The American Interest

DOLLARS & SENSE

SIZE MATTERS

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As the American political system hurtles toward its quadrennial encounter with the oracle of democracy, it is worth our while to take stock of the country's place in a world beset by bewilderingly rapid change. (Heaven knows none of the candidates will bother to do this.) I want to suggest that an old yet generally neglected subject remains particularly relevant: the relationship between the size of political units and the effective scale of systems of economic production and exchange. Another way to describe this relationship is by recourse to the hoary scholarly phrase "political economy", a term of art that has unfortunately gone out of style.

American strategists and statesmen have sometimes been attuned to this subject. In their approach to Europe just after World War II, American leaders understood that political identity and scope, national security, and economic scale were intertwined variables in defining power on the global stage. For most of the Cold War period, however, American statesmen tended to think of politico-military affairs and economic matters as dancing on opposite sides of the ballroom floor. Henry Kissinger famously admitted his lack of familiarity and expertise with economic issues and just as famously implied that, after all, they weren't very important compared to decisions about war and peace in the nuclear age.

Perhaps that was so in 1968 and even 1988, but it is certainly not so in 2008. The relationship between the size of political units and the scale of economic activity is again critically important. It defines the international context in which the United States operates. It tells us what states have to do to excel and it goes far to define what U.S. leaders must do so that America can keep up with other countries, some of which are growing more rapidly than we are. In other words, it tells us much about what our real strategic options are.

MADE TO SCALE

The growth of China, India and the European Union evince one primary characteristic: They all progress economically at more rapid rates than the United States. China and India grow vertically through high percentage increases in GDP per year. The European Union grows horizontally by adding countries, lately about one a year. As a result, the combined GDP of the EU's 27 members is now higher than that of the United States. Europe will probably go on adding members to its Union without a fixed "manifest destiny" limit.

The economic scale of political units, whether countries as traditionally defined or still unsettled agglomerations like the European Union, is growing because contemporary globalization rewards the big and punishes the small. Political units that can command the largest markets and the most capital and labor can produce the most; hence, they have the greatest influence in a world rather taken with the desire for material affluence.

In the 19th century the United States and Russia had the greatest GDPs because they had the largest markets, populations and sources of raw materials. The British Empire came next because England could export manufactured goods to its dominions and import raw materials and food from them. In other words, Britain made up for the small size of its home islands by enlarging its economic domain through imperial rule. After Britain came France, whose empire was neither as large nor as powerful as Britain's but fairly large all the same. Those countries unable to acquire very large empires, like Japan, Germany and to some degree Italy, fell into a middle category, with Portugal, Belgium and Spain behind them. They exported abroad, but when tariffs rose against their manufactures, they did not have guaranteed markets for their goods. Germany, Japan and Italy concluded that they needed more territory—either at "home" close to the European or Asian mainland, or overseas—to keep up with the United States, Russia, Britain and France.

Today, despite what is commonly asserted, the premium on size has not declined. All the talk about niche production is true as far as it goes, but it doesn't go very far. Certainly companies can use information technology to learn about specific markets, and use technology to manufacture, market and transport goods into those markets. But governments, which are responsible for the identity, security and well-being of their citizens, however much they may be helped by skillful niche-oriented manufacturers in their midst, cannot practice niche statecraft. Political units still align power with wealth, and, all else equal, the more wealth the more power.

And there will soon be far more wealth to compete over. That is because the number of what we may fairly call modern consumers has recently doubled and is about to triple. If a modern consumer is, at the simplest level, anyone with a cell phone and access to banking services, then there are about two billion such persons today. But as Tom Hayes tells us in *Jump Point* (2008), cell phone industry experts expect there to be three billion by 2011, most of them from parts of the world where there is today the highest concentration of poverty and illiteracy. As Michael S. Malone puts it, whoever figures out the preferences of this new trillion-dollar market will end up at the top of a reshuffled competitive world.[1]

This does not mean that the size of the relevant economic domain that produces wealth must be brought inside the territorial boundaries of the political unit. This used to be a popular strategy; indeed, it is what the many contiguous land empires of history have been all about. But it is not the only method. The overseas mercantile empires already noted illustrate a second method, in which nations controlled territories as colonies or protectorates but did not make them formally part of their own countries. And in theory, at least, there is also a third method: free trade.[2]

If international trade were completely open and capital flows unfettered, even small states could prosper in the world market, as the United Provinces and Venice did in ages past, and as Singapore has tried with some success to do today. But the global market is not completely open, nor will it become so anytime soon. The Doha Round of tariff reductions has failed, and country after country has opted for bilateral trade pacts with other nations instead. Singapore has gone into ASEAN-Plus-Three with the hope that it will eventually become a free-trade union. Industrial tariffs continue to limit the export of manufactured goods into Europe, Japan and most of what used to be called the Third World. Indeed, agricultural restrictions and subsidies are now higher than they were in the 19th century. So are formal restrictions on labor migration. The theory of free trade has not been vitiated, but its practice has been drastically curtailed. Regional or bilateral customs unions have become the best available substitute for open trade, so negotiated trade access is now the preferred method of organizing international commerce.

