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Imperial Overstretch?

The United States and the Rising Costs of the War on Terrorism

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In his address to the nation shortly after Labor Day, 2003, President Bush spoke of the problems in Iraq and appealed to the will of Americans to persevere and make sacrifices. In Europe this was widely viewed as the long-overdue admission of failure and of the growing strain on America's military power and financial resources. In the US proponents of the "imperial overstretch" thesis felt vindicated as well. This view, however, is motivated by wishful thinking. America's military standing is still unchallenged and the ability of the Bush Administration to mobilise national and particularly international economic resources in its large-scale "war on terrorism" is far from exhausted. Bush does not intend to beg for international help. His Administration will accept offers to share the burden to the extent that they do not infringe on America's own interest in harvesting the fruits of victory in Iraq.

Rather than admit the failure of his Iraq policies in his September 7 speech, President Bush did not deviate at all from his previous course. The only policy adjustment occurred when he changed the way of presenting the costs of the Iraq commitment to the American public. The deliberate underestimation of the duration and especially of the costs of American military operations in Iraq which was instigated by the Pentagon leadership under Defence Secretary Rumsfeld and Deputy Secretary of Defence Wolfowitz and to which the Administration held fast from September 2002 until Summer 2003 – has been dropped. Instead, without referring again to the argument of prevention of possible threats, the President has now declared Iraq to be the most important theatre in the war on terrorism and, on the eve of the September 11 anniversary, appealed to the American people to persevere and to be ready to make sacrifices. Thus, his Iraq speech of September 7 as well as the speech three days later to the FBI academy in Quantico on homeland security must be seen as a comprehensive strategy aimed at the American public and Congress to muster domestic support in the run-up to the elections of November 2004.

Typical war-time miscalculations

The war against Iraq was strongly influenced by experiences gathered from the first Gulf War of 1991, both militarily and financially. Militarily, the Pentagon felt that due to technical progress in integrated battlefield management and precision-guided munitions it needed fewer troops than in 1991. Post-war planning assumed a largely intact infrastructure and no major reconstruction requirements. With regard to personnel requirements for controlling the country in the post-war phase, the Administration pointed to the experience in Germany and Japan after World War II where war-weary populations were ready to co-operate with the occupying powers in exchange for a new beginning. This made it seem conceivable that most troops could be withdrawn shortly after the second Gulf War, as in 1991.

Financially, the direct costs of the military commitment were to be borne entirely by the US federal budget, unlike in 1991 when almost 90% of the war costs were covered by financial contributions from the allies. However, the Administration assumed that reconstruction costs would be financed by the Iraqis themselves under a new political regime with revenue from the swift resumption of oil exports. On the basis of exports of two million barrels a day, which was the level of exports under the UN's Oil-for-Food programme in 2002, government revenue from oil exports were estimated to be at least $18 billion a year.

While the Pentagon's low cost estimates for the six weeks of the war against the Saddam regime were accurate, they proved to be wrong for the period after his removal from power. Personnel expenses for controlling the country have increased instead of decreased, and the estimated costs for reconstruction have grown to $75 billion as a result of destruction from looting and sabotage. The anticipated financing from Iraqi resources has faded into the distant future. The domestic fuel supply has become one of the numerous bottlenecks for the economy and oil exports in August 2003 amounted to only 800,000 barrels a day, 40% of what it was in 2002. In the provisional Iraqi national budget for July to December 2003, profits from oil exports were forecast to be $3.5 billion, but actual profits will fall far short of that amount. Initial plans for capitalisation of Iraqi oil reserves through (partial) privatisation of the Iraqi oil industry have failed because of legal problems and political objections, even though they could still be implemented under a future, democratically-elected Iraqi government. Alternative plans for Iraq to borrow against future oil profits, which have recently been discussed as a magic formula in Congress, are unlikely to succeed not only because of problems of conformity with international law but also because there is little of the necessary support from international banks in light of the unsolved question of Iraqi foreign liabilities (with estimates ranging from 160 to more than 300 billion dollars).

Thus the reconstruction of Iraq is threatening to become a long-term budgetary liability for the US. Of the $87 billion for Iraq in the supplementary budget announced by Bush, $20.3 billion is earmarked for reconstruction.

Nevertheless, in Bush's speech of September 7 there was no admission whatsoever of careless planning. Instead, the increasing burden of the Iraq engagement is used by the Administration as additional evidence of the urgent necessity of this commitment within the framework of the war on terrorism because it shows how strong the enemy still is.

