



4.3 RESPONDING TO ECONOMIC AND FINANCIAL ATTACKS

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GENERAL COMMENTS

Jim Rickards' report concerning economic and financial attacks is a long and very rich paper. I found a very useful summary late in the paper of existing U.S. laws, institutions, and instruments to deal with some of the threats that he discusses in the core of the paper, as well as a much briefer, but nonetheless useful, summary of instruments available to the European Union. He provides a quick rundown of what could be done instrumentally and legally to deal with threats to the U.S.

In contrast, I found his long introduction on economic models and financial markets simply a distraction. I found it a confusing mixture. The essential point, which I think is correct, is that modern financial markets are large, complex, nonlinear, dynamic, and stochastic systems. Economic models are very useful for pedagogy and for understanding some features of these systems;

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unfortunately, the economic models have been applied within the risk management sections of banks, insurance companies, and rating agencies, but they are totally inadequate to deal with the nature of real markets in all of their complexity. That is a point worth making, but it also has a bearing on the possible threats to our system.

ANALYSIS OF SCENARIOS

The Rickards report has a section on the national security implications of the current recession. Some of you know that the House Armed Services Committee held hearings on this particular issue two weeks ago, where I was one of the panelists discussing what the possible implications are of the current recession. Those discussions are available elsewhere, so I will not comment further on them. [1] Instead, I am going to focus on the three sections of the paper that detail possible manipulation by foreign entities, either governments or possibly nongovernment entities or adversaries, against U.S. interests. I will focus on deliberate manipulation.

The first such manipulated activity involves what could be called swarm tactics by one foreign entity operating through many channels or several foreign entities operating in collaboration, designed to disrupt U.S. financial markets and cause financial and/or economic chaos. The Rickards paper provides a very useful discussion concerning how any foreign entity so motivated could conceal its activities ahead of time in today's financial markets; this issue also was broached in Dan Wolf's discussion of cyber attacks [Cybersecurity: Attacks on the Critical Infrastructure]. We could not necessarily—at least initially—attribute such actions to a particular source; this assertion is a very useful contribution to this topic. It is certainly possible that such an action could take place.

To reiterate Rickards' essential point, financial markets are dynamic, large, complex, nonlinear, and stochastic systems. They are hard to predict, not only by analysts in the U.S. but also by any foreign adversary who wanted to disrupt them. The probability of disrupting them through a single action or set of concerted

actions is negligibly small. It would be a coincidence if it were to occur. It could occur, but it would just be a coincidence.

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Consequently, any strongly motivated adversary would have to try several different methods many times to achieve a successful disruption of markets. This trial-and-error methodology makes the action, in principle, detectable. It is like code breaking. If you have a single message in code and the coder is good, you have negligible chance of breaking the code, but if there are repeated messages in the same code, a competent cryptographer is likely to break it. This is one area where I think there is some scope for interagency interaction. I just want to note, as Rickards does in his paper, that market manipulation of U.S. markets is illegal and actionable by the Securities and Exchange Commission (SEC).

Another section of the Rickards report relates to covert acquisition of a controlling interest in companies that have technologies or other information that might be useful for a foreign adversary. Again, I think the Rickards paper has done a good job of indicating how this could be done. With current markets, it would be easy with some forethought and effort to acquire a controlling interest in an American company through diverse channels.

What Rickards does not explain is how, having achieved such a controlling interest, the adversary could then take adverse action against the U.S. Additional steps are necessary beyond simply achieving controlling interest (e.g., controlling enough voting shares). I can identify three possible channels.

One, after achieving a controlling interest, the foreign adversary could change the Chief Executive Officer (CEO) and other board members. However, hostile proxy fights in the U.S. attract a lot of attention. This would no longer be a covert action. If the U.S. government is paying attention and has some idea of what

it wants to look for, then such an action would clearly be detectable. Again, this is another area for interagency cooperation.

It would be harder to detect if the acquirer persuaded the CEO and the board that the agent should actually have a board seat, thereby not starting a noticeable proxy fight. This second scenario, of course, requires the cooperation of the CEO and the existing board and gives away the concealment. As Rickards reminds us, under our laws, if you acquire more than five percent of a publicly traded U.S. corporation, by law you must declare your acquisition and what your interest is. Are you just a portfolio investor, or are you planning to acquire more shares and so forth? It is a giveaway, and it is illegal if it is not declared.

The third possibility would be threats to the CEO or the Chief Financial Officer (CFO) through, for example, sales of stock in which the officer owns a lot of options. The officer can be financially damaged if he does not turn over information that is desired by the adversary so that, in effect, the CEO or some other senior officer is recruited by the foreign adversary as a spy. That is the only way to describe it. That is always possible. Even without stock ownership, it is possible, although owning some stock may make the possibility of extortion somewhat greater.

This scenario threatens the security of U.S. companies generally, particularly those dealing with highly sensitive defense work. It is not a new problem, although financial leverage may add a new dimension to the capabilities of a foreign adversary. Again, it would violate several U.S. laws. This is certainly another area for interagency cooperation and raises the question, who is responsible in the U.S. government for dealing with industrial espionage?

