of three of history's great economists. Adam Smith (1723-1790) described the perfection of free market supply and demand decisions (he called it the "invisible hand") in responding to the questions of what to produce, how much of it, and at what price. These choices, he believed, were the result of rational people seeking to maximize their own interests. John Maynard Keynes (1883-1946) recognized that the decisions made by totally free markets were not always perfect or sufficiently timely. For example, they did not deal with

issues such as inflation, unemployment and income inequity. Keynes proposed a key role for governments to help manage economies. Karl Marx (1818-1883) did not think the decisions of a free market would be orderly and harmonious. He believed that the success of capitalist businessmen would always be achieved at the expense of exploited workers. Accordingly, he prescribed economies that were entirely under the control and plans of governments.

While Marxism as an ideology has failed, the Keynesian version of government economic involvement is very much alive. The debate that will never be resolved concerns the question of *how much* governments should be involved in economic/market management.

OBJECTIVES

1. Explore the significance of understanding economics in addressing national security strategy.

2. Develop a basic comprehension of how free market economies function and the interrelationship between supply and demand.

3. Understand the reasoning behind government involvement in managing economies and markets.

ISSUES FOR CONSIDERATION

1. In the 1990s, when have economic issues been prominent in circumstances resulting in the deployment of U.S. military forces?

2. What are current national security issues that involve significant economic components? Where do economic issues have prominence in the current National Security Strategy?

3. Is there any such thing as a truly free market economy with no government involvement? Is such an economy realistically possible? Why? What are the circumstances where you consider government involvement to be necessary or appropriate?

4. Think of some examples of how price might influence your "demand" for certain goods and services. Consider Furbies: how did high demand influence supply and cost?

5. Do you trust economic statistics? How and why might they be distorted? Why would governments wish to distort their own statistics?

REQUIRED READINGS

— Baumol and Blinder: Chapters 2 (including the appendix) (22 pgs.), 3 (17 pgs.), and 4 (24 pgs.)
— Heilbroner and Thurow: Chapters 2 (18 pgs.) and 12 (10 pgs.)
— “Hold Your Tongue,” The Economist, January 4, 1999 (1 pg.)
— “Damned Lies,” *The Economist*, Nov. 23, 1996 (2 pgs.)

SUGGESTED READING

— Baumol and Blinder: Chapter 1 (though page 9)
— Heilbroner and Thurow: Chapter 1 (15 pgs.)

Topic 2

Economic Growth

"Wealth is not without its advantages" –John Kenneth Galbraith

Monday
24 August
1330-1500 (IS)

OVERVIEW

Most societies share a number of economic goals. These include: full employment, price stability, economic security (e.g., for those who are old, ill or unemployed) and economic efficiency (that is, getting the most from the available scarce resources). The highest profile goal is economic growth. Economic growth is the production of more and better goods and services and a higher standard of living.

The current standard measure of growth is the rate of change in Gross Domestic Product (GDP). GDP is the final market value of all of the goods and services produced within the boundaries of a country (such as the United States). Growth can occur as the result of a variety of reasons. For example, growth takes place when the existing labor force is used more efficiently as the unemployment rate is reduced, natural resource supplies expand (e.g., oil is discovered), and resource quality is improved (e.g., workers have more education). Growth expands the possibilities for increased production.

Most importantly, increased productivity – producing more goods and services with approximately the same amount of basic resources (natural, human or investment) – is one of the most important elements of growth. Increased productivity is the result of such things as improved management, technological innovation and better-trained or educated labor.

An obvious reason for growth is increased consumption: the amount of goods and services bought by people and governments. Consumption is, of course, limited by income. It is also limited by the amount of income that is placed in savings, rather than consumed.

Savings, too, have an important role in growth. Savings are ultimately used to finance investment: building new or improved production capacity.

Growth of GDP is not always an indicator that the standard of living is improving for the people of a given country. There are a number of things that can distort the meaning of GDP growth. For example, population growth can actually mean a lower amount of GDP is available for each person (i.e., per capita GDP) even if the total amount is increasing. Inflation (the increase in the general level of prices in an economy) can distort the "real" growth that is taking place in GDP. Inequitable distribution of income also can impact on the social outcome of economic growth.

Several alternative means to measuring economic growth have been developed. One of these is called Purchasing Power Parity (PPP). PPP seeks to overcome the differences between foreign exchange rates and the buying power of currency. *The Economist* has developed an excellent illustration of PPP, known as the Big Mac Index, in which the converted dollar price of Ronald McDonald's favorite burger is compared in key markets around the world.