In finance, as well, the fear of contagion has become widespread, so big lenders, fearing excessive exposure and loss of control, are drawing in their portfolios. The recent collapse of Bear Stearns, whose leveraged obligations through counter-parties extended into the trillions of dollars, underscores the main point: No market is large enough to be fully independent. As *New York Times* analyst Andrew Sorkin pointed out: “We’re now so interconnected with the markets abroad, whether it be Japan or even Brazil, that whatever we do on our own is almost beside the point.” If the United States had not stanched its own crisis, the effects would have migrated overseas to Europe and Japan to a far greater extent than it has.

In addition, global corporations have grown larger through economies of scale, sharpening and complicating the connection between the size of political units and the scale of economic space. As W. Brian Arthur, an expert on “economies of scale”, has shown, there may be as few as two or three competitive companies in some industries.[3]Civil aviation now has two worldwide suppliers of long haul aircraft, Boeing and Airbus. In the automobile industry, the number of worldwide suppliers is less than ten, compared to about 200 companies in the early 1900s. Some of these will not survive and will have to merge with stronger partners. In the defense industry, too, consolidation is proceeding. In the United States there is Boeing (which bought McDonnell Douglas), Lockheed Martin and Northrop Grumman—all products of successful mergers. In Europe EADS and BAE are the leading contenders, though Russia has one or two suppliers as well. Major ore producers include Rio Tinto, BHP-Billiton, Vale (Brazil), Alcoa, Alcan and only a few others. Steel companies are combining forces vigorously—with Arcelor-Mittal, Nippon Steel, Baosteel and Wuhan Steel as leading producers. Software, finance and insurance have also become critical categories of economic activity where increasing concentration is the order of the day.

Corporate scale clearly poses a challenge to governments with restricted jurisdiction and limited size, though the scale and nature of the challenge is open to debate.[4] What is not debatable is that many companies with headquarters inside one jurisdiction typically produce and sell in others. Increasingly, their design functions are decentralized, as well. In this process, corporations become genuinely multinational in character, and it is by no means clear that their interests are fully consistent with those of their parent state. If states are to keep up with corporations to ensure that key economic elements—factors of production, raw materials and markets—do not elude their grasp, they must increase their own scope and size in one way or another. As Arthur writes, "In response to communications, existing governance structures have given way from villages to city-states to principalities to nation-states and finally to larger structures like the European Union."[5]

That is why, in many regions of the world, forms of literal or quasi-political integration are taking place—precisely to catch up with the natural scale of potential economic activity. The European Union clearly sets the standard here, but regional trading unions bearing political implications are developing in the Americas and the Far East. In Asia, ASEAN has now been joined by Japan, Korea and China. Plans are afoot for a customs union and for the creation of a Far Eastern currency. Trading relations have intensified within the bloc at the expense of outsiders. Capital is pouring into China and Vietnam. Overseas Chinese in Taiwan, Singapore, Indonesia, Malaysia and Vietnam have formed a trading community with one another, and the Japanese are participating as well.

These arrangements have been accumulating integrative depth over time. The small parent organization, ASEAN—originally including only Thailand, Malaysia, the Philippines and Indonesia—was formed in a Cold War context to be only political in character. With its broadening membership, however, and the advent of a new global context and new market-expanding technologies, its economic functions have burgeoned to the point of making ASEAN political in ways its founders could not have imagined.

In the Western Hemisphere, NAFTA remains and may be strengthened. Both Mexico and Canada would like to see NAFTA deepened to deal with migration and other current issues. Some have suggested enlarging its governance scope (as well as its geographical ambit) so that it more closely resembles the accession criteria of the European Union.[6] The Central American Free Trade Area is on the drawing boards. If South American countries would agree, the United States would be interested in a free-trade area for the Americas covering the entire Hemisphere. Thus far, however, South Americans have preferred to broaden MERCOSUR (Argentina, Brazil, Uruguay and Paraguay) without including the United States. Venezuela, Bolivia, Chile and Mexico have joined as associate members.

