

U.S. INTERNATIONAL ECONOMIC STRATEGY IN A TURBULENT WORLD



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Preface

This is the fifth volume in the RAND *Strategic Rethink* project. The project develops conceptual perspectives on how U.S. thinking, institutions, and policies must adapt to the many changes in the international environment, as detailed in the four previous volumes. Together, these studies help clarify the strategic choices that will face the country in the 2016 presidential elections and beyond.

The first volume, anchored by Ambassador James Dobbins, outlines the foreign policy choices that U.S. policymakers now face in three critical regions—the Middle East, Europe, and Asia—as well as on such problems as counterterrorism, climate change, and cybersecurity. The second study, by Hans Binnendijk, assesses the state of U.S. alliances and partnerships, exemplifying three alternative strategies for managing potential adversaries. The third volume, on defense issues, by David Ochmanek and Andrew Hoehn, demonstrates that the United States suffers a “security gap” between its stated military strategy and the resources allocated to its defense posture. The fourth, a Perspective by Ambassador Charles Ries, probes the deficiencies in the U.S. national security policymaking and policy implementation systems, offering eight recommendations for reorganizing and improving decisionmaking in an era of rising challenges and shrinking policymaker bandwidth.

This report presents the strategic choices the United States faces regarding the international economy over the medium term. The United States has largely recovered from the financial crisis and the Great Recession, although it still faces challenges, particularly in ensuring that economic gains reach all members of society and in guarding

against longer-term fiscal problems. Globally, its growth prospects are better than those of many of its traditional allies, and it is a major trader, investor, and innovator. But as the economic weight of traditional allies falls, the weight of potential adversaries and potential new allies in the global economy has been rising.

Although the United States faces many choices regarding the global economy, this report focuses on policy choices in three areas. These include maintaining and improving the rules-based international economic system; working with China and better integrating it into the existing system; and supporting the economic growth of allies, friends, and partners, as well as using economic tools to deter unwanted behavior and adversaries.

This report should be of interest to national leaders and economic policy decisionmakers, practitioners in the executive and legislative branches, analysts, the media, staff and advisers to the 2016 presidential candidates, nongovernmental organizations, and others concerned with the role of the United States and other nations in advancing global economic well-being.

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Contents

Preface	iii
Figures and Tables	ix
Summary	xi
Acknowledgments	xix
Abbreviations	xxi
CHAPTER ONE	
Economic Issues in the United States' Role in the World	1
Economics and U.S. National Strategy	2
The Ends of Economics and the Means to Achieve Them	3
CHAPTER TWO	
The U.S. Economy Today	9
Positive Growth, Productivity, and Financial Conditions	9
Trouble in the Labor Force	13
Trouble with Government Finances	21
Summing Up the U.S. Economy Today	25
CHAPTER THREE	
How the U.S. Economy Connects with the World	27
International Trade	28
Foreign Direct Investment	30
The Energy Revolution	34
The Federal Reserve	39
Conclusion	41

CHAPTER FOUR

The United States' Economic Standing in the World 43

Gross Domestic Product and the U.S. Share of the World Economy 46

Population Trends 49

World Trade 50

Foreign Direct Investment 52

Intellectual Property 55

The Labor Force 60

Interpreting Global Economic Trends 63

CHAPTER FIVE

Strategic Choices Abroad: Maintaining the Liberal Rules-Based International System 67

The Pillars of the Liberal Rules-Based System 68

Trade Liberalization 69

Multilateral Institutions 77

Liberal Capitalism Versus State Capitalism 81

Conclusion 82

CHAPTER SIX

Strategic Choices Abroad: China 85

Recent Events in China 86

An Unbalanced Economy 88

Reaching Out to the World 93

The U.S.–China Economic Relationship 95

China and the Mega-Trade Deals 100

China and International Institutions 101

A Bilateral Instrument for Working with China 106

Engaging with China 109

CHAPTER SEVEN

Strategic Choices Abroad: Supporting Partners and Deterring Unwanted Behavior 111

Restoring Growth in Allies and Reviving Growth in Unstable Regions 112

Balancing Sanctions and the Economy 120

Conclusion 124

CHAPTER EIGHT

Conclusion: U.S. Policy Choices for the Global Economy..... 125

The Rules-Based Global Economic System 126

The Rise of China..... 127

Supporting Partners and Deterring Unwanted Behavior..... 128

Paving the Way for the Next Era of Global Growth..... 129

References 131

Figures and Tables

Figures

2.1.	Growth of U.S. Gross Domestic Product.....	10
2.2.	U.S. Inflation as Measured by the Consumer Price Index.....	11
2.3.	U.S. Private-Sector Multifactor Productivity Growth.....	12
2.4.	Monthly Change in Nonfarm Employment.....	15
2.5.	Monthly Unemployment and U-6 Rates	16
2.6.	Labor-Force Participation, All Working-Age People and Prime Working-Age People.....	17
2.7.	Index of Median Weekly Earnings	19
2.8.	Median Weekly Earnings by Education	20
2.9.	Federal Debt Held by the Public.....	22
2.10.	The Long-Term Debt Profile (as a percentage of GDP)	23
3.1.	U.S. Current Account Balance (as a percentage of GDP).....	29
3.2.	Goods Trade Balance and the Services Trade Balance.....	30
3.3.	Services Trade as a Percentage of Goods Trade	31
3.4.	Direct Investment Position	32
3.5.	Sales by Multinational Affiliates Versus Trade	34
3.6.	U.S. Natural Gas Prices Versus Selected International Natural Gas Prices.....	37
3.7.	The Decline in Petroleum Prices.....	38
4.1.	Share of Nominal World GDP.....	47
4.2.	World Population	49
4.3.	Share of World Trade of Goods and Services	51
4.4.	Share of World Exports of Goods and Services.....	52

4.5.	Share of Outward Direct Investment.....	53
4.6.	Share of Inward Direct Investment.....	54
4.7.	Share of Global Patent Applications by National Origin.....	57
4.8.	Share of Global Patents Granted by National Origin.....	58
4.9.	Proportion of National-Origin Patents Granted Abroad.....	59
4.10.	Labor-Force Participation.....	61
4.11.	Female Labor-Force Participation.....	62
4.12.	Male Labor-Force Participation.....	63
6.1.	The U.S.–China Merchandise Trade Deficit.....	96
6.2.	World Shares of U.S. Imports.....	97
6.3.	Share of Goods and Services Supplied by U.S. Majority-Owned Foreign Affiliates, by Destination.....	99

Tables

4.1.	GDP Growth Projections for 2016 and 2017.....	44
5.1.	Decline of Poverty in the Developing World.....	69
6.1.	Chinese Annual Average Per Capita Economic Growth, by Decade.....	87
7.1.	Average Annual Growth of Real Per-Capita GDP.....	113

Summary

The upcoming U.S. presidential election presents an opportunity to confirm, better define, or redefine the United States' role in the world. Economic power and policy will have an important place in any conception of the United States' role in the world.

The goal of U.S. international economic policy is to contribute to national economic growth and prosperity. Contributing to the prosperity of allies and friends and seeking global growth and development more generally supports this goal. Rising domestic standards of living have been an important policy goal of the United States for generations. A strong economy is also necessary to pay for the implementation of foreign policy. Tax revenues are necessary to fund military, diplomatic, commercial, environmental, and humanitarian efforts.

Among the tools the United States has at its disposal are:

- treaties and agreements with other countries
- international financial institutions
- policy coordination and discussion with other countries, often through the international financial institutions or other multilateral venues
- foreign assistance to help countries overcome social and security problems and to accelerate growth
- sanctions to dissuade countries from pursuing specific policies inimical to U.S. interests, or to punish them for doing so
- domestic laws and regulations regarding international trade and investment.

An even more powerful tool is the strength of the domestic U.S. economy. U.S. economic power, its market size, its ability to generate and execute policy ideas, and its ability to shape those ideas so that other countries see benefits are among the reasons for its longstanding leadership of the global economy. Accordingly, improving the U.S. economy is an essential part of exercising international leadership.

The United States and its allies have created a rules-based, global economic system in which nations are relatively free to trade and invest with each other. An important challenge is that although the United States is still the world's largest single economy, the economies of countries that have not necessarily been close partners are growing more quickly, and the economies of traditional allies, particularly Europe and Japan, are growing more slowly. This means that the combined economic weight of the United States and its traditional partners is receding. How this will affect the United States' ability to maintain and improve the global economic system is unclear, but it certainly does not make the job easier. Accordingly, the United States and its allies will need to carefully consider not only how to maintain a system that has provided enormous benefits regarding global growth and poverty alleviation, but also how to better integrate the developing economies into the system, both as participants and as countries with a voice in the formation of system rules.

The U.S. Economy: Domestic Status, Connections with the World, and Relative Global Standing

The United States has largely recovered from the Great Recession, which officially started in December 2007 and ended in June 2009 and which was the deepest U.S. economic downturn since the Great Depression. As of early 2016, U.S. growth, inflation, and unemployment were all favorable. However, the country still faces challenges, particularly in ensuring that economic gains reach all members of society and in guarding against longer-term fiscal problems.

U.S. involvement with the world also has grown. Total trade has expanded from 19.2 percent of gross domestic product (GDP) in 1991

to 29.9 percent in 2014. Similarly, foreign direct investment by U.S. companies grew from 7.6 percent of GDP in 1991 to 28.4 percent in 2014, and the stock of investment by foreign companies in the United States grew from 6.8 percent of U.S. GDP in 1991 to 16.7 percent in 2014.

In the immediate term, U.S. growth prospects are better than those of any other major developed country. Among the world's top five developing nations—Brazil, Russia, India, China, and South Africa—U.S. prospects outstrip those of three: Brazil, Russia, and South Africa. Nonetheless, the U.S. share of the global economy has been falling somewhat, largely because numerous developing countries are growing more rapidly.

One factor helping the United States maintain its economic and population growth is immigration. Immigrants constituted 34.7 percent of U.S. population growth between 1990 and 2000, 33.6 percent between 2000 and 2010, and 23.5 percent between 2010 and 2014. In addition, immigrants have contributed substantially to innovation and technological change in the United States. Because economic growth rates are the result of growth in capital, labor, and productivity, sustained and significant levels of immigration will help the United States retain the standing and influence in the world that stems from its economic size.

Despite the growth of other countries, the United States remains the leading economy in terms of GDP, a major trading country, and the leading exporter of services, as well as the leading global investor in terms of direct investment. The United States also leads in innovation, filing high-quality patents and hosting the world's leading research universities. The United States also dominates financial markets. Since 1996, the U.S. dollar has constituted more than 60 percent of global official reserves among the reserves for which a denomination is known. In addition, much of global trade is denominated in dollars, even in East Asia, where China is the leading trading partner of many countries. This combination of dominance of international reserves and dollar-denomination of trade has enabled the United States to borrow in dollars globally without worrying about exchange rate risk.

The biggest weakness the United States faces globally is the relative decline of its leading allies. The European and Japanese economies have not been performing well and both have lost much more share in the global economy than has the U.S. economy. Notably, they have retained their innovation potential and have increased the proportion of working age people who choose to join the labor force, both of which help foster economic growth.

Although the United States faces many choices regarding the global economy, there are three broad policy areas in particular that demand attention. These include maintaining and improving the rules-based international economic system; working with China and better integrating it into the existing system; and supporting the economic growth of allies, friends, and partners, as well as using economic tools to deter unwanted behavior and adversaries, or to shape the actions of other countries.

The Rules-Based Global Economic System

Safeguarding, maintaining, and broadening the liberal, rules-based global economic system and its institutions present one set of choices facing U.S. policymakers. The liberalization of global trade and investment has contributed enormously to global economic growth.

With the dual goal of liberalizing trade and maintaining the legitimacy of the World Trade Organization (WTO), the United States should aim to restart a new broad-based multilateral negotiating round. Although the most recent multilateral round, the Doha Development Agenda, fell through, there is value to developing sets of rules to apply to all countries. Given the changes in the global economy since the last broad-based agreement was concluded in 1995, there are no doubt areas that a new agreement could address.

A new multilateral round will present challenges, however. Therefore, the United States also should aim to negotiate agreements with smaller groups of countries within the WTO, but they should be agreements that apply to all countries and that can be easily joined by new signatories after they are negotiated. Such “open plurilateral agree-

ments” may be all that can be achieved even if a new multilateral round gets started.

Among regional trade agreements, U.S. policymakers should strive to complete and approve some version of a broad Pacific trade and investment agreement and a broad Atlantic trade and investment agreement. They should then turn to expanding participation in those agreements and having them supersede existing agreements to reduce complexity in the system.

The United States also will benefit by ensuring that such global institutions as the International Monetary Fund (IMF) and the World Bank, as well as regional development banks, are strong and effective. For both sets of institutions, this means better integration of growing developing countries into the governance structure so that the institutions retain legitimacy. The IMF will benefit from having enough capital and policy freedom to respond to the possibility of a new recession and increased difficulties that countries are having with the global slowdown being experienced in early 2016. The World Bank will benefit if the United States can spur reforms that increase agility and ensure changes based on the results of evaluations.

The Rise of China

Despite current economic difficulties, China is still growing and likely will continue to grow, gaining more economic influence in the world. The United States will benefit most if China’s rise can be accommodated within the current global system. The two economies are intertwined, and many U.S. allies have sizable trade and investment relations with China.

Creating an on-ramp for China into a Pacific trade deal that is finally approved should be a priority. In 2014 (the latest year for comparable data), China was the largest exporter and the second largest importer of goods and services in the world, just ahead of the United States in exports and behind in imports. The United States had the most total trade. Bringing China into a Pacific trade deal will be neither easy nor quick, but creating a commitment will enable both China

and the incumbent members of any trade deal to treat negotiations more seriously and could strengthen forces for reform in China. The United States also could contemplate joining a parallel trade deal that China is negotiating with Asian partners.

Other negotiations that will not be easy are those involving a new U.S.–China bilateral investment treaty. Both countries could derive great value from an agreement representing broad investment liberalization and containing strong enforcement provisions. Such a deal also could help empower China’s reformers and more closely lock China into the current rules-based international system.

It is less clear how the United States should approach new China-led development institutions, specifically the Asian Infrastructure Investment Bank and the New Development Bank. At a minimum, it should monitor and report on their activities to act as an external and transparent check on them. The United States also could work to foster cooperation between those institutions and other regional development banks or U.S. development agencies, or the United States could attempt to join them. It is likely China would welcome U.S. participation, albeit in a subordinate role. These options will require further study and will depend, in part, on how well the banks operate in their early years.

Supporting Partners and Deterring Unwanted Behavior

Regardless of whether the world moves into recession in 2016 or 2017, as some fear, the United States still has an important role in fostering global growth and development. For its advanced country partners, economic integration via the large regional trade agreements can help, as can policy coordination. Otherwise, these partners will need to execute the policies they believe they need and it will be up to them to determine how and whether the United States can help.

For developing countries, maintaining aid levels should be the minimum policy and increases should be considered. Stronger, actionable evaluations should be a component of aid delivery; forms of aid

that do not work or that benefit the U.S. economy while delivering little to the host economy should be minimized.

Greater policy certainty with trade preferences also will benefit the United States and partner countries. The United States offers an array of trade preferences, but these often come up for renewal and this renewal is delayed, leading to economic uncertainty. Additionally, the United States should consider integrating more developing countries into its system of free trade agreements and unifying these agreements to lower complexity.

While the United States can help the economies of other countries, it also can hurt them through sanctions in an attempt to change behavior. These programs should be evaluated regularly for their effectiveness and for how well they strike a balance between shaping behavior and hurting the target country's population.

Paving the Way for the Next Era of Global Growth

The world economy faces numerous challenges as of early 2016. Growth in most major economies either has slowed or is slowing; a major multilateral trade round has fallen through; global debt is increasing, especially that of emerging markets; and developing countries are slowing as well, stemming in part from China's economic slowdown. In addition, parallel institutions are emerging, with unknown effect.

The U.S. economy also faces challenges. In considering any strategy, U.S. leaders will benefit by getting the domestic economic house in order. The most important problems include opportunity in the U.S. labor market and the longer-term fiscal outlook. Growing polarization may make solving these problems more difficult, but not solving them will harm U.S. economic performance, and therefore credibility and ability to lead.

The United States has led the world economy for several reasons, including its economic size, its ability to formulate and execute policies, and the fact that most countries have found it in their interest to follow the United States' lead. Even with global challenges, there

is little reason to think that the rules-based international system that has evolved since the end of World War II is any less useful now than it was throughout the postwar era. Furthermore, ideas for replacing it are scarce. Therefore, the United States should strive to maintain and improve the system, integrating growing economic powers to maintain system legitimacy, improving global rules to foster free exchange, and working to spur growth and development so that lives are improved and countries find the U.S.-led system a desirable one in which to participate.

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Abbreviations

AIIB	Asian Infrastructure Investment Bank
ASEAN	Association of Southeast Asian Nations
BEA	Bureau of Economic Analysis
BIRS	Brazil, India, Russia, and South Africa
BLS	Bureau of Labor Statistics
BRICS	Brazil, Russia, India, China, and South Africa
CBO	Congressional Budget Office
EU	European Union
FDI	foreign direct investment
FRED	Federal Reserve Economic Data
G7	Group of Seven (the United States, Canada, France, Germany, Italy, Japan, and the United Kingdom)
GATT	General Agreement on Tariffs and Trade
GDP	gross domestic product
IMF	International Monetary Fund
LFP	labor-force participation
LNG	liquefied natural gas
NAFTA	North American Free Trade Agreement
OECD	Organisation for Economic Co-operation and Development
PPP	purchasing-power parity

R&D	research and development
RMB	renminbi
TPP	Trans-Pacific Partnership
TTIP	Trans-Atlantic Trade and Investment Partnership
UK	United Kingdom
WTO	World Trade Organization

Economic Issues in the United States' Role in the World

Building up to the presidential election of 2016, policymakers and policy analysts have focused their attention on redefining—or better defining—the United States' role in the world. This has included rethinking the overall connections among U.S. foreign policy goals, how to achieve those goals, and what resources can be brought to bear for the effort. Economic power and policy will play an important role: Certainly since the end of World War II, they have helped define the United States' global leadership.

There are good reasons to undertake a strategic reassessment of the United States' role in the world. Although well out of recession, the United States is still dealing with the effects of its worst financial crisis and economic downturn since the Great Depression. Unemployment is low, but jobs appropriate for people with medium levels of education are disappearing, raising concerns about the future standard of living of many Americans. The nation is facing fiscal challenges. Taxes will have to be raised or benefits cut as the baby-boom generation retires and seeks to tap underfunded government pension and medical programs. The alternative is the buildup of unsustainable levels of debt. The share of global income earned by the United States and its allies has been declining at a time when major nations have violated norms of sovereignty and international behavior. Resurgent and new terrorist groups are challenging the lives, security, and prosperity of the United States and its friends and allies.

Rethinking the United States' role in the world is not a new exercise, and the foreign policy goals and purposes of the United States are

perennially subject to reexamination. In the late 1990s, two academic strategists noted that the United States needed a new grand strategy after the end of the Cold War and the closing of the 20th century, and evaluated four options.¹ In 2001, the Center for the Study of the Presidency noted in a report that “the United States confronts a fundamental strategic transformation. . . . A new comprehensive strategic assessment is needed to address our critical deficiencies.”² Leading up to the 2012 election, a report from the Center for a New American Security noted that “America confronts a world in transition. . . . America’s next president must confront all these changes and many more.”³

Economics and U.S. National Strategy

To define the role of economics in U.S. strategy toward international affairs, it is helpful to start by exploring the elements of strategy in general. Definitions abound in the literature on security, management, and government. Gaddis and Rumelt both provide particularly useful definitions.⁴ For Gaddis, strategy is “the calculated relationship of means to large ends.”⁵ For Rumelt, good strategy contains three elements: a diagnosis of a challenge, simplifying reality and identifying critical aspects; a guiding policy, setting out the overall approach to overcoming obstacles, thereby marking what types of actions can be used and

¹ Barry R. Posen and Andrew L. Ross, “Competing Visions for U.S. Grand Strategy,” *International Security*, Vol. 21, No. 3, Winter 1996/97, pp. 5–53.

² Center for the Study of the Presidency, *Comprehensive Strategic Reform: A Panel Report for the President and Congress*, Washington, D.C., 2001, p. 1.

³ Richard Fontaine and Kristin M. Lord, eds., *America’s Path: Grand Strategy for the Next Administration*, Washington, D.C.: Center for a New American Security, 2012, p. 5.

⁴ John Lewis Gaddis, “What Is Grand Strategy?” prepared as the Karl Von Der Heyden Distinguished Lecture, Duke University, February 26, 2009; Richard P. Rumelt, *Good Strategy Bad Strategy: The Difference and Why It Matters*, New York: Crown Business, 2011.

⁵ Gaddis, 2009.

what kinds will be ruled out; and a set of coherent actions that are coordinated and work together to accomplish the guiding policy.⁶

These definitions are not far apart. Both contain some element of a goal—“large ends”—and an approach to overcoming a diagnosed challenge. Both also specify that any strategy should describe actions that will work together to help the organization achieve its ends, and both suggest that those actions be chosen carefully—even rationally—with the purpose of working together to achieve the defined aims.

Rumelt notes one other point: A strategy is much like a scientific hypothesis—an educated prediction about how the world will work, based on insight but tested against known principles and accumulated knowledge, and then refined once the hypothesis is tested. One additional factor distinguishes this process from most of science but is common with engineering: The environment may change. The rethinking as already described is essential to strategy. Ends, ways, and means are defined; the results and changes in the environment are observed; and then the ends, ways, and means are redefined based on results.

The Ends of Economics and the Means to Achieve Them

The ends of U.S. international economic policy are to contribute to national economic growth and prosperity. Contributing to the prosperity of allies and friends and seeking global growth and development more generally support this goal. Rising standards of living have been an important policy goal of the United States for generations. A strong economy is also necessary to pay for the implementation of foreign policy. Tax revenues are necessary to fund military, diplomatic, commercial, environmental, and humanitarian efforts.

U.S. economic policy can influence the well-being of other nations, and thus the United States' global standing. The 2008 financial crisis was a major contributor to global recession, creating resentment in some countries and denting the preeminence of U.S. financial and economic leadership. As the U.S. economic recovery outstrips that

⁶ Rumelt, 2011, pp. 77, 84.

of many other nations, a commensurate gain in U.S. clout over international economic policy and governance may follow.

The United States and its allies have created a rules-based, global economic system in which nations are relatively free to trade and invest with each other. An important challenge is that although the United States is still the world's largest single economy, the economies of countries that have not necessarily been close partners are growing faster, and the economies of traditional allies, particularly Europe and Japan, are growing more slowly. This means that the combined economic weight of the United States and its traditional partners is receding. How this will translate into U.S. ability to maintain and improve the global economic system is unclear, but it certainly does not make the job easier. Accordingly, the United States and its allies will need to carefully consider how to integrate the developing economies into the system, both as participants and as countries with a voice in the formation of system rules.

Within this system, the World Trade Organization (WTO), free trade agreements, bilateral investment treaties, and other mechanisms form the international institutional foundation. The International Monetary Fund (IMF), originally the creation of the United States and its allies, has now become the global central bank. It assists all member nations experiencing balance-of-payments or other economic crises. The United States and its allies also created a set of multilateral institutions that provide lending and expert advice to help poor nations grow—the World Bank, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, and the European Bank for Reconstruction and Development, among others. Assistance to poorer countries also can increase U.S. security. For example, analysis of the causes of civil wars has found that slow economic growth is associated with such wars, as are events that cause economies to fall into recession.⁷ Such wars can have spillover effects for U.S. allies or result in ungoverned spaces that serve as havens for violent groups.

⁷ Christopher Blattman and Edward Miguel, "Civil War," *Journal of Economic Literature*, Vol. 48, No. 1, March 2010, pp. 3–57.

Another segment of this global economic infrastructure includes institutions that enable policy coordination and progress toward economic liberalization and advancement. For example, the Organisation for Economic Co-operation and Development (OECD) is a group of more than 30 democratic market economies that serves as a forum for sharing best practices, maintains multicountry databases, and publishes research and policy reviews. Other such organizations include the Group of Seven (G-7)—the United States, Canada, France, Germany, Italy, Japan, and the United Kingdom (UK)—and the G-20 group of leading economies as well as the Asia Pacific Economic Cooperation forum and the International Energy Agency. Although these organizations have critics, most of the criticism focuses on their actions rather than the need for or desirability of their existence. This network of institutions, with the United States as either the leading nation or an influential voice, has enabled a more liberal international economic order. The resulting growth in trade and economic exchange has enabled greater global prosperity.⁸ More important from the U.S. point of view, it has enabled domestic economic growth and prosperity and helped attract a large set of countries to participate in this system because of the benefits they derive from it.

For all of these reasons, economics is an important part of U.S. international strategy, to the degree that some argue it should even play a leading role.⁹ Looking forward, sustained U.S. economic growth would allow the United States not only to invest in infrastructure and education at home, but also to maintain the institutions and personnel needed to fulfill its foreign-policy and defense goals, heighten its standing in the world, and continue to set a global agenda that has benefited not only U.S. citizens but billions worldwide.¹⁰ U.S. national security

⁸ Jeffrey A. Frankel and David H. Romer, "Does Trade Cause Growth?" *The American Economic Review*, Vol. 89, No. 3, 1999, pp. 379–399.

⁹ Robert Zoellick, "The Currency of Power: Want to Understand America's Place in the World? Write Economics Back into the Plan," *Foreign Policy*, November 2012, pp. 67–73; Robert D. Blackwill and Jennifer M. Harris, *War by Other Means: Geoeconomics and Statecraft*, Cambridge, Mass.: Harvard University Press, 2016.

¹⁰ Zoellick, 2012.

strategies have long included the goal of promoting global prosperity, but often as one piece of or as an adjunct to other policies.¹¹

The United States has a variety of policy tools to deal with the international economy. It can:

- improve its own economy (As noted, a healthy economy enables the United States to take most necessary actions. It also may have more effect on the global economy, U.S. allies and friends, and the developing world than any other policy measure the federal government could take.)
- sign and enforce treaties and agreements with other countries
- approve and enforce domestic laws and regulations regarding international trade and investment
- support international financial institutions
- engage in persuasion and discussion with other countries on improving and coordinating economic policies, often through the international financial institutions or other multilateral venues
- provide foreign assistance to help countries overcome social and security problems and to accelerate growth
- levy sanctions to dissuade countries from pursuing specific policies inimical to U.S. interests, or punish them for doing so
- conduct monetary policy in a way that supports other countries, or minimizes harm to them, in the context of the Federal Reserve fulfilling its dual policy mandates of price stability and maximum sustainable employment.

These tools give the United States strong influence, but nothing close to full control. Nearly 200 governments, hundreds of millions of businesses, and billions of consumers also get a vote.

To date, intellectual leadership and economic size have enabled the United States to lead the development of the international system in such a way that other nations find it useful to join out of self-interest. Whether

¹¹ White House, *A National Security Strategy for a Global Age*, Washington, D.C., December 2000; White House, *The National Security Strategy of the United States of America*, Washington, D.C., March 2006; White House, *National Security Strategy*, Washington, D.C., May 2010.

this will continue to be the case will therefore depend in part on whether the United States can maintain intellectual leadership, which in turn can benefit from a well-understood and agreed-upon strategic vision. There is some fear that increased political polarization has made the solution of domestic and foreign problems that face the country far more difficult.¹² Addressing that problem is well beyond the scope of this report, but it is possible to at least lay out options for international economic policy that a reasonably functioning system can hope to achieve.

A number of methods and data sources were drawn upon to arrive at these options. For policy options, the report focuses on the international economy. Numerous domestic policy issues influence U.S. interactions with the global economy. But many U.S. international policy choices can be made independently of numerous different domestic policy choices, as evidenced by international economic policy consistency across administrations for many decades. So, the report maintains a focus on the international. In exploring the major international policy issues, it incorporates analysis by academics and policy research organizations and draws from media reporting, to stay current within publication timelines, as well as from original documents. To set the stage for the analysis, the report includes official U.S. data on the domestic economy and on U.S. interactions with the global economy, as well as multilateral data sources to create cross-country comparisons.¹³

To better understand U.S. options, it is first useful to understand the environment in which the United States is operating. Accordingly, in the next three chapters, the report describes the state of the U.S.

¹² James A. Thomson, *A House Divided: Polarization and its Effect on RAND*, Santa Monica, Calif.: RAND Corporation, OP-291-RC, 2010.

