ISN ETH Zurich

24 July 2014

Another Kind of Victory: Wartime Economic Statecraft

Wars create financial dependencies that powerful creditor nations often exploit. That’s certainly true of the United States, writes Rosella Cappella Zielinski. In World War I and II, it capitalized on Great Britain’s financial vulnerabilities for its own geopolitical gain.

By Rosella Capella Zielinski for ISN

The redistribution of power in the international system has traditionally been attributed to two mechanisms - long-term economic growth and the final outcome of war between victor(s) and vanquished. Yet, in an international system that’s currently defined by economic austerity and anti-war sentiment, the ability of leaders to redistribute power via either of these means is greatly diminished. Neither of these predicaments is likely to last forever, which in turn raises the unpalatable prospect of state trying to flex its geopolitical muscle with military power. But that’s not to say that some states cannot capitalize on wartime to the shift the distribution of power in their favor without firing a single shot.

Wartime vs. Peacetime Economic Statecraft

Economic statecraft has long been used by states to exercise power (and manipulate) over rivals and allies. The formula is straightforward enough: state A withholds (or threatens to withhold) something of value to state B in order to make it comply with a specified form of behavior. Put another way, economic statecraft is about exploiting dependencies.

Yet, while the literature on economic statecraft is vast and comprehensive, it tends to overlook how wartime impacts upon the aforementioned ‘rules of the game’. The few works that do emphasize wartime focus on warring adversaries and are more concerned with how to deny the enemy access to strategic resources or financing. Very little attention is paid to how allies can exploit their own relationships for gain beyond advancing the war effort.

In peacetime, the ability to find substitutes for needed goods is relatively easy. States can bypass sanction regimes by smuggling, conserving resources or developing new markets for goods. During wartime, however, the state may not have time to create these long-term alternatives. In order to match the adversary, the state needs inputs for the war immediately. The penalty for leaders who lose the war, or whose war effort goes badly, ranges from being voted out of office to being put to death. As a result, states are more likely to acquiesce to demands made by states they are dependent upon in wartime rather than peacetime.

Creating Wartime Dependencies

Leaders acquire war inputs by seizing them, making them, or buying them. These inputs include manpower, equipment (reflected via a defense industry or a convertible civilian industry coupled with raw materials), foodstuffs, and transportation assets. When a state supplies its entire war effort via domestic inputs (i.e. autarkic defense production), it negates the need to purchase inputs from abroad and isolates it from financial dependencies.

Wartime dependency occurs when a state needs to purchase goods for its war effort from abroad yet does not have enough of the supplier state's currency to pay for them. Ensuring ample currency to purchase goods from abroad is paramount. In wartime, exports often become limited, as trading partners are hurt by the war, enemies enact blockades, or states convert export-oriented industries for the war effort. Simultaneously, the need to import goods increases in order to supply armed forces. The decrease in exports results in a decrease of currency reserves while the increase in imports increases the need for it. Since self-correcting mechanisms to increase currency reserves are unavailable, states need currency loans to continue wartime purchases, resulting in debtor dependency. The larger the loan, the more difficult the ability of the belligerent state to procure the supplier state's currency. The more intense the war effort, the higher the level of debtor dependency.

The size of the loan varies by price of goods purchased. Military equipment, particularly finished goods such as airplanes or battleships, will be among the most expensive. Given that modern weapons systems are increasingly complex, the ability to switch factors of production within an economy to wartime industrial production is becoming ever more difficult. Thus, we can expect increasing debtor dependency as states purchase expensive finished goods.

Debt dependency also varies with the ability of the belligerent state to procure the supplier state's currency. States that are able to run a balance of payments deficit, whose currency is widely held, or are characterized as having a reserve currency, are more likely to avoid financial dependencies. The demand for the belligerent state's currency provides the state with a unique ability to accrue other national currencies. Supplier states' desire to hold belligerent states' currencies decreases potential dependencies.

Finally, the extent of debtor dependency varies with the intensity of the war effort. As the war expands, the state needs more goods to confront the enemy. Simultaneously, domestic production reaches its limit and the state will need to purchase more war inputs from abroad. At the same time, leaders feel more pressure to win the war in order to avoid losing power. As the political economist Susan Strange wrote, "The greater the perceived threat to security, the higher price will be willingly paid and the greater risk accepted."[i] Thus, the need to purchase goods from abroad is compounded, resulting in increased dependency on creditors extending currency loans.