The president is following the logic of any government that begins a war and that is dependent on the approval of its population. Pre-war, in order to legitimise the pending decision to proceed, the military assignment is portrayed as a simple, low-cost exercise, in exchange for greater benefits in the future. Once the war has started and the situation in the military theatre takes an unfavourable turn, politicians can count on public support for a considerable expansion of the commitment of personnel and resources given that the alternative of withdrawal would mean admitting defeat.

Stretched resources?

There is no doubt that Congress will approve the supplementary budget. Together with the $79 billion in additional funds already granted in April 2003, this brings the sum of approved funds for the war on terrorism to $166 billion, of which approximately $150 billion is for Iraq.

Nevertheless, Congress and the American public are asking whether the Bush Administration has overstretched the military and financial resources of the country for the commitment in Iraq and a foreign policy dominated by the war on terrorism. The domestic political debate is dominated by two issues: One issue is the direct military, and particularly personnel resources, and the second is the national budget and the possible economic repercussions of an increasing budget deficit.

Senator Robert Byrd, the harshest critic of the Iraq War in the Senate, asked the Congressional Budget Office (CBO) whether a longer commitment of the armed forces as an occupying power in Iraq could be supported with existing military personnel. On September 3, the CBO issued a detailed report which stated that the US, with its present ground forces (US Army and Marine Corps) of 470,000 on active duty and 505,000 reserves, can station from 67,000 to a maximum of 106,000 soldiers in Iraq on a long-term basis without losing the ability to engage in another theatre of war. A higher deployment number (currently 180,000 US soldiers are deployed in Iraq, 30,000 of whom are in Kuwait) would only be possible in the medium-term if additional active units were formed.

At most, a short-term personnel resource problem exists from this perspective: The high number of reservists and National Guard troops currently deployed as well as the long duration of their commitment has led to political irritation in some US states. Since 11 September 2001, 212,000 reservists have been called up and 90,000 national guardsmen have been mobilised. Their time of deployment is rapidly approaching the legal limit of 750 days within five years. The extended foreign deployment of these reservists and the National Guard troops, who are normally stationed at home, has had a significant negative impact on several communities in the U.S., with repercussions on Congress via increasingly frustrated local constituencies. This places even greater importance on the present recruitment efforts, particularly those of the army, which have been clearly expanded and backed up with considerably enhanced financial incentives. Thus far, these efforts have been successful.

Financially, the CBO estimates that a longer-term deployment of 106,000 soldiers in Iraq would lead to additional costs of $19 billion per annum that is not covered by the normal armed forces budget. A strengthening of the forces beyond this number would involve further costs:

- by releasing 65,000 soldiers from administrative tasks through the hiring of additional civilian personnel, one-time costs of $15.1–16.3 billion dollars and annual costs of $6.4–6.9 billion;
- by increasing personnel by 80,000 soldiers via new recruitment, one-time costs of $18–19.4 billion and annual costs of $9.5–10 billion.

The estimated supplementary costs are not trivial in either case, but with a current defence budget of $450 billion they do not pose a significant budgetary burden.

Growth promoting defence budget

Against the background of a rapidly growing budget deficit and a continuingly high current account deficit, concerns are growing in the US and among America's economic partners that the increasing costs of the Iraq commitment and the war on terrorism could become a serious burden on the American economy.

The government and its economic advisers do not see this as a problem. Bush is steadfastly maintaining his course of fiscal stimulation for growth through tax reductions, because it corresponds to his own deep aversion to "big government" which he understands as using the national product for an active, socio-political role of the state in the economy. However, under Bush's leadership, the share of federal spending in GDP is expected to rise from 18.4% in 2000 to at least 21.5% in 2004. The growth in GDP of 3.1% in the 2nd quarter of 2003 is to a large extent directly due to the higher level of debt-financed spending of the federal budget, which increased by 25% over the previous quarter. The current upswing can be fairly attributed in large part to the Iraq War.

This also explains why the US Government wants American businesses, almost exclusively, to profit from the funds budgeted for Iraqi reconstruction. This ensures that this spending will be a growth stimulus for the US economy. Presently, $3.1 billion has been allocated, of which $1.3 billion has gone to Halliburton, Inc. and $1 billion to Bechtel, Inc. Contracts for an additional $1.6 billion are being prepared, about half of which will go to Halliburton.