¹³ Main U.S. data sources included the Bureau of Economic Analysis (BEA) of the U.S. Department of Commerce, the Bureau of Labor Statistics (BLS) of the U.S. Department of Labor, the Congressional Budget Office (CBO), the Energy Information Administration of the U.S. Department of Energy, the U.S. International Trade Commission, and Federal Reserve Economic Data (FRED) of the Federal Reserve Bank of St. Louis. Main multilateral data sources included the IMF, the United Nations Conference on Trade and Development, the World Bank (specifically its World Development Indicators databank), and the World Intellectual Property Organization. Specific citations of these sources are included throughout the report.

economy today, the global connections of the United States, and how the United States compares with the rest of the world. It then goes on to list the main strategic choices that policymakers face regarding the economic aspects of U.S. engagement with the world. Chapter Five covers supporting the rules-based international economic system, and Chapter Six discusses the United States' relationship with China. Chapter Seven discusses the challenges of using economic policy in supporting friends, allies, and partners and dissuading adversaries or countries whose actions are counter to U.S. interests. Chapter Eight lists conclusions and policy recommendations.

The U.S. Economy Today

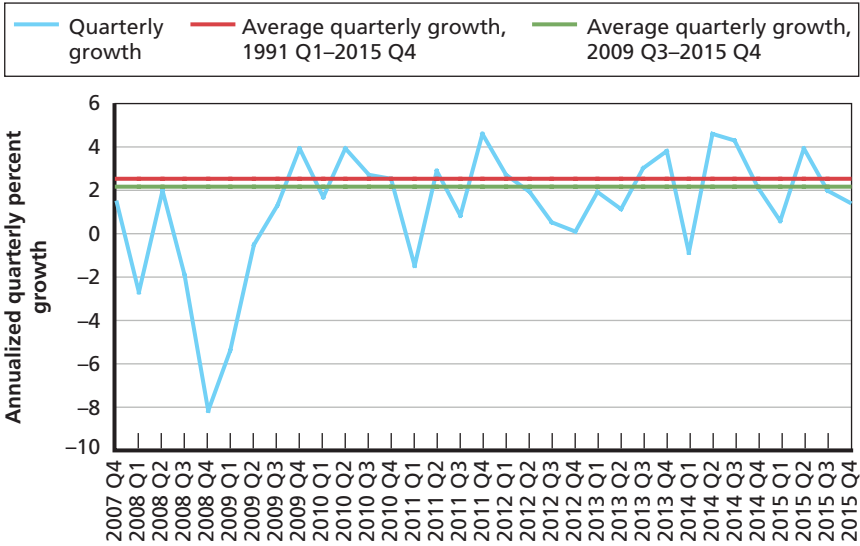
The United States has largely recovered from the Great Recession, which officially started in December 2007 and ended in June 2009 and was the deepest U.S. economic downturn since the Great Depression. However, the country still faces challenges, particularly in ensuring that economic gains reach all members of society. In addition, an aging population may create a longer-term drag on aggregate growth, and the U.S. budget outlook is weak. Although this report focuses on U.S. strategy regarding the international economy, U.S. ability to carry out any strategy that involves international engagement will be more difficult without public support and economic strength at home. Policy questions for shoring up domestic strength should focus on labor market policy, including the development of human capital and improving immigration policy; encouraging productivity through private and public investment; and improving fiscal policy.¹

Positive Growth, Productivity, and Financial Conditions

Postrecovery growth of gross domestic product (GDP) has been positive on average, but volatile, with quarterly growth ranging from -1.5 percent to 4.6 percent and averaging 2.1 percent through the fourth quarter of 2015 (Figure 2.1). This is lower than the average quarterly growth

¹ Immigration is discussed in Chapter Four in the section on population trends. High immigration flows are a major reason for continued growth in the U.S. population.

Figure 2.1
Growth of U.S. Gross Domestic Product



SOURCE: BEA, "Gross Domestic Product: Percent Change from Preceding Period," downloadable spreadsheet, *National Economic Accounts: Gross Domestic Products*, U.S. Department of Commerce, March 25, 2016b.

NOTE: The period starting in the third quarter of 2009 is the recovery period following the Great Recession.

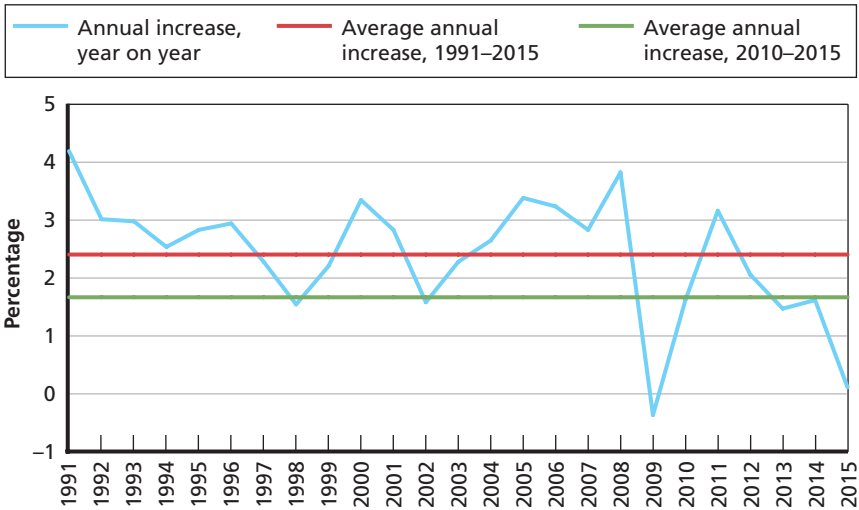
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of 2.5 since 1991, a period that included two recessions, including the Great Recession, and the end of a third recession.

Other indicators have performed more strongly. Much credit for the recovery must be given to unprecedented monetary expansion by the Federal Reserve in response to the Great Recession. For a time, there were fears that this expansion would spur sharp increases in inflation.² However, inflation has remained low (Figure 2.2). This is not an unalloyed positive, however. The current very low inflation is well

² Rolfe Winkler, "Fed Walks the Tightrope," *Reuters*, July 29, 2009; Binyamin Appelbaum, "A Fed Policy Maker, Changing His Mind, Urges More Stimulus," *New York Times*, January 27, 2014; Martin Feldstein, "The Puzzle Over Low Inflation Will Be Resolved Soon," *MarketWatch*, June 2, 2015.

Figure 2.2
U.S. Inflation as Measured by the Consumer Price Index



SOURCE: BLS/FRED, "Consumer Price Index for All Urban Consumers: All Items [CPIAUCNS]," undated-e.

NOTE: The period starting in 2010 is the recovery period following the Great Recession.

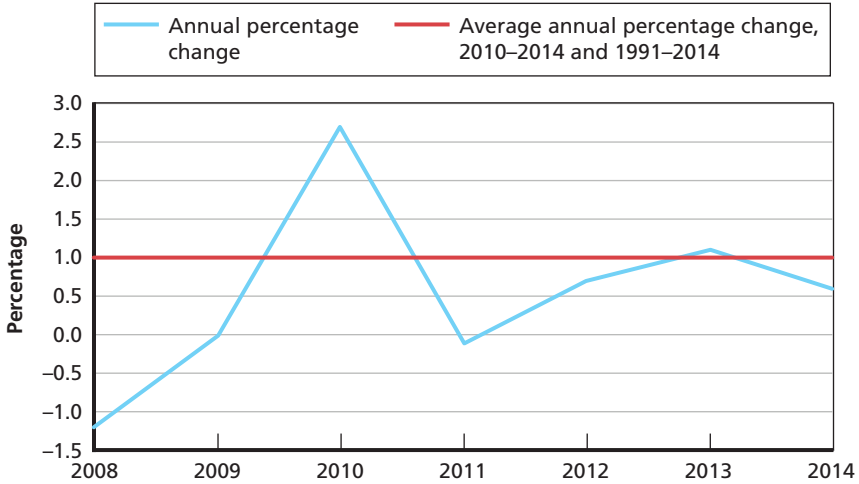
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below the Federal Reserve's target of 2 percent, suggesting weakness in the economy, despite some positive indicators.³

The productivity of the private-sector economy also has remained positive, with average annual growth in multifactor productivity from 2010 through 2014 matching average annual growth since 1991 (Figure 2.3). Multifactor productivity measures the productivity of the economy after taking account of growth of capital and labor. Increases in capital should raise output, as should increases in labor. Any additional growth beyond those increases means the economy is using those

³ John Hilsenrath, "Fed Minutes Reveal Officials' Concern About Low Inflation," *Wall Street Journal*, January 6, 2016. Figure 2.2 shows inflation as measured by the consumer price index, the inflation measure most known to the public. The Federal Reserve actually uses a different measure, that for personal consumption expenditures. This does not, however, change the underlying point about low—and maybe too low—inflation.

Figure 2.3
U.S. Private-Sector Multifactor Productivity Growth



SOURCE: BLS, “Net Multifactor Productivity and Costs, 1987–2014: Private Business Sector (Excluding Government Enterprises),” June 23, 2015.

NOTE: The period starting in 2010 is the recovery period following the Great Recession.

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resources more efficiently, getting more out of capital and labor than it has in the past. If capital and labor are measured correctly, increases in multifactor productivity usually reflect innovation in inputs, processes, or organization. U.S. labor productivity, in contrast, has been low since 2010. The causes of this are poorly understood.⁴

Financial conditions also have generally been positive, driven largely by Federal Reserve monetary policy. Despite stock market declines in January 2016, the Standard and Poor’s 500 index rose from a Great Recession low of 676.53 on March 9, 2009, to a close of 2,043.94 on December 31, 2015.⁵ Thirty-year conventional mortgage

⁴ Alan S. Blinder, “The Mystery of Declining Productivity Growth,” *Wall Street Journal*, May 14, 2015.

⁵ Yahoo! Finance, “S&P 500 (^GSPC) Historical Prices,” undated. Prices cited are the adjusted close.

rates have averaged 4.21 percent from July 2009, the end of the Great Recession, to December 2015, well below the 1991 to 2015 average of 6.35 percent.⁶ And 48-month new auto loan rates have averaged slightly more than 5 percent since July 2009, compared with almost 7.7 percent for the period 1991 to 2015.⁷

Trouble in the Labor Force

Despite positive overall economic conditions, trends in the labor market have been more mixed. Employment is growing, and the unemployment rate—by several measures—is once again low, suggesting that people who want jobs can generally find them. However, wages have been flat, and the proportion of people who could work but do not want to (for whatever reason), known as labor-force participation (LFP), has fallen. More worrisome, jobs available for people with medium levels of skills are declining.

U.S. labor-market data focuses on people ages 16 and older, considered working-age. They may be engaged in any number of activities that can be divided into seven broad categories:

1. employed, including self-employment or casual employment
2. in education, not employed, and not actively looking for work
3. in education, not employed, but actively looking for work
4. in education and employed
5. actively looking for work but not in education
6. engaged in household activities, but not employed, actively looking for work, or in education
7. doing none of the above (this can be considered idle).

⁶ Federal Reserve Bank of St. Louis, “30-Year Conventional Mortgage Rate, Percent, Monthly, Not Seasonally Adjusted,” January 4, 2016a.

⁷ Federal Reserve Bank of St. Louis, “Finance Rate on Consumer Installment Loans at Commercial Banks, New Autos 48 Month Loan, Percent, Monthly, Not Seasonally Adjusted,” January 8, 2016b. Averages reflect all available data; some months are missing data.

People in most of these categories also may be doing household work, but for smaller or larger portions of the day.

People in categories (1), (3), (4), and (5) would be considered in the labor force. The labor force, both the level and the participation rate, are measures of labor supply, one determinant of the overall level of production in an economy.⁸ Of the components of labor supply, the number of people not employed but actively looking for employment can indicate whether working-age people think their chances of finding a job are good. Working-age people who opt not to look for work but who would like to work and otherwise are doing few other productive activities are sometimes referred to as *discouraged workers*.

Overall, employment growth has been relatively good, with total average monthly nonfarm employment growth of 157,000 since the Great Recession ended, compared with a monthly average of 114,000 from 1991 through February 2016 (Figure 2.4).

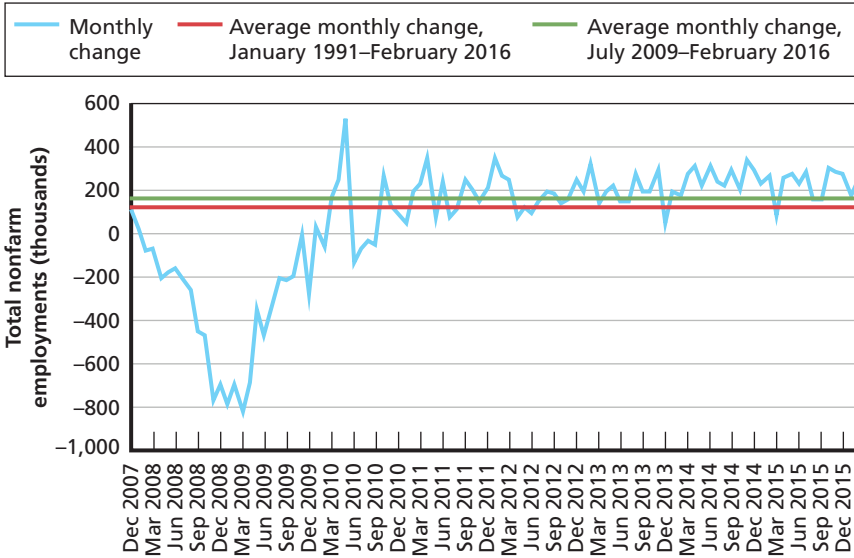
The unemployment rate was high during the early part of the recovery, but has since declined to well below its 1991-to-February-2016 average (Figure 2.5). This is also true, although to a more modest extent, with a rate that measures forms of underemployment, known as the U-6 rate. The U-6 rate includes the unemployed, people who currently are neither working nor looking for work but indicate that they want and are available for a job and have looked for work recently, and people employed part time who want and are available for full-time work but have had to settle for a part-time schedule.⁹

As of February 2016, the unemployment rate was 4.9 percent, well below the 1991-to-February-2016 average of 6.1 percent and the cur-

⁸ Labor demand, the types and numbers of employees desired by employers, is the other side of the labor market. The level of capital also determines the level of production in an economy.

⁹ More technically, the U-6 measure includes four groups of people: (1) those who are *unemployed*, meaning those who do not have a job but are actively seeking work; (2) *persons marginally attached to the labor force*, meaning those who currently are neither working nor looking for work but indicate that they want and are available for a job and have looked for work sometime in the past 12 months; (3) *discouraged workers*, a subset of the marginally attached, meaning those who have given a job-market related reason for not currently looking for work; and (4) *persons employed part time for economic reasons*, meaning those who want and are available for full-time work but have had to settle for a part-time schedule.

Figure 2.4
Monthly Change in Nonfarm Employment



SOURCE: BLS, "All Employees, Thousands, Total Nonfarm, Seasonally Adjusted," Series ID: CES0000000001, undated-a.

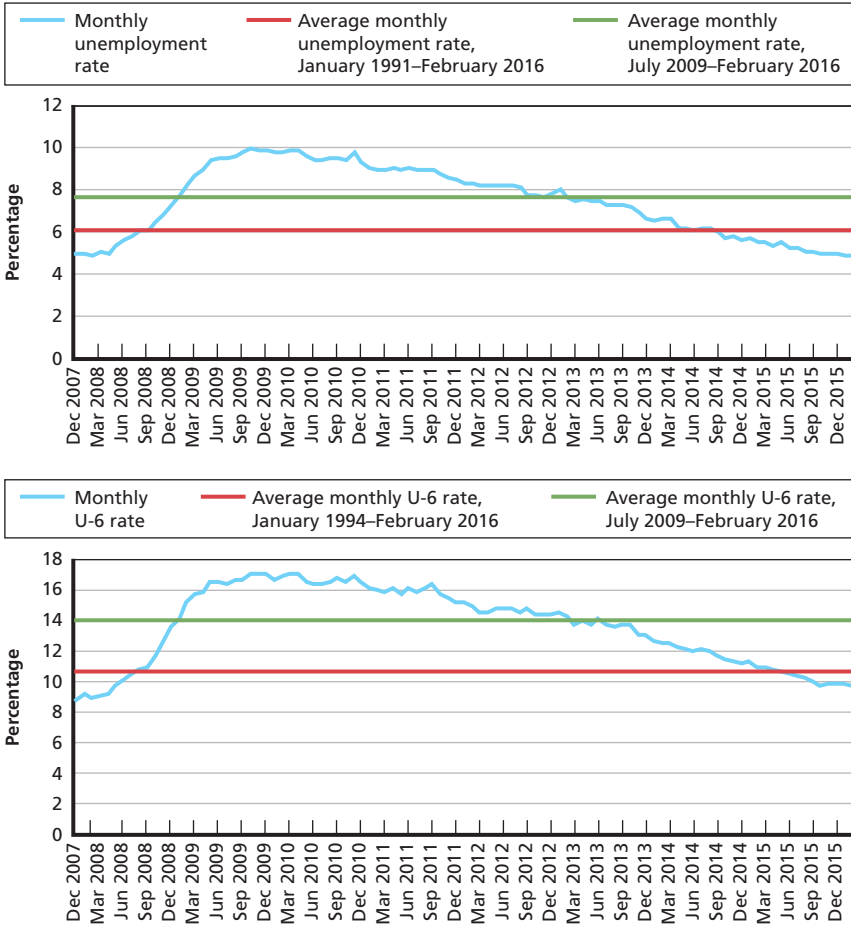
NOTE: The period starting in July 2009 is the recovery period following the Great Recession.

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rent recovery average (from July 2009 to February 2016) of 7.7 percent. In fact, that is equal to or lower than the unemployment rate in almost 60 percent of the months from 1991 to November 2007, immediately preceding the Great Recession. The U-6 rate also has fallen below the longer-term trends. It was 9.7 percent in February 2016, below the 1994-to-February-2016 average of 10.7 percent and the current recovery average (from July 2009 to February 2016) of 14.1 percent. However, it is equal to or lower than only about 20 percent of the months from 1994 to November 2007, indicating it may still have room to fall.

Although unemployment has returned to economically positive territory, LFP is showing signs of weakness. Labor force participation has been on a steady, decades-long decline for men, but started declining for women in 2000 after decades of increases (Figure 2.6). Some

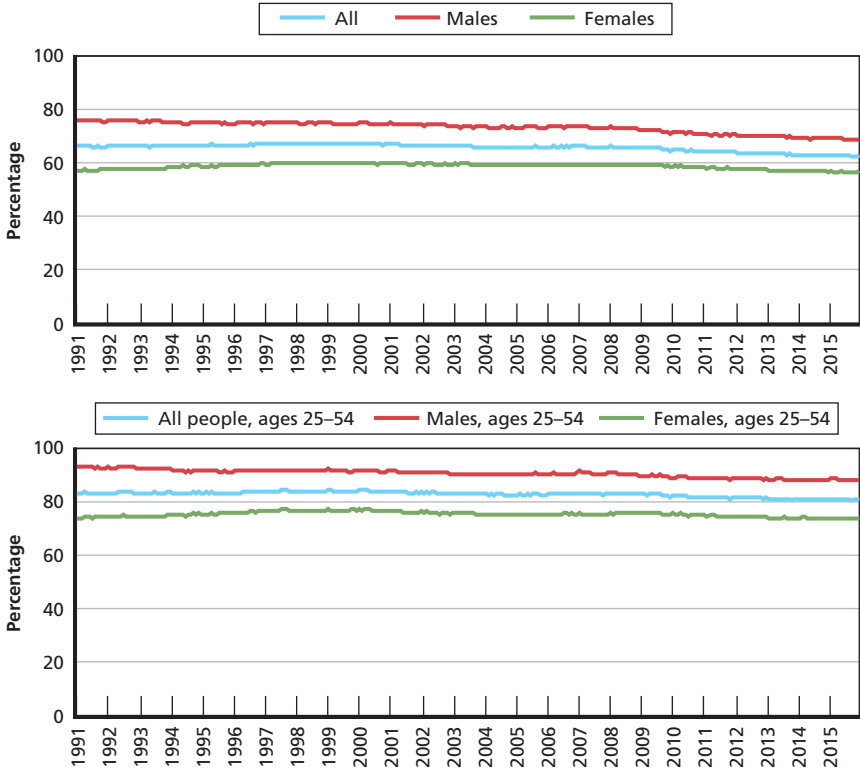
Figure 2.5
Monthly Unemployment and U-6 Rates



SOURCES: BLS, “Unemployment Rate, Seasonally Adjusted,” Series ID: LNS1400000, undated-l; BLS, “Total Unemployed, Plus All Marginally Attached Workers Plus Total Employed Part Time For Economic Reasons, as a Percent of All Civilian Labor Force Plus All Marginally Attached Workers, Seasonally Adjusted,” Series ID: LNS13327709, undated-k.

NOTES: The period starting in July 2009 is the recovery period following the Great Recession. The U-6 rate is available only from 1994.

Figure 2.6
Labor-Force Participation, All Working-Age People and Prime Working-Age People



SOURCES: BLS/FRED, "Civilian Labor Force Participation Rate: Men, Percent, Monthly, Seasonally Adjusted," undated-a; BLS/FRED, "Civilian Labor Force Participation Rate: Total, 25 to 54 Years, Percent, Monthly, Seasonally Adjusted," undated-b; BLS/FRED, "Civilian Labor Force Participation Rate: Total, Percent, Monthly, Seasonally Adjusted," undated-c; BLS/FRED, "Civilian Labor Force Participation Rate: Women, Percent, Monthly, Seasonally Adjusted," undated-d; BLS, "Civilian Labor Force Participation Rate: Men, 25 to 54 Years, Percent, Monthly, Seasonally Adjusted," Series ID: LNS11300061, undated-b; BLS, "Civilian Labor Force Participation Rate: Women, 25 to 54 Years, Percent, Monthly, Seasonally Adjusted," Series ID: LNS11300062, undated-c.

of this is attributable to aging: the statistic is calculated for all people ages 16 and older, and as more U.S. residents pass retirement age, they are far less likely to participate in the labor force. However, the trend is the same for people of prime working age, those ages 25 to 54. In fact, the downward slide for women of prime working age started at the same time as the downward slide for all women. Although the causes of this decline are still not well understood, it is notable that a higher proportion of people in this age group were on disability, in school or training, wanted a job but were not in the labor force, and to a smaller extent, were taking care of family in 2014 compared with those numbers in 1999.¹⁰

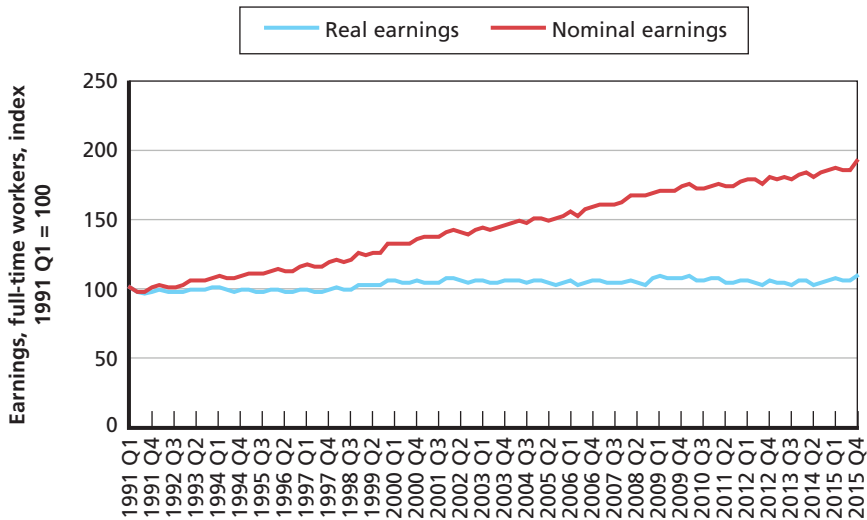
Earnings trends provide further concern about labor market outcomes. Median weekly earnings for all full-time workers have risen from \$432 in 1991 to \$825 at the end of 2015, but accounting for inflation, these earnings have been flat. An index set to 100 in the first quarter of 1991 registered only 109 in the fourth quarter of 2015, meaning real median earnings had risen only 9 percent in 25 years (Figure 2.7). This does not account for total compensation, such as employer-paid health insurance and other benefits. Including those elements would result in greater gains.¹¹

Furthermore, the earnings gap between groups with different levels of education has been widening, although all groups have gained ground in nominal terms (Figure 2.8). Whether the growth in the gap is large or small depends on one's viewpoint—there is no objective measure of how big or small such a gap should be, given that it is recognized that people with more education earn more than those with less on average. Between the first quarter of 2000 and the second quarter of 2009, the last year of the Great Recession, a person with a high school diploma made, on average, 40 percent more than a person without a high school diploma. A person with some college education made

¹⁰ Josh Zumbrun, "What We Know About the 92 Million Americans Who Aren't in the Labor Force," *Wall Street Journal*, October 21, 2015b.

¹¹ There is also a debate about what inflation adjustment to make. Gains in compensation look different—and better—depending on the choice of inflation measure used (Josh Zumbrun, "Just How Stagnant Are Wages, Anyway?" *Wall Street Journal*, July 6, 2015a).

Figure 2.7
Index of Median Weekly Earnings



SOURCES: BLS, "Constant (1982–1984) Dollar Adjusted to CPI-U-Median Usual Weekly Earnings, Employed Full Time, Wage and Salary Workers, Age 16 Years and Higher, Not Seasonally Adjusted," Series ID: LEU0252881600, undated-d; BLS, "Median Usual Weekly Earnings (Second Quartile), Employed Full Time, Wage and Salary Workers, Age 16 Years and Higher," Series ID: LEU0252881500, undated-f.

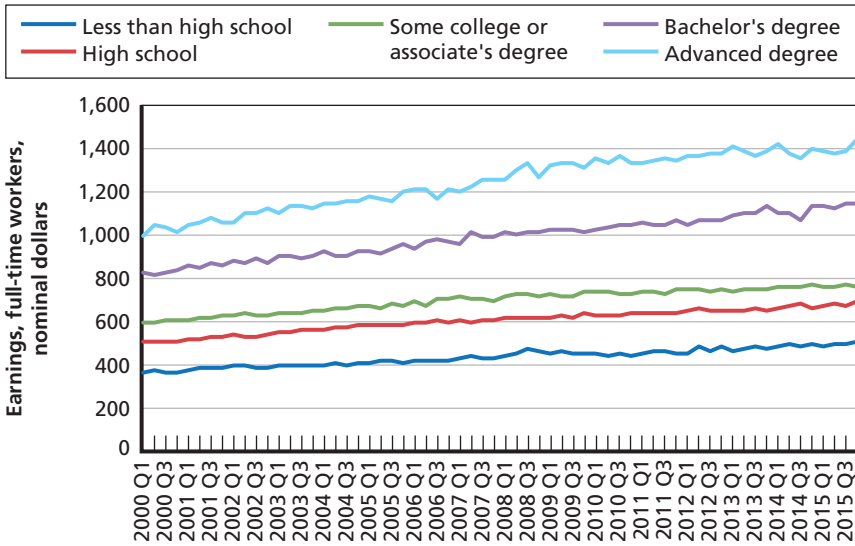
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63 percent more; a person with a bachelor's degree made 127 percent more, and a person with an advanced degree made 185 percent more. For the postrecession period of the third quarter of 2009 to the fourth quarter of 2015, these figures averaged 39 percent, 60 percent, 131 percent, and 194 percent. This means that people without a college degree lost relative ground to people with a college degree, and those with an advanced degree made the highest relative gains.

Part of the reason for the leveling off of earnings may be the evolution of the labor demand; specifically, the availability of middle-skill jobs—those appropriate for people with medium levels of education—has declined, with the implication that achieving a middle-class lifestyle has become more difficult for many.

Jobs may be divided into manual and cognitive, and routine and nonroutine. Cognitive, nonroutine jobs usually require a college degree

Figure 2.8
Median Weekly Earnings by Education



SOURCES: BLS, "Median Usual Weekly Earnings (Second Quartile), Employed Full Time, Wage and Salary Workers, Advanced Degree, 25 Years and Over, Not Seasonally Adjusted," Series ID: LEU0252919700, undated-e; BLS, "Median Usual Weekly Earnings (Second Quartile), Employed Full Time, Wage and Salary Workers, Bachelor's Degree Only, 25 Years and Over, Not Seasonally Adjusted," Series ID: LEU0252919100, undated-g; BLS, "Median Usual Weekly Earnings (Second Quartile), Employed Full Time, Wage and Salary Workers, High School Graduates, No College, 25 Years and Over, Not Seasonally Adjusted," Series ID: LEU0252917300, undated-h; BLS, "Median Usual Weekly Earnings (Second Quartile), Employed Full Time, Wage and Salary Workers, Less Than a High School Diploma, 25 Years and Over, Not Seasonally Adjusted," Series ID: LEU0252916700, undated-i; BLS, "Median Usual Weekly Earnings (Second Quartile), Employed Full Time, Wage and Salary Workers, Some College or Associate Degree, 25 Years and Over, Not Seasonally Adjusted," Series ID: LEU0254929400, undated-j.