The third section of the Rickards paper that deals with manipulative action by foreign entities, especially governments, concerns a somewhat creative proposal for issuing a gold-backed currency with the objective of undermining the U.S. dollar. Russia is used as an example. However, Rickards indicates that although Russia is the most obvious country, it is not the only country that could do it.

I have to say I do not understand this proposal at a fundamental level, or I find it completely farfetched. The key idea is that Russia would create a gold-backed ruble, managed from either London or Zurich, and insist that its oil and gas sales should be paid in this new currency. The original paper valued the gold ruble or the gold behind the gold ruble at \$4,000 an ounce, roughly four times the existing price, although the revision dropped the initial price to around \$1,000 an ounce. The assumption is that the price would quickly rise much higher than \$1,000 an ounce.

This action allegedly would undermine the U.S. dollar as an international currency and, through U.S. inflation, would also undermine it as a domestic currency. Fundamentally, I do not understand the dynamic that links the action proposed. Russia could issue a gold currency at any time with the supposed result. Rather than go into it in detail, I just want to list a number of questions—Pieter Bottelier has already touched on a few of them—that require sound answers for me to concede that this is a reasonable option. Even so, I think that my own list of questions taken together cannot be answered in a way that is persuasive.

First, as Rickards points out in his paper, it would not take a government to carry this out. Anyone with enough capital could issue a gold-backed currency. If it is going to be as lucrative as Jim suggests, the equilibrium price of gold must be around \$4,000 an ounce. That is more than four times the existing price. This is an economist type question: Why has someone not done it? It looks like a \$20 bill lying on the sidewalk. Why has someone not picked it up?

Presumably the answer is that Russia would be more persuasive. First, it has a pile of dollars that it could use to buy the gold. Although, as Pieter Bottelier said, that pile is diminishing rapidly as we speak. Second, Russia, unlike a private party, could insist that at least its oil and gas had to be paid in this new currency. Russia's trustworthiness is very low worldwide, hence the role of London or Zurich in ensuring success, which is part of Rickards' proposal.

My first question is: Why would either Britain or Switzerland cooperate with Russia in a scheme whose objective is to undermine U.S. currency? The second question, as Pieter Bottelier touched on, is: What would Russia do with its existing ruble? Concretely, will the Russian public and private oil producers and the mostly private gold producers be paid in the gold ruble or with existing rubles? The Russians would have to make that decision, and either way, it does not go well. If they did not pay the gold and oil producers in the new currency, it would create a credibility problem in the rest of the world. If they did, it would create deep complications for the Russian economy.

Third, how would other oil exporters—Mexico, Saudi Arabia, and Canada or Norway, both members of the North Atlantic Treaty Organization (NATO)—respond? If Venezuela were the only country to sign on, why would the scheme take off?

Fourth, there is actually a lot of gold in the world. Some of it is in the ground. However, at \$4,000 an ounce—even at \$1,000 an ounce, which is roughly where we are now—much more of that gold is going to be mined and processed. Mining companies are sifting through the tailings of the mines of the 19th Century because at today's prices it is profitable to extract the gold and silver that remains. Therefore, the potential increase in new gold supply is very large.

Central banks around the world hold a huge amount of gold. The International Monetary Fund, but also many central banks, particularly European central banks, began to sell their gold when prices were much lower than they are now, around \$300 an ounce, roughly a decade ago in quite substantial amounts. Switzerland, Britain, Belgium, Portugal, and a number of other countries started to sell their gold.

The African gold producers complained and persuaded the Europeans to pull back from their gold sales on the grounds that central bank gold sales would depress the price of their newly mined gold from their poor countries. With a perfectly elastic demand for gold because of this new currency, though, that argument goes away. Why would not the central banks just sell their

gold to Russia at the new price, essentially swamping Russia's ability to take this gold? How would the other governments of the world respond in terms of their own gold?

Fifth, how would foreigners actually hold this new currency? Assuming Russia succeeded in getting it established, how would they hold it? Most institutions want to hold marketable instruments. We have dollar bills, Euros, and British pounds in our billfold. Where are the marketable instruments? Who would pay interest on this? Now, with a high confidence in the ability of financial markets to innovate, we could say such instruments could be devised and marketed. Maybe institutions would issue such things, maybe not. It is a big question mark.

Finally, if the U.S. dollar were depreciated as much as Jim Rickards expects, U.S. goods would become super competitive in world markets. U.S. asset prices would rise sharply with foreign demand because productive U.S. assets would be really cheap. It is not clear that either of these developments would be devastating to the U.S. economy.

Then, there is a more technical point that is unclear: whether Rickards' scenario would yield a real or only a nominal rise in the value of the gold ruble. What happens to world prices other than Russian oil and gas prices, which by assumption are linked to this? This gets into the general equilibrium effects and is a more technical discussion than we can address here.

My ultimate point is that there are so many important questions with very uncertain outcomes, the scheme cannot be taken seriously. These concerns will surely detour any sensible Russian from actually putting forward the proposal. Therefore, I am very skeptical about this proposal.