OBJECTIVES

1. Understand the role and importance of growth in a market economy.

2. Explain how growth can occur.

3. Analyze what GDP means – and what it does not mean.

4. Explore other measures of economic growth.

ISSUES FOR CONSIDERATION

1. What are the social ills that can be hidden within a growing GDP?

2. What have been the key elements in U.S. economic growth in the 1990s?

3. What are some of the ways in which economic productivity can be increased?

4. What is the difference between GDP and GNP? Is this difference very significant?

5. What are the things that might retard economic growth?

6. Why is it important to consider different measurements of growth?

REQUIRED READINGS

— Baumol and Blinder: Chapters 22 (19 pgs.) and 24 (23 pgs.).
— Heilbroner and Thurow: Chapters 3 (11 pgs.), 5 (10 pgs.), 6 (9 pgs.) and 7 (11 pgs.).
— Bradford De Long, "How Fast Is Modern Economic Growth?" *Federal Reserve Weekly Letter,* Oct. 6, 1998 (5 pgs).
— "Big Mac Currencies," *The Economist,* April 2, 1999

SUGGESTED READING

- Heilbroner and Thurow: Chapter 4 (16 pgs.)

Topic 3

Problems of Market Economies

"Blessed are the young, for they shall inherit the national debt." –Herbert Hoover

Wednesday
26 August
0830-1000 (IS)

OVERVIEW

Winston Churchill is renowned for having said that democracy is the worst form of government – except for all of the others. On the subject of economics, perhaps the same can be said of market economies. In this section, we will explore some of the difficulties encountered by market economies.

Historically, the two most common economic problems have been inflation and unemployment. Until the American economic boom of the 1990s, it was thought that either inflation or unemployment was inevitable – if you did not have one then you were facing the other. The ideal was to keep them at some acceptable level of balance. Inflation (an overall increase in prices) is the result of an excessive demand on limited supply. As unemployment decreases, the ever-increasing demand for labor (that is, the creation of new jobs), permits workers to "sell" their services at a higher price, eventually causing inflation. Similarly, when prices become too high (due to inflation), the amount of goods and services people can buy declines, resulting in a lower demand for labor (an excess of supply) generating increased unemployment.

In recent years, much attention has been given to the topic of fiscal deficits – that is, when governments spend more money than they take in through revenues (e.g., taxes, fees). Collectively, un-repaid past fiscal deficits comprise the national debt. There is significant debate as to whether government debt is really harmful to the country and future generations. There are convincing arguments that say that a reasonable amount of debt may be acceptable. As you will see, the incurrence of a fiscal deficit can sometimes be considered an appropriate corrective tool when economies suffer periods of crisis.

At the extremes, when market economies experience their worst problems, nations suffer hyperinflation, recessions and depressions. During such times, total output of the economy falls – that is, instead of growing, the economy shrinks. The result has humanitarian as well as political consequences, as many people lose their jobs and homes. In

some countries, economic crisis can result in political instability, bringing down governments and increasing the potential for physical conflict, a subject discussed in greater detail in Topic 7.

OBJECTIVES

1. Develop a perspective of the problems that regularly occur within market economies.

2. Understand the nature of inflation and unemployment and how these two concerns are related.

3. Understand the causes and nature of economic recessions and depressions.

4. Understand the nature of fiscal deficits and their importance in the context of an overall economy.

ISSUES FOR CONSIDERATION

1. Explain the relationship between supply, demand, inflation, and unemployment.

2. What is your informed opinion about government deficits and debts? How much do these concern you: not at all, a little, a great deal? Why?

3. If the United States is able to maintain budget surpluses for the foreseeable future, how do you think these should be used? Should they be "invested" in education or the social security system, used to reduce the national debt, or returned to the people in the form of tax reductions? Why?

4. What is your opinion about inequity in income distribution? Should the government intervene to correct this? If so, when should it do so and how?

5. What are the key problems facing the U.S. economy, today?

6. Do you trust economic forecasts (for example, projections of U.S. Government deficits or surpluses)? Why might they be inaccurate? What is the risk in trusting them? Why are forecasts useful? Who uses forecasts?