THE EUROPEAN DIFFERENCE

Most important, however, has been the expansion of the European Union. It has a deliciously "in-between" character. Since it is not a superstate headed by a single leader or president, it does not attract military attention or opposition. But neither is it a mere disaggregated amalgam of states, the members of which may be peeled off or annexed by others. The functions of national and international security are reserved to member states with independent military forces (and for Britain and France, nuclear weapons capabilities). But social, economic and financial functions (for euro-area members) are governed by the European Union (the Commission and the European Council). In their areas of jurisdiction, European courts decide matters, not national judiciaries. The key to European integration resides in the *acquis communautaire*, or community agreement, by which all members subscribe to the social-democratic and welfare goals defined by the European Union. Once in the Union, they do not withdraw. Unlike previous alliance systems or military pacts, the EU has essentially attained irreversibility of membership. Parag Khanna writes: "As the most highly evolved form of interstate governance, the EU aggregates countries in a manner more resembling a corporate merger than a political conquest."[7]

There is therefore now a European identity that joins national cultures together and to which others wish to be admitted. Does that make the European Union simply a larger state, or something else? It is a larger state in the sense that it has made economic activity roughly coterminous with territorial expanse. The EU controls what goods and services are transferred in and out of its domain—indeed, it is quite protectionist as these things go. But it is not a larger state in traditional national security terms. In that regard, it looks more like a Great Power concert, similar to its European historical predecessors, and has no congealing enemy against which to direct its attention. But it does have American military protection *in extremis*.

Whatever else it is, the in-between character of the European Union provides a very useful clarifying agent for understanding the current international context. It forces attention on the question of what is more important in defining power in the 21st century: a political unit that has an economic system large enough to generate available potential wealth, or a political unit that controls available potential instruments of military coercion?

Americans have traditionally scoffed at the failure of European integration to attain the status of a United States of Europe. Henry Kissinger once famously complained that there was no single phone number for Europe to call in a crisis situation. Since then the problem has changed: There is now a single phone number for the High Representative of the Common Foreign and Security Policy of the EU, and Condoleezza Rice can call up Javier Solana without much trouble. The problem begins once Solana puts down the phone, looks around, and finds himself pretty much alone in a large office. Solana has a title and an airplane at his disposal, but for any practical purpose he has no more divisions than does the Pope. If conducting foreign and national security policy is about integrating diplomacy with the literal and implied uses of power, how can Solana be considered a serious partner when the EU commands no such power?

As Europeans winnow the number of their leaders under the terms of the Lisbon Treaty, the disconnect between the EU's common foreign policy and the means to make it work may be lessened over time.[8] But that's not really the point. The point is that European integration copes extremely well with two required features of the present international system that many American observers seem not to adequately appreciate: the need to encompass the huge market created by globalization, and the need to create a peaceful and permanent community of states in the process—to paraphrase Clausewitz, real security by other means.

As to the first, European capital, technology, markets and labor address the problem of deficient size by attracting capital and investment from outside. No Asian supplier can succeed if it cannot operate in and sell to the European Union. Trade between Europe and Asia exceeds trade between the United States and Asia. The European market is equally important for the United States. As Europe grows in size, the United States, as well as Russia, China and India, will have to find markets, labor forces and technology there.

Second, no other peaceful grouping of nations has attained the status of a “pluralistic security community” among its members.[9] Realistic expectations of peaceful change exist among the core members of the European Union, and their number is constantly being expanded.[10] The enlargement of the EU marks the achievement by new members of reciprocal ties of peaceful relations with their neighbors. This is particularly noteworthy for the recently added states of eastern Europe and potential future candidates in the Caucasus and Central Asia. None of these states, individually, achieved such an outcome during or immediately after the Cold War. In this sense, Europe has found at least a partial and peaceful answer to the problem of size in world politics. It has negotiated larger political and economic scale. It has coped effectively with globalization. And so far, thanks largely to the NATO Transatlantic tie, it has not been forced to defend its pluralistic security community from an external threat.

THE CHALLENGE OF CHINA

The challenge of China also militates in favor of greater geopolitical size for Europe and the United States. In normal historical circumstances, two great powers (one rising and the other static) fight one another. Rising France fought Britain in the Napoleonic Wars; rising Germany fought Britain in World War I. And, from another standpoint, Germany tried twice to derail the Russian challenge, in 1914 and 1941. During the Cold War, the United States sought to match Russian growth and prevent Soviet expansion. In due course, it succeeded in doing both.