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and can be considered high-skill. Manual, nonroutine jobs usually do not require a high school diploma and can be considered low-skill.¹²

¹² Anton Cheremukhin, "Middle-Skill Jobs Lost in U.S. Labor Market Polarization," *Economic Letter: Federal Reserve Bank of Dallas*, Vol. 9, No. 5, May 2014. Cheremukhin characterizes manual, nonroutine jobs as those that involve manual tasks and "require personal traits such as situational adaptability, visual/language recognition and in-person interaction" (pp. 1–2). These include jobs in food service and personal care, for example.

The other two categories—manual, routine jobs and cognitive, routine jobs—can be considered middle skill and generally require a high school diploma or higher levels of education, such as an associate’s degree.

These routine jobs, the middle-skill jobs, have declined from 58 percent of employment in 1981 to only 44 percent of employment in 2011. In contrast, the shares of the labor force in both the low-skill jobs and high-skill jobs have increased, with the share of high-skill jobs increasing by a greater amount. Although women initially were more affected by the decline of routine jobs, they have adjusted well, with more than half finding better-paying jobs. Men, in contrast, have predominantly moved into lower-paying jobs when they lost their middle-skill jobs.¹³ The result is a widening income distribution among those who work, and a more difficult life for many of those who are displaced but cannot find new jobs.

This phenomenon is not unique to the United States. In a comparison with 16 European countries, middle-wage jobs declined as a share of all jobs in all countries and high-wage jobs increased their share in all countries between 1993 and 2010.¹⁴ Low-wage jobs increased their share in 14 countries (all but Luxembourg and Finland). The similarity of patterns suggests that there is a common phenomenon affecting all developed countries. However, diversity across countries also suggests that each country has specific policies or faces specific challenges exacerbating this pattern.¹⁵

Trouble with Government Finances

Besides the labor market, a second economic challenge facing policymakers is a potentially large increase in net debt with the resulting consequences for U.S. budgets and its labor market. Stresses on the federal budget could lead to a future inability to fund specific programs that

¹³ Cheremukhin, 2014.

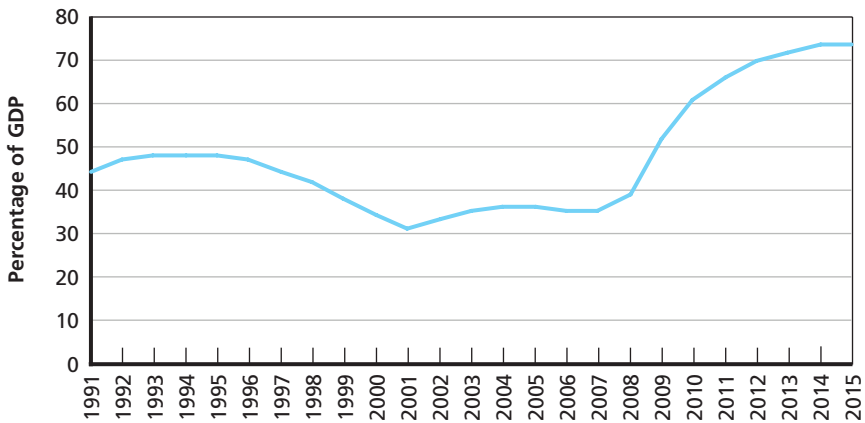
¹⁴ David Autor, “Polanyi’s Paradox and the Shape of Employment Growth,” paper presented at the Federal Reserve Bank of Kansas City’s Jackson Hole Conference, August 11, 2014.

¹⁵ Autor, 2014.

may help people advance and to fund overall national strategy. There is some hint that this may soon be the case with national defense strategy.¹⁶

Spurred by the financial crisis, federal debt held by the public has more than doubled relative to the size of the economy since 2000 (Figure 2.9).¹⁷ Although it was almost 50 percent of GDP in the early 1990s, it fell to as low as 31 percent in 2001 and had risen to only 35 percent by 2007, the year of the onset of the recession preceding the financial crisis.¹⁸ As of 2015, it was 74 percent. Starting in 1790, this figure has been exceeded only seven times—all of them between 1944 and 1950, with a peak at 106 percent in 1946.¹⁹

Figure 2.9
Federal Debt Held by the Public



SOURCE: CBO, *The 2015 Long-Term Budget Outlook*, Washington, D.C., June 2015.

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¹⁶ Nora Bensahel, “Why ‘More’ Is Not a Better Plan for U.S. Defense,” *Defense One*, September 3, 2014.

¹⁷ Federal debt held by the public includes debt held by individuals, corporations, state and local governments, federal reserve banks, foreign governments, and other foreign entities, minus so-called Federal Financing Bank securities. Additional debt is held by the U.S. government in government accounts and trust funds (U.S. Department of the Treasury, “Frequently Asked Questions About the Public Debt,” Bureau of the Fiscal Service, July 30, 2015).

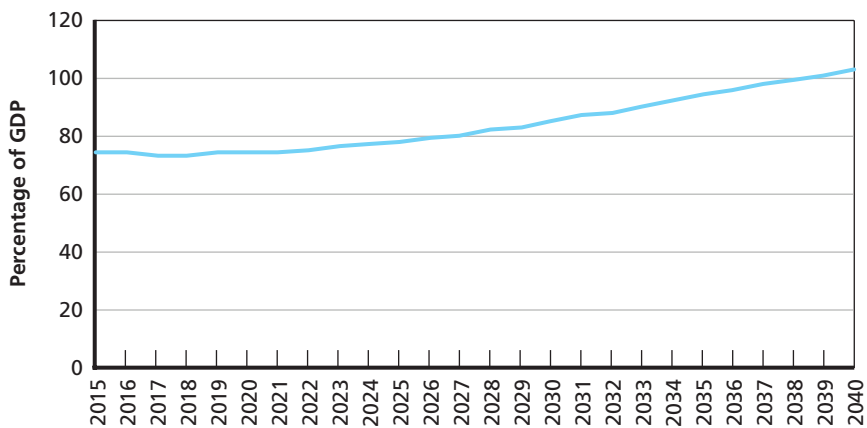
¹⁸ CBO, 2015.

¹⁹ CBO, 2015.

Some of the increase in the ratio of net debt to GDP is to be expected. During recessions, so-called automatic stabilizers kick in. For example, unemployment benefits rise because more people are jobless. This helps people smooth their consumption during hard times. A major stimulus program by the federal government also increased the federal debt. Although not unanimous, many economists agreed that such a stimulus was useful in helping the nation get through the severe financial crisis. Furthermore, the medium-term outlook for the debt is positive: The CBO projects that it will dip to 73 percent of GDP in 2017.

However, the nation faces severe longer-term fiscal challenges, driven largely by increases in promised retirement payments and health care benefits as the population ages. When combined with an inability or unwillingness to raise additional federal revenues, the result under current law is ever-increasing deficits and ever-increasing debt (Figure 2.10). If current law continues, the deficit is expected to rise from 2.7 percent of GDP in 2015 to 5.9 percent of GDP by 2040. The debt is expected to rise from 74 percent of GDP to 103 percent of GDP by 2040. And while spending on Social Security, Medicare, Medicaid, the federal Children's Health Insurance Program, and

Figure 2.10
The Long-Term Debt Profile (as a percentage of GDP)



SOURCE: CBO, 2015.

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health insurance subsidies was expected to consume 57.1 percent of federal revenues in 2015, they will take 73.2 percent of federal revenue in 2040, leaving little money for much else.²⁰ One of the consequences of this large and growing debt is that it could “compromise national security by constraining defense spending in times of international crisis or by limiting the country’s ability to prepare for such a crisis.”²¹

There is uncertainty with any projection, and especially with long-term projections. One of the elements of uncertainty is the interest-rate path. Today’s low interest rates mean federal debt service is quite low—the CBO estimated in mid-2015 that net interest payments by the federal government on its debt would amount to only 1.3 percent of GDP and about 7 percent of all federal spending. However, if interest rates were to return to more normal levels, these figures would rise, and could rise a great deal as the debt mounts. The CBO estimates that in 2040, interest payments could amount to 4.3 percent of GDP and 22.2 percent of all federal revenue. Recall that entitlement spending is expected to amount to 73.2 percent of federal revenue that same year, so there will be little left over for defense, diplomacy, education, environmental protection, and all other discretionary programs.

These considerable dangers need not mean that the United States must move to balance immediately. Rather, there needs to be a credible demonstration of long-term fiscal sustainability. Such credibility would not only remove the danger of a budget crisis, but it would make fiscal policy more effective at improving the economy and meeting national needs.²² The means of fixing the United States’ fiscal problems are well understood and clear: Even with more-rapid

²⁰ Over the even longer term, the deficit is expected to rise to 9.5 percent and the debt is expected to rise to 181 percent of GDP by 2090. Spending on Social Security, Medicare, Medicaid, the federal Children’s Health Insurance Program, and health insurance subsidies is expected to equal 83.2 percent of federal revenue in 2090 (CBO, 2015).

²¹ CBO, 2015, p. 4. This exact quotation appeared as well in the 2014 version of CBO’s long-term budget outlook.

²² Jeffrey Sachs, “Time to Plan for Post-Keynesian Era,” *Financial Times*, June 7, 2010.

economic growth (if it materializes), there will need to be spending cuts and revenue increases.²³ Elements of fixing the United States' fiscal problems include setting firm budget goals; keeping all options open regarding cutting spending, increasing revenue, and boosting growth; giving extra attention to the growth rate of spending; recognizing that different spending challenges will need different approaches; increasing taxes (such as by introducing a value-added tax) that will do the least harm to incentives for work and productivity; and rethinking any new programs that will build in new expenditures.²⁴ Moreover, there is solid evidence that the mechanism for raising money—the current tax system—also needs repair. It is needlessly complex, economically harmful, often unfair, increasingly unpredictable, and an overall failure at its basic task of raising enough money to pay for government expenditures.²⁵ Unfortunately, there is no political consensus as yet on how to raise money more efficiently or achieve this longer-term balance.²⁶

Summing Up the U.S. Economy Today

The Great Recession was a shock to the United States and to the world. As of early 2016, the United States had largely recovered. Growth, inflation, and unemployment were all favorable. However, the United States still faces two domestic economic challenges: creating the conditions for people to succeed in the labor market, and solving medium-to-long-term fiscal imbalances.

These may be both symptoms and causes of longer-term problems. The economist Robert Gordon has noted that U.S. total factor produc-

²³ Donald B. Marron, "America in the Red," *National Affairs*, Spring 2010, pp. 3–19.

²⁴ Marron, 2010.

²⁵ Donald B. Marron, "Cutting Tax Preferences Is Key to Tax Reform and Deficit Reduction," testimony before the Senate Committee on the Budget, February 2, 2011.

²⁶ Sachs, 2010.

tivity since the 1970s has been well below that of 1920 to 1970.²⁷ He has identified four headwinds to future growth: (1) the demographic transition of aging and slower population growth, (2) a slowdown in educational achievement and a rise of student debt, (3) income inequality, and (4) federal government debt. This report discusses population issues in Chapter Four; education and income inequality are related to the job market issues as described, and federal debt was already discussed. Although this report focuses on international economic policy rather than domestic policy, at least there is value to having a full portrait of the U.S. economic situation when formulating an approach to the international economy.²⁸

International economic engagement has long been known to contribute to spurring U.S. growth and innovation as well as widening incomes. The next chapter describes the nature of U.S. international engagement in the forms of trade, direct investment, and monetary policymaking.

²⁷ Robert Gordon, “U.S. Economic Growth Is Over: The Short Run Meets the Long Run,” in *Growth Convergence and Income Distribution: The Road from the Brisbane G-20 Summit*, Brookings, Think Tank 20, November 2014, pp. 185–192.

²⁸ Understanding the current situation is critical to diagnosing the challenge, as mentioned in Rumelt’s definition of strategy (Rumelt, 2011). Gordon does propose a number of policies:

My standard list of policy recommendations includes raising the retirement age in line with life expectancy, drastically raising the quotas for legal immigration, legalizing drugs and emptying the prisons of non-violent offenders, and learning from Canada how to finance higher education. The U.S. would be a much better place with a medical system as a right of citizenship, a value-added tax to pay for it, a massive tax reform to eliminate the omnipresent loopholes, and an increase in the tax rate on dividends and capital gains back to the 1993–97 Clinton levels. (Gordon, 2014, p. 191)

How the U.S. Economy Connects with the World

The United States engages with the world economy in a variety of ways. These include trade; operations by U.S. companies in other countries (known as foreign *direct* investment [FDI]); operations by foreign companies in the United States; purchases of foreign equities and bonds (known as foreign *portfolio* investment); purchases by foreigners of U.S. equities and bonds; flows of people (immigration, emigration, tourism, and travel); and supply of currency (many international transactions take place in dollars, many foreign countries hold reserves in dollars, and many economies use dollars, either as a matter of policy or as a matter of fact because of lack of confidence in the local currency).

This chapter will highlight four aspects of U.S. international engagement with the world: trade, FDI, the energy revolution and its implications for the United States, and the influence of the Federal Reserve (the U.S. monetary policy authority) over the global economy. Although still in deficit, the U.S. trade balance has narrowed a great deal in the past ten years, reducing the need for foreign financing of U.S. consumption and production; a trade deficit is financed by borrowing abroad. Trade is one channel of engaging with the world, but a more important channel in dollar terms is FDI—sales abroad by affiliates of multinationals far outstrip U.S. exports. One source of the reduction of the trade deficit has been a revolution in the exploitation of hydrocarbons and increases in production of U.S. oil and gas. That has principally helped keep oil and gas prices low and now, with the removal of a longstanding ban on U.S. exports of crude oil, may increase U.S. exports. Finally, the Federal Reserve is another channel through which the United States engages with the international economy. Although its principal responsibilities

focus on the well-being of the U.S. economy, any measure the Federal Reserve takes has international implications; in addition, it has helped rescue the international economy during times of economic stress, such as the period of the Great Recession.

International Trade

One way the United States engages with the world is through the sale abroad of U.S.-produced goods and services and the purchase of foreign-produced goods and services. Total U.S. trade relative to GDP has been expanding. In 1991, exports of goods and services plus imports of goods and services totaled 19.2 percent of GDP. By 2014, that figure was 29.9 percent of GDP and from 2011 through 2013 it was slightly more than 30 percent. In fact, the proportion in the five-year recovery period following the Great Recession, 2010 through 2014, averaged 30.0 percent, far more than the 24.6-percent average for the entire period from 1991 through 2014.

The broadest measure of such international transactions is the current account, which includes not only trade, but also investment income and employee compensation earned abroad, or sent from the United States to foreign entities. Trade in goods and services makes up the vast majority of the current account.

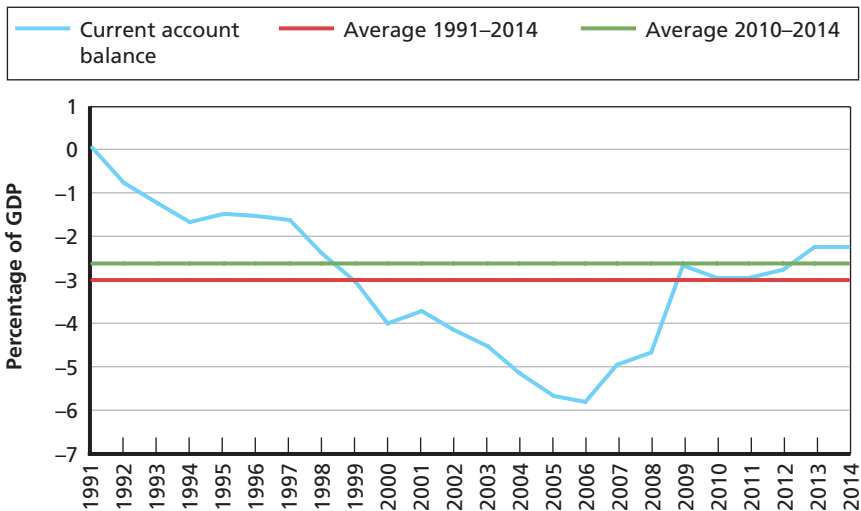
A decade ago, the size of the current account deficit was of great concern, hitting almost 6 percent of GDP in 2006. Some feared that the deficit was a sign that the United States was living unsustainably beyond its means. Such deficits must be financed by foreigners, and the financing comes primarily in the form of lending money to the United States or buying U.S. assets. One of the biggest concerns was that foreigners might eventually tire of accumulating dollars in their portfolios, leading to a large decrease in demand for dollars, a large depreciation of the dollar, and a difficult adjustment for the U.S. economy as imports became far more expensive than before the depreciation.¹

¹ Jeffrey A. Frankel, "Guest Contribution: Is the U.S. Current Account Deficit Problem Over?" *Econbrowser*, October 24, 2014.

This problem—if it ever was a problem—has dramatically receded (Figure 3.1).² From a post-1991 trough of -5.8 percent of GDP in 2006, the current account deficit in 2014 registered only -2.2 percent of GDP. It averaged -3.0 percent in the entire post-1991 period, but only -2.6 percent in the recovery period following the Great Recession.

Part of what is fueling the narrowing of the current account deficit is the rapid advance in services trade. Although most people are exposed to trade through goods—such as foreign-made clothing or cars—trade in services is large and growing. This includes international tourism, financial services, transportation, and other categories, many of which require highly skilled or highly educated

Figure 3.1
U.S. Current Account Balance (as a percentage of GDP)



SOURCES: BEA, "GDP in Billions of Current Dollars," *Current-Dollar and "Real" Gross Domestic Product*, Excel spreadsheet, July 2015a; BEA, "U.S. International Transactions: Third Quarter 2015," news release, BEA 15-64, December 17, 2015h, Table 1.

NOTE: The period starting in 2010 is the recovery period following the Great Recession.

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² In fact, because of mismeasurement in official statistics, the current account might actually have gone into surplus in 2009 and stayed there (Frankel, 2014).

workers. The U.S. deficit in goods trade has largely been flat since 2006 (except for the Great Recession year of 2009, when imports fell by \$560 billion and exports fell by \$240 billion), albeit with some improvement (Figure 3.2). In contrast, the services surplus in 2014 was triple that in 2006.

As of 2014, the value of services exports equaled 43.5 percent of the value of goods exports (Figure 3.3). In contrast, services imports constituted only 20.1 percent of goods imports. Given the U.S. advantage in producing internationally traded services, a clear implication is that U.S. policymakers will want to reduce foreign barriers to such trade.

Foreign Direct Investment

Besides trade, the United States engages with the world economically through FDI, defined as cross-border investment for the purpose of controlling a business enterprise or purchasing land. Companies

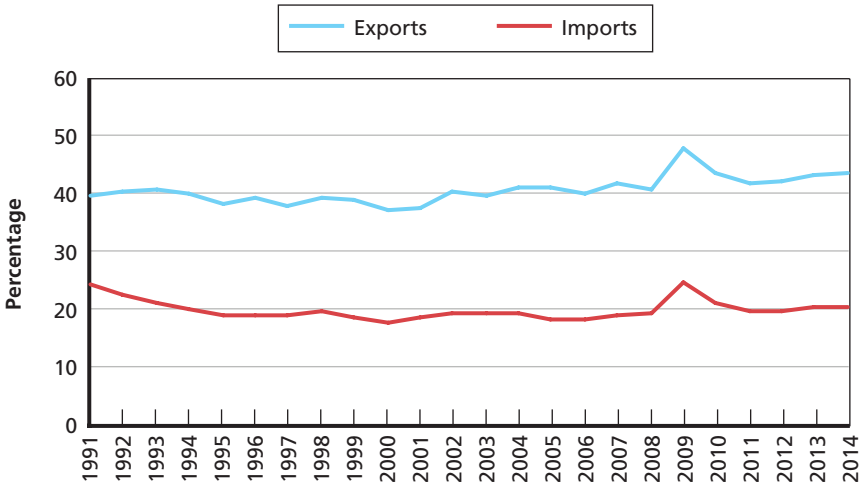
Figure 3.2
Goods Trade Balance and the Services Trade Balance



SOURCE: BEA, 2015i.

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Figure 3.3
Services Trade as a Percentage of Goods Trade



SOURCE: BEA, 2015i.

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that invest abroad then own foreign affiliates or branches. Sales of goods and services by foreign affiliates of U.S. companies far outstrip exports of goods and services from the United States. Multinational affiliates are subsidiaries or branches set up in a foreign, or *host*, country by a parent company in a *home* country. One example is Pan Asia Technical Automotive Center Co., Ltd., 50–50 owned by U.S.-headquartered General Motors and China-headquartered SAIC Motor (formerly Shanghai Automotive Industry Corporation).³

Companies tend to gain efficiencies when they expand abroad by lowering production costs and the costs of sales to final markets. These efficiencies result in higher profits, wages, and benefits. In fact, foreign capital spending and foreign hiring are associated with increased domestic capital spending and hiring.⁴ Likewise, FDI by foreign companies in the United States contributes to U.S. productivity gains,

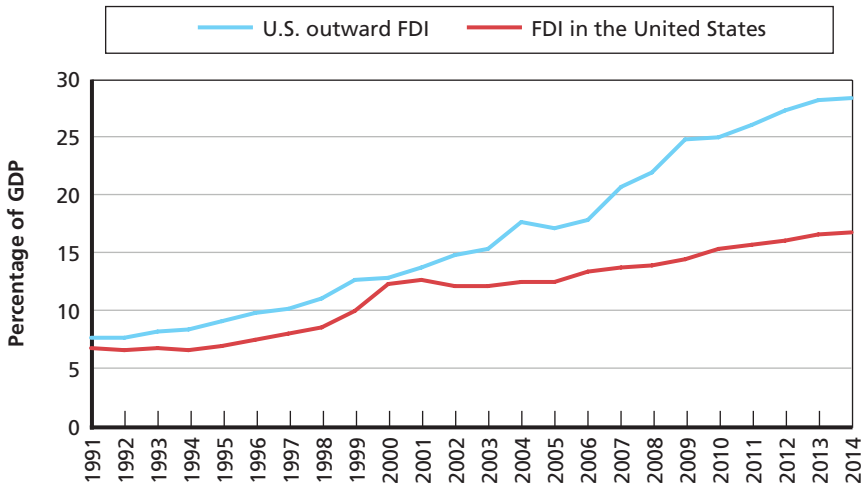
³ General Motors China, *Backgrounder: General Motors in China*, March 5, 2015.

⁴ White House, *Economic Report of the President, 2007*, Washington, D.C.: U.S. Government Printing Office, 2007, Ch. 8.

increased trade, increased research and development, an increase in the capital stock, and financing for the current account deficit.⁵

Both outward and inward FDI have risen steadily, with outward FDI rising much more rapidly after 2000 (Figure 3.4). The outward direct investment position—the cumulative value of equity, inter-company debt, and other forms of investment into facilities for production overseas—rose from 7.6 percent of GDP in 1991 to 12.8 percent in 2000 and hit 28.4 percent in 2014. In contrast, the inward direct investment position rose from 6.8 percent of GDP in 1991 to 12.2 percent in 2000—both numbers on par with the outward direct invest-

Figure 3.4
Direct Investment Position



SOURCES: BEA, July 2015a; BEA, “International Data, Direct Investment and MNE,” (search string: Foreign Direct Investment in the United States, Balance of Payments and Direct Investment Position Data, Foreign Direct Investment Position in the United States on a Historical-Cost Basis), Washington, D.C.: U.S. Department of Commerce, July 2015b; BEA, “International Data, Direct Investment and MNE,” (search string: U.S. Direct Investment Position Abroad, Balance of Payments and Direct Investment Position Data, U.S. Direct Investment Position on a Historical-Cost Basis), Washington, D.C.: U.S. Department of Commerce, July 2015c.

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⁵ White House, 2007, Ch. 8.

ment position—but then rose to only 16.7 percent in 2014, well below the increase of outward FDI.

There is some uncertainty with numbers from individual countries because companies in one country may route their investments through another country for tax-saving purposes or for other efficiencies. For example, the direct investment position held by investors moving money directly from the UK to the United States was almost \$449 billion in 2014. When accounting for UK firms that were ultimate beneficial owners but that might have moved their money through third countries, however, that total rises to almost \$466 billion. In fact, foreign investment into the United States from ultimate beneficial owners who were actually in the United States was almost \$80 billion. However, since this is out of a total inward direct investment position of \$2.9 trillion, it does not have a large effect on understanding aggregate trends.

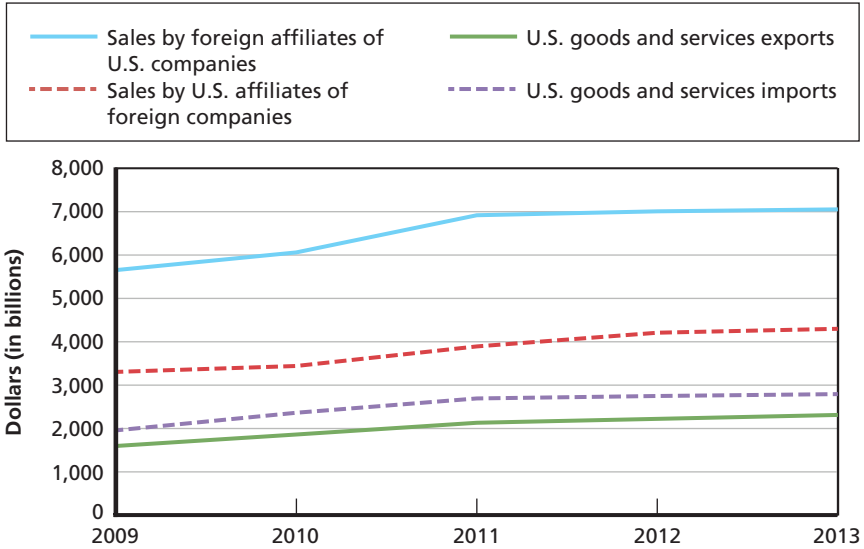
Among the reasons to invest abroad are to sell products and services to local markets more easily. Production in a market enables companies to reduce transport costs, gain better market intelligence, localize products more easily, and respond more quickly to changes in local market demand. In fact, sales by foreign affiliates of U.S. companies far outstrip U.S. exports (Figure 3.5). The vast majority of these sales go to the market in which they are located or other foreign countries, rather than being shipped back to the United States. These sales, rather than trade, are the preferred way to serve foreign markets. In 2013, more than 90 percent of all goods and services supplied by majority-owned foreign affiliates of U.S. companies went to foreign markets.⁶

Sales by foreign affiliates of U.S. companies have averaged more than three times U.S. exports since the end of the Great Recession. Sales by U.S. affiliates of foreign companies have averaged 1.15 times U.S. imports during the same period.⁷ One implication of the U.S. direct investment track record is that policymakers will want to con-

⁶ BEA, *Activities of U.S. Multinational Enterprises: U.S. Parent Companies and Their Foreign Affiliates: Preliminary 2013 Statistics*, Washington, D.C.: U.S. Department of Commerce, August 2015d, Table II.E.2

⁷ These averages are calculated for the period 2010–2013; in contrast, Figure 3.5 shows the full available data series, 2009–2013.

Figure 3.5
Sales by Multinational Affiliates Versus Trade



SOURCES: BEA, “International Data, Direct Investment and MNE,” (search string: U.S. Direct Investment Abroad, Data on Activities of Multinational Enterprises, All Foreign Affiliates, Total Sales, Data for 2009 and Forward), Washington, D.C.: U.S. Department of Commerce, August 24, 2015f; BEA, 2015h, Table 1.

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tinue to expand opportunities for U.S. firms to invest abroad. Likewise, given the benefits of direct investment to the U.S. economy, they will want to make sure the U.S. investment climate remains open on a nondiscriminatory basis.

The Energy Revolution

As already noted, the current account has been narrowing. One cause of that is the advent of greater domestically produced supplies of hydrocarbons through the hydraulic fracturing process. These supplies are frequently called tight oil and shale gas, and are produced from fracturing underground rock formations to release the supplies. This revo-

lution is reflected in both production and reserves; monthly average field production of crude oil rose 85 percent from 2006 to 2015.⁸

At the end of 2006, the United States was considered to have proven reserves of oil totaling 29.9 billion barrels and proven reserves of natural gas totaling 209.15 trillion cubic feet.⁹ By the end of 2013, thanks to the way the new technologies enabled companies to produce, the United States was considered to have proven reserves of oil totaling 44.2 billion barrels and proven reserves of natural gas totaling 330.0 trillion cubic feet.¹⁰ This placed the United States tenth in the world in oil reserves, although well behind leaders Venezuela (298.3 billion barrels), Saudi Arabia (265.9 billion barrels), and Canada (174.3 billion barrels). It placed the United States fifth in natural gas reserves. Although well behind leaders Iran (1,192.9 trillion cubic feet), Russia (1,103.6 trillion cubic feet), and Qatar (871.5 trillion cubic feet), U.S. gas reserves now exceed those of Saudi Arabia, the United Arab Emirates, and Venezuela.