REQUIRED READINGS

— Baumol and Blinder: Chapters 23 [Skip pgs. 551-553, “Inflation and the Tax System”] (24 pgs.) and 32 [Skip pgs 757-760, “Budget Deficits and Inflation” and “The Monetization Issue”] (21 pgs.)
— Heilbroner and Thurow: Chapters 13 (12 pgs.) and 15 (9 pgs.)
— Paul Krugman, “Baby-Sitting the Economy,” *Slate*, August 13, 1998
— “Singing the Deflationary Blues,” *The Economist,* October 13, 1998

Topic 4

Fiscal and Monetary Policy:
Tools to Strengthen or Repair Economies

"If it sounds easy, you don't have all the facts." –James L. Brewer.

Monday
31 August
1330-1500 (IS)

OVERVIEW

As we learned in Topic 1, John Maynard Keynes observed that, contrary to the opinion of Adam Smith, market economies do not always function perfectly. To remedy this, he suggested that governments should have an important role.

The fact is that pure free market economies do not exist. Even in the most open economy – the United States – the government is significantly involved in management. The most pro-business person would not debate that government performs a legitimate, essential role in economic management (e.g. printing currency, regulating and supervising banks). The real issue is the *extent* to which and in which areas government should be involved.

There are two main categories of economic "tools" available to governments: fiscal and monetary. Such tools are applied both to correct the problems studied in the previous Topic, or – better still – to avoid the onset of such problems before they begin.

Fiscal policy is defined as the changes in government spending and tax collections for the purpose of achieving a full-employment and non-inflationary domestic output. By increasing spending during a period of recession, governments augment demand; the result is increased employment and incomes as the economy strives to produce the additional goods and services. If spending is increased too much, government "competition" for relatively finite resources (e.g. credit) with the private sector can result in inflation and increased deficits. When there is inflation, governments increase taxes, reducing demand by taking money away from potential consumers. In the extreme, however, high taxation reduces growth and employment to the overall detriment of the economy.

Monetary policy affects the supply of money available to the economy. By and large, monetary policy in the United States is implemented by its

central bank, The Federal Reserve System (known as "the Fed"). Monetary policy also is used to stimulate full employment and minimize inflation. The most important way the Fed influences the supply of money is through open market operations, that is, the buying and selling of government bonds in the open market. Probably the most visible tool of monetary policy used by the Fed is the establishment of loan interest rates, which it does by adjusting the amount it charges banks to borrow funds. The end result is one already familiar to you: when there is more money available, consumer (businesses and individuals) demand increases, triggering an increase in supply (the output of goods and services), more employment, etc. The downside, as you have also seen, is that too much stimulation to the market can produce inflation and all of its consequences.

The management of fiscal and monetary policy is key to the operation of most economies. As you will learn in Topic 7, such policies usually are at the core of recommendations made by the International Monetary Fund (IMF) when economies find themselves in crisis (e.g., Indonesia, Thailand).

OBJECTIVES

1. Understand the nature and application of fiscal and monetary policy.

2. Understand the role of monetary and fiscal policy in optimizing economic performance and addressing economic problems, such as inflation and unemployment.

3. Understand the role of, and the tools employed by, the Federal Reserve System.

ISSUES FOR CONSIDERATION

1. What are the relative strengths and weaknesses of fiscal and monetary policy?

2. What is the impact of economic globalism on the effectiveness of fiscal and monetary tools?

3. How important is the political independence of the U.S. Federal Reserve System? What are the risks on both sides of the issue (i.e. too much or too little independence)?

4. Consider European economic integration, specifically the creation of a single currency. Will this new configuration increase or decrease the effectiveness of the use of fiscal and monetary tools in Europe?

5. How do fiscal and monetary policies affect savings and investment?

REQUIRED READINGS

— Baumol and Blinder: Chapters 28 (pgs. 649-654, 657-666), (16 pgs.)
— "In The Money," *The Washington Post*, February 10, 1999 (16 pgs)
— Heilbroner and Thurow: Chapters 8 (14 pgs.), 9 (9 pgs.), 10 (8 pgs.) and 11 (11 pgs.)
— "Glittering Economic Prizes," (pg. 19); "Desperately Seeking a Perfect Model," (pgs. 67-69); "The Good and Bad Model Guide," (pg. 68); "Unfinished Battle," (pg. 77), *The Economist,* April 10, 1999 (5 pgs.).

SUGGESTED READING

— Baumol and Blinder: Chapters 29 (14 pgs.) and 30 (22 pgs.)