The next challenge for the United States will undoubtedly come from the rise of the People’s Republic of China. In recent times, China’s GDP has doubled every eight years while U.S. GDP has doubled only every 24 years. If present trends continue, at some time in the 2030s China will draw even with the United States, though not in per capita income. Does this mean that China and the United States will fight? Not if U.S. scale increases proportionately. How could this occur?

The United States could grow larger by means of a successful policy of imperialism overseas. In theory, anyway, America could meet the twin challenges of globalization and the rise of China by creating more and bigger colonies that could be made lucrative economically, as Britain and France once did. But this is a theory without practical application. The American Republic lacks the imperial gene, and even if it were to splice it in, it is highly unlikely that the international system would sit still in face of new American imperial ventures. In any event, it is hard to imagine that any such venture would not constitute an economic drag, given how expensive American military power is to buy and use. Surely, a U.S. military invasion and occupation of Iran or Saudi Arabia could not be cost-effective, once we factor in the political and terrorist reactions it would likely engender. There is no other area of the world where a coercive U.S. military occupation would provide satisfactory results by imperial measure, not even the adjacent lands of Canada and Mexico.

Nor can economic growth by itself provide a solution to needed enlargement, economically and politically. The United States cannot expect to grow at 10 percent per year to keep up with China. One reason for this is simply demographic: The U.S. population is just over 300 million; China has 300 million people, too—plus another *billion*. A large percentage of China's population is now poor and wants to become affluent. Since these aspirants now operate in a market system that can fulfill that desire, there is every reason to expect them to thrive, driving Chinese growth rates forward at high levels for a long time.

In recovering from recession, the United States might achieve a 6 percent growth rate for a year or two, but that growth cannot continue indefinitely. The mature American capitalist economy can probably muster 3 percent growth on average over a period of time, but, given demographic realities, it cannot average 6 percent, to say nothing of 9 or 10 percent. Moreover, while American productivity still leads the world, productivity rates tend to converge over time.[11] The United States will not remain ahead in perpetuity, and there are signs that the United States is losing its edge in several scientific and technical fields as well. So "vertical growth" does not provide a solution.

ATLANTIC UNION

If imperialism is out of question and vertical growth inadequate, another possibility is lateral or horizontal growth as a result of political-economic mergers with other countries. In theory, again, horizontal growth can be achieved by forging stronger institutional ties with other states. But mere alliances or regional groupings that lack real economic content are insufficient in the face of contemporary globalization. Unless trade and factors of production move seamlessly within the grouping, the necessary economic and political benefits of greater scale will not be achieved.

But what countries, what alliances? Of course, the United States can firm up its links with Western Hemisphere nations. As suggested above, NAFTA can be deepened through reforms and broadened by including new members. As much sense as this makes, the politics for actually doing it are not even close to being in place. Mexican trucks still cannot drive on U.S. roads. Illegal Mexican immigrants in the United States have no route to legitimacy or citizenship. American capital has not entered Mexico in sufficient amounts to stem the tide of migration to the United States.

Present problems notwithstanding, North American economic integration will come in time. The North American community will become more united and its capital market will extend from Hudson Bay to Chiapas. But even the North American incorporation of another $1–2 trillion in GDP will not appreciably affect the long-term challenge of China or overcome the rigors of globalization. Even a much larger Free Trade Area of the Americas that would expand NAFTA to include Brazil, Argentina, Venezuela and Chile would not transform the U.S. position. In 2030, China will have a GDP of $30 trillion and the United States will need an injection of at least $30 trillion more to maintain its current position as the leading power in the international system. As Everett Dirksen might have said, that's real money.

In 1938, Clarence Kirshman Streit published a book calling for a union of the North Atlantic democracies. Though Streit has been long forgotten by most people, his book was widely read and discussed at the time. After World War II, too, a few analysts saw the seeds of an eventual democratic union in the North Atlantic institutions built to fight the Cold War—not just a tight security alliance, but an actual political union that would integrate the North Atlantic economic space.

Of course, none of this happened, and a full merger between the United States (and probably Canada) with an enlarging European continent is still well beyond the bounds of current possibilities. But while our thinking is not there yet our money already is, and so, consequently, are many of our interests. There is no better example of this than the emerging dollar crisis. A look back provides some context as to just how important Europe's role in buoying the dollar can be. In both 1978 and 1979, there were massive runs on the U.S. dollar. To offset them, the United States needed funds from overseas, which required lower interest rates abroad and much higher rates at home. Only such conditions enabled the dollar to rise again between 1980 and 1985. Europe was critical to America's emerging from this crisis relatively unscathed.

