



4.2 OVERARCHING ECONOMIC THREAT

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GENERAL COMMENTS

One of the great merits of Jim Rickard's report on economic and financial attacks is that it forces you to think about things that you do not normally think about, concepts such as weaponized money. His report can serve as a useful manual for discussion or instruction on issues that are unquestionably very important. I will start with three general comments, make some observations on some of the scenarios in Mr. Rickard's report, and then end with some conclusions.

It is ironic that we are here together to discuss the possibility of some foreign financial or economic attack on the U.S. Presently, we are in a mighty crisis, which we have provoked ourselves. To reiterate what Dr. Overholt mentioned in his address to this roundtable, no adversary could have done to the U.S. what we have done to ourselves in neglecting proper regulation and

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supervision of the U.S. financial sector during the past seven or eight years.

It is sobering to realize that the enormous losses that we have inflicted upon ourselves and the rest of the world are the result of gross mismanagement of our financial system. While I recognize that foreigners or adversaries of a non-state nature could try to inflict significant damage on this country by causing disruptions of the financial system, I do not think anybody could do as thorough a job as we have done ourselves.

Having said that, I believe Jim Rickard's report is a valuable addition to the discussion of our vulnerabilities to financial attack. I cannot claim expertise in financial markets as much as he does. I have never run or advised a hedge fund. I initially had some trouble understanding credit default swaps; I had never heard of them before the crisis broke. Although I am not an insider in the financial world, I am quite convinced that this report provides an excellent basis for discussion on these subjects.

The third general comment is that I have also been convinced that non-conventional threats to U.S. security in the form of monetary, financial, and economic attacks are a serious matter. We have not really seen much of it—that I am aware of—but I think it behooves us to think these issues through because one day those threats might become serious. We are naturally more inclined to think of security threats in terms of military issues, access to raw materials, and other related concerns. I think some of the scenarios in Jim's report are potentially very real, and as such, I commend his work.

ANALYSIS OF SCENARIOS

One of the scenarios Jim explores in the earlier part of the report is the possibility of an organized, coordinated hedge fund attack on the U.S. by a group, either a state or a non-state actor, that puts together maybe \$10 billion leverage in the U.S. capital markets to cover a huge fund with which they can purchase assets and then release them in a way that disrupts markets and decreases asset values.

When I was reading that, I wondered, “Is that plausible or not? Which state actor could possibly be motivated to organize such a thing?” I could not really think of one. The actors that would have enough money, knowledge, and expertise to carry out such an action would be Canada, the European countries, China, or maybe Russia, but we must ask: what could be their motivation and how could they benefit from an economic crisis in the U.S.—assuming they can actually provoke one, which I doubt. The possibility that a non-state actor—al Qaeda, for example—would come up with such a scheme seems even more remote.

Although I found the idea interesting and thought provoking, I did not come away with the impression that this was a real threat. Europeans would never do it. They would have absolutely zero motivation. I cannot think of any reason why the Chinese would wish to try, except perhaps in the unlikely case of war over Taiwan, but even then, it sounds implausible to me. I do not think the Russians could organize themselves to do it. Who is left? Brazil?

On many of the other scenarios, I had different reactions. I think that the risks to companies of strategic importance to the U.S. are perhaps more serious than I had first realized. I can see that through various mechanisms, ill-intentioned foreign parties, states, or agents on behalf of state or non-state adversaries, could indeed acquire a minority interest in disguised forms and begin to influence or gain access to privileged information in a way that escapes attention. I was rather impressed by that section of the report that deals with equity positions in U.S. companies that can be disguised in ways that are hard to detect. I think we should study that carefully. Whether the current instruments with which we deal, enumerated in the back of the report, or the various legal instruments we have are adequate to deal with these risks, I do not know. I am inclined to think not.

On sovereign wealth funds, which are the focus of many of the comments in Jim’s report, I see a potential threat but, realistically, nothing serious. Russia’s pile of money is dwindling as a result of lower energy prices and efforts by the Russian Central Bank to support the exchange rate through the sale of reserves,

so I do not see Russia in a position to inflict serious intentional damage on U.S. companies or financial systems through the use of its sovereign wealth funds or proxies for them. The largest sovereign wealth funds are actually held by countries in the Gulf and Norway, which are allies of the U.S. Norway has a huge fund, and I think Jim correctly identifies that as one of the most transparent operations of its kind.