Topic 5

Globalization and Trade

"There are some people, who if they don't already know, you can't tell them." –Yogi Berra

Thursday
3 September
1330-1500 (IS)

OVERVIEW

In Course #1, you already have begun a discussion of "globalization." This is a topic to which you will return frequently during the year. The term globalization generally refers to views and processes that transcend the nation-state. As a concept, globalization can have political or economic connotations. More often, though, it is economic. At the base of this is international trade and investment.

Trade is basic human behavior. In ancient times, a hunter would trade (i.e., barter) meat for vegetables from a farmer. Why? Because each man wanted or needed what the other had, and it was not realistically efficient for each to both hunt *and* farm. It was far more beneficial for each of them to specialize. In its essence, trade produces mutual gains by redistributing products in a way that provides an opportunity for all parties to obtain the combination of goods that they prefer to the ones they previously held.

By world standards, the United States is a large, generally self-sufficient country. Though we do not usually think about it in such terms, there is trade that occurs *within* the U.S. Florida orange juice is consumed in Michigan; while someone in Miami is driving a Ford from Detroit. The reasons for this are not much different from those that motivate trade between nations. Maximizing the efficient use of scarce factors of production (natural resources, labor, and investment capital) – making the most of comparative advantages – makes it in the American national interest to trade. Accordingly, through trade, we can have coffee grown in tropical climates, oil from those who can produce in excess to their needs and other products (e.g., clothing) that we can buy less expensively than we ourselves can produce. These are the same kinds of reasons that other countries buy so many goods and services from the U.S. – which, by far, is still the largest exporter in the world.

International free (unprotected) trade is a high priority objective of U.S. policy. Within the borders of the U.S. – between the states – one can see a relatively pure model of free trade. Although many of the barriers have

been reduced or eliminated, no equally "clean" model of free trade exists between nations.* Barriers to trade include tariffs (taxes on imports), quotas (limits on imports), subsidies and non-tariff barriers (e.g., sanitation standards for agricultural products). The debate on free trade most often occurs (but not exclusively) between domestic producers, who do not want foreign competition and seek government protection, and consumers, whose interests are best met when they are offered the greatest variety, the highest quality and the lowest cost for goods and services.

The often hard to accept fact is that the most efficient economies must be constantly changing to remain efficient, highly productive and competitive. Thus it is that the most successful economy in the world, that of the United States, over its history has shifted emphasis from agriculture to heavy industry and, most recently, to technology – with other stops in between. American success is significantly attributable to the fact that our economy emphasizes that which it can do best.

OBJECTIVES

1. Understand the essential role of trade in a free market economy, including the concepts of comparative advantage and specialization.

2. Understand the nature and impact of the obstacles to free trade.

3. Understand the dynamics and role of change of successful free market economies.

ISSUES FOR CONSIDERATION

1. What would change in your life – for better and worse – if the U.S. did not trade with foreign partners?

2. How do you and the nation benefit from freer trade? What have been the costs? How do you weigh the balance?

3. In your opinion, will the European Union produce free trade in that region? What are the obstacles? Will the situation become as open as "trade" between the states of the U.S.?

4. What would be the costs and benefits of protecting American defense industries?

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* Interstate free trade is certainly one of the objectives of the European Union. It will be interesting to note the extent to which that objective is achieved.

5. List actual examples of trade barriers (e.g. subsidies, quotas, tariffs, protected industries) in the U.S. and other countries.

6. Course #1 will discuss economic trade sanctions. How do such sanctions relate to the barriers to free trade covered in this Topic?

7. To the best of your knowledge, compare the openness of the U.S. economy with that of other countries.

REQUIRED READINGS

— Baumol and Blinder: Chapters 37 (through pg. 884) (16 pgs.) and 34 (Skip pgs. 803-806 – The Graphics of Comparative Advantage), (21 pgs.)
— Heilbroner and Thurow: Chapter 17 (9 pgs.)
— "Financial Indicators," *The Economist,* April 24, 1999
— WTO, "Basics," http://wto.org/about/facts0.htm (2 pgs.)
— "Fifty Years On," *The Economist,* May 16, 1998
— "The Beef Over Bananas," *The Economist, March 6, 1999, (3 pgs.)*
— "On The Edge," *The Economist,* Sept. 8, 1998

Topic 6

The Money Side of Trade

"An economist is an expert who will know tomorrow why the things he predicted yesterday didn't happen today." –L. Peter

Tuesday
8 September
1330-1500 (IS)

OVERVIEW

To continue our discussion of international trade, we now take a look at exchange rates, the purposes they serve, how they are established and the impact they have.