Until late December 2015, the U.S. government banned the export of crude oil from the continental United States except to Canada and in swaps with Mexico. Because of the energy revolution, with U.S. oil production increasing 90 percent since August 2008, and with a concomitant drop in oil and gasoline prices, Congress decided to lift the 40-year-old ban and tucked the repeal in an end-of-year budget and tax bill; President Obama had threatened to veto a stand-alone bill.¹¹

Even with the ban in place, the United States has been the world's largest exporter of refined oil products. It has exported more than 3 million barrels per day of refined oil products, more than 15 percent

⁸ U.S. Energy Information Administration, "U.S. Field Production of Crude Oil (Thousand Barrels)," in Data Spreadsheet PET_CRD_CRPDN_ADC_MBBL_M.xls, April 2016. Percentage gain is based on monthly averages in 2006 and 2015. Actual numbers are 155 million barrels per month in 2006 and 287 million barrels per month in 2015. By February 2016, the month of latest available data, this figure was 265 million barrels per month.

⁹ BP, *BP Statistical Review of World Energy 2007*, London, June 2007

¹⁰ BP, *BP Statistical Review of World Energy 2014*, London, June 2014.

¹¹ Amy Harder and Lynn Cook, "Congressional Leaders Agree to Lift 40-Year Ban on Oil Exports," *Wall Street Journal*, December 16, 2015.

of U.S. consumption of refined oil products, in recent years. With the ban on exports of crude oil lifted, some oil that is currently refined and exported abroad as product may be exported as crude. However, U.S. refineries are highly efficient and most profitable when operated near capacity, so it is not clear how much of a shift from refined products to crude might take place.

The international gas market is becoming more flexible, with the continued development of liquefied natural gas (LNG) that can move by ship from any port with a liquefaction terminal to any port with a gasification terminal. However, natural gas is primarily traded on three large regional markets: North America, Europe and Eurasia, and East Asia. In North America and Europe, almost all gas is imported through pipelines. These pipelines are fixed, meaning it remains difficult to redirect flows to take advantage of international differences in prices. In 2014, trade movements by pipeline totaled 663.9 billion cubic meters, whereas trade movements by LNG totaled 333.3 billion cubic meters.¹² As a result, there is not yet one world market.

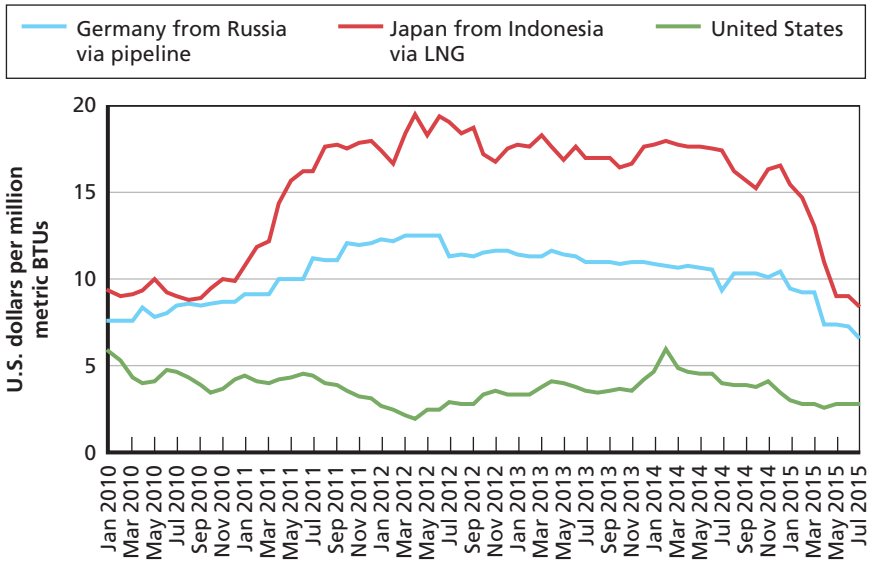
Given dramatically increased supplies of U.S. natural gas, gas prices in the United States have remained far lower than elsewhere (Figure 3.6). Until recently, price differentials between natural gas in East Asia and North America were large. However, with the decline in world market oil prices (which are linked to natural gas prices), the spread has become much smaller, reducing the attractiveness of importing LNG from the United States to East Asia and Europe.

The implications of this new energy potential are still unclear. Under a variety of conditions, U.S. energy imports and exports are expected to come into balance between 2019 and 2028.¹³ The United States will still import oil on net, although less than before, but is expected to become a net exporter of natural gas, especially LNG, by 2017. This will allow U.S. producers to sell to Europe in competition with Russia and other pipeline exporters, should U.S. and European

¹² BP, *BP Statistical Review of World Energy 2015*, London, June 2015.

¹³ U.S. Energy Information Administration, *Annual Energy Outlook 2015, With Projections to 2040*, Washington, D.C.: U.S. Department of Energy, April 2015a.

Figure 3.6
U.S. Natural Gas Prices Versus Selected International Natural Gas Prices



SOURCE: IMF, "Monthly Data" (commodity prices), Excel spreadsheet, *IMF Primary Commodity Prices*, undated.

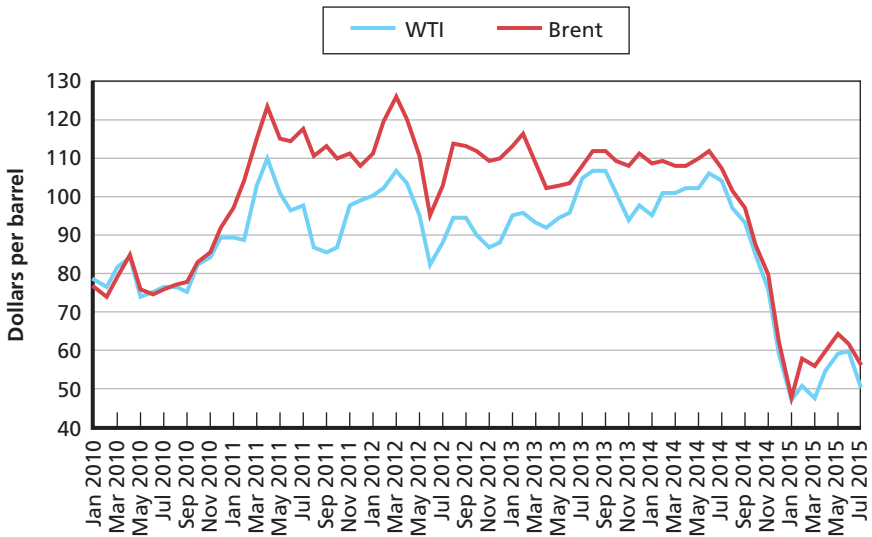
NOTE: Figure shows the monthly average price per million metric British Thermal Units (BTUs) of the Russian natural gas border price in Germany, Indonesian LNG in Japan, and the natural gas spot price at the Henry Hub terminal in Louisiana.

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companies find the LNG infrastructure investment to make business sense.

This changed energy landscape will not allow the United States to delink from the world energy market. The world oil market is one market, so any price volatility should feed through to U.S. prices. However, there have been advantages. Increased gas and oil production have contributed to increased employment in energy industries, and these jobs are generally higher-paying than many other jobs in the United States. U.S. oil production has contributed strongly to the dramatic decrease in global oil prices between 2014 and 2015 (Figure 3.7) and this production as of October 2015 showed little sign of letting up. Should U.S. producers increase their exports of crude oil without

Figure 3.7
The Decline in Petroleum Prices



SOURCE: U.S. Energy Information Administration, *Electricity Monthly Update*, with data for May 2015, July 27, 2015b.

NOTE: Figure shows the Cushing, Oklahoma, monthly average spot price per barrel of West Texas Intermediate (WTI) (variable "RWTC" in the source database) and the European Spot Price for Brent Crude Free On Board (variable "RBRETE" in the source database).

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decreasing their exports of refined products, the additional export revenues would enter the U.S. economy.

Increased gas production may have more direct benefits to U.S. economic growth. Because the world gas market is not yet a unified market, U.S. consumers and businesses should continue to pay lower gas prices than consumers and businesses elsewhere in the world, giving a competitive edge to U.S. industries that are intensive in gas use. These industries include foundries, paper mills, and other heavy industrial processes.¹⁴ In addition, consumers should benefit because electricity generation has

¹⁴ Michael E. Porter, David S. Gee, and Gregory J. Pope, *America's Unconventional Energy Opportunity: A Win-Win Plan for the Economy, the Environment, and a Lower-Carbon, Cleaner-Energy Future*, Harvard Business School and The Boston Consulting Group, 2015.

gradually been relying more and more on natural gas, although coal still remained the single largest fuel source in 2015.¹⁵

Lower net oil imports and higher net gas exports could help improve the trade balance. That is not guaranteed, however, as Americans may use the money they saved on foreign oil to purchase other imported goods. The trade balance will be more heavily influenced by the overall U.S. savings and investment balance; so, to improve its external economic performance, U.S. policymakers will need to institute other policies to complement the changes in the energy markets.¹⁶

Finally, the energy revolution might mean a global price cap on oil for several years, even if U.S. oil wells are not producing because the price is too low to make production profitable. As of mid-February 2016, the United States had 4,000 oil wells that had been drilled and were not producing, but that could be brought online in 80 days if the price were right. Some estimate that price to be \$50 per barrel.¹⁷

The Federal Reserve

The discussion to this point has dealt largely with what is known as the real economy—trade in goods and services—including oil, gas, and refined products—and investment for the purpose of production. The United States also interacts with the global economy in the financial economy through the purchase and sale of equities and debt and other financial instruments. The United States has the largest finan-

¹⁵ U.S. Energy Information Administration, 2015b. In 2016, it appears that natural gas will supplant coal as the largest source of electric power generation and that ongoing retirements of older coal-fired power plants will cement natural gas in that position.

¹⁶ In balance of payments accounting, the current account, the broadest measure of the trade balance, is equal to a nation's savings minus its investment, where investment means new buildings, plants, and equipment. Therefore, to carry a current account surplus, a nation must save more than it invests. This increased saving can come in the form of government budget surpluses or higher household and business saving.

¹⁷ Javier Blas and Dan Murtaugh, "There's One Place Where OPEC Can't Broker an Oil Deal: Texas," *BloombergBusiness*, February 17, 2016.

cial market in the world, in dollar terms, and the deepest, in terms of amount of trading and variety of securities. Underpinning this is the U.S. dollar and the Federal Reserve (the Fed), an operationally independent government agency.

The Fed has a dual mandate of price stability and maximum sustainable employment.¹⁸ These are largely domestic concerns, but because of the degree to which the U.S. and global economies are intertwined, the Fed also pays attention to its effect on foreign economies. Economic problems in other countries may adversely affect the U.S. economy, and instability in the U.S. economy may adversely affect foreign economies with negative feedback to the U.S. economy. As a result, monetary policy, whether in normal or crisis times, is conducted with an eye toward the global economy.

Interest rate changes—the Fed’s main policy instrument, at least until the financial crisis that brought on the Great Recession—affect the value of the dollar and therefore of other currencies, as well as capital flows into or out of the United States, and therefore into or out of other countries. Furthermore, its more recent policy innovation of directly buying U.S. assets to help with the U.S. economic recovery caused increases in the prices of foreign assets, including riskier assets in foreign countries.¹⁹

In a number of instances, the Fed has gotten directly involved in foreign economies or foreign economic policymaking. For example, the Fed and other central bank governors worked with finance ministers in 1985 to halt the appreciation of the U.S. dollar. Regular meetings of senior central bank officials have helped with information exchange and coordination of foreign-exchange market intervention—as in 1998, when central banks coordinated in reaction to Japanese yen depreciation following the Asian financial crisis, and in 2000, when they reacted to euro depreciation. As the financial crisis developed in 2008, the Fed and

¹⁸ Stanley Fischer, vice chairman, Board of Governors of the Federal Reserve System, “The Federal Reserve and the Global Economy,” speech at the conference held in honor of Professor Haim Ben-Shahar, former president of Tel Aviv University, Tel Aviv, Israel, May 26, 2015.

¹⁹ Fischer, 2015.

the central banks of Europe, the UK, Canada, Switzerland, and Sweden coordinated an easing of monetary policy.²⁰

The fact that the dollar is globally used also has necessitated Fed cooperation. Because foreign financial institutions borrow and lend in dollars, they need to be assured that they will be able to access dollars when they need them, or they might be faced with an inability to meet their obligations. Accordingly, in the early days of the financial crisis in 2007, the Fed set up dollar swap lines with 14 foreign central banks, enabling it to exchange dollars for the currencies held by those central banks. The Fed renewed five of those swap lines in 2010.²¹

Conclusion

The U.S. economy has increasingly globalized over the long post-World War II period, with this trend accelerating since the opening of China, first in the late 1970s and more so in the 1990s, and the end of the Soviet Union and its domination of parts of Europe from 1989 through 1991. In recent years, a number of positive developments have occurred: The broad trade balance has improved, energy production has risen and prices have fallen, and the United States has maintained strong performance in services exports.

Furthermore, without judgment as to whether this is positive or negative, U.S. trade and investment relative to the size of the economy have risen strongly. This suggests that the influence of the global economy on the U.S. economy likely has risen as well, and that the United States will benefit from staying engaged in the global economy.

Every trade has a partner, and every foreign investment has a destination. So far, this report has considered U.S. economic trends against past measures. The next chapter presents U.S. economic trends in an international comparative perspective.

²⁰ Barry Eichengreen, *Does the Federal Reserve Care About the Rest of the World?* Cambridge, Mass.: National Bureau of Economic Research Working Paper 19405, September 2013.

²¹ Eichengreen, 2013.

The United States' Economic Standing in the World

For some, the Great Recession that started with the 2008 financial crisis called into question the value of the U.S. economic model. Combined with continued robust growth in China and the developing world during the immediate postrecession period, the Great Recession raised questions about the dominant role the United States has played in the global economy since the end of the Second World War. In considering the economic component of the United States' role in the world, U.S. policymakers need to consider not only what the United States wants, but what it has the power to bring about. For now at least, that power is considerable.

In the immediate term, U.S. growth prospects are better than those of any other major developed country and even better than those of most of the members of the vaunted BRICS club—Brazil, Russia, India, China, and South Africa (Table 4.1). Both the World Bank and the IMF anticipate that in 2016 and 2017 the United States will grow faster than high-income countries as a group, the Euro area, Japan, the UK, Brazil, Russia, and South Africa.¹ China and India are both projected to grow rapidly, but both international institutions project that China may be at the low end of, or miss, its target growth rate of 6.5 percent to 7.0 percent per year through 2020; India among all major economies is projected to grow the fastest. Beyond the BRICS,

¹ World Bank, *Global Economic Prospects: Spillovers Amid Weak Growth*, Washington, D.C., January 2016a; IMF, *World Economic Outlook: Too Slow for Too Long*, Washington, D.C., April 2016.

Table 4.1
GDP Growth Projections for 2016 and 2017

Country or Region	World Bank		IMF	
	2016	2017	2016	2017
World	2.9	3.1	3.2	3.5
High-income	2.1	2.1	1.9	2.0
Developing	4.8	5.3	4.1	4.6
United States	2.7	2.4	2.4	2.5
Euro area	1.7	1.7	1.5	1.6
Japan	1.3	0.9	0.5	-0.1
UK	2.4	2.2	1.9	2.2
Brazil	-2.5	1.4	-3.8	0.0
China	6.7	6.5	6.5	6.2
India	7.8	7.9	7.5	7.5
Russia	-0.7	1.3	-1.8	0.8
South Africa	1.4	1.6	0.6	1.2

SOURCES: World Bank, 2016a; IMF, 2016.

NOTES: The World Bank and the IMF define the groupings of high-income and developing countries differently. For example, the World Bank includes Russia among its high-income countries, whereas the IMF does not. In addition, the World Bank groups countries as “high income” and “developing,” whereas the IMF groups them as “advanced economies” and “emerging market and developing economies.” Finally, the World Bank refers to its numbers as forecasts, whereas the IMF refers to its numbers as projections.

emerging markets more generally have been slowing, and concerns about emerging market debt have been rising.²

The United States remains the world’s leading economy, even as the global economic environment has changed greatly over the past four decades. In part, emulating U.S. economic policies, the global economy has liberalized dramatically since the Latin American debt crisis of 1982, sparked by Mexico’s default. One early sign of this opening was the

² Ian Talley, “Why Emerging Markets Are Melting Down, and Why It Matters, in 10 Charts,” *Wall Street Journal*, January 7, 2016; Elaine Moore and Jonathan Wheatley, “Fears Mount Over the Rise of Sovereign-Backed Corporate Debt,” *Financial Times*, January 5, 2016.

reform of laws and regulations by host nations regarding the freedom of foreign companies to invest in companies within their borders.³

Liberalization accelerated in the 1990s with the collapse of the Soviet Union and the centrally planned economic system it chose for itself and imposed on its satellites; Deng Xiaoping's dramatic 1992 trip to the south of China, sparking major reforms there, building on the initial opening of the late 1970s; the start of the North American Free Trade Agreement (NAFTA) in 1994; and the completion of the Uruguay Round of trade negotiations and the entry into force of the new WTO in 1995. Fueled by technological innovation, a telecommunications and Internet build-out that culminated in the dot-com bubble and crash of 2001, continued liberalization, a debt buildup that spurred investment in real estate in a number of countries (in addition to the United States), and other factors, the global economy expanded until the financial crisis of 2008 temporarily halted growth. Despite that crisis, the U.S. and global economies retained the assets created during the long period of growth, particularly the human capital, the physical infrastructure (including the Internet and communications infrastructure), and the market-oriented economic systems (primarily embodied in corporations), that generate output.

The creation of the Internet and communications infrastructure has resulted in a second major change in the global economic environment. In addition to greater integration, the world is now more tightly bound in terms of both the volume of information flowing and the speed with which it flows. As a consequence, reaction times for market participants and policymakers are often quicker than in years past. As one sign of this global information revolution, worldwide mobile cellular subscriptions per 100 people grew from 0.3 in 1991 to 96.3 in 2013: In that latter year there were almost as many cellular subscriptions as there were people on the planet.⁴ However, many people held multiple subscriptions; unique mobile subscribers in early March 2016 totaled almost 5.0 billion—more

³ Howard J. Shatz, *The Location of U.S. Multinational Affiliates*, Ph.D. dissertation, Harvard University, 2000.

⁴ World Bank, *World Development Indicators*, database, 2016b.

than two-thirds of the world's inhabitants.⁵ So far, the United States and its major allies have been in the lead on the information and communications technology revolution, partly because of high levels of innovation. Reflecting this innovation activity, the United States has the largest global share of knowledge-intensive service industries, at 32 percent of the global total, and the largest share of high-technology manufacturing, at 27 percent—although China closely follows in the latter category.⁶ In terms of exports, the United States is second behind the European Union (EU) in knowledge-intensive services, and third behind China and the EU in manufactured high-technology products.

This chapter provides information about trends in the global economy from 1991 through 2014 to illustrate the relative standing of the United States. Comparison regions and countries include the EU, Japan, China, a grouping of Brazil, India, Russia, and South Africa (BIRS), and the rest of the world, which consists mostly of developing countries.

Gross Domestic Product and the U.S. Share of the World Economy

The United States remains the world's largest economy.⁷ Although the U.S. share of the global economy declined by 3.5 percentage points

⁵ GSMA Intelligence, "Global Data: Unique Mobile Subscribers," 2016.

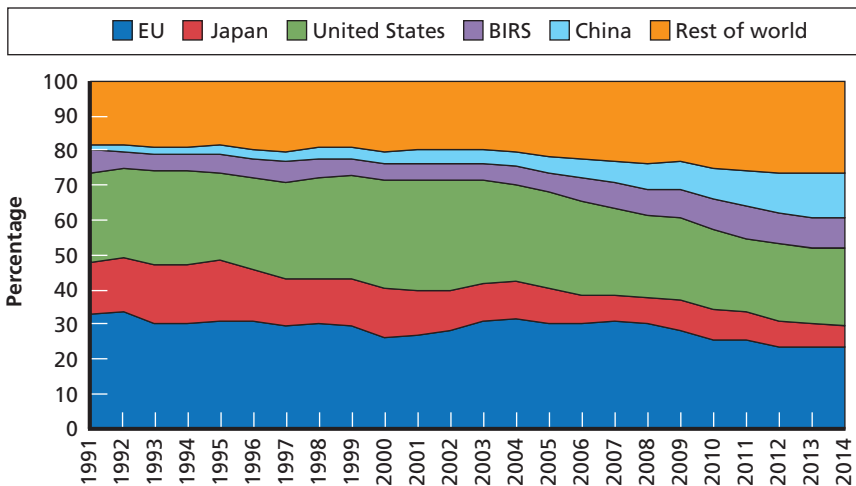
⁶ National Science Board, *Science and Engineering Indicators 2014*, Arlington, Va.: National Science Foundation, NSB 14-01, 2014.

⁷ In 2014, according to data in the World Bank's world development indicators, China surpassed the United States on a purchasing-power parity (PPP) price adjusted comparison. At market rates, U.S. GDP was \$17.4 billion and China's GDP was \$10.4 billion, but at PPP rates, U.S. GDP was the same, whereas China's GDP was \$18.0 billion. PPP reprises goods and services to have the same value and is used to indicate standard of living. For example, people in developing countries ordinarily earn far less than people in economically advanced countries when their wage values are translated at market rates, but such items as haircuts are also much less expensive in developing countries. The PPP adjustment measures such equivalent items at the same price. For purposes of measuring economic power, GDP measured at market exchange rates is the better comparison because it is impossible to spend PPP currency on the international market, whereas GDP at market rates reflects the ability to purchase and invest abroad.

between 1991 and 2014, the U.S. economy still constitutes more than one-fifth of global output (Figure 4.1). Much of the slow growth between 1991 and 2014 took place after the financial crisis, and in fact, the United States had small increases in 2012, 2013, and 2014. If U.S. growth continues, the Chinese slowdown intensifies, and slow growth in Europe and elsewhere continue—as the IMF and World Bank project—this recent decline in the share of global output may continue to reverse.

A greater concern than the relative trend line of the share of U.S. GDP in the global total is that of U.S. allies. They are performing far more poorly. In 1991, the EU's economy constituted 32.9 percent of nominal global GDP; by 2014, that figure was 23.8 percent. Japan's share of the nominal global economy also has declined a great deal, although from a much smaller starting point. In 1991, Japan accounted for 14.8 percent of global output, but by 2014, that had fallen by more than half. On the other hand, the global economy remains heavily

Figure 4.1
Share of Nominal World GDP



SOURCE: World Bank, 2016b.

NOTE: Figure shows each country's or group's share of global GDP, as measured in current U.S. dollars.

dominated by free-market democracies despite the oft-cited appeal of alternative economic and political models.

One other important trend is the spread of more-rapid economic growth to other parts of the world. In 1991, the economies of the United States, the EU, Japan, and China constituted 75.2 percent of global GDP. But by 2014, this share had fallen to 65.4 percent. Many other economies grew more rapidly. For example, the BRICS economies as a group grew from 6.3 percent of the global economy in 1991 to 8.5 percent in 2014, peaking at 9.3 percent in 2011. However, all except India were, as of early 2016, experiencing notable economic slowdowns.

These shifts in shares of global output are likely to continue. As shown in Table 4.1, both the IMF and the World Bank expect poorer countries to grow faster than the United States and economically advanced countries as a whole in 2016 and 2017. Among the emerging market and developing economies, much of that growth is expected to come from China, India, the Association of Southeast Asian Nations (ASEAN), and sub-Saharan Africa. Growth in Latin America and the Caribbean is projected to lag.

This spread in growth may have positive effects on the U.S. economy. First, the more prosperous other economies are, the more likely they are to buy U.S. products and services. Second, as they enter into greater international trade and investment relations, they are likely to become more active supporters of a rules-based international economic system. The spread of growth is also a positive outcome of the rules-based system the United States has led.

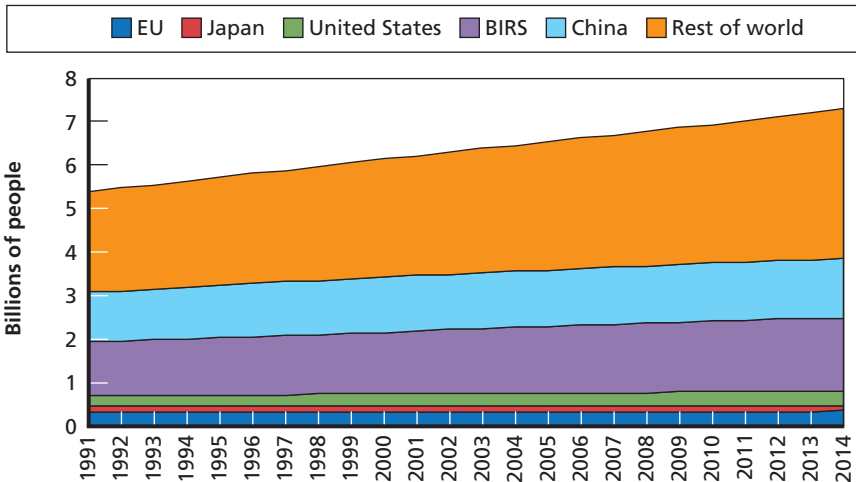
The United States is likely to remain the world's largest national economy for at least another decade and possibly beyond. This observation assumes no rapid deceleration of or crisis in the Chinese economy, as well as the United States maintaining a growth rate close to its historical average, or even slowing somewhat. If Europe and Japan continue to struggle, the United States and its allies as a group will continue to lose weight in the global economy. However, as Figure 4.1 suggests, market democracies will continue to dominate the international economy and the advanced countries will continue to be the most desirable markets because of their size and openness.

Population Trends

The United States is the largest country economically, but certainly not in terms of population (Figure 4.2). However, it is and should remain the third most populous country for a long period. As with GDP, the population growth of its leading allies has already slowed and is expected to continue to decline.⁸

U.S. population rose 26 percent between 1991 and 2014, nine points slower than the rate of growth of the world population, which rose 35 percent. In contrast, the populations of the EU and Japan rose 8 percent and 3 percent, respectively, while the populations of India and China grew 46 percent and 19 percent, respectively. The population of Russia declined by more than 3 percent during the same period.

Figure 4.2
World Population



SOURCE: World Bank, 2016b.

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⁸ Martin C. Libicki, Howard J. Shatz, and Julie E. Taylor, *Global Demographic Change and Its Implications for Military Power*, Santa Monica, Calif.: RAND Corporation, MG-1091-AF, 2011.

One of the most important reasons for U.S. population growth was and is immigration. As of 2014, foreign-born residents of the United States (both legal and illegal residents) constituted 13.1 percent of the U.S. population. Although this proportion was slightly higher from 1860 through 1920, the immigrant contribution to U.S. population growth is the highest it has been since at least 1850. Immigrants constituted 34.7 percent of U.S. population growth between 1990 and 2000, 33.6 percent of U.S. population growth between 2000 and 2010, and 23.5 percent of U.S. population growth between 2010 and 2014. This excludes additional population growth in the form of the children of immigrants. Besides adding to population growth, immigrants have also contributed substantially to innovation and technological change in the United States.⁹ Because economic growth rates are the result of growth in capital, labor, and productivity, sustained and significant levels of immigration will help the United States retain the standing and influence in the world that stems from its economic size. Accordingly, any sensible labor market policy will consider how to integrate these large immigrant populations and enhance their productivity.¹⁰

World Trade

The shares of the United States in total trade in goods and services and exports of goods and services have fallen unambiguously. Despite those relative losses, U.S. trade has continued to grow. In 2014 the United States remained the largest trader in goods and services in the world,

⁹ Annalee Saxenian, *Silicon Valley's New Immigrant Entrepreneurs*, San Francisco, Calif.: Public Policy Institute of California, 1999.