In the American debate on the financial burden of the war on terrorism, comparisons are currently being made with World War II or the Vietnam War. These comparisons are both reassuring and irritating for the Bush Administration. They are reassuring in purely economic terms. In the mid-1960s the escalation of the Vietnam War occurred during a phase of both high employment and capacity utilisation and quickly led to an overheated economy. In contrast, the current debt-financed spending expansion, similar to the situation of 1940/41, seems to be leading the US economy out of a phase of stagnation. The current burden on the economy under the Bush Administration is still nowhere near the burden placed on the economy by World War II. This is true even though the budget has not plunged so sharply into deficit, measured as a percentage of GDP, in such a short amount of time since the attack on Pearl Harbor (see Fig. 1, p. 8).

Politically, however, the two historical analogies underline the importance of domestic support for the war. This support was lost in the Vietnam War but remained unquestioned during World War II. The greater the support, the greater the willingness of the population to make sacrifices. As the "guns and butter" policy demonstrates, the Bush Administration has placed remarkably little confidence in the population's willingness to make sacrifices.

Guns and butter

At the moment, both government spending and private consumption are still growing in the US. In the 2nd quarter of 2003, the aggregate savings-rate – private savings without depreciation minus governmental deficits as a percentage of GDP – fell below 1% for the first time since 1945. About 70% of US GDP comes from private consumption, 20% from state spending, for a total of 90%. Private investments amounted to 15% of GDP in gross terms (including replacement investments from depreciation) bringing the total to 105%. The excess 5% was made up by foreign countries. The US offers goods and services on credit to the extent of the American deficit on current account.

To draw the conclusion from this difference that the US is living beyond its means is still not justified. In the late 1990s the US economy posted an increasing deficit on current account of more than 4% of GDP. Even then the question of whether this deficit was sustainable was raised. Then, however, the national budget showed a surplus and the technology boom made the American economy the most attractive investment location, drawing in the savings of the world via the capital markets. With these funds, the surplus of imports of goods and services could easily be paid for by exports. The high deficit on current account was also seen by many economists as an indication of the strength of the US economy.

Today the situation has changed. Although the fact that the US budget deficit of approximately 4.5% of GDP is approximately the same as the deficit on current account may be an arithmetic coincidence, it is one which is gaining increasing importance. Net private capital imports into the US have decreased drastically, especially with regard to foreign direct investment. At the same time, the dollar currency reserves of the countries with the highest balance of trade surpluses with the US have increased enormously in recent years (Fig. 2, p. 8). These countries – particularly Japan, China, Hong Kong and South Korea – are currently financing a large part of the exploding US budget deficit by purchasing US Treasury bonds through their central banks. Japan and China alone held nearly 20% of all outstanding US Treasury bonds in July 2003, in the amounts of $444 billion and $126 billion respectively.

As long as the crediting of the US economy by its trading partners functions smoothly, the Bush Administration will have no reason to finance its increased government expenditures, particularly for the war on terrorism, by raising taxes at the expense of private consumption. Thanks to the safeguarded financing of the double deficit through foreign business and central banks, the Administration can continue to offer its voters "guns and butter" for the time being.

This, of course, is not the only reason the Government has refrained from burdening the US taxpayer with the costs of the war on terrorism. After 11 September 2001 it would have received widespread support for such a move. The tax cuts achieved by Bush at the federal level are aimed in particular at granting tax relief to enterprises and investors. The goal is to lower the threshold beyond which an investment is profitable by raising the yield after taxes. Such a policy does not necessarily direct capital into the most productive uses, but can, however – according to the expressed goal – assure that the US remains the best investment location and thus continues to attract capital from all over the world. In this respect, the combination of tax cuts and increased costs for domestic security and foreign policy is not a contradiction for the Bush Administration. The former safeguards economic independence so that the latter does not lead to financial constraints.

The American twin deficit – a problem for the world economy?

The apparently best of all worlds – guns and butter, financed by foreign countries – is not without foreign and domestic problems, disregarding for the moment the economic contradictions and risks. It is indeed possible that this solution will remain intact until Election Day on 2 November 2004 and that Clinton's "It's the economy, stupid!" will not become a liability for Bush's re-election. But this is not something he can count on.

The financing of the budget and current-account deficits by foreign countries is a welcome mechanism for the US to produce an international division of labour without having to concede decision-making power regarding American foreign and national security policies. But this is not genuine cost sharing as during the Gulf War of 1991. This time it is a question of borrowing from the American economy for which interest must also be paid. The result is a further deterioration of the US net asset position vis-à-vis foreign countries. With a rapidly increasing deficit, the current account will continue to burden the balance of capital earnings – a self-perpetuating effect.