China is a bit of a question mark because its leaders are very new to this. The initial \$200 billion they put in that fund is often seen to be a potential threat to foreigners, although I am personally inclined to discount that threat. I just came back from China on Sunday. While there, I met with some of the senior managers overseeing their sovereign wealth fund. They are having a hard time. Their first investments (in the Blackstone Group, Morgan Stanley, the Belgian Dutch Bank, Fortis, and Barclays) were all bummers: They lost 80 percent of their money. To deal with the suspicion that the Chinese state might use that fund to gain access to corporations surreptitiously, they are trying to emulate the Norwegian example by subcontracting the investment of these funds through a number of independent agents, who would then compete amongst themselves to get the best return for the parent company.

The significance of what I see in Jim's report is that the Chinese cannot win. If they do not follow the Norwegian example, they will be subject to the suspicion that they themselves directly used that fund for political purposes. If they subcontract investment decisions to independent agents acting in their own name, there is a new suspicion, namely that these agents would gain positions in companies without divulging that they are actually owned indirectly by the Chinese state.

I am inclined to think that we should not be so afraid of these sovereign wealth funds; they have a very useful role to play in our damaged global financial system. They can contribute to the recapitalization of our banks and non-financial corporations with long-term capital that is not leveraged in the same way as hedge funds. I am altogether in a more positive frame of mind

on sovereign wealth funds. I see them as mostly benign and potentially very helpful to us in the current crisis.

Jim plausibly argues that there are all sorts of devious contractual arrangements, wolf pack attacks, and derivative contracts that can be used as weapons to strategically gain access or control over important companies or commodity markets. I agree. We should understand these things. If there are such risks, we should carefully examine whether our regulatory supervisory system adequately protects us against these risks.

Another scenario he discusses at some length is the possibility of market and price manipulation through the spreading of rumors, announcements, and so-called head fakes. These could undermine open market processes and I think can be harmful. However, I doubt very much that they could cause disturbances and damage on a scale that could cause national security risks. Nonetheless, these are risks that we should consider.

Concerning the macro-oriented scenarios that Jim developed—scenarios that discuss undermining the U.S. currency as an international reserve currency—I think they are useful. The first scenario is the Russian gold reserve dollar. I have not really thought that through, but it is an intriguing idea: one country with a lot of oil and gas to export and little else could create a gold-based currency with which it could require its customers to pay.

However, we have to think this through a little further. For example, what would happen to oil prices if this pricing mechanism would unintentionally trigger a recession in the industrialized world? In conventional dollar terms, the price is likely to go up sharply. The demand for oil would then shrink. What would be the consequences of that, particularly if the Organization of Petroleum Exporting Countries (OPEC) were then to undercut the Russian pricing scheme by offering different rules and discounts?

Another question I have not thought through but wonder about is: what will happen to the ruble? Jim suggests that it would remain the domestic currency for Russia, but how long can we maintain a watertight separation between the new international currency, aimed at sharp depreciation of the U.S. dollar, and the

ruble? I think that after awhile, that system would be in danger of collapsing because it would lead to all sorts of unintended domestic economic and social consequences in Russia.

In any event, it is interesting. We should think about it. I am not convinced that this is a real option for the Russians. I am certainly not convinced the Chinese would join the Russians for two reasons: (a) the Chinese are smart enough to see the possible pitfalls of such a scheme and (b) they never fully trust the Russians. They would not go along with the Russians simply to pester the Americans.

The possibility that China might drive a wider gap between short and long-term interest rates in the U.S. by (1) selling an initial \$100 billion worth of Treasury holdings and then announcing that they would sell more if the situation would warrant it and/or (2) shortening the maturity structure of the Treasury holdings to steepen the yield curve significantly could become troublesome for the U.S. economy. However, China would pay a price for that. They would significantly reduce the returns on their investments. Why would they do it? The Chinese want to build their own economy as quickly and as strongly as possible; a prosperous U.S. economy is much more helpful to them than a damaged one. The Chinese are a stakeholder in America's prosperity, as we are in theirs. It is hard to imagine circumstances that would fundamentally change this equation.

THE OVERARCHING THREAT

Whereas we should have security people worry about these potential scenarios, the biggest threat to U.S. security is the U.S. itself. Economic mismanagement in the U.S. has triggered the largest crisis in the last 80 years. It has spilled over into the global economy, unintentionally causing enormous wealth losses, almost equal to global GDP by the latest accounts.

What is the answer? I think the best security protection for the U.S. in the economic/financial arena is to have good domestic supervision and regulation of the financial system. A second precaution is economic policies aimed at ensuring a strong, real economy and high employment. I think we have to reform the

health care and education systems. We have to rebuild infrastructure and aim at much higher levels of energy efficiency. Japan and Europe are well ahead of the U.S. in terms of energy efficiency. Our dependence on imported energy and the associated vulnerability is much greater than it should be and can be with sound economic policies.

I believe that Jim wrote an interesting and important report, but it does not, in my opinion, profile what I see as the biggest security risk: poor oversight of our financial system.