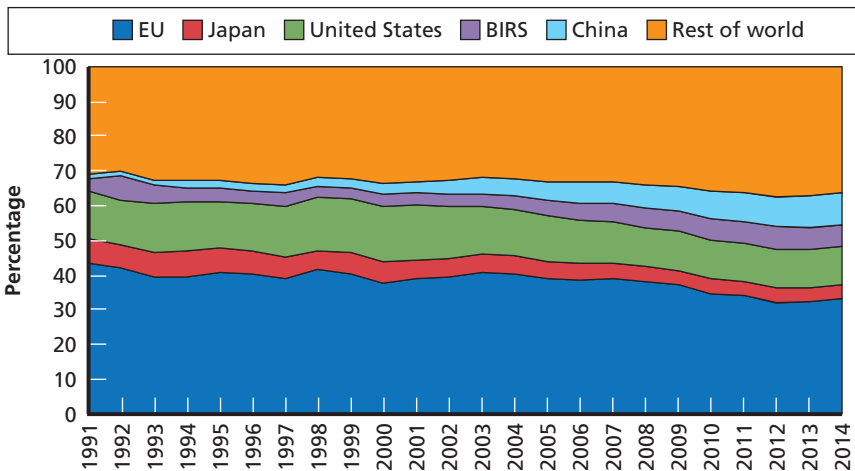
¹⁰ Data on foreign-born population from 1850 through 2000 is from Campbell Gibson and Kay Jung, *Historical Census Statistics on the Foreign-Born Population of the United States: 1850 to 2000*, Washington, D.C.: U.S. Census Bureau, Population Division, Working Paper No. 81, February 2006. Data on foreign-born population from 2010 is from U.S. Census Bureau, "S0501: Selected Characteristics of the Native and Foreign-Born Populations," Five-Year Estimates, *American Community Survey*, 2006–2010. Data on foreign-born population from 2014 is from U.S. Census Bureau, "S0501: Selected Characteristics of the Native and Foreign-Born Populations," Five-Year Estimates, *American Community Survey*, 2010–2014.

with 11.2 percent of total trade in goods and services, compared with 9.3 percent for China.

In terms of total trade, growth in the EU and Japan has been far lower than world growth (Figure 4.3). From 1991 to 2014, the nominal value of goods and services trade grew by more than five times. Japanese trade grew by less than three times, and EU trade grew by 3.9 times, including intra-EU trade. U.S. trade grew by 4.3 times, while Chinese trade grew by 34.2 times. As a result, the U.S. share of world trade fell from 13.5 percent in 1991 to 11.2 percent in 2014, and the Chinese share grew from 1.4 percent in 1991 to 9.3 percent in 2014.

These trends are the same for exports of goods and services. However, in 2014, China surpassed the United States as the world's leading exporter of goods and services, although only slightly: Trade from each rounded to 9.9 percent of world trade in goods and services. As before, Japanese and EU growth in exports of goods and services was below world growth, whereas growth in China and India was above world growth and their shares increased accordingly (Figure 4.4).

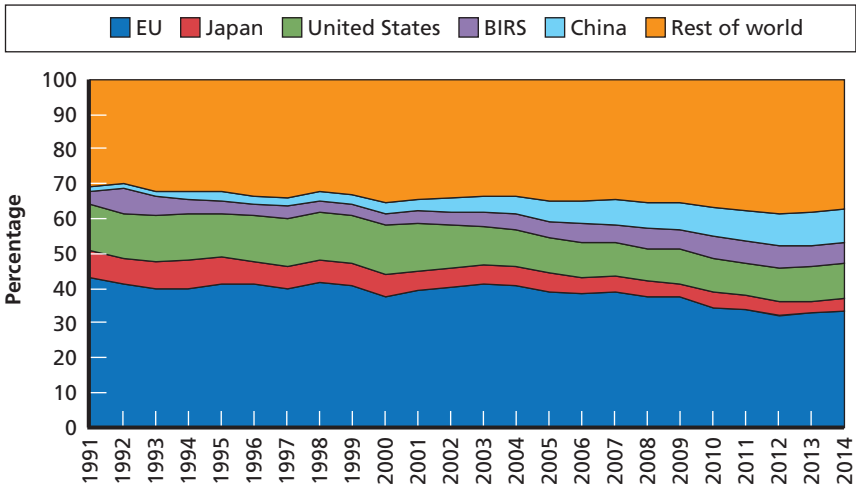
Figure 4.3
Share of World Trade of Goods and Services



SOURCE: World Bank, 2016b.

NOTE: Figure shows each country's or group's sum of exports and imports of goods and services as a percentage of the sum of global exports and imports of goods and services.

Figure 4.4
Share of World Exports of Goods and Services



SOURCE: World Bank, 2016b.

NOTE: Figure shows each country's or group's share of global exports of goods and services.

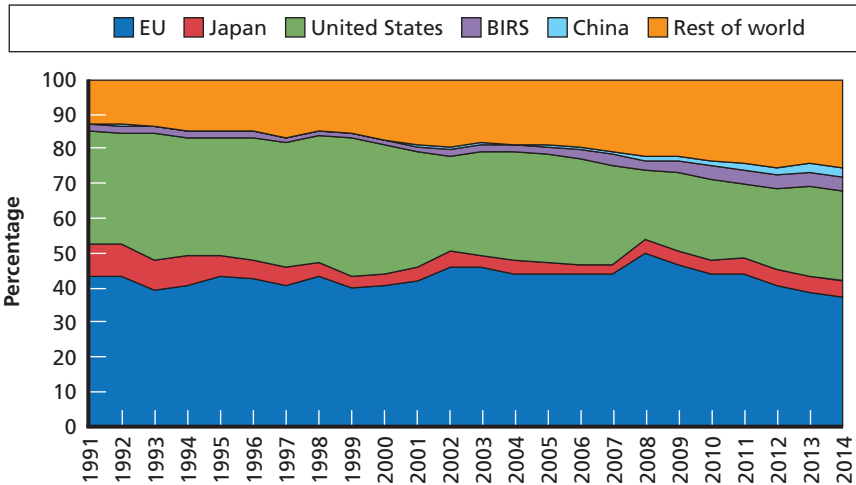
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Foreign Direct Investment

The United States remains by far the leading source of outward FDI (overseas investment for the purpose of controlling a business or owning real estate), although its share has fallen since 1991. In 2014, the stock of U.S. outward FDI totaled \$6.3 trillion and constituted 25.7 percent of world outward FDI (Figure 4.5). The EU had more—\$9.2 trillion and 37.2 percent of the world total—but that was among 28 countries and included investment within the EU. The EU country with the largest amount of outward FDI was the UK, with \$1.6 trillion, only \$867 million more than that of second-place Germany.

Chinese outward direct investment has grown steadily from 0.2 percent of the global total in 1991 to 3.0 percent in 2014. This placed China ninth among all countries, just below the Netherlands and above Canada. The U.S. share, although the highest in 2014, was well below the 1991 level of 32.7 percent. Most of the growth in share

Figure 4.5
Share of Outward Direct Investment



SOURCE: United Nations Conference on Trade and Development, "Foreign Direct Investment: Inward and Outward Flows and Stock, Annual, 1980–2014," web-based database, October 2, 2015.

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came from the rest of the world, a grouping that includes such friendly nations as Australia, South Korea, Taiwan, and the ASEAN countries, among others. The rest of the world's share of outward FDI rose from 12.4 percent in 1991 to 25.1 percent in 2014. Among leading U.S. allies, Japan's share has fallen dramatically, from 9.2 percent in 1991 to 4.8 percent in 2014 (although the absolute level rose more than five-fold). The EU's share also fell, from 43.2 percent in 1991 to 37.2 percent in 2014, after peaking at 49.8 percent in 2008.

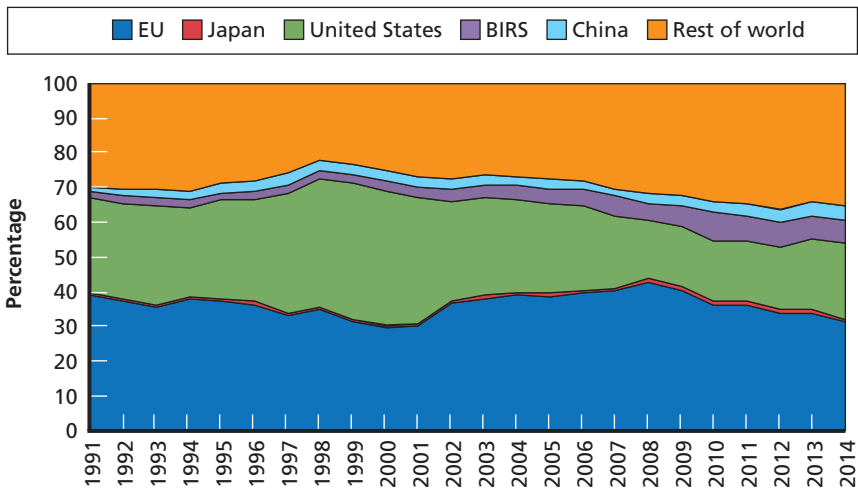
Although the U.S. share has fallen, the absolute level has risen strongly, which has likely stemmed from U.S. economic growth; many more investment opportunities since 1991, including the increased opening of China and the opening of the former Soviet Union and Eastern Europe; growth around the world; and liberalization of direct investment rules throughout the world. The fact that growth of direct investment from the rest of the world has outpaced that from the United

States is largely a consequence of European integration and global growth, with countries investing outward as they become wealthier.

As with outward direct investment, the United States was the largest single host for inward direct investment, with 22.0 percent of the global total in 2014. However, this was somewhat below the 27.1 percent it held in 1991 and well below the 39.5 percent it held in 1999, during the technology bubble. Despite the rise of inward direct investment in China from \$25 billion in 1991 to \$1.1 trillion in 2014, China still hosts a very small share of global direct investment, only 3.4 percent in 2014, well below its share of global GDP (Figure 4.6).

Among the major groups of countries on which this report focuses, the BIRS countries have experienced the largest absolute change in share, rising 4.2 percentage points, from 2.0 percent of the world total in 1991 to 6.2 percent in 2014. This was driven largely by growth of FDI into India and Russia. Among U.S. allies, Japan's share grew, albeit remaining less than 1 percent of global totals, and the EU's share fell. All of this decrease occurred from 2008 to 2014.

Figure 4.6
Share of Inward Direct Investment



SOURCE: United Nations Conference on Trade and Development, 2015.

The decline in the U.S. share of inward FDI could stem from a number of causes. First, since it is a share decrease, more-rapid economic growth throughout the rest of the world for much of the period from 1991 to 2014 simply meant that even though the U.S. economy was attractive, other economies were more so. In fact, the absolute level of FDI in the United States increased dramatically, and at a slightly higher rate than the absolute level of FDI originating from the United States. But it also could mean that investors perceived current and future profit opportunities to be lower; if this were the case, it likely would be related to the slower pace of economic growth that the United States experienced in the years since the financial crisis. The two potential causes are simply different sides of the same coin, although a situation of potentially diminishing profit opportunities is amenable to U.S. policy action.

Intellectual Property

Just as the advanced economies of the United States, Europe, and Japan tend to conduct a large share of their international transactions through multinationals rather than through trade, they also specialize in goods and services that have high content in intellectual property. As demonstrated by U.S. dominance in the Internet, and by U.S., German, and Japanese dominance in advanced manufacturing, the three major economies rely on innovation for their economic advancement.¹¹

¹¹ China is the world's leading manufacturer by output, but the economically advanced countries are leaders in what has become known as advanced manufacturing. Although definitions vary, it is best described as "both new ways to manufacture existing products and the manufacture of new products emerging from new advanced technologies" (President's Council of Advisors on Science and Technology, Executive Office of the President, *Report to the President on Capturing Domestic Competitive Advantage in Advanced Manufacturing*, July 2012). The report notes that the United States, as the longtime advanced manufacturing leader, has slowly been ceding ground (p. 10). Other reports note that the United States and Germany have advantages for advanced manufacturing that others do not, and that the United States is likely to have the best manufacturing environment within five years (Deloitte and U.S. Council on Competitiveness, *2013 Global Manufacturing Competitiveness Index*, Deloitte Global Services Limited, 2012; Deloitte and U.S. Council on Competitiveness, *2016 Global Manufacturing Competitiveness Index*, Deloitte Touche Tomatsu Limited, 2015).

There are a number of ways, none of them perfect, to measure innovation, intellectual property, and creativity. The bulk of this section focuses on patents, which are convenient because they can be measured easily in a number of ways. However, the section first reviews a number of other measures to give a more complete picture.

In terms of total dollars spent, the United States spends the most of any country on research and development (R&D), followed by China, Japan, Germany, and South Korea.¹² In terms of gross R&D spending as a proportion of GDP, the United States is well above the EU and OECD averages, but below a number of smaller countries that spend heavily on R&D, including Israel, Japan, Finland, South Korea, Sweden, Denmark, Taiwan, Switzerland, Austria, and Germany.¹³

Entertainment is another example of the creation of U.S. intellectual property. The prime example is in movies. Trade and business publications indicate that U.S.-produced movies have global audiences and earn more revenue than movies from other countries. For example, one source puts the worldwide gross revenues of the movie *Avatar* at \$2.8 billion, with \$761 million coming from U.S. revenues and \$2.0 billion from international revenues. The top 24 highest-grossing movies all made more than \$1 billion internationally.¹⁴ In contrast, \$114 million in global revenues made the comedy *PK* the

¹² National Science Board, *Science & Engineering Indicators 2016*, Washington, D.C.: National Science Foundation, 2016. The National Science Board measures R&D expenditures in terms of PPP dollars, and notes that PPP is the preferred international standard and used in official R&D tabulations by the OECD (pp. 4–35). Specific dollar figures cited are for 2013 and are \$457.0 billion for the United States, \$336.5 billion for China, \$160.3 billion for Japan, \$101.0 billion for Germany, and \$68.9 billion for South Korea. Following them are \$55.2 billion for France, \$40.7 billion for Russia, \$39.9 billion for the UK, and \$36.2 billion for India.

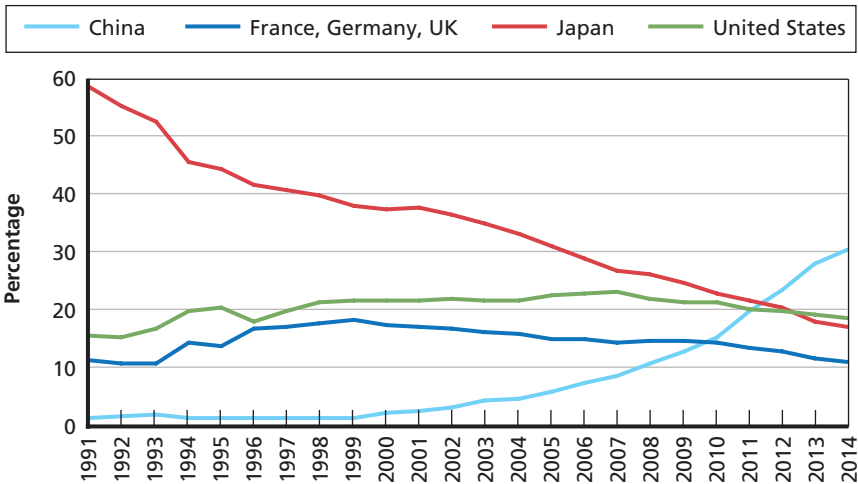
¹³ National Science Board, 2016. Those figures for 2013 are 4.21 percent for Israel, 3.47 percent for Japan, 3.32 percent for Finland, 4.15 percent for South Korea, 3.30 percent for Sweden, 3.06 percent for Denmark, 2.99 percent for Taiwan, 2.96 percent for Switzerland, 2.95 percent for Austria, 2.85 percent for Germany, and 2.73 percent for the United States. The figure for China is 2.08 percent.

¹⁴ Nash Information Services LLC, “All Time Highest Grossing Movies Worldwide,” *The Numbers*, 2016.

highest-earning movie from India, which has an enormous movie production industry.¹⁵

As already noted, another way of measuring innovation is through patenting. The United States has largely maintained its long-term share of innovation, as represented by the number of patents filed by U.S. residents relative to the rest of the world (Figure 4.7). In fact, the proportion of patent applications filed by Americans in 2001–2014 was 2.2 percentage points higher than the proportion in 1991–2000. For leading European nations, those proportions were about the same in both decades. Two contrasts stand out. First, the share of patents filed by Japanese residents has declined precipitously, from an average of almost 45 percent in 1991–2000 to 27 percent in 2001–2014. Second,

Figure 4.7
Share of Global Patent Applications by National Origin



SOURCE: World Intellectual Property Organization, *WIPO Statistics Database*, December 2015b.

NOTE: Figure shows global share of total count of patent applications, direct and Patent Cooperation Treaty national phase entries, by national origin.

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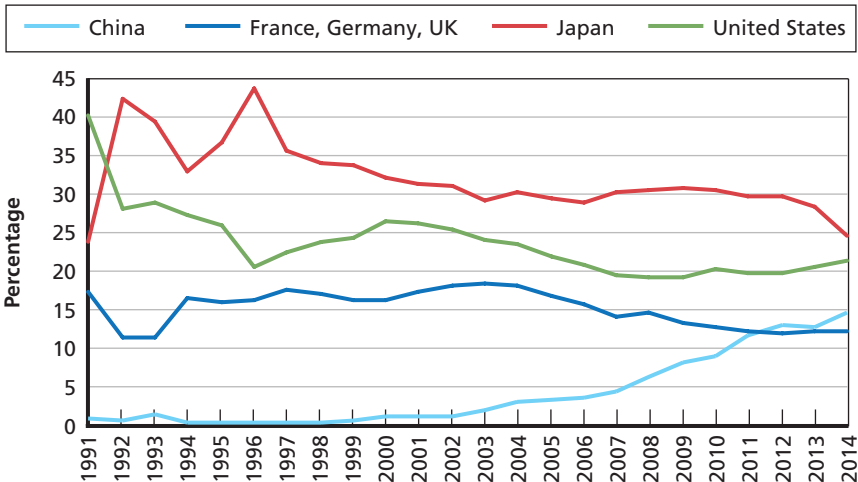
¹⁵ Rob Cain, "Oops . . . 'PK' Is Not Actually India's Top-Grossing Movie Ever," *Forbes*, August 14, 2015.

the share of patents filed by Chinese residents has risen greatly, overtaking that of both the United States and Japan in 2012.

Not all patent applications are granted. However, this increased Chinese patenting activity has started to translate into patents granted (Figure 4.8). In 2012, patents granted of Chinese origin surpassed those of French, German, and UK origin, although patents granted originating in the United States and Japan have remained the largest share of patents granted worldwide.

The Chinese record accords with specific Chinese policy to increase patenting activity and innovation. However, these patents may not be up to international standards. Nearly all patents applied for by Chinese residents are applied for in China, where the ideas being patented often are not of the same quality as would be required internationally.¹⁶ So another

Figure 4.8
Share of Global Patents Granted by National Origin



SOURCE: World Intellectual Property Organization, 2015b.

NOTE: Figure shows global share of total count of patent grants, direct and Patent Cooperation Treaty national phase entries, by national origin.

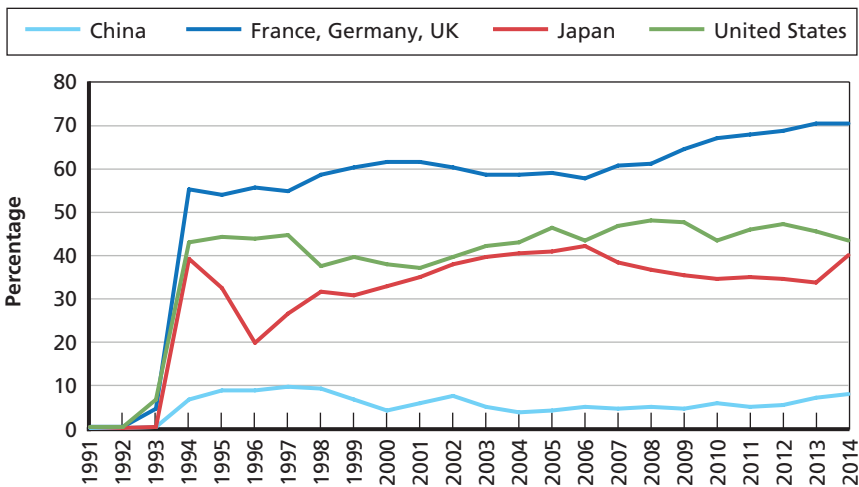
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¹⁶ “Patent Applications Surge in China but Quality Remains Low,” Xinhua, April 25, 2013; “Patents Yes; Ideas Maybe,” *The Economist*, October 14, 2010.

useful measure of innovation is the proportion of patents being granted abroad (Figure 4.9). The proportion of all patents originating in France, Germany, and the UK granted by patent offices not in those countries was almost 71 percent in 2014; U.S.- and Japanese-origin patents granted abroad were more than 40 percent in 2014 and have been more than 40 percent for U.S.-origin patents every year since 2003. In contrast, that figure has remained well below one-tenth for Chinese-origin patents. As a proportion of all patents granted outside the home country of the entity applying, the trend for Chinese-origin patents is upward, but the figure is still well below that of the most innovative countries.

Another measure of innovation is patents through the Patent Cooperation Treaty, a treaty with more than 148 contracting states that allows one to seek patent protection in a large number of states by filing a single international patent application. China was third among countries as a source of Patent Cooperation Treaty applica-

Figure 4.9
Proportion of National-Origin Patents Granted Abroad



SOURCE: World Intellectual Property Organization, 2015b.

NOTE: Figure shows share of patent grants, direct and Patent Cooperation Treaty national phase entries, originating in each geographic area but granted in other geographic areas. For France, Germany, and the UK, that proportion excludes patents granted by each specific home country, as well as by the European Patent Office.

tions in 2013 and 2014, but it was still well behind the United States and Japan. Among companies filing, in 2014, China's Huawei was the top filer worldwide and China's ZTE was third; China had six companies among the top 50. Japan, in contrast, had 19 companies and the United States had 15 companies among the top 50. In addition, the United States had 28 universities among top university filers, Korea had seven, and Japan had five, whereas China had three among the top 50 filers.¹⁷

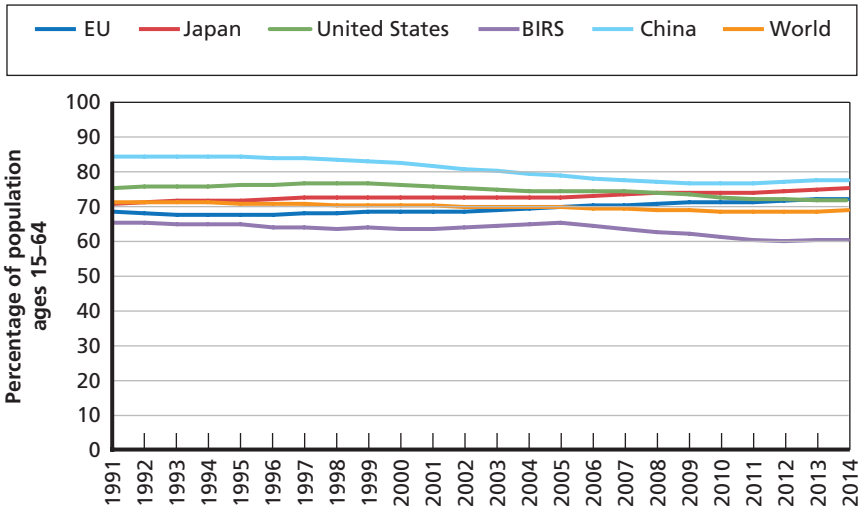
The Labor Force

Innovation reflects activity by human capital, one aspect of the labor market. As noted earlier, U.S. LFP has been falling. This is true worldwide among people ages 15 to 64 since 1991, from 71.2 percent in 1991 to 68.7 percent in 2014. In contrast, it has risen in Japan and the EU (Figure 4.10). Both locations had been below world averages, but more recently, both (and especially Japan) are above world averages. Participation in the United States and China, while falling, is also above the world average. Participation in the BIRS countries is particularly poor and falling. Although the reason for the decline of LFP may differ by economy, LFPs are usually low because of social conventions against working-age women joining the labor force; poor employment prospects causing potential workers to become discouraged; or government benefits, such as generous disability payments or early retirement schemes, causing people to leave the labor force when they can do nearly as well by not working.

One of the main reasons for the improving labor supply in the EU and Japan is the entry of women into the labor force (Figure 4.11). Although global female LFP has decreased slightly, from 57.3 percent in 1991 to 55.3 percent in 2014, it increased in the EU from 54.0 percent to 66.2 percent and in Japan from 57.9 percent to 65.4 percent. It

¹⁷ World Intellectual Property Organization, *Patent Cooperation Treaty Yearly Review: The International Patent System*, Economics and Statistics Division, Geneva, 2015a; World Intellectual Property Organization, *Patent Cooperation Treaty Yearly Review: The International Patent System*, Economics and Statistics Division, Geneva, 2014.

Figure 4.10
Labor-Force Participation



SOURCE: World Bank, 2016b.

NOTES: Figure shows the percentage of people ages 15–64 who are either employed or actively seeking employment. The BIRS figure is computed as a weighted average of the LFP for each country, with the weight equal to each country's population share among the four.

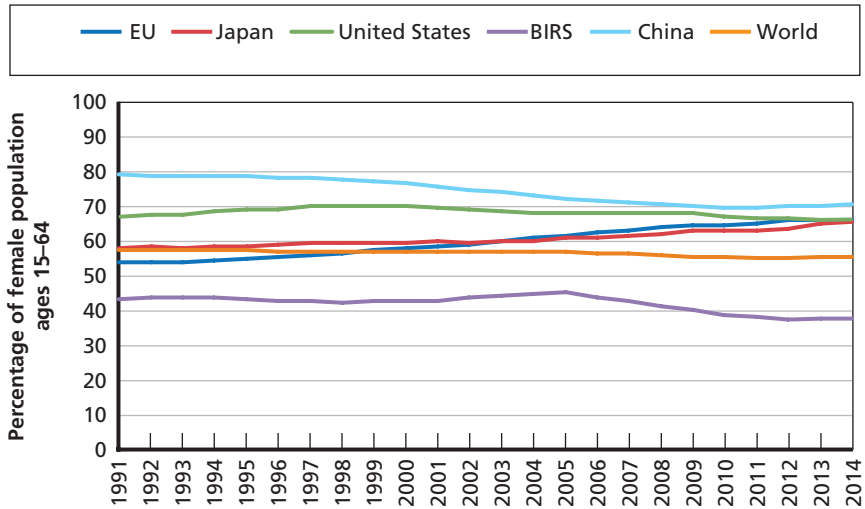
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has fallen in the major developing countries but held largely steady in the United States, first rising and then falling by 2014 to 0.7 percentage points below its 1991 level.¹⁸

As with overall LFP, participation among men ages 15–64 is also falling worldwide (Figure 4.12). This is particularly the case in the United States, China, and the BIRS group. Between 1991 and 2014,

¹⁸ Female LFP might have fallen in developing countries because they have become wealthier. There is thought to be a U-shaped relationship between female LFP and national income, with women in low-income countries participating in large numbers in subsistence agriculture and women in high-income countries participating broadly in the economy. However, in middle-income countries, it is thought that female LFP falls as jobs transition to manufacturing, which tends to be more male-dominated. However, there is evidence suggesting this is far from a complete explanation (“Women Are Less Likely Than Men to Participate in the Labor Market in Most Countries,” World Bank, April 9, 2012; Sher Verick, “Female Labor Force Participation in Developing Countries,” *IAZ World of Labor*, No. 87, September 2014).

Figure 4.11
Female Labor-Force Participation



SOURCE: World Bank, 2016b.

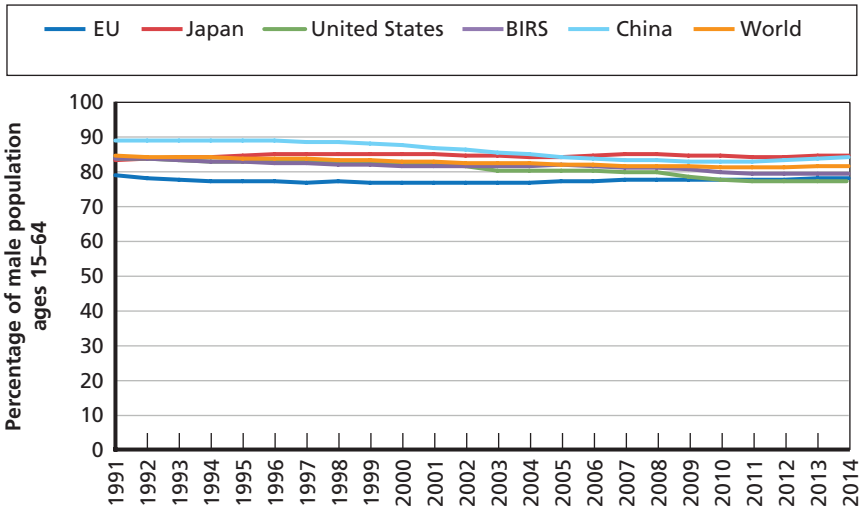
NOTE: Figure shows the percentage of females ages 15–64 who are either employed or actively seeking employment. The BIRS figure is computed as a weighted average of the LFP for each country, with the weight equal to each country's female population share among the four.

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male LFP fell by 6.4 percentage points in the United States, and in 2011 fell below that of the EU for the first time in many years. Other large declines included 4.6 percentage points in China, and 4.3 percentage points in the BIRS countries. In contrast, male LFP has actually risen in Japan and dropped by only one percentage point in the EU.