There is no doubt that the US, on the one side, and Japan and China, on the other, depend on each other in their mutual foreign trade imbalances. For Japan's economy, which is now taking its first promising steps towards overcoming a decade of crisis, the trade surplus with the US is a decisive growth factor. China needs export-driven growth to cushion the social adjustment pressure brought on by WTO membership. But Chinese and Japanese imports increase the competitive pressure on American manufacturers, who are losing market shares in their domestic markets. For this reason the current US economic growth is accompanied not only by unemployment stagnating at a high level but also by a disproportionately high loss of better paid jobs in manufacturing.

Although the extensive purchases of US Treasury bonds by Asian central banks and the on-going low interest rate policy of the American Federal Reserve Board are currently preventing the increasing US national debt from driving up interest rates in the capital markets, both, however, are leading to a build up of a speculative misallocation of capital and a high inflation potential both in East Asia and in the US. This will lower the ability of central banks to control abrupt interest rate changes and will increase the vulnerability of capital markets to another shock.

The growing balance of trade surpluses, particularly those of the Asian countries vis-à-vis the US, and their exploding dollar currency reserves, as welcome as this may be for the placement of American treasuries, increases the pressure on these countries to float their currencies freely on foreign exchange markets. This affects China in particular, which has pegged its yuan to the US dollar. However, Japan is also attempting to defend the yen against a sharp revaluation through numerous currency support interventions. Pressure on these countries comes from the markets themselves. In anticipation of a revaluation against the dollar, they receive huge amounts of capital inflow, sometimes for less productive purposes. In addition, for political reasons, they are increasingly forced to let the markets determine the value of their currencies, which is especially true for China. US Secretary of the Treasury John Snow has stressed this point, not only during his visit to China at the beginning of September 2003 but also at the meeting of the G7 finance ministers on 20/21 September. In preparation for the autumn meeting of the IMF and the World Bank in Dubai, Snow succeeded in getting a strong appeal to China to introduce more flexibility in its exchange rate policies into the final declaration. Monetary "China bashing" has become politically popular in the US with its growing unemployment problems, while Japan, as the most important security partner of US in the region, can still expect some political consideration to be shown.

A forced revaluation against the dollar would bring considerable risks for the countries involved, and ultimately also for the US itself. In Japan the economic recovery could be interrupted. In China, a strong revaluation could cause a severe financial crisis and a sharp contraction of economic activity, in the wake of which the exchange rate of the yuan could decrease sharply against the dollar. Both countries would then have to limit their purchases of American government bonds or might even become even net sellers of US Treasury bonds – in either case there would be massive effects on the capital markets and interest rates in the US.

International burden sharing?

Does Washington need international help for its increasingly expensive commitment in Iraq? Certainly not on economic grounds. Here an assumption of costs and burdens would be "nice to have" but not something for which the US must beg. However, the growing political risks at home make distribution of the burden on several shoulders appear desirable.

This is also confirmed by the results of the recent survey by the German Marshall Fund of the United States (Transatlantic Perspectives, September 2003) on the attitude of the American public and seven European states towards current American foreign policy. An internationalisation of the Iraq commitment is also being demanded by Democrats in Congress, in response to public opinion, as a condition for their approval of Bush's supplemental budget request. The president now feels forced to take a diplomatic initiative for stronger international burden sharing.

He responded to this domestic political pressure by appearing at the UN General Assembly on September 23. At the same time, however, he also made it clear that the US will not relinquish control of its project to construct a "stable, democratic Iraq" with a free-market economy.

Under these conditions, it is doubtful that the U.S. can gain the truly substantial international support that it hopes for at the "donors conference" for Iraq at the end of October in Madrid. As was underscored by the meeting with Prime Minister Blair, Chancellor Schroeder and President Chirac on September 20 in Berlin, it is clear that all leading partners in the Western alliance are ultimately interested in the successful stabilisation and reconstruction of a democratic Iraq. In this respect the American commitment in Iraq and the war on terrorism could be seen as a kind of "global public good". Because it benefits everyone non-exclusively its costs cannot be covered by the market – or by its political equivalent, the "Coalition of the Willing" – but only by political agreement among its main beneficiaries.

Such an agreement, however, would also have to contain a definition of what constitutes this global public good and what it is meant to provide. In terms of the economic options, the G-8 could be the instrument for such an agreement. In institutional terms, the major administrative role would have to be played by the United Nations, as Germany, France and Russia have proposed.