Going back in time once more, the farmer we met swapped his sacks of corn and beans for the hunter's wild hog carcass. Barter trade was simple. When barter was no longer practical, men substituted other items, such as gold, as the medium of exchange. In this way, the farmer and hunter no longer needed to find one another. That problem was now resolved by a marketplace (most often run by intermediary traders) where consumers could find the products they required. Eventually, people decided that using things such as gold as the medium of exchange also was not very practical. Thus it was that money came into being.

When our Floridian sends oranges to Michigan and ultimately wants to buy those Fords, he has no problem in the transaction, since both parties use the same currency, the dollar. However, when Dell Computers wishes to purchase memory chips from Malaysia, there are two different currencies involved. The problem for the Malaysian producer is that he must pay his workers in local currency, and thus must exchange the dollars he receives for the memory chips for Malaysian ringgits.

In theory, exchange rates should produce equal results – purchasing power parity. Thus, a Big Mac (the example used by *The Economist* magazine – See Topic 2) should cost the same in Paris as it does in Washington – once francs are converted to dollars. That this is not always the case has an important impact on trade and development around the world.

When countries trade, they seek a balance – that is, they seek to achieve equilibrium between the amounts (stated as a cash value) they import and export. A balance of payments deficit, therefore, is the amount by

which a country's imports exceed its exports expressed in monetary terms.

For most of the past decade, the United States has operated in a balance of payments deficit position, and yet its economy has flourished. Japan's economy, which continues to accumulate large trade surpluses, has fared less well. Both situations defy conventional wisdom.

As the leading world currency for most of the 20th century, some would say that the dollar has enhanced the economic power of the United States. A number of people are concerned that the advent of the Euro, the new currency of the European Union which will come into circulation early in the next decade, will threaten the primacy of the dollar and thereby weaken the U.S. economy.

While it is commonplace to identify its weaknesses, the U.S. economy has been dominant throughout most of the 20th century. This is evident in the volume of U.S. imports and exports, the preponderant role of the U.S. dollar in the world economy, and the level of foreign and domestic investment in this country. Nevertheless, while U.S. economic power is indisputable in the absolute sense, it has diminished relative to increased strength in Western Europe and parts of Asia since the end of World War II.

OBJECTIVES

1. Understand how exchange rates are established and the consequences of interference with free market exchange mechanisms.

2. Understand the nature and importance of the role of the convertibility of international currencies.

3. Understand the concepts of the balances of trade and payments and their relationship to economic strength (perceived and actual).

4. Review the importance and role of the U.S. dollar both to international trade and to the strength of the American economy.

ISSUES FOR CONSIDERATION

1. What is an overvalued (or undervalued) exchange rate? What are the causes of this? What are the consequences of such a rate for a) tourists, b) exporters and c) importers?

2. What is the link between U.S. competitiveness and dollar exchange rates? Are other factors more important?

3. Is the notion of barter still relevant? Explain.

4. As a national security strategist, what are the risks of having a chronic U.S. trade deficit?

5. Do you believe that the Euro will threaten the role of the dollar as the world's primary medium of exchange? Explain.

REQUIRED READINGS

— Baumol and Blinder: Chapters 35 (22 pgs.) and 36 (18 pgs.)
— Heilbroner and Thurow: Chapter 18 (11 pgs.) and 19 (12 pgs.)
— "Currencies In Crisis: A Beanie Baby Guide To a Grown-Up Problem," *Washington Post,* February 7, 1999. (2 pgs.)
— "Who's Afraid of the Euro?" Paul Krugman, *Fortune,* April 27, 1998. (3 pgs.)
— "Financial Indicators," *The Economist,* October 13, 1998. (1 pg.)
— "Eleven Into One May Go," *The Economist,* October 21, 1998. (4 pgs.)
— "Monomoney Mania," Paul Krugman, *Slate,* April 15, 1999. (6 pgs.)
— "Eurocollision," Richard C. Morais, *Forbes,* April 19, 1999. (3 pgs.)
— "World Money," James W. Michaels, *Forbes,* November 16, 1998. (10 pgs.)