Globally, LFP has fallen. This is likely partly due to demographic trends worldwide—much of the world, not just the United States, is aging. In fact, much of the developed world is aging at a faster rate than the United States. Even with that, U.S. LFP as of 2014 was below that in its peer economies in the EU and Japan, with the rate actually rising in those economies. Total output depends on the raw input of labor and the productivity of that labor; so, without positive trends in productivity, the relative U.S. falloff in LFP is a warning sign of possible reduced growth in the future. It also suggests that if the United States

Figure 4.12
Male Labor-Force Participation



SOURCE: World Bank, 2016b.

NOTE: Figure shows the percentage of males ages 15–64 who are either employed or actively seeking employment. The BIRS figure is computed as a weighted average of the LFP for each country, with the weight equal to each country's male population share among the four.

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wants to restore participation on both an absolute and comparative basis, it should reevaluate labor market regulations and other policies that might be suppressing participation, as well as improve education to help with skill development that might lead people to decide to enter the job market because they see opportunity for themselves.

Interpreting Global Economic Trends

Despite the growth of other countries, the United States remains the leading economy in terms of GDP, a major trading country and the leading exporter of services, and the leading global investor in terms of direct investment. The United States also leads in innovation, filing high-quality patents and hosting the world's leading research universi-

ties. It is true that its share of the world economy is declining, but that can be interpreted as a sign of success—under the right conditions, poorer countries will grow faster than richer countries.¹⁹ The United States was instrumental in creating conditions in which poor countries could grow.

The United States also dominates financial markets. Since 1996, the U.S. dollar has constituted more than 60 percent of global official reserves among the reserves for which a denomination is known.²⁰ In addition, much of global trade is denominated in dollars, even in East Asia, where China is the leading trading partner of many countries.²¹ This combination of dominance of international reserves and dollar-denomination of trade has enabled the United States to borrow in dollars globally without worrying about exchange rate risk. If other countries borrow in dollars and their currency depreciates against the dollar, the cost of their loan servicing and the value of their debt rise in national terms. The United States does not face this problem. Not all economists find this a virtue and some suggest it has led to overborrowing on the part of the United States and deindustrialization.²² Aside from its place in the global economy, the United States retains a leading voice in global economic institutions (see Chapter Five for more on this, as well as challenges).

The biggest weakness the United States faces globally is the relative decline of its leading allies. The European and Japanese economies have not been performing well and both have lost much more share in the global economy than has the U.S. economy. This is especially true of GDP, a measure of national income and therefore of the resources they can mobilize to pay for military forces or other instruments of

¹⁹ Robert J. Barro and Xavier Sala-i-Martin, *Economic Growth*, New York: McGraw-Hill, 1995.

²⁰ IMF, “Currency Composition of Official Foreign Exchange Reserves (COFER),” web page and electronic database, September 30, 2014.

²¹ Ronald McKinnon and Gunther Schnabl, “China’s Exchange Rate and Financial Repression: The Conflicted Emergence of the RMB as an International Currency,” *China & World Economy*, Vol. 22, No. 3, 2014, pp. 1–35.

²² Jared Bernstein, “Dethrone King Dollar,” *New York Times*, August 27, 2014.

international influence and alliance action. Still, as measured by the quality of patents, they have retained their innovation potential, and this potential is still unmatched by rising countries. In addition, they have increased their LFP rates, largely through the increased entry of females into the labor force, thus increasing the goods and services they can produce despite adverse demographic trends.

As the economic weight of traditional allies falls, the weight of potential adversaries and potential new allies in the global economy has been rising. This is especially true of China and India. A challenge for the United States will be to ensure that the former does not become an adversary and that the latter becomes a stronger partner.

Strategic Choices Abroad: Maintaining the Liberal Rules-Based International System

Still strong in the global economy but facing internal challenges, the United States will have a variety of international economic policy choices over the next decade as it seeks to maintain and improve a global economic environment that will benefit its population. The most important of these choices for U.S. international economic policy include maintaining and broadening the liberal rules-based international economic system and its institutions; managing the relationship with China and, to the extent possible, further integrating it into the global system; supporting growth and development of allies, friends, and partners; and balancing the use of economic instruments of conflict, such as sanctions, with the integrity of the international economic system.

This chapter focuses on the international system. International institutions, such as the IMF and the World Bank, and rules about governance of exchange rates, trade, and other forms of economic exchange have provided the foundation for the enormous growth of prosperity worldwide since the end of World War II. However, the system has faced modest challenges in the past decade. For the first time, a multilateral trade liberalization round has fallen through. Developing countries are growing in economic size but not necessarily in the influence they can exercise in these traditional institutions, so they are starting to create their own. Chief among these is China. This chapter will focus on the international system as a whole; the next will focus on China's place in that system, as well as China's bilateral relationship with the United States.

The Pillars of the Liberal Rules-Based System

The rules-based international economic system established following World War II has rested on two main pillars. The first is multilateral trade liberalization through what was originally the General Agreement on Tariffs and Trade (GATT) and what is now the WTO. The second is assistance through multilateral institutions for balance-of-payment adjustments following financial and budget crises under the IMF, and economic development under the World Bank and regional development banks.

These pillars have supported a simple idea that has been implemented slowly: International trade and investment should be free among nations, with benefits that are accorded to one partner accorded to all; and businesses of one nation operating in another, either through trade or investment, should be afforded the same treatment as the local businesses in the nation in which they are operating.

The result is a system that has gradually opened to increased trade and investment, enabled reforming countries such as China and the entire former Soviet bloc to take part in opportunities for trade and investment, facilitated rapid growth of international exchange, and enabled a dramatic growth in incomes worldwide.

Global merchandise exports grew more than 9 percent each year between 1948 and 2014, to \$19 trillion. Global services exports grew 8.0 percent each year between 1980 and 2013 (the longest time period with available data) to \$4.6 trillion, even faster than merchandise trade during the same period, at 7.0 percent.¹ And the outward FDI position grew faster still, at 12.2 percent per year from 1980 to 2013 and an additional 1 percent from 2013 to 2014, to \$24.6 trillion.²

This rapid growth of international exchange has contributed to growth in world incomes. One widely accepted analysis has found that a 1-percent increase in trade relative to GDP results in per capita GDP growth of between 0.85 percent and 1.97 percent.³ Increased trade also

¹ World Trade Organization, "Statistics Database: Time Series on International Trade," undated.

² United Nations Conference on Trade and Development, 2015.

³ Frankel and Romer, 1999.

has contributed to the global decline of poverty (Table 5.1). Although much of this decline took place in China, China's growth and development was enabled by both its internal move to markets, originally in agriculture, and to its opening to the world. China's growth, in turn, helped boost the growth of its many trade partners.

The United States has been the dominant player in most of the institutions supporting these ideals. The GATT was modeled on reciprocal trade agreements negotiated by the United States in the 1930s, and the United States retains the only single-country veto at both the IMF and World Bank. The IMF has primarily helped countries with balance-of-payment problems, although it also has spearheaded broader rescue efforts when countries run out of money and are unable to pay their debts or need policy reforms. The World Bank has primarily helped countries with longer-term development finance and policy advice. Both pillars face modest challenges. In addition, there have been fears that the liberal idea of equal treatment has come under contest from state-owned competitors, favored by their home country governments in a form of state capitalism.

Trade Liberalization

The WTO entered into force after years of negotiation under what was known as the Uruguay Round of trade negotiations. As those nego-

Table 5.1
Decline of Poverty in the Developing World

Region	2005 (%)	2011 (%)
East Asia and the Pacific	16.7	7.9
Europe and Central Asia	1.3	0.5
Latin America and the Caribbean	7.3	4.6
Middle East and North Africa	3.0	1.7
Sub-Saharan Africa	52.8	46.8
World	21.1	14.5

SOURCE: World Bank, 2016b (search string term: SI.POV.DDAY).

NOTE: Data show percentage of population living on \$1.25 per day or less, valued at PPP.

tiations stalled, the United States, Canada, and Mexico introduced the idea of competitive liberalization and embarked on negotiations for NAFTA. Both sets of talks succeeded, with NAFTA entering into force in 1994 and the WTO starting in 1995. Since then, regional and bilateral free trade agreements have proliferated. In addition, a new WTO negotiating round, the Doha Development Agenda, started in 2001. However, these negotiations appear to have ended, and nations are seeking other trade arrangements to increase economic integration.

WTO Negotiations

At a December 2015 meeting in Nairobi, 164 trade ministers did not reaffirm the Doha Development Agenda for the first time, although they did reach agreement on a number of issues.⁴ This move effectively killed the round, but the decision was far from unanimous. India was particularly disappointed in the collapse.⁵ Numerous other developing countries were also opposed to ending Doha, including China, those countries classified as least developed, African countries, members of the ACP Group (comprising African, Caribbean, and Pacific countries), and developing countries that are members of a grouping known as the G-33.⁶ Ironically, there is a view that developing countries caused a variety of negotiating difficulties in the first place.⁷

In contrast to the developing countries, the United States, Europe, and WTO leadership presented the end of Doha as a positive opportunity. European Commissioner for Trade Cecilia Malmström has noted the many problems with the Doha Development Agenda and that there are alternative ways to continue trade liberalization, such as

⁴ Shawn Donnan, “World Trade Organisation Moves on from Stalled Doha Round,” *Financial Times*, December 19, 2015a; Shawn Donnan, “Trade Talks Lead to ‘Death of Doha and Birth of New WTO,’” *Financial Times*, December 20, 2015b.

⁵ Donnan, 2015a and 2015b.

⁶ Simon Lester, “Is the Doha Round Over? The WTO’s Negotiating Agenda for 2016 and Beyond,” *Free Trade Bulletin*, No. 64, Herbert A. Stiefel Center for Trade Policy Studies, Cato Institute, February 11, 2016.

⁷ Richard Baldwin, “The World Trade Organization and the Future of Multilateralism,” *Journal of Economic Perspectives*, Vol. 30, No. 1, Winter 2016, pp. 95–116.

by negotiating among smaller groups of countries but extending the results of the talks to all countries. She wrote that Nairobi “showed the world that multilateral institutions can produce results.”⁸ Likewise, WTO Director General Roberto Azevêdo’s closing remarks at Nairobi noted many successes and acknowledged the end of the Doha Development Round, although without mentioning it by name; in a speech he made the following January, he said that Nairobi has delivered “some of the biggest reforms in global trade policy for 20 years” and that there would be ways to build on this progress.⁹ A more modest, and likely more realistic, assessment came from Canada’s ambassador to the WTO, Jonathan Fried, who said that “the sobering reality of Nairobi’s fairly modest results will require realistic articulation of what is achievable within or beyond the Doha framework in the next two years.”¹⁰

Doha did have many flaws, including leaving important new issues off the table, such as competition policy and aspects of investment and services.¹¹ Despite the positive talk of how the demise of Doha will result in a new and better effort at trade liberalization, something important will be lost if broad-based, multilateral liberalization is forsaken. The WTO motivating idea that nothing was final until everything was agreed upon did make negotiations more difficult, but it also put all issues on the table and enlarged the space for trade-offs. Focusing on only areas of likely agreement will lead to unresolved or unaddressed areas that the majority of countries might be reluctant to liberalize. Second, pursuing agreements with smaller sets of coun-

⁸ These are what are known as plurilateral agreements. Cecilia Malmström, “Doha May Be Dead. Long Live Free Trade,” *Politico Europe*, January 21, 2016.

⁹ Roberto Azevêdo, “DG Azevêdo’s Address to the MC10 Closing Ceremony,” December 19, 2015; Roberto Azevêdo, “Build on Historic Success of Nairobi to Tackle Urgent Challenges Facing the WTO,” speech at the University of the West Indies, Jamaica, January 18, 2016. Nairobi did deliver a number of achievements, including an agreement on eliminating agricultural export subsidies, new guidelines for agricultural export finance, new cotton market access for poor countries, and an agreement among 53 countries on information technology trade (Donnan, 2015a and 2015b; Lester, 2016).

¹⁰ Jonathan Fried, “After Nairobi, What Lies Ahead for World Trade?” *Agenda*, World Economic Forum, January 7, 2016.

¹¹ Malmström, 2016.

tries creates a risk of leaving some countries outside rules that could be beneficial to them but that they would be unable to institute without inclusion in a broad-based agreement. For example, China's accession process to the WTO enabled reformers there to succeed with changes that might otherwise have been impossible. A two-speed world risks eroding global support for the current rules-based system, especially if some countries fail to benefit from it.

Accordingly, the United States has a number of options for proceeding within the WTO. It can pursue closed plurilateral agreements that apply only to signatories; it can pursue open plurilateral agreements, which not every country signs but all countries can join at any time (and which apply to all members regardless of whether they sign); or it could pursue a new broad-based multilateral round. All of these would result in trade liberalization and maintaining the WTO as the leading global trade institution. However, closed plurilateral agreements risk the exclusion of countries from all the benefits of the WTO and could undermine the institution's legitimacy in the long run. Open plurilateral agreements are better, but risk leaving off the table issues that are important to countries not participating in the negotiations. Broad-based multilateral agreements have the most promise, but are the hardest to negotiate.

Given the dual desirability of liberalizing trade and maintaining the legitimacy of the WTO, the United States would likely benefit most by working to restart a broad-based multilateral round. Countries are only now absorbing the meaning of the demise of Doha and may be more inclined to reach agreement under a new round. At the same time, the United States should pursue open plurilateral agreements with an eye toward bringing in a wide group of countries and ensuring that such agreements are not viewed as just the results of a wealthy-nations club. Finally, the United States should continue to pursue regional arrangements, as discussed in the next section.

Regional Arrangements

While the Doha Development Agenda negotiations were proceeding, countries around the world were also pursuing bilateral trade agreements and regional trade agreements. The new regional negotiations involve much larger groups of countries than previously and have

become known as mega-free trade agreements or mega-regionals. The five largest are the Trans-Pacific Partnership (TPP), involving 12 Pacific Rim countries that collectively account for 38 percent of world GDP and 24 percent of world exports; the Trans-Atlantic Trade and Investment Partnership (TTIP), involving 29 countries (namely, the United States and the EU), 46 percent of world GDP, and 25 percent of world exports; the Regional Comprehensive Economic Partnership, involving 16 countries from Asia and Oceania, 29 percent of world GDP, and 30 percent of world exports; the EU-Japan free trade agreement, involving 29 countries and more than one-third of world GDP; and the Comprehensive Economic and Trade Agreement, involving 29 countries (namely, Canada and the EU) and more than one-quarter of world GDP.¹² More recently, an effort toward a pan-Africa trade deal was announced.¹³ Two of these mega-regionals include the United States: TPP, the Pacific trade deal, and TTIP, the Europe trade deal.¹⁴

For purposes of U.S. policy toward the institutional arrangements of the world economy, TPP and TTIP are by far the most important. In both cases, negotiators intend to complete a deal that not only addresses traditional trade issues (such as tariffs and quotas on manufactured goods), but also more-difficult issues (such as agricultural barriers, regulatory barriers, and regulatory harmonization) and trade-related rules (such as those related to the treatment of investors and labor).¹⁵ In the case of TTIP, U.S. and EU tariffs are already so low that

¹² Ruben Van den Hengel, "The Rise of the Mega-FTAs," Fact Sheet, EU Centre in Singapore, October 2013; Jeffrey J. Schott, "Can Mega-Regionals Support Multilateralism?" presentation at the OECD Global Forum on Trade, *Reconciling Regionalism and Multilateralism in a Post-Bali World*, Paris, February 11, 2014. Updated figures for the TPP countries were 36 percent of world GDP and 24 percent of world exports of goods and services as of 2014 (World Bank, 2016a).

¹³ "Toward Africa's Own Mega-Regional: The CFTA," *Bridges Africa*, Vol. 5, No. 1, February 12, 2016.

¹⁴ Schott, 2014; European Commission, "Countries and Regions: Japan," Directorate-General for Trade, September 15, 2014; Foreign Affairs, Trade and Development Canada, "Canada-European Union: Comprehensive Economic and Trade Agreement (CETA): Agreement Overview," November 4, 2014.

¹⁵ Shayerah Ilias Akhtar and Vivian C. Jones, *Proposed Transatlantic Trade and Investment Partnership (T-TIP): In Brief*, Washington, D.C.: Congressional Research Service, June 11, 2014.

most of the gains from such an agreement will come from agreements on those difficult issues. Should these agreements succeed, the parties would then use the agreements to help set the standards for broader, multilateral trade agreements.

The Pacific and European deals are also noted for having potential strategic benefits. In the case of the TPP, the agreement is seen as a sign of the rebalance to Asia.¹⁶ In the case of the TTIP, the agreement is viewed as reinforcing U.S. commitment to Europe, especially in light of the rebalance to Asia.¹⁷

The Pacific Deal

TPP negotiators reached agreement on October 4, 2015, making that deal the first to be completed.¹⁸ Trade ministers signed the deal on February 4, 2016, in New Zealand (February 3 in the United States).¹⁹ The next step is ratification, sparking a ferocious debate in many of the participating countries.

At the heart of this debate is who will benefit—specifically, whether lower-skilled workers will be hurt. There is much less disagreement about overall benefits; most agree there will be.²⁰ So far, a variety of politicians and institutions have lined up on both sides of the issue, not necessarily aligned by party. Democratic presidential candidate Hillary Clinton came out against the deal, but so did Rob Portman, a Republican former U.S. trade representative running for reelection as senator in Ohio. Economists are also split: Experts at the Peterson Institute for International Economics have argued that the deal would bring large benefits, but a specialist at the American Enterprise Insti-

¹⁶ Ian F. Fergusson, Mark A. McMinimy, and Brock R. Williams, *The Trans-Pacific Partnership (TPP) Negotiations and Issues for Congress*, Washington, D.C.: Congressional Research Service, March 20, 2015.

¹⁷ Akhtar and Jones, 2014.

¹⁸ Office of the U.S. Trade Representative, “Summary of the Trans-Pacific Partnership Agreement,” October 2015.

¹⁹ William Mauldin, “Dozen Nations Sign Pacific Trade Deal, Kicking off Battle for Ratification,” *Wall Street Journal*, February 3, 2016.

²⁰ Dani Rodrik, “The Trade Numbers Game,” *Project Syndicate*, February 10, 2016.

tute wrote that the deal is so flawed that ratifying it will make future liberalization more difficult.²¹

While the TPP agreement will need to be considered in detail, it seems clear that an agreement of this sort will provide benefit both to the U.S. economy and to U.S. influence in Asia and beyond. On the other hand, not entering into a partnership sought by successive U.S. administrations of both parties and pursued through more than eight years of negotiation would represent a significant blow to U.S. leadership and its commitment to Asian peace and prosperity. There are a number of other, more-specific factors that make the idea of the TPP a good one. First, it paves the way for Japan and the United States to be members of the same free trade agreement. There are large potential gains to freer trade between the world's largest and third-largest economies, but a bilateral deal between the two countries is likely too politically difficult. The United States already has free trade agreements with some of the TPP countries. Without Japan in the TPP, only 5 percent of U.S. trade to TPP countries in 2012 was to countries that did not already have a U.S. free trade agreement. With Japan, that number is 20 percent for merchandise trade and 32 percent for services trade.²² Second, bilateral deals between countries often create complex rules that might degrade the efficiencies that stem from freer trade. Deals including larger sets of countries are likely to have far larger gains. Third, because the TPP is an open agreement, meaning other countries can join in the future, approving and implementing the deal would enable the United States and its partners to establish the template for future global trade liberalization on terms most favorable to them, and possibly reap further benefits by creating on-ramps for new participants—including South Korea, ASEAN nations not currently in the deal, and China, the world's second largest economy. (The next chapter will discuss the issue of China.)

²¹ Gary Clyde Hufbauer and Cathleen Cimino-Isaacs, "Why the Trans-Pacific Partnership Isn't a Bum Deal," *PBS News Hour*, February 5, 2016; Derek Scissors, "Grading the Trans-Pacific Partnership," American Enterprise Institute, December 2015.

²² Fergusson, McMinimy, and Williams, 2015.

In sum, the United States should favor such a deal. It may not be this specific Pacific deal; although renegotiation is difficult, it is not impossible and not unprecedented. However, working to establish a Pacific trade deal is in the economic interest of the United States, especially with WTO members turning their backs on broad-based deals.

The Europe Deal

Negotiations for TTIP started in July 2013 with both sides intending to finish in two years, although this aggressive deadline has passed. When completed, TTIP will be a closed agreement; other nations will not be able to join.²³ It also will include the largest economy in the world (the United States) and the largest unified multinational economy (the EU, even larger than the United States).

As already noted, there is widespread consensus that free trade agreements lead to higher overall income for the parties, but critics fault trade and free trade agreements for widening the U.S. income distribution and spurring deindustrialization. Actual effects are hotly debated, and such charges usually center on trade with poorer countries. In the case of the Europe deal, this objection is moot: The agreement will be a deal among countries that have similar levels of income. This has not stopped opponents on both sides from worrying about whether one side has lower standards it will force on the other.²⁴

Even though both the United States and the EU have few traditional trade barriers toward each other's exports and investment, there are still many ways they could integrate. Given their size, it is likely any good deal will have economic gains for both sides. If successful, the deal would improve market access on goods and services and enlarge the ability of companies to bid for public tenders regardless of location, harmonize regulations or allow for mutual recognition of regulations when they differ, and ease a variety of trade rules.²⁵ The result would be greater

²³ Akhtar and Jones, 2014.

²⁴ Leala Padmanabhan, "TTIP: The EU-US Trade Deal Explained," BBC News, December 18, 2014.

²⁵ European Commission, "In Focus: Trans-Atlantic Trade and Investment Partnership (TTIP): Questions and Answers," March 19, 2015.

competition, more variety in the market, higher productivity, and faster economic growth. Accordingly, it is in the United States' interest to proceed with negotiations and eventually approve such a deal.

It may also be worthwhile to involve the United States' North American partners, Canada and Mexico, in that agreement. Canada is negotiating its own agreement with the EU, and Mexico already has one. Gains for all partners would likely be larger if there were a unified North America–EU agreement.

The Pacific and European deals together, if successful, would integrate the majority of the world's economic production well beyond what could be achieved within the WTO. Therefore, ideally, U.S. policymakers will want to see if they can unify these deals over the longer term. Such unification will not only create a larger area subject to one set of trade and investment rules, but may provide a better template than now exists for a global deal.

Multilateral Institutions

The IMF and World Bank, founded by the United States and the World War II allied powers (excluding the Soviet Union), have been dominated by those countries throughout their institutional existence. There is some justification for this: Under this leadership, the two institutions have served as important foundations for global prosperity. The president of the World Bank has always been an American, and the managing director of the IMF has always been a European. In addition, the United States and Europe remain collectively the world's largest economies and have contributed the most to World Bank capital and IMF financial commitments. In recent years, however, other countries have grown and become large contributors to the institutions and to the health of the global economy without commensurate gains in power over governance. In addition, other countries, such as China, have expanded their bilateral development assistance.²⁶

²⁶ Arvind Subramanian, "Preserving the Open Global Economic System: A Strategic Blueprint for China and the United States," Peterson Institute for International Economics,

In 2010, both the World Bank and the IMF introduced major reforms in the voting power held by their member countries, increasing the voting power of emerging markets.²⁷ U.S. congressional approval was needed for the IMF changes, but that did not come for years afterward, nor did the Obama administration arrive at a way to gain legislative support. This inaction was widely considered to be eroding global support of the United States' leading role in the institution. Congress finally approved the changes in December 2015, in part through concerted efforts of Treasury Secretary Jack Lew and former George W. Bush Treasury Undersecretary John B. Taylor.²⁸ This move was widely approved by experts on the international economy and international economic institutions, although some had reservations about conditions Congress attached.²⁹ Under the new reforms, the United States remains the only single country that can veto major changes in governance in the two institutions. European countries, when voting together, also have veto power.

Congressional tardiness in approving governance reforms reflects a longstanding unease by many around the world with the IMF, the World Bank, and their allied international institutions, such as the Asian Development Bank. There have been repeated calls for reform throughout the decades. Some of this unease is now reflected in the founding of two new institutions outside that network: the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank, also known as the BRICS Bank for its founders Brazil, Russia, India, China, and South Africa. Because China is at the center of the founding of these institutions, they are dealt with in the next chapter.

Policy Brief PB13-16, June 2013.

²⁷ IMF, "IMF Executive Board Approves Major Overhaul of Quotas and Governance," Press Release No. 10/418, Washington, D.C., November 5, 2010; Sameer Vasta, "World Bank Gets Capital Increase and Reforms Voting Power," *Voices*, World Bank Blog, April 25, 2010.

²⁸ Jackie Calmes, "I.M.F. Breakthrough Is Seen to Bolster U.S. on World Stage," *International New York Times*, January 6, 2016.

²⁹ Edwin M. Truman, "IMF Governance Reform: Better Late Than Never," RealTime Economic Issues Watch, Peterson Institute for International Economics, December 16, 2015.

A recent symposium in the *Journal of Economic Perspectives* outlined several paths forward for the IMF and the World Bank.³⁰ IMF lending in the aftermath of the Great Recession rose to a historic high as a share of world GDP and remains elevated, despite having decreased since then. With emerging markets slowing, the institution may face another round of demands on its capital. Accordingly, the United States and its members will need to ensure that it has enough capital and that it is lending it effectively. One proposal is that it focus on providing liquidity to countries that face a short-term financial crisis—helping countries that face only a temporary problem in meeting their obligations—and leaving the lending for insolvent countries to other institutions.³¹ Whichever role the IMF eventually takes on, it will need to improve its ability to monitor global and national economic conditions; refine and justify the demands it places on recipients of its loans, known as conditionalities; better determine its stance toward sovereign debt problems—ranging from providing liquidity to serving as more of an international bankruptcy court; and continue governance reforms in a way that enhances the legitimacy of the institution.³²

The World Bank was originally founded when it was widely thought that global financial markets could not support development finance. In many cases, that is no longer true. Accordingly, a number of ideas have been put forth for World Bank reform. One is that the World Bank should focus explicitly on the reduction of extreme poverty.³³ Because doing so often involves policy reforms, the World Bank's legitimacy can help spur those reforms better than advice from a single

³⁰ Carmen M. Reinhart and Christoph Trebesch, "The International Monetary Fund: 70 Years of Reinvention," *Journal of Economic Perspectives*, Vol. 30, No. 1, Winter 2016, pp. 3–28; Barry Eichengreen and Ngaire Woods, "The IMF's Unmet Challenges," *Journal of Economic Perspectives*, Vol. 30, No. 1, Winter 2016, pp. 29–52; Michael A. Clemens and Michael Kremer, "The New Role for the World Bank," *Journal of Economic Perspectives*, Vol. 30, No. 1, Winter 2016, pp. 53–76; Martin Ravallion, "The World Bank: Why It Is Still Needed and Why It Still Disappoints," *Journal of Economic Perspectives*, Vol. 30, No. 1, Winter 2016, pp. 77–94.

³¹ Reinhart and Trebesch, 2016.

³² Eichengreen and Woods, 2016.

³³ Clemens and Kremer, 2016.

country could. Another view is that, in conjunction with helping reduce poverty, the World Bank should enhance its role as the purveyor of knowledge about development; increase its actions in spurring international coordination to reduce poverty; and improve its abilities to address gaps in global public goods, such as stopping pandemics and mitigating climate change.³⁴ Embedded in these suggestions is the idea that the World Bank's activities are effective. To ensure this, it would be valuable to enhance both internal and external evaluation functions of these activities and then act on the results by changing the institution as the need for change becomes apparent.

Despite any unease with the institutions, it is in the United States' national interest to support them, not least because the United States is the leading power within them. At their best, the World Bank and IMF can bring less-politicized advice to member countries because they do not represent the views of any single member, and they can provide aid in amounts far exceeding what individual members want to provide. Furthermore, their multilateral status, and the extent to which they are seen as not being dominated by one country, lends legitimacy to their advice. Finally, they help support the global, rules-based system that the United States helped create and that benefits the United States. Maintaining their legitimacy and improving their effectiveness also will provide benefits to the United States.

Accordingly, it is in the United States' interest to make sure their capital is adequate to their task and, especially in the case of the IMF, to make sure that powers are broad enough to handle future global recessions and crises. In addition, the United States should continue to support an increased voice for rising powers, although it likely will benefit by keeping its own veto powers. Finally, the United States should favor evaluation and subsequent reform, as it is attempting to do with its own development agencies. (For more on this, see Chapter Seven.)

³⁴ Ravallion, 2016.

Liberal Capitalism Versus State Capitalism

In the wake of the global financial crisis, when both the U.S. and European economies were crippled, concerns grew that state-dominated businesses and their sponsoring countries could challenge the global economic system.³⁵ The state's role as regulator, enforcer of regulations, and business owner could result in challenges to a liberal, market-based global economic order.³⁶ States could block competition in their home markets to favor their state-owned enterprises. They could subsidize their state-owned enterprises with cheap capital through credit guarantees, direct subsidies, or other mechanisms for activities both at home and abroad—again, making it harder for private-sector firms to compete. Such activities would challenge the idea of national treatment and fair competition.