Thus far the Bush Administration has shown no interest in such a solution. Only massive economic or domestic pressure could force the Administration in this direction, especially if the mobilisation effects of the speeches the president has given since Labor Day should dissipate. Ultimately, the American stock exchanges and the ballot boxes in 2004 will decide whether the Bush Administration has been too ambitious in its foreign and national-security policies.

Figure 1
US budget deficit as a % of GDP 1962–2003

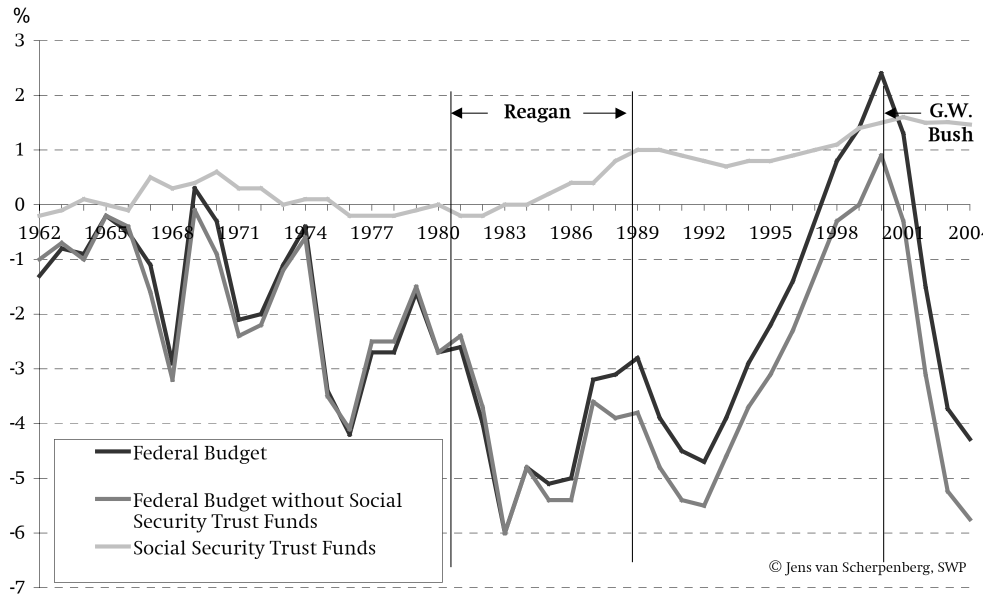
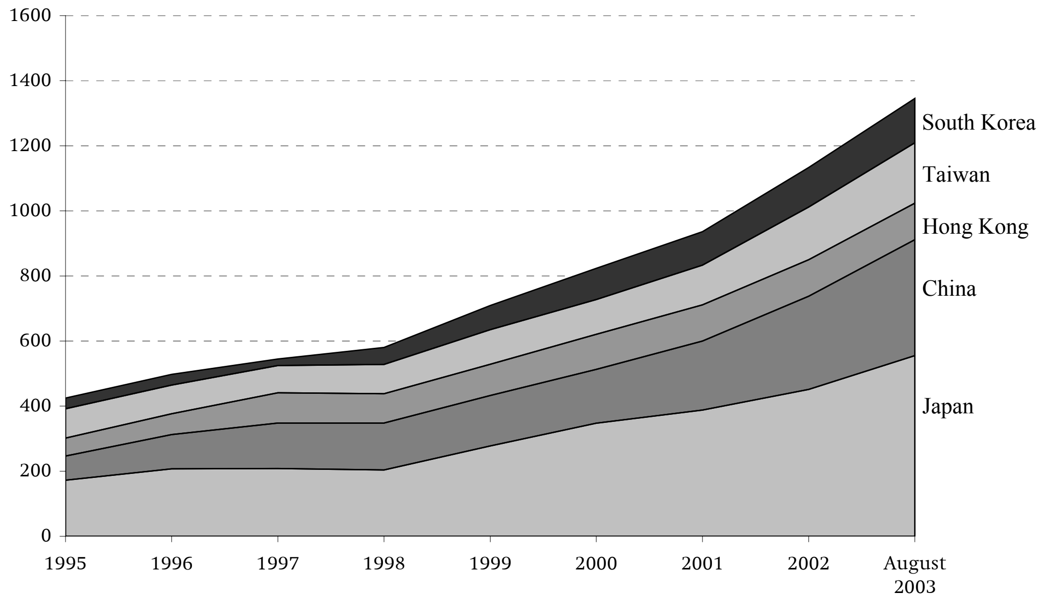


Figure 2
Currency reserves of Asian countries in billion US dollars 1995–2003



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