Topic 7

Dysfunctional economies: Underdevelopment and Crisis

"We are confronted with insurmountable opportunities." –Walt Kelly

Thursday
10 September
0830-1000 (IS)

OVERVIEW

In this final topic, we will be applying some of the knowledge acquired in the past few weeks to the real world of the strategist. Proceeding through the NWC core courses, there will be many occasions where economic problems are at the heart of high profile national security issues. The collapse of the Soviet Union, the Gulf War, and the economic crises of Indonesia and Thailand are only a few such examples.

Nearly 85 percent of the world's population live in countries classified as underdeveloped by the World Bank. Two-thirds of this group are in the poorest countries. What exactly does it mean when it is said that a country is underdeveloped? While there is not a simple answer to this question, there are some basic factors where agreement is nearly universal. An illustrative list of these includes: life expectancy at birth, the population growth rate, the number of children who survive until their first birthday, and adult literacy. A more controversial indicator is per capita GDP. The current statistic favored by the World Bank is the number of people whose income is less than $1 per day.

What causes such poverty and why haven't these problems been resolved after decades and billions of dollars of economic aid? There is no definitive answer to either question. The causes include government instability, corruption, bad/poorly administered economic policies and numerous other issues that defy generalization. Just as no two people and their problems are the same, country circumstances, while often conforming to established patterns, also are unique.

Economic crises – be they in countries as diverse as Indonesia, Mexico or Brazil – also have their individual characteristics. Nevertheless, there are important elements that many of these situations share, and it is useful to understand what they are. High among these issues is corruption, which can originate from a wide variety of sources (e.g., the president's family, influential businessmen criminal organizations). Also prominent are flawed economic policies, such as insufficient transparency in the

banking system, costly protection of inefficient national industries (e.g., through subsidies or tariffs), and overvalued exchange rates. Eventually, the economic distortions created by such policies can undermine even the most successful economies.

There is a fairly wide variety of organizations that seek to address the problems of economic crisis and underdevelopment. These include several types of aid agencies (e.g. bilateral, multilateral, NGO) that, to some extent, implement programs that have identifiable differences. Among these organizations, the one that has achieved a particularly high profile in the past several years has been the International Monetary Fund (IMF). There are some misconceptions about the role of the Fund and its programs. Because of the increased significance of the Fund, it is important that you, the well-informed senior strategist, have a clear understanding of the functions that it performs.

OBJECTIVES

1. Develop an informed understanding of the nature and causes of economic underdevelopment.

2. Develop an informed understanding of the nature and causes of economic crises.

3. Understand the variety of organizations that address development issues and the instruments that they use.

4. Develop a working knowledge of the role and tools of the International Monetary Fund.

ISSUES FOR CONSIDERATION

1. Select an underdeveloped country. Analyze its development profile. What are the issues you will consider to: a) determine the extent of its underdevelopment, and b) the reasons for its underdevelopment?

2. Consider three types of international development organizations: bilateral (e.g. USAID), multilateral (e.g. the United Nations Development Program), and NGOs (e.g.CARE). What are the similarities and differences between these programs with regard to their: a) institutional purpose, b) programmatic approach to development problems, and c) sources of funding? How do these organizations relate to one another?

3. From what you understand, explain the probable causes of the economic crisis suffered by Indonesia. Draw parallels, both favorable and unfavorable, with other countries.

4. What is the difference between the roles and programs of the IMF and the World Bank? Are they redundant or complimentary?

5. What uniquely defines the role of the IMF? How would you change the IMF?

REQUIRED READINGS

— Baumol and Blinder: Chapter 37, pgs. 884-894 (11 pgs.)
— David Driscoll; ***The IMF and the World Bank: How Do They Differ?;*** (IMF, 1996) (11 pgs.)
— "A Survey of the Third World: Poor Man's Burden," *The Economist (September 23, 1989) pgs. 1-58 (28 pgs.)*
— Stigliz/Squire, **Foreign Policy,** "International Development: Is It Possible?", (Spring '98) pgs. 138-150 (13 pgs.)
--"Emerging Market Indicators," *The Economist,* September 14, 1998. (1 pg.)
-- "World Bank Mulls Reform," CNN Financial Network, February 22, 1999. (3 pgs.)
-- "Lender Without Limit," *The Economist,* October 13, 1998, (2 pgs.)
-- "Making Aid Work," *The Economist,* November 13, 1998. (2 pgs.)