There is no doubt that state companies are dominant in some countries. For example, in 2011, state-controlled companies constituted 80 percent of stock market capitalization in China, 62 percent in Russia, and 38 percent in Brazil.³⁷ Countries are certainly free to organize their economic systems as they like. However, to the extent that such choices undermine a global economic system that has brought unparalleled growth and development to the world economy, they represent a challenge that may need a response.

One reason they *may* need a response, rather than require one, is that state-owned enterprises tend to be inefficient: Some have been linked to corruption;³⁸ capital gets misallocated. While a particular state firm may grow rapidly, its home economy may suffer more generally as opportunities for higher rates of return are lost because capital is invested in state-owned companies. The state firms themselves may use the capital inefficiently and perform poorly. Between 2007

³⁵ Ian Bremmer, "State Capitalism and the Crisis," McKinsey & Company, 2009; "The Rise of State-Controlled Capitalism," NPR, May 17, 2010; Joshua Kurlantzick, "The Rise of Innovative State Capitalism," *Businessweek*, June 28, 2012.

³⁶ Max Büge et al., "State-Owned Enterprises in the Global Economy: Reason for Concern?" *Vox: CEPR's Policy Portal*, May 2, 2013.

³⁷ "The Visible Hand," *The Economist*, January 21, 2012.

³⁸ "State Capitalism in the Dock," *The Economist*, November 22, 2014.

and 2014, although stock markets rose 5 percent on average, the state-owned enterprises among the top 500 firms lost between 33 percent and 37 percent of their value.³⁹ Put differently, the inefficiencies of state capitalism may hamstring such an economy without a strong response.

Waiting out state enterprises is a low-cost policy response that will not put the United States and its allies in the position of being seen to oppose other countries' internal economic policy decisions. The United States already has most of the regulatory tools it needs to ensure that state enterprises compete in the United States in a commercial manner, such as antitrust laws. On this issue, as on others, maintenance and improvement of the global rules-based system is the key. The WTO has rules on state-owned trading enterprises.⁴⁰ As with other WTO rules, these are enforceable under the WTO's dispute settlement system. Trade agreements under negotiation, such as the TPP, may break new ground on the rules of state-owned enterprises in the global economy.⁴¹ To the extent that these new agreements are successful and set the example for broader, multilateral liberalization, they also will constrain state capitalism.

Conclusion

The United States took the lead in creating the current rules-based international system and has been a leading force behind its expansion. It has benefited enormously. One reason for its leadership is that it is one of the few entities with the economic size, the desire, and the institutions—such as the Departments of Treasury and State, the international economics section of the National Security Council and National Economic Council staffs, the U.S. Trade Representative, and the President's Council of Economic Advisers—to conceptualize initiatives, drive new agreements, and translate them into text. Beyond

³⁹ "State Capitalism in the Dock," 2014.

⁴⁰ World Trade Organization, "Technical Information on State Trading Enterprises," web page, Geneva, 2015.

⁴¹ Fergusson, McMinimy, and Williams, 2015.

the United States, the EU and other international institutions, such as the United Nations, have these capabilities.

It is difficult to conceive of a completely different system that will deliver the same gains as the existing system. Ongoing reform will be necessary, but there are gains to be had. It will remain incumbent on the United States to take a leading role in safeguarding, reforming, and expanding the system, at least for now. An unknown is whether China, now the world's second-largest economy, will develop these capabilities. The next chapter focuses on China, its growing role in global institutions, and its relations with the United States.

Strategic Choices Abroad: China

The United States has strategic and economic interests in all parts of the world. However, one evolving relationship is likely to prove pivotal, and that is the one with China. The relationship between the largest (U.S.) and second-largest (Chinese) economies in the world is likely to be critical to the global economy because of the respective sizes of the two economies and because the two countries are neither allies nor adversaries, adding complexity to the relationship. The implications are not limited to the two economies; they extend to the global system.

China has been growing much faster than the United States and is likely to overtake it in terms of aggregate GDP in the next few decades. The size of China's economy is driven in part by China's large population. On a per-person basis, China is still much poorer. In 2014, U.S. per capita GDP was almost \$55,000, whereas Chinese per capita GDP was less than \$8,000. Passing the United States in terms of per capita GDP would take much longer, and there is no guarantee it will occur at all.

China's economic interests have become global, and its security interests are expanding. Accordingly, U.S. economic policymakers have been trying to work more closely with China, as exemplified by the Strategic Economic Dialogue under President George W. Bush and the Strategic and Economic Dialogue under President Barack Obama. U.S. military strategists also have devoted considerable time to evaluating China's security strategy, as well as any threats it may present to U.S. interests and how to respond.¹ Indeed, a major theme of the

¹ Terrence K. Kelly, James Dobbins, David A. Shlapak, et al., *The U.S. Army in Asia, 2030–2040*, Santa Monica, Calif.: RAND Corporation, RR-474-A, 2014.

Obama administration's 2012 defense strategy was to "rebalance" U.S. attention and resources toward the Asia-Pacific region.² In considering U.S. policy toward China, there are two broad areas to consider: China's own internal economic problems, and the nature of the U.S.–China economic relationship.

Recent Events in China

China's economic growth has been remarkable: the most rapid sustained economic growth of any large country in the economic history of the world (Table 6.1). However, it faces a number of internal weaknesses that are making it hard to sustain this growth.

A number of events in late 2015 and early 2016 drew widespread attention to China's economic problems. From June 2015 to September 2015, the Shanghai Composite Index crashed, dropping from 5,178 to 2,850, and Chinese policymakers implemented a number of unorthodox, nonmarket measures to halt the slide; investors remained skittish even into 2016 about the government's handling of the stock market.³

In November, the IMF announced it would include the Chinese currency (the renminbi [RMB]) in its basket of reserve currencies (an international type of monetary reserve currency known as special drawing rights). China had devalued the RMB by a small amount in what it said was a move to bring the value more in line with the market.⁴ Such short-term moves may not matter in the long run: The inclusion in the IMF's basket is meant to be a medium- to long-term play to internationalize the RMB and have it accepted more widely as a reserve cur-

² White House, *Sustaining U.S. Global Leadership: Priorities for 21st Century Defense*, Washington, D.C., January 2012, p. 2.

³ George Magnus, "Will China Drag Down the World Economy?" *Prospect*, January 7, 2016a; Edward Wong, Neil Gough, and Alexandra Stevenson, "China's Response to Stock Plunge Rattles Traders," *New York Times*, September 9, 2015.

⁴ Carlos Tejada, "5 Things to Know About China's Currency Devaluation," *Wall Street Journal*, August 10, 2015.

Table 6.1
Chinese Annual Average Per Capita Economic Growth, by Decade

Country or Region	1980–1990 (%)	1990–2000 (%)	2000–2010 (%)
China	7.7	9.3	9.9
Developing East Asia and Pacific, excluding China	3.4	3.1	3.8
World	1.4	1.3	1.3
Addendum	1955–1965 (%)	1965–1975 (%)	1975–1985 (%)
Japan	7.6	6.8	3.5

SOURCE: World Bank, 2016b; Statistics Bureau, “3-3-a Gross Domestic Product Classified by Economic Activities (Major Industry Group) (At Current Prices, At Constant Prices, Deflators)—68SNA, Benchmark Year=1990 (1955–1998),” downloadable spreadsheet, Ministry of Internal Affairs and Communication, Japan, 1996.

NOTES: Data show average annual growth of real per capita GDP in 2005 U.S. dollars, except for Japanese data in the bottom row, which show average annual growth of real per capita GDP in 1990 Japanese yen. We provide data for Japan from an earlier period because Japan was a relatively mature economy when China began its economic reforms.

rency and for international transactions.⁵ Still, these exchange rate moves unsettled the markets—and were a symptom of another problem.

That problem is that China has been bleeding capital. One group estimated that \$676 billion in net capital exited China in 2015.⁶ Others put the figure at \$1 trillion, although it is not clear if this is net or gross.⁷ This capital outflow is quite a reversal from one of the main U.S. policy concerns in the first decade of the 21st century—rapid capital accumulation by China. This earlier accumulation led to complaints that China’s economic policies were damaging the U.S. economy, charges of currency manipulation by China, and even threats by members of the Chinese military to dump U.S. Treasury bonds (although they had

⁵ Nyshka Chandran, “SDR Inclusion to Help China Lure Trillion-Dollar Flows,” CNBC, November 30, 2015; Jennifer Hughes, “China Inclusion in IMF Currency Basket Not Just Symbolic,” *Financial Times*, November 19, 2015.

⁶ Shawn Donnan, “Capital Flight from China Worse Than Thought,” *Financial Times*, January 20, 2016.

⁷ Mark Magnier, “Slip Sliding Away: China’s Capital Outflow Quandary, China Real Time,” *Wall Street Journal*, February 5, 2016b.

no power to actually do so) to hurt the U.S. economy.⁸ Lost in that threat was the possibility that dumping Treasury bonds might actually damage China's economy as well, since it would have lowered the value of China's reserves and likely raised the cost of other reserve currencies as China sought to put its reserves elsewhere.

Some of the outflow is due to fears of further devaluation—people and firms changing their RMB into dollars before the dollar gets more expensive. But much more is due to a recognition that the Chinese economy is slowing. From 2004 to 2014, Chinese aggregate GDP grew 10.0 percent annually in real terms, and per capita GDP grew 9.4 percent.⁹ However, China's economy grew only 6.9 percent in 2015, and its economic growth is likely to remain at that level or go lower; some speculate that it could actually go much lower.¹⁰ Rates in the 4 percent to 7 percent range are still enviable to many other countries, but they are far different from what China has experienced in the past. These problems are not sudden. Instead, they have been developing for years.

An Unbalanced Economy

China has a uniquely unbalanced economy; it invests too much and consumes too little. Its levels of investment as a share of GDP far exceed those of any other rapidly growing East Asian country, even when those countries were at China's level of development. This has resulted in overinvestment, which is inefficient for the economy and signals poorer growth prospects ahead. One outcome of this overinvestment is that China's capital-output ratio is higher than was the

⁸ Paul Krugman, "Chinese New Year," *New York Times*, December 31, 2009; Wharton School, "Attached at the Wallet: The Delicate Financial Relationship Between the U.S. and China," *Knowledge@Wharton*, University of Pennsylvania, April 29, 2009; Michael Schuman, "Will China Dump U.S. Debt?" *Time*, February 26, 2010; Chris Buckley, "China PLA Officers Urge Economic Punch Against the U.S.," Reuters, February 9, 2010.

⁹ World Bank, 2016b.

¹⁰ Mark Magnier, "China's Economic Growth in 2015 Is Slowest in 25 Years," *Wall Street Journal*, January 19, 2016a; Pei Li, "China GDP Growth Could Be as Low as 4.3 Percent, Chinese Professor Says," *Wall Street Journal*, January 27, 2016.

case in other fast-growing economies when they were at China's level of development, another sign of unproductive capital investment.¹¹ Meanwhile, Chinese consumption as a share of GDP is far less than that of other fast-growing East Asian economies—even when their per capita incomes were at the same level as China's. Chinese workers do not receive a large share of the income generated in their economy, a metric known as the *labor share of the economy*. In 2007, that figure had fallen to 43 percent, the lowest among all countries in a broad comparison sample.¹² With such a small share of GDP going to labor, household consumption also has been unusually low. In 2000–2010, it averaged 39 percent of the total economy, between 20 and 40 percentage points lower than household consumption in Japan, Singapore, and South Korea when those countries were at similar levels of development.¹³

China's high investment and low consumption has a number of causes. One has been a financial system that prohibits people from saving and investing outside the country, that pays very low interest rates on savings, and that channels loans to large state-owned enterprises.¹⁴ Without a strong social safety net and with a low return on savings, the Chinese people must save large amounts to fund emergency events and their retirement years. Channeling loans to state-owned enterprises is a problem because those enterprises tend to be less efficient than their private-sector peers, thus limiting employment growth and greater household incomes, and because the low levels of dividends to the government

¹¹ David Dollar, "China's Rebalancing: Lessons from East Asian Economic History," Working Paper Series, John L. Thornton China Center, Brookings Institution, October 2013.

¹² David Dollar and Benjamin F. Jones, "China: An Institutional View of an Unusual Macroeconomy," Cambridge, Mass.: National Bureau of Economic Research Working Paper 19662, November 2013. In contrast, in 2007, the U.S. labor share was 63.4 percent, although it had fallen to 62.2 percent in 2011 (Robert C. Feenstra, Robert Inklaar, and Marcel P. Timmer, "The Next Generation of the Penn World Table," University of Groningen, 2013; University of Groningen and University of California, Davis, "Share of Labor Compensation in GDP at Current National Prices for United States [LABSHPUSA156NRUG]," retrieved from FRED, March 2016.

¹³ Dollar and Jones, 2013.

¹⁴ Nicholas Lardy and Nicholas Borst, "A Blueprint for Rebalancing the Chinese Economy," Peterson Institute for International Economics, Washington, D.C., Policy Brief Number PB13-02, February 2013; McKinnon and Schnabl, 2014.

tend to get recycled back to the state-owned enterprises in the form of subsidies, limiting the flow of their profits to the household sector.¹⁵ In addition, channeling capital to state-owned enterprises results in small, potentially fast-growing businesses having a harder time getting capital—which, again, limits employment growth and growth of household incomes. Other causes of the unbalanced economy include a permit system that hampers the ability of rural labor to move to higher-productivity jobs in the cities and a system of career advancement for local officials that rewards growth and investment.¹⁶ In addition, price controls on energy effectively subsidize industry, which consumes two-thirds of energy in China.¹⁷

Chinese officials are well aware of these issues. Without a new growth model, China is unlikely to keep growing rapidly.¹⁸ Accordingly, following the Third Plenary Session of the Chinese Communist Party Central Committee in November 2013, the Party issued a communiqué outlining changes (as is standard practice) that many analysts considered vague. The initial document, however, was followed by a more ambitious one with 60 reform steps.¹⁹

The communiqué called for the market to play a *decisive* role in allocating resources, in contrast to language from 2002 that called for

¹⁵ Gao Xu, “Rebalancing China Through SOE Reform,” third annual NYU Conference on Chinese Capital Markets, December 6, 2013; Curtis J. Milhaupt and Wentong Zheng, *Why Mixed-Ownership Reforms Cannot Fix China’s State Sector*, Paulson Policy Memorandum, Paulson Institute, January 2016.

¹⁶ Dollar and Jones, 2013; Dollar, 2013. Dollar and Jones discuss a number of reasons why the limited labor mobility resulting from the system of residency permits, known as *hukou*, results in lower wages and therefore a lower household share of the total economy. Migrants without a permit do not have full rights and end up being paid less than they would if they were *hukou*-holders, although they do earn more than if they had stayed in rural areas, because hiring migrants can be costly—there are fees that firms must pay if hiring migrants. In addition, job opportunities are more limited for migrants than for *hukou*-holders—there are quotas for employers on migrant hiring.

¹⁷ Lardy and Borst, 2013.

¹⁸ Richard Cooper, “The Third Plenum and Economic Reform,” Harvard University, December 2013.

¹⁹ “The Decision on Major Issues Concerning Comprehensively Deepening Reforms in Brief,” *China Daily*, November 16, 2013.

the market to play a *fundamental* role in allocating resources. The follow-up document outlined steps for reforming state-owned enterprises, but did not call for them to become less dominant. In addition, it called for financial sector reform but lacked many necessary details about those proposed reforms. It also listed steps for strengthening the fiscal underpinnings of the Chinese government at the national and subnational levels, expanded land-use rights for farmers and outlined initial steps for reforming the residency system that hampers rural labor from moving, called for opening up specific service sectors to foreign investment, and outlined concrete steps for improving China's environment.²⁰ Analysts generally consider most of these steps to be in the right direction and to reflect many points made in a landmark reform study by the World Bank and China's Development Research Center in 2013.²¹ However, there is some doubt as to whether they went far enough—and, conversely, whether China's leaders can successfully implement them.²²

With the more recent economic problems, concern has grown that the reforms are stalled and that a more pernicious problem has developed: debt accumulation, starting with a stimulus program instituted during the global financial crisis. Initially about 100 percent of GDP, Chinese nonfinancial debt (aggregate debt owed by all entities except those in the financial sector) had been accelerating in 2014 and 2015 and had risen to about 250 percent of GDP by January 2016.²³ This presents a problem because the debt was taken out in anticipation of higher growth rates; with a slower growth rate, debt service will mount, and will rise even more for any dollar-denominated loans if the currency depreciates. Furthermore, much of the newer debt has come

²⁰ Nargiza Salidjanova and Jacob Koch-Weser, "Third Plenum Economic Reform Proposals: A Scorecard," U.S.–China Economic and Security Review Commission, staff research backgrounder, November 19, 2013.

²¹ World Bank and Development Research Center of the State Council, the People's Republic of China, *China 2030: Building a Modern, Harmonious, and Creative Society*, Washington, D.C., 2013.

²² Cooper, 2013.

²³ George Magnus, "China's Credit Binge Is the Real Concern," *Financial Times*, January 11, 2016b.

from what is known as the shadow-banking sector, in which loans are not recorded on balance sheets and thus have less backing behind them should they go bad.²⁴

Although Chinese policymakers expect growth to slow from previous years, they still expect to maintain high growth rates. China took a further step in making clear its economic intentions with the introduction of the 13th Five-Year Plan at the Fifth Plenary Session of the 18th Communist Party of China Central Committee in October 2015, and then the plan's approval at the two-session meetings of the National People's Congress and the Chinese People's Political Consultative Conference in March 2016.²⁵ The plan called for a growth rate of 6.5 percent to 7.0 percent from 2016 through 2020 to bring China's per capita income to double the level it was in 2010.²⁶ This drive for growth may encourage further debt buildup.²⁷

Therefore, aside from having to rebalance its economy toward consumption, China also faces the challenge of reducing debt in its economy. Reducing this debt could be costly and further slow the economy, suggesting China's policymakers have no easy task ahead of them.²⁸

²⁴ Don Weinland and Gabriel Wildau, "China Financial Regulator Clamps Down on Shadow Banking," *Financial Times*, May 20, 2016.

²⁵ Pumin Yin, "Mapping Out Success: New Five-Year Blueprint Lays Down Specific Objectives for a Prosperous China," *Beijing Review*, No. 45, November 5, 2015; Guan Wang, "China Just Passed Its 13th Five-Year Plan. Here's What It Means," *CCTV America*, March 16, 2016.

²⁶ "China Releases Full Texts of Government Work Report, 5 Year Plan," *Xinhua Finance*, March 17, 2016; Mandy Zuo, "Key Takeaways from China's 13th Five-Year Plan and Annual Reports," *South China Morning Post*, March 5, 2016; Edward Wong, "As Economy Slows, Experts Call on China to Drop Growth Target," *New York Times*, March 4, 2016.

²⁷ Wong, 2016.

²⁸ Michael Pettis, "Will China's New 'Supply-Side' Reforms Help China?" *Michael Pettis' China Financial Markets*, January 25, 2016.

Reaching Out to the World

China has steadily become more engaged with global economic institutions, culminating in a number of new initiatives during the term of leader Xi Jinping.

Announced in two separate speeches by Xi in 2013, first in Kazakhstan and then in Indonesia, the flagship initiative is the “Silk Road Economic Belt” and the “21st Century Maritime Silk Road,” also known as One Belt One Road, or Belt and Road. The Belt refers to a series of overland roads, pipelines, railways, and other infrastructure through Central Asia, South Asia, and the Middle East to Europe. The Road refers to a series of ports and maritime trade routes through the South China Sea and the Indian Ocean to the Middle East, the east coast of Africa, and onward to Europe.²⁹

In March 2015, a set of Chinese government bodies released a document laying out the broad vision for the Belt and Road, noting that the initiative embraced what the Chinese said were global trends toward multipolarity, economic globalization, cultural diversity, and greater use of information technologies; the document also noted that the initiative would uphold global free trade, an open world economy, and open regional cooperation.³⁰ Both components are also designed to enhance what China refers to as five types of connections: policy or political coordination, transportation connectivity, trade and investment cooperation, financial integration and use of the renminbi as a currency, and stronger people-to-people connections. Almost the only portion of the globe not explicitly part of this concept is the Western Hemisphere.³¹

²⁹ Jacob Stokes, “China’s Road Rules: Beijing Looks West Toward Eurasian Integration,” *Foreign Affairs*, April 19, 2015; Shaohua Yan, “Why the ‘One Belt One Road’ Initiative Matters for the EU,” *The Diplomat*, April 9, 2015.

³⁰ National Development and Reform Commission, *Vision and Actions on Jointly Building Silk Road Economic Belt and 21st Century Maritime Silk Road*, Beijing: Ministry of Foreign Affairs, Ministry of Commerce of the People’s Republic of China, with State Council Authorization, March 28, 2015.

³¹ National Development and Reform Commission, 2015; Ze Shi and Chenxi Yang, *China’s Diplomatic Efforts to Promote Energy and Resources Cooperation Along the “One Belt and One Road,”* China Institute of International Studies, CIIS Report No. 5, May 2015.

Beijing is aiming for what it calls a win-win situation by directly or indirectly financing a substantial part of the infrastructure construction needed to facilitate greater trade and transportation connectivity. The direct financing components include a \$40 billion Silk Road Fund, to be run as a private equity fund, and a \$113 billion fund put forward by CITIC Ltd., a state-owned conglomerate.³² Less directly, China is establishing new international financial institutions in part to fund the One Belt One Road initiative, including the AIIB and the New Development (or BRICS) Bank. These are discussed later in this chapter. Beijing also plans to involve the China-ASEAN Interbank Association and Shanghai Cooperation Organization Interbank Association in financing One Belt One Road.³³

Aside from financing, achieving the vision of One Belt One Road may require deft diplomacy and cooperation from numerous other governments in Asia, each of which will pursue its own interests.³⁴ Shortly after the AIIB articles were signed, India and Kazakhstan signed a set of cooperation agreements in early July 2015, and Pakistan and Kazakhstan sought to sign their own set of agreements in late August 2015.³⁵

Beyond the Belt and Road initiative, China has actively invested throughout the world, often through state banks or investment funds, and its construction companies are building infrastructure throughout the world as well. For example, China has loaned Venezuela more than \$45 billion, including at least \$37 billion from the China Development Bank, a state policy bank.³⁶ And in December 2015, Xi Jinping pledged \$60 billion for projects in Africa, including \$5 billion in interest-free

³² Paul Carsten and Ben Blanchard, "China to Establish \$40 Billion Silk Road Infrastructure Fund," Reuters, November 8, 2014; Shu Zhang and Matthew Miller, "China's CITIC to Invest \$113 Billion for 'Silk Road' Investments," Reuters, June 24, 2015.

³³ Philippa Brant, "'One Belt, One Road? China's Community of Common Destiny,'" *The Interpreter*, Lowy Institute for International Policy, March 31, 2015.

³⁴ Stokes, 2015.

³⁵ Dipanjan Roy Chaudhury, "PM Modi's Visit to Central Asia: India and Kazakhstan Ink Deals on Uranium Supply, Defence," *Economic Times*, July 9, 2015; "PM Leaves for Kazakhstan on Two-Day Official Visit," *The News (Pakistan)*, August 25, 2015,

³⁶ Prudence Ho, "Venezuela Oil Loans Go Awry for China," *Wall Street Journal*, June 18, 2015.

loans and \$35 billion in preferential financing.³⁷ Some commentators question whether there is a global competition between China and the United States for economic influence within regions and suggest the United States is losing ground. However, the two systems work quite differently. While much of China's activity appears to be state directed, there is evidence that some investments are not paying off or are not occurring to the degree policymakers would like, and that Chinese activities have created resentment among local populations.³⁸ Furthermore, with its private-sector economy, there is no reason to think that the United States could do business in the developing world the way China is. As with consumers and businesses everywhere, consumers in the developing world are likely to favor products that offer the best value, businesses are likely to favor partnerships that offer the best return, and there is no reason to think that state-directed investment and trade will outperform the private-sector versions. More important than competition in other countries is the nature of the U.S.–China relationship in the United States and China.

The U.S.–China Economic Relationship

In 2007, China became the largest source of U.S. merchandise imports, outstripping imports from Canada by almost \$10 billion and sending \$323 billion worth of goods to the United States. It has remained number one ever since, and in 2015 was responsible for \$477 billion, 21.5 percent of all U.S. merchandise imports. U.S. merchandise exports to China have been growing, as well: Since 2000, they have been growing much faster than merchandise imports. Between 2000 and 2015, imports from China grew at an average annual rate of 11.0 percent and exports to China grew at an average annual rate of 13.9 percent. How-

³⁷ Rene Vollgraaff, Amogelang Mbatha, and Mike Cohen, "Xi Unveils \$60 Billion Funding Pledge at South Africa Summit," Bloomberg, December 4, 2015.

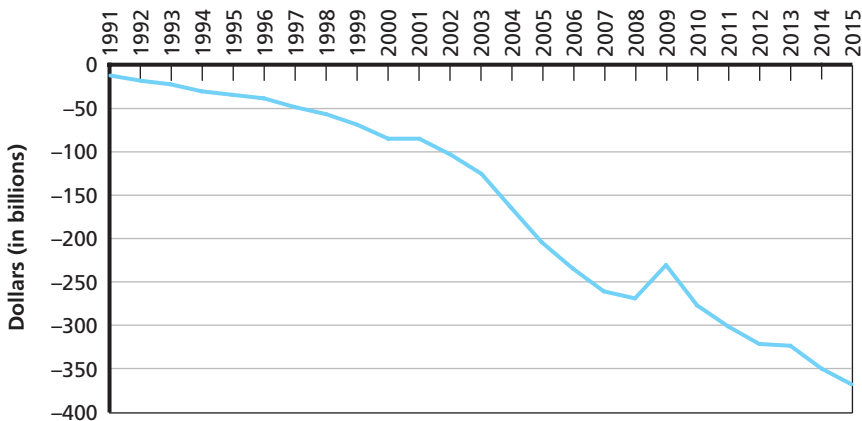
³⁸ Yuzhe Zhang and Ling Wang, "Cheers, Fears for China's Next Step Overseas," *Caixin*, July 22, 2015; Simon Romero, "China's Ambitious Rail Projects Crash into Hard Realities in Latin America," *International New York Times*, October 3, 2015.

ever, exports grew from a far lower base, so the overall U.S.–China merchandise trade deficit has expanded (Figure 6.1).

At first glance, this very large deficit may seem to imply that Chinese goods are flooding the U.S. market in addition to high levels of imports from other countries. However, Chinese goods appear to have actually displaced U.S. imports from other Asian countries. The share of U.S. imports from the rest of East and Southeast Asia fell every year from 1994 through 2008, and then fell again in 2010 and 2011 (Figure 6.2). In fact, the overall East and Southeast Asian share of U.S. merchandise imports, including imports from China, averaged 38.1 percent from 1991–2000, 34.5 percent from 2001–2010, and 36.3 percent from 2011–2015.

China’s share of U.S. imports has grown largely at the expense of Japan, but the share of U.S. imports from East Asia and ASEAN also shrank. Part of this may be due to the growth of intra-Asian production networks. Such networks may result in other Asian

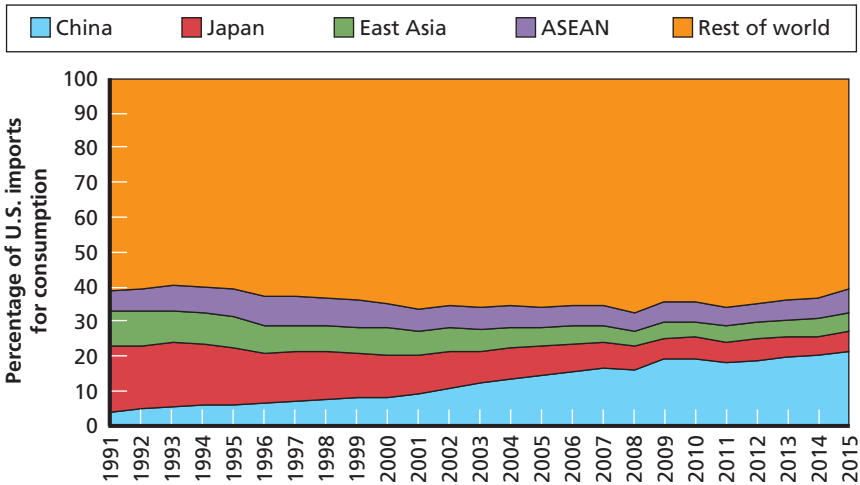
Figure 6.1
The U.S.–China Merchandise Trade Deficit



SOURCE: U.S. International Trade Commission, *Dataweb*, database, Version 3.1.0, undated (free, but login required).

NOTE: The trade balance is calculated by subtracting imports from exports and can be in deficit, in surplus, or perfectly balanced, although that last situation is rare. In this calculation imports are imports for consumption and exports are domestic exports.