States unable to secure inputs for war domestically (or pay for imported goods outright) need a currency loan to purchase goods from abroad. In order to mobilize and sustain warfare and ensure leadership and state survival, these states become dependent on their wartime creditors. Once dependent, creditor states are able to exploit their newfound power, extracting concessions on issues or goods the belligerent states would otherwise not acquiesce too. The result is a shift in the distribution of power in favor of the creditor state without having to go to war.

It worked for Washington

While many creditor states have exploited their wartime financial dependencies, the United States has generated the greatest shifts and redistributions of power in the international system. At the start of the First World War, for example, Great Britain attempted to domestically secure its war inputs. Yet, as the war increased in intensity and its French and Russian allies were no longer able to provide for their own war efforts, Britain needed to purchase goods from the United States. And as imports far exceeded exports (especially as Britain assumed financial responsibility for French and Russian dollar contracts in the United States), London did not have enough dollars and gold to purchase American goods outright. In short, Britain needed a dollar loan.

The American government, led by President Wilson and Treasury Secretary McAdoo, realized Britain's newfound dependency and began to exploit it with the goal of replacing the Pound with the dollar as the dominant reserve currency, thereby moving the world financial center away from London in the process. This was not lost on the British. Keynes wrote in May 1918, "It almost looks as if they took a satisfaction in reducing us to a position of complete financial helplessness and dependence."[ii] Unable to continue fighting the war without a dollar loan, the British acquiesced to American demands. While the British, and Allied powers, were able to successfully defeat the Germans, they were unable to preserve Sterling's status. Not only did the financing of the war drain Britain of its assets, it caused the rise of a reserve currency competitor. Washington was able to repeat its wartime dependency exploitation during the Second World War.

A Note of Caution

The United States has, so far, been able to avoid the fate it helped to bestow on Great Britain. The dollar remains the dominant reserve currency and inputs for its war efforts are produced within its borders. However, the two pillars which allow Washington to avoid racking up debts and exploit creditor dependencies might soon be resting upon shakier foundations.

Recent events have brought the supremacy of the dollar into question. Since 2009, China and Russia have used their growing economic prowess to repeatedly call for the replacement of the dollar as the dominant reserve currency. Within the U.S., fears are rising that the recent trend of dollar depreciation will result in decreased demand for the dollar as foreign states restructure their reserve holdings. These fears were compounded in 2013, when an unprecedented near-default on U.S. government debt resulted in credit rating warnings.

In addition, the fact that autarkic defense production is no longer the norm potentially creates new economic vulnerabilities for the United States. For example, the total number of licensed production and coproduction/co-development programs between1986–1990 were almost 200% greater than1961–1965 and more than 50% greater than 1971–1975. In 1990, an Office of Technology Assessment report noted that, "Much weapons technology…is developed by large multinational companies with manufacturing facilities around the world…Many U.S. weapons systems depend…on Japanese and European technology, parts, and components. Interdependence of the defense industries is a fact of life."[iii]

In sum, wartime creates unique financial dependencies that are ripe for exploitation by creditor states. The greater the dependency, the greater the ability of a state to extract concessions that it would not otherwise be able to do. The U.S. capitalized on this dependency in both World Wars to promote the shift in power from Britain to America. The dollar's role as reserve currency and autarkic defense production has maintained U.S. power. That said, these pillars of strength are waning as the dollar comes under question and the U.S. outsources defense production. Thus, if the U.S. does not want to fall into the same trap as Britain during WWII and be exploited by potential creditors in the next big war, it needs to be aware of the dangers that these potential dependencies might create.

[i] Strange, S. (1988) *States and Markets*. New York: Continuum, 29.

[ii] Burk, K. (1979) 'Great Britain in the United States, 1917-1918: the turning point', *The International History Review* 1(2): 228–45, 242.

[iii] Brooks, S. G. (2005) *Producing Security: Multinational Corporations, Globalization, and the Changing Calculus of Conflict*, Princeton: Princeton University Press, 87.

For more information on issues and events that shape our world, please visit the ISN Blog or browse our resources.

Rosella Cappella Zielinski is an Assistant Professor of Political Science at Boston University and a former fellow at the Dickey Center for International Understanding at Dartmouth College.

Publisher

International Relations and Security Network (ISN)

Creative Commons - Attribution-Noncommercial-No Derivative Works 3.0 Unported