Finally, Rickards mentions in passing that the U.S. should, as a preventive move, go back to the gold standard. That is an entirely different subject. If you remember, we actually conducted an official study of that course of action in 1980–82. There was a bill signed by President Carter but concluded under Ronald Reagan. Many people looked at that issue; there were a lot of hearings, papers, and so forth. The general conclusion was that the gold

standard in the late 20th Century, and now by inference in the 21st Century, for the U.S. would be a disaster.

I want to say one further comment about the yield curve, which Rickards mentioned in his oil remarks. I agree with Pieter Bottelier that I do not see the Chinese motivation for converting their holdings of U.S. Treasury bills to short-term only, which would increase the yield curve. However, let us suppose they did. Anything they do, we can undo with fiscal and monetary management. Particularly these days, we have, as was mentioned, a large amount of new debt to be floated every month. Decisions have to be made by the Treasury about where to float the new debt, at the short, medium, or long term.

Anything the Chinese do, the U.S. Treasury, with minor adjustments, can undo on the yield curve. If the Treasury does not do it, the Fed could do it now that they are buying bonds again. In my opinion, the technicians in the People's Bank of China would discourage the Chinese from even thinking about it. Why do it if you only create a fuss and some irritation in Washington and accomplish nothing for it?

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INTERAGENCY COLLABORATION NEEDS

Let me conclude by discussing the interagency implications, which I have already foreshadowed. I think, along with Pieter Bottelier, Jim Rickards’ paper has pointed out some possibilities for concealed foreign action, none of which could be devastating to the U.S. but nonetheless would be undesirable. It is very useful to point them out. We should know about them. We should arm ourselves with knowledge of what is happening and what could

happen. This involves some classic intelligence, particularly communications intelligence, working with U.S. government agencies and legal authorities that are not used to working with the intelligence community.

In particular, some in the SEC and in the Department of Justice (DoJ) need to be cleared for National Security Agency (NSA) briefings. Some in the Treasury Department already are cleared for NSA intelligence. More importantly, we need to think about the targeting strategies. Who decides how our intelligence assets are targeted? Already, there is some tension when we are using our limited intelligence resources to address national objectives and military objectives. This would add further to already existing tension.

There are priority issues. There is an allocation issue. Having decided the priorities at a senior level, then there is the actual targeting issue: How do you get information on the targets? In terms of the objectives of this symposium, I would put these down as new assignments for the intelligence community with the objects in the first instance being selected sovereign wealth funds and selected state-owned enterprises, because they are the ones who will be the initiators on behalf of their governments. The Treasury, DoJ, Federal Bureau Investigation (FBI), and SEC would be a new set of customers.

This raises not only process questions of priorities and targeting but also issues concerning the ethics of employees in the intelligence community. The Treasury has always been very stingy with financial information within the U.S. government. I know that because I worked in the State Department on several occasions. That stinginess is partly due to unhelpful, unsatisfactory bureaucratic reasons, but it is partly for real reasons (e.g., having prior information about financial transactions can create huge opportunities to make money).

We must have very clear rules and some monitoring to enforce the rules on the employees who are involved in collecting information on actual and potential financial transactions. I do not know what the rules for NSA are on such matters. I do know

the rules for the Federal Reserve. Federal Reserve employees are essentially precluded from holding most assets. Anyone collecting intelligence becomes a potential insider in SEC terms. Of course, inside trading in the U.S. is illegal. There are some very practical issues that arise, but these are all soluble.

Finally, I will mention one issue that is not discussed in Rickards' paper but which relates to the previous session: critical materials. With the unexpected invasion of South Korea by North Korea in 1950, materials prices shot up. There were those in Washington who thought—because Stalin was still in charge of the Soviet Union—that this was just the first shot of World War III and we were demobilized.

We were also short of some key materials based on our experience in World War II. Consequently, we built up a huge stockpile. As I recall, there were 109 items in the list of critical materials. It included tungsten, tin, feathers, and industrial diamonds. There was a long list of critical materials that the U.S. government purchased on the assumption that we might need them.

Our interest in those materials receded enormously. We still, of course, have a big stockpile of oil, which was done in a different program. We are not going to fight World War III, which we assume will not occur. It is certainly not going to be on the model of World War II. Therefore, many of these materials are not necessary.

However, a useful interagency activity would be—I do not know what the right timeframe is but maybe once a decade if we have not done it recently, and as far as I am aware we have not—for a group of knowledgeable DoD people, with the aid of other agencies (i.e., U.S. Department of Agriculture (USDA), DoE, etc.), to convene and ask, "In the next five years, what are the really critical materials that could be in jeopardy because of our dependence on foreign suppliers?" I think it would be useful to have a

review, at not too frequent but regular intervals, of vulnerabilities relating to critical materials.

REFERENCE

1. Richard N. Cooper, "Global Recession and U.S. National Security," Testimony Before the House Armed Services Committee, 11 March 2009: http://armedservices.house.gov/pdfs/FC031109/Cooper_Testimony031109.pdf.