Figure 6.2
World Shares of U.S. Imports



SOURCE: U.S. International Trade Commission, undated.

NOTE: East Asia includes Hong Kong, Macao, Mongolia, North Korea, South Korea, and Taiwan. ASEAN includes Brunei, Burma, Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand, and Vietnam.

RAND RR1521-6.2

countries manufacturing components, rather than final goods, and sending them to China for final assembly and then for export to the United States and the rest of the world, rather than those countries making the entire product and selling it themselves. Alternatively, those countries also might simply sell China raw materials for use in its economy, with China exporting some of the final products to the United States and the rest of the world.

Merchandise imports are not the only value to consider in the U.S.–China economic relationship. U.S. merchandise and service exports to China have been growing faster than U.S. merchandise and service imports from China. But the value of these exports pales in comparison with the primary method that U.S. businesses use to serve the China market: sales by China-based affiliates of U.S. multinational companies.

Worldwide in 2013, the United States exported \$1.4 trillion in merchandise and imported \$2.2 trillion, for total merchandise

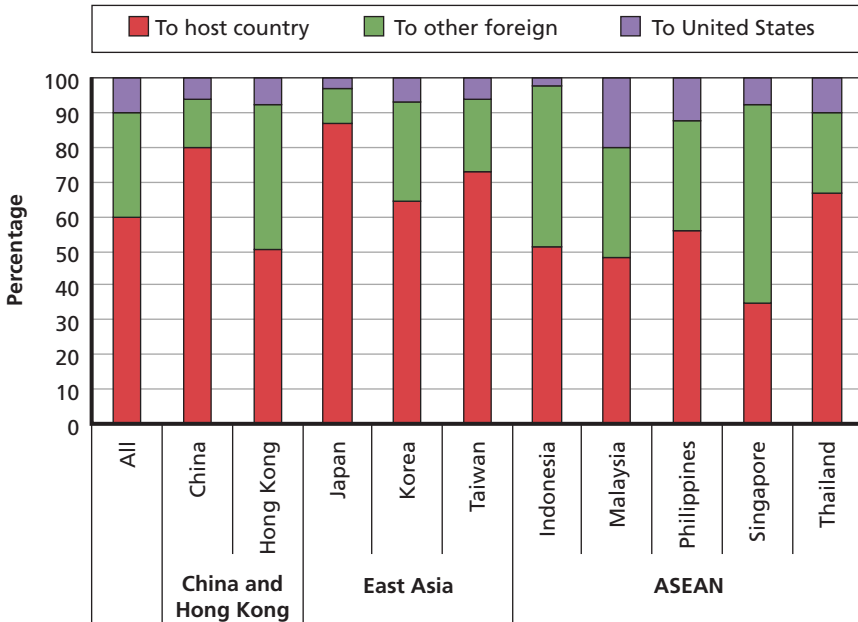
trade of \$3.6 trillion. That same year, goods and services supplied by majority-owned foreign affiliates of U.S. multinational companies totaled \$5.8 trillion.³⁹ Of this, \$5.2 trillion was supplied to countries other than the United States; only \$568 billion was supplied back to the United States. The vast majority of goods and services supplied by foreign affiliates of U.S. multinationals are to their host countries, the countries in which they are located. Within Asia, this is especially true of Japan, but it is also true of China, where the proportion to the host market is above the overall proportion by all U.S. foreign affiliates throughout the world (Figure 6.3).

U.S. companies overwhelmingly serve the Chinese market through their affiliates there rather than through trade. In 2013, the U.S. merchandise trade deficit with China was \$324 billion. However, the total deficit—including (1) merchandise trade, plus (2) services trade, plus (3) goods and services supplied by multinational affiliates in the host country—was very different. The United States had merchandise exports of \$114 billion, services exports of \$37 billion, and goods and services supplied by U.S.-owned foreign affiliates in China of \$206 billion, for a total of \$357 billion. China exported \$438 billion worth of merchandise to the United States and \$14 billion worth of services, and Chinese-owned companies in the United States provided goods and services worth \$16 billion, for a total of \$468 billion.⁴⁰ There-

³⁹ Majority-owned foreign affiliates had total sales (a more comprehensive category than goods and services supplied) of \$6 trillion. Sales includes sales of outputs that are tangible (goods), sales of outputs that are intangible (services), and investment income that is included in the sales of gross operation revenue of an income statement. Sales by all foreign affiliates of U.S. multinational companies, including minority-owned affiliates, totaled \$7 trillion. Unfortunately, the destination of these sales is not available, so the analysis in the text focuses on goods and services supplied. Data on goods and services supplied by majority-owned foreign affiliates are from BEA, *Activities of U.S. Multinational Enterprises: U.S. Parent Companies and Their Foreign Affiliates: Preliminary 2013 Statistics*, Washington, D.C.: U.S. Department of Commerce, August 2015d, Table II.E.2. Data on sales by all foreign affiliates and by majority-owned foreign affiliates are from BEA, *Data on Activities of Multinational Enterprises*, August 14, 2015e.

⁴⁰ Merchandise trade data are from the U.S. International Trade Commission, undated. Data for goods and services supplied by U.S.-owned foreign affiliates are from BEA, "International Trade in Goods and Services, January 2016," Washington, D.C.: U.S. Department of Commerce, (Tables 1–9), March 4, 2016a, Tables 7 and 8. Data for goods and services

Figure 6.3
Share of Goods and Services Supplied by U.S. Majority-Owned Foreign Affiliates, by Destination



SOURCE: BEA, 2015d, Table II.E.2.

RAND RR1521-6.3

fore, the total imbalance was \$111 billion. And this is probably overstated, since it excludes sales by U.S. multinationals based throughout Asia and Europe selling to China. In 2013, U.S. affiliates in five major ASEAN countries supplied \$286 billion worth of goods and services (50 percent of all their goods and services supplied) to countries other

supplied by Chinese-owned foreign affiliates in the United States are from BEA, *Foreign Direct Investment in the United States: Preliminary 2013 Statistics*, Washington, D.C.: U.S. Department of Commerce, November 2015g, Table II.E.2. That table does not break down the data by destination, so the calculation includes all goods and services supplied. Since some of these might have been supplied to destinations outside the United States, the calculation slightly overstates Chinese sales in the United States, and therefore is a conservative estimate.

than their host countries and the United States. It is likely that much of this went to China.⁴¹

Given China's involvement in the global economy and its integration with the U.S. economy, it is in the United States' interest to keep China acting within the current global rules-based system of international trade and investment. This chapter next turns to new developments in that system.

China and the Mega-Trade Deals

As noted in Chapter Five, the United States and 11 partner nations have completed the TPP, the first of several mega-regional trade deals in the works. If the 12 partners ratify it, they will face a new challenge: whether and how to integrate China. China is not among the negotiating partners and will not be able to join until after the deal has entered into force. Accordingly, there have been some doubts about how much influence the agreement will really have on the course of world trading rules.⁴² However, it is not clear that China would have been able to meet the standards of openness the negotiators intended, at least at this time. Just as important as considering how to integrate China is how China perceives the TPP. Some in Beijing view it as a challenge, part of a U.S. strategy to counter a rising China. However, the official Chinese view is open, but cautious.⁴³ In part, this is because, as already noted, China has used previous trade agreements, especially joining the WTO in 2001, to push internal reforms.

Once the trade deal is in effect, the partners could opt to keep China out. This likely would be a mistake because of China's economic size and the risk that it will develop and favor parallel institu-

⁴¹ These countries were Indonesia, Malaysia, Philippines, Singapore, and Thailand.

⁴² Yuqing Feng and Qingzi Xu, "Interview with U.S. Economist Stephen Roach, Brookings Researchers Mezze: The Era of Multilateral Trade Negotiations Has Ended," *Finance Daily News*, November 15, 2013.

⁴³ Yunling Zhang, "RCEP, TPP & FTAAP," Chinese Academy of Social Sciences, briefing slides, 2014.

tions. Rather, it would be beneficial to develop an on-ramp for China. Such an on-ramp may take many years to complete, but as with WTO accession, it could empower reformers in China and help keep China in a system—and benefiting from a system—that benefits the United States.

The complement to the issue of the U.S.-led Pacific trade deal is whether the United States should join the Regional Comprehensive Economic Partnership, the China-led Asian trade deal, if that deal is completed.⁴⁴ The issue has not been widely discussed. Notably, in August 2015, U.S. Trade Representative Michael Froman said that the TPP and Regional Comprehensive Economic Partnership were not in competition with each other.⁴⁵ However, U.S. accession would provide another venue for the United States to influence the trade grouping and perhaps create opportunities to develop a broader Asia-Pacific trade deal, or even provide the foundation for a new multilateral WTO round.

China and International Institutions

As noted, China has been involved with the creation of two new development banks, the China-led AIIB and the New Development (BRICS) Bank. Some have suggested that Congress's inaction on IMF governance reforms contributed to China's efforts in this direction, but even if this is true, there is no evidence that it was a major cause.

The AIIB is to focus on infrastructure in the Belt and Road countries stretching from China to Europe. The New Development Bank is to

⁴⁴ The 16 countries negotiating regional comprehensive economic partnerships include the 10 ASEAN countries (Brunei, Burma [Myanmar], Cambodia, Indonesia, Laos, Malaysia, Philippines, Singapore, Thailand, and Vietnam) along with Australia, China, India, Japan, New Zealand, and South Korea. The twelfth round of negotiations took place in April 2016 in Perth, Australia, and the thirteenth round was to take place in June in Auckland, New Zealand (China FTA Network, "The 12th Round of Negotiation of Regional Comprehensive Economic Partnership [RCEP] Held in Perth," Ministry of Commerce, People's Republic of China, May 3, 2016).

⁴⁵ Jiamin Lua and Xueling Lin, "U.S. Trade Rep Welcomes Rival China-Backed Deal," *Channel News Asia*, August 25, 2015.

focus on infrastructure and sustainable development, and is meant to be a worldwide institution. There is widespread agreement that more infrastructure financing is necessary. One analysis suggested that Asia alone would need to invest \$8 trillion in infrastructure from 2010 to 2020 and that an Asian infrastructure fund is needed.⁴⁶ However, this does not necessarily mean that new development banks are needed: In many cases, if utilities were properly priced and investors could make a return on their investment, commercial financing likely would be available.

What makes these institutions different from the existing development banks is that developing countries, rather than the developed countries, have a majority of shares, giving them control. The two banks will have two other different features from the existing development banks. First, the main development lending institutions often put conditions on their loans or aid, such as governance reforms, measures to protect the environment, or measures to enhance social inclusion. These are known as *conditionalities* and have sometimes been strongly opposed by aid-recipient countries. However, if they want the assistance, they end up with little choice but to accept the conditions, although measures to address the conditions are negotiable. The new institutions intend to limit such conditions. Second, the AIIB and the New Development bank could insulate the founding countries from financial sanctions, such as those placed on Russia following its takeover of Crimea.⁴⁷

The AIIB has been driven largely by China and has been remarkably successful in gaining members. It was announced by Chinese leader Xi Jinping in Indonesia in October 2013, but had been planned by Beijing for at least five years (before the kerfuffle about Congress not approving IMF reforms began).⁴⁸ It is to be capitalized at \$100 billion, with China contributing the single largest share.

⁴⁶ Asian Development Bank and Asian Development Bank Institute, *Infrastructure for a Seamless Asia*, Manila and Tokyo, 2009.

⁴⁷ Bruce D. Jones, "The BRICS and their Bank," *The American Interest*, July 26, 2014.

⁴⁸ Yong Wang and Gregory Chin, "The Asian Infrastructure Investment Bank: Prospects for a China-led Institution," *SPERI Comment*, University of Sheffield, July 31, 2014.

As of October 2014, 21 countries had signed up. Several more continued to join through March 2015. The United States government opposed the creation of the new institution and lobbied countries, requesting that they not join it. In March 2015, the UK broke with the United States to become the 27th founding member, and the dam broke. Major European allies of the United States joined. Despite U.S. opposition, 57 countries had been accepted as founding members.⁴⁹ Canada, Japan, and the United States are now the only G-7 countries to not join.

In late June 2015, 50 of the 57 prospective members signed the bank's articles of agreement in China, with the remaining seven joining before the end of the year.⁵⁰ The Bank was formally established in December, with an inauguration ceremony held in January 2016.⁵¹

An analysis of the articles of incorporation indicates that with 26.06 percent of the voting power, China will have veto power over major decisions because of supermajority voting rules. China, India, Russia, and Germany are each to hold individual board seats, while the other countries will hold board seats in groups. Board membership is to be weighted more toward members from Asia, Oceania, and the Middle East and away from members from Europe, Africa, and Latin America.⁵² In sum, developing countries and the region will be in the lead. Taiwan will be permitted to join, unlike with the World Bank but as is the case with the Asian Development Bank.⁵³

Shortly after the establishment of the AIIB, the five BRICS countries established the New Development Bank.⁵⁴ Unlike the AIIB,

⁴⁹ Shannon Tiezzi, "China's AIIB: The Final Tally," *The Diplomat*, April 17, 2015.

⁵⁰ Asian Infrastructure Investment Bank, "Fifty Countries Sign the Articles of Agreement for the Asian Infrastructure Investment Bank," AIIB, June 29, 2015; Himanshu Goenka, "Philippines to Join China-Led AIIB, to Become Last Founding Member," *International Business Times*, December 30, 2015.

⁵¹ "Backgrounder: The AIIB," Xinhua, January 16, 2016.

⁵² Scott Morris and Mamoru Higashikokubaru, "Doing the Math on AIIB Governance," Center for Global Development blog, July 2, 2015.

⁵³ Chenxi (Chex) Yu, "How Does the Newly Minted AIIB Charter Compare to the World Bank, IBRD Charter?" *Foreign Policy News*, June 30, 2015.

⁵⁴ "BRICS Countries Launch New Development Bank," BBC News, July 21, 2015.

formed under China's leadership, the New Development Bank appears to be equally driven by the BRICS countries. They announced the formation of the New Development Bank in Fortaleza, Brazil, in July 2014. In the articles of agreement, each country agreed to contribute \$10 billion to the bank's capital, with the potential to raise total bank capital from \$50 billion to \$100 billion eventually.⁵⁵ The articles of agreement also lay out the governance structure and the ability of new members to join; the voting power of the founding five would not fall below 55 percent. The BRICS countries also have created a \$100 billion Contingent Reserve Arrangement, which would serve to help countries with balance-of-payment problems, as the IMF does now.⁵⁶ Unlike with the New Development Bank, China would be the largest contributor to the Contingent Reserve Arrangement.⁵⁷

Analysts indicate that China and its partners could achieve a number of objectives through these institutions, including increasing China's international influence. The New Development Bank could demonstrate that the BRICS are viable and dynamic, despite recent growth slowdowns. These institutions could even challenge the global order established by developed countries—although that would most likely happen in terms of spurring more efficiency in grants and uses of development assistance, rather than directly challenging the international liberal economic order.⁵⁸ Some analysts indicate that the AIIB would help China make more efficient use of its foreign exchange reserves, internationalize its currency, secure contracts for Chinese companies, and insulate China from the local resentment it has some-

⁵⁵ Brazil Ministry of External Relations, "Agreement on the New Development Bank—Fortaleza, July 15," *BRICS*, July 15, 2014.

⁵⁶ Raj M. Desai and James Raymond Vreeland, "What the New Bank of BRICS Is All About," The Monkey Cage blog, *Washington Post*, July 17, 2014.

⁵⁷ "Treaty for the Establishment of a Contingent Reserve Arrangement—Fortaleza, July 15," July 15, 2014.

⁵⁸ Dingding Chen, "3 Reasons the BRICS' New Development Bank Matters," *The Diplomat*, July 23, 2014.

times sparked through China-funded infrastructure projects.⁵⁹ As already noted, the AIIB is expected to be one of the prime financiers of the Belt and Road initiative.

Beyond the goal of achieving the vision of One Belt One Road, an open question remains as to whether China and its partners can achieve greater global influence through these new institutions or somehow subvert existing institutions. There have been other institutions outside the orbit of the World Bank and IMF that have had positive effects on development without noticeably lowering World Bank and IMF influence, such as the Corporación Andina de Fomento, which serves the Andean countries.

The AIIB, which is far more advanced than the New Development Bank, will face a number of other challenges. It will have to attract strong management, when member countries might prefer that it hire politically favored candidates; it must attract people to live in Beijing; it will likely have a higher cost of funds and lower creditor status than other development banks; it will have to learn to conduct private-sector lending, which is more complicated than sovereign lending; and it will have to navigate the desirability of country ownership with lack of country capacity and the bank's own reluctance to get involved in policy.⁶⁰

For both banks, the most important issues regarding success are likely to come down to governance and conditionalities. If partner countries in the institutions believe they have a sufficient voice in governance, these institutions may well succeed. Likewise, if the voice of developing countries in the leading multilaterals is increased, they may find involvement in alternative institutions to be less productive. Conditionalities may depend on how successful these institutions are at getting their loans paid back and whether their citizens can tolerate loans for projects that, for example, damage the environment or displace poor or indigenous peoples. Despite optimism about the need for

⁵⁹ Cecilia Tortajada and Asit K. Biswas, "Asian Investment Bank: Realigning the Status Quo," *Straits Times*, September 2, 2014.

⁶⁰ Larry Greenwood, "AIIB: Now Comes the Hard Part," Center for Strategic and International Studies, February 18, 2016.

infrastructure, there remains a question as to whether there are enough projects that will provide high enough returns that enable debtors to make repayment and that enable the AIIB and the numerous other available funders to receive repayment. The leading multilateral institutions started imposing conditionalities in part to ensure repayment; at the same time, the environmental and social consequences of projects they funded were being challenged. The AIIB and the New Development Bank are likely to face similar pressures—despite their intentions, they will still be banks and will still require repayment.

The United States has a number of options regarding these institutions. None are clearly superior, except that a policy of active opposition is likely inferior. The United States can continue to sit outside of the institutions or opt to join them. Joining them will likely give the United States a greater voice in governance—but it will be a minority voice, an uncharacteristic position for Washington. It also can try to influence the institutions through allies that are members, but the inability of the United States to persuade them not to join in the first place indicates they may not be willing to try to exercise influence on the United States' behalf. A third route would be to work outside these institutions to try to influence them, perhaps by fostering cooperation between the new development banks and the existing development banks where the United States is in the lead, by cooperating with them through U.S. development agencies, or by carefully monitoring them and reporting on their activities. Whatever route is taken, it is unlikely that the United States will be able to change China's preeminent role in the new institutions or that the institutions will disappear, so the challenge will be learning how to work with them.

A Bilateral Instrument for Working with China

The United States has a much clearer option to try to influence China directly in a way that would benefit both countries, and that is through a new agreement covering investment. Both the United States and China economically benefit a great deal from each other, and from the rules-based international economic system that the United States has been

instrumental in creating and sustaining. It is not entirely clear what China ultimately wants, whether it is to have a greater say in international economic affairs or ultimately to displace the United States as the leading power in global economic institutions (recognizing that these are not necessarily conflicting goals). For now, at least, each has an interest in the other maintaining economic strength and growth because of the numerous benefits of the relationship, and both have an interest in maintaining the broad outlines of the global economic system.

One approach is completion of a bilateral investment treaty between the nations. China's accession to the WTO in 2001 illustrates one reason a proposed bilateral investment treaty might be important. It took China 15 years to meet the requirements of WTO membership, the longest entry period of any country up to that time. However, such international requirements can be an effective method of countering domestic opposition,⁶¹ and much of China's leadership viewed the process as beneficial in pushing desired economic reforms.⁶² Since these reforms were required by the WTO, which is driven by the consensus of its members, the rest of the trading world believed these reforms would be in their interest. A bilateral investment treaty between the United States and China could provide a similar mechanism for continuing Chinese reforms.

A standard U.S. bilateral investment treaty includes agreements on market access, nondiscrimination and national treatment (in which foreign investors are treated exactly as local investors), rights of remitting profits and interest to the home country and repatriating capital, bans on local content or export requirements, and independent dispute-resolution measures.⁶³ As of October 2014, the United States had 42 bilateral investment agreements in force, but that understates the number of U.S. trade partners that honor bilateral investment deal provisions, since those same provisions are almost always also included in

⁶¹ Chen, 2014.

⁶² Permanent Mission of China to the WTO, "China in the WTO: Past, Present and Future," Geneva, World Trade Organization, 2011; Chen, 2014.

⁶³ Daniel M. Price and Michael J. Smart, *BIT by BIT: A Path to Strengthen US-China Economic Relations*, Paulson Policy Memorandum, The Paulson Institute, July 2013.

free trade agreements. As of the same date, the United States had free trade agreements with an additional 18 countries. There are approximately 3,000 bilateral investment treaties in force worldwide, although they are of varying standards, depending on the signatories.

China and the United States have been negotiating a bilateral investment treaty for many years, with the current efforts starting in July 2013; negotiations have not been going smoothly. The main sticking point appears to be market access. When the countries agreed to restart negotiations, U.S. investors faced barriers in China in about 90 sectors.⁶⁴ As talks proceeded, Washington became frustrated by the number of sectors that Beijing wanted to exclude from the treaty.⁶⁵ The two countries made some progress in July 2014, although it was difficult.⁶⁶ Progress continued in 2015 when China agreed to reduce the number of sectors it wanted to exclude from the treaty in a run-up to Xi Jinping's U.S. visit in late summer.⁶⁷ However, China then missed a self-imposed deadline in March 2016 to present a list of sectors that would remain closed to U.S. investment.⁶⁸

Proponents of a bilateral investment treaty say it will vastly improve access to the Chinese market for U.S. investors, help Chinese reformers guide their country to a more open economy, help the United States and China set the international investment agenda for the rest of the world, and provide the two countries with the basis of a forward-looking trade and investment agenda.⁶⁹ Others doubt China's willingness not only to provide adequate market access, but also

⁶⁴ Paul Eckert and Anna Yukhananov, "U.S., China Agree to Restart Investment Treaty Talks," Reuters, July 12, 2013.

⁶⁵ Ian Katz, "China Faces Yuan on Yuan as U.S. Decries Weak Currency," Bloomberg, July 7, 2014.

⁶⁶ Office of the U.S. Trade Representative, "Statement by U.S. Trade Representative Michael Froman on the Sixth Annual Strategic and Economic Dialogue," July 10, 2014.

⁶⁷ William Mauldin, "U.S., China Make Progress Toward Trade and Investment Deal," *Wall Street Journal*, September 25, 2015.

⁶⁸ David Lawder, "China Misses Deadline for 'Negative List' Investment Offer to U.S.," Reuters, April 1, 2016.

⁶⁹ Price and Smart, 2013.

to enforce that openness.⁷⁰ This leaves U.S. policymakers with difficult choices regarding what compromises to make during negotiations, given they must base their decisions on hopes that China will honor the treaty fully in the future. A bilateral investment treaty that will be enforced certainly will generate benefits that satisfy both countries. However, reaching that point will be difficult, and there may always be doubts about enforcement.

Engaging with China

Numerous U.S. policy mechanisms have been suggested over the years for dealing with China, such as high U.S. tariffs in response to China's exchange rate management. Some of these mechanisms would be counterproductive, potentially hurting the U.S. economy and U.S. friends and partners that trade with China, and even sparking a trade war. The United States has a number of mechanisms already in place to resolve differences, including such policy coordination forums as the Strategic and Economic Dialogue and the U.S.–China Joint Commission on Commerce and Trade. Further, U.S. trade laws address the sale by foreign companies of items in the United States at prices less than the cost of production, as well as subsidy support by foreign governments.

Equally important are mechanisms provided by international institutions. As a signatory to the WTO, China is subject to that organization's rules; therefore, the United States can and has pursued cases against China in WTO tribunals. Furthermore, China has actively sought reform assistance from the World Bank, and the United States, as the largest shareholder in both the World Bank and the IMF, has a say in support to China. A bilateral investment treaty would provide a further mechanism for binding China to an enforceable rules-based trading and investment system. These mechanisms might be insufficient for dealing with all conflicts; for example, they might not be amenable to dealing with the challenge of cyberattacks on U.S. companies

⁷⁰ Derek Scissors, "Stop the US-China Bilateral Investment Treaty (BIT) Talks," *AEIdeas*, American Enterprise Institute, August 19, 2014.

or with the theft of intellectual property. If not, given the complexity of the relationship, new targeted mechanisms should be tried before broad attempts are made to shift China's policies; such efforts could damage the U.S. economy as well as China's.

The United States will benefit if China's economic development is facilitated within the existing international rules and institutions, with a concomitant strengthening of the rules-based global economic system more generally. These two goals may not always complement each other, and might conflict. Although China has largely followed global rules and certainly benefited from them, China also might see value in changing those rules to benefit itself at the expense of the United States and U.S. allies, or in creating parallel institutions outside the current system.

Strategic Choices Abroad: Supporting Partners and Deterring Unwanted Behavior

As of early 2016, the world economy was once again at risk of a recession. At least, that is what the bond market was signaling: Government bonds worth nearly \$6 trillion were trading at negative yields in Europe and Japan, and the ten-year U.S. Treasury bond had hit a nine-month low of 1.80 percent in the first week of February.¹ Should recession strike, major economies are already at a disadvantage because many are fiscally stressed and interest rates are already low; increased spending and monetary expansion would be the natural reactions, ideally globally coordinated.²

Regardless of the short term, the world faces a growth and productivity challenge over the medium and long terms, and the United

¹ Elaine Moore, Robin Wigglesworth, and Leo Lewis, “Government Bond Yields Send Recession Signal,” *Financial Times*, February 5, 2016. The specific recession signal of the ten-year bond rate is its relationship to shorter-term rates, specifically the two-year bond rate; this relationship is known as the yield curve. The ten-year rate is generally higher than shorter-term rates. If longer-term rates are low in relation to shorter-term rates—if the yield curve is flat or inverted—that means investors are expecting low short-term rates in the future. The reason they would expect this is they anticipate a recession and central bank actions to keep interest rates low. The yield curve has proven to be a good predictor of recessions (Dusan Stojanovic and Mark D. Vaughan, “Yielding Clues About Recessions: The Yield Curve as a Forecasting Tool,” *Regional Economist*, Federal Reserve Bank of St. Louis, October 1997). Regarding current interest rates, some economists said that fears of a recession based on the yield curve were overblown as of January 2016 (Tim Duy, “So You Think a Recession Is Imminent, Yield Curve Edition,” Tim Duy’s Fed Watch Blog, January 14, 2016).

² Lawrence H. Summers, “I’m More Convinced of Secular Stagnation Than Ever Before,” Wonkblog, *Washington Post*, February 17, 2016.

States can play a leading role in responding to that challenge. Because of its weight and technical expertise, the United States can help or harm economies. In particular, regarding the latter, sanctions can hamper economic activity in foreign countries and signal U.S. disapproval of foreign government actions.

This chapter discusses the help and harm that the United States can provide to countries in the global economy. It starts with issues of assisting other countries in their growth and development, then moves to the topic of sanctions.

Restoring Growth in Allies and Reviving Growth in Unstable Regions

The challenges of providing economic assistance will be different for different types of countries, and the United States will have different levels of credibility for different areas in need of reform. For example, given the complexity and inefficiency of its own system, it is not clear that U.S. government advice on how to run a rational tax system will be welcome; however, technical assistance on taxation from private U.S. groups may be welcome.

For developed countries, the key tools are policy coordination and greater economic integration. For developing countries, one of the most important tools available to the United States is aid. The United States has been a leader in providing aid since the end of World War II and has sought to innovate the delivery of aid.

Assisting Developed Allies, Friends, and Partners

Although U.S. growth has been weak since the financial crisis, it is far better than that of the EU and Japan, key U.S. economic and security partners (Table 7.1). Aside from their importance as major trading partners—together, they accounted for 22 percent of 2014 U.S. merchandise imports and exports—they are pillars of the regional security architecture that the United States constructed following World War II. While Japan is maintaining and even strengthening its security role, defense expenditures in Europe have fallen sharply and military capabilities have

Table 7.1
Average Annual Growth of Real Per-Capita GDP

Country or Region	1991–2000 (%)	2000–2007 (%)	2007–2014 (%)	1991–2014 (%)
EU	2.2	1.9	–0.1	1.4
Japan	0.6	1.3	0.2	0.7
United States	2.6	1.5	0.3	1.6
World	1.5	1.9	0.7	1.4

SOURCE: World Bank, 2016b.

NOTE: Data show average annual growth of real per-capita GDP in 2005 U.S. dollars.

deteriorated at a time when Russia has presented new threats by invading Ukraine and annexing Crimea in contravention of agreements.³

U.S. policy options are limited regarding the assistance it can offer. Europe and Japan have well-functioning institutions and highly capable policymakers, and in both cases, the general outline of needed policy steps is well known. The key issue is assembling the political forces to adopt and implement reforms. However