Clarence Streit, 1941

The United States is again heading into an extended dollar crisis, one that will probably lower the value of the dollar to eighty yen and nearly six renminbi, while the value of the euro will rise to $1.65 or $1.70. If the dollar is to be stabilized there, it will again need foreign central banks helping it, and an accord similar to the Plaza or Louvre Accords will be required. While the Chinese central bank will be involved in any new agreement, Europe will again be crucial. Part of the next U.S. rapprochement with Europe will see the euro emerging *by mutual consent* as a major reserve currency, competing with the historic role of the U.S. dollar. As Wolfgang Munchau argues:

I would expect U.S. inflation to pick up significantly once the present recession ends. Future inflation will weigh heavily on the global role of the U.S. dollar. An immediate consequence of high inflation is that many developing countries will find it harder to maintain their dollar pegs. . . . There will come a point when the rise in inflationary pressures becomes unbearable. If and when they drop their pegs [that is, raise their currency values against the dollar] they will almost certainly rebalance their reserve portfolios as well.[12]

Since the United States will have no grounds to oppose this, its only choice will be to coordinate the consequences with the European Central Bank and its political masters.

In the meantime, a U.S. response is already long overdue to the propositions floated by German Chancellor Angela Merkel in her visit to Washington in 2006, when she advocated the creation of a Transatlantic free-trade agreement with the United States—an economic *Atlantikbrücke*, an "Atlantic Bridge." If achieved, a new free-trade union between the EU and the United States would comprise about 60 percent of world production and 13 percent of the world's population. It would not only increase demand for European and American products within the bloc, it would also stimulate outsiders to join in one fashion or another. And external suppliers would almost certainly seek free-trade access to it, and be willing to make concessions in order to gain the privilege.

Suppose, just as a thought experiment, that such an agreement could actually be achieved. What would be its effects? Unlike the traditional response in Western history, it would not generate balance-of-power responses against the new Euro-American free-trade union. The amount of economic power already accumulated within the bloc would draw others in, not motivate them to oppose it—and for two reasons.

First, economic power attracts outsiders even when political-military power repels them. External states whose societies care about material wealth would have to be associated with such a large market. Second, in geopolitical terms, the balance of world power would already be inside the union with 60 percent of world GDP. Others could not balance effectively against it. Japan almost certainly would wish to be associated with it, and as Tokyo drafted articles of adhesion, there is no way Beijing could stay entirely outside. India and others would be attracted, as well. It is thus quite possible that as the economic magnetism of an economic Atlantic Bridge grew, the size of the political-economic state unit would begin to approach the size of the international market for the first time in world history.

BACK TO REALITY

Thought experiments are very nice. They are fun, and they can be helpful to our understanding. But none of this is going to happen anytime soon. Indeed, no major American politician can be expected even to wish aloud for it to happen. In the aftermath of the 2008 U.S. presidential election, we are likely to hear very different sorts of notions. After all, several candidates have inveighed against NAFTA, whose net effect on the U.S. economy has been minor, as well as against even less consequential bilateral free-trade pacts, because of their failure to include higher labor and environmental standards in the exporting countries. If carried out rigorously, such requirements would put an end to the further negotiation of such trade agreements.

These demands have cropped up periodically throughout the modern freer trade period, but they have lately gained traction in response to the effects of a possible U.S. and world recession. Unemployment is up, real wages are down or static, and the housing market has not yet reached a stable bottom. After the end of the current showdown, inflation will be a problem that will require higher, not lower interest rates, possibly prolonging the slump. In time, however, normal economic conditions will return; entrepreneurs will wish to export and produce abroad under favorable conditions. They will favor customs unions as offering a positive political base supporting investment abroad.

Opposition to further economic negotiations is thus unlikely to persist for the full tenure of the next administration, and an Atlantic accord is not beyond the bounds of long-term political possibility. If only for purposes of responding to Merkel's proposals, it would be a good idea if someone in the government thought the matter through. The work very likely will not go to waste. Indeed, unless the Chinese economy implodes or globalization is stunted or reversed for some reason—both could happen, of course, but the odds lean against it—a Euro-American deal of unprecedented scale is the only way the United States can preserve its privileged position atop the global hierarchy. One day, most likely, it will happen. When it does, Clarence Streit will look down (or up) from wherever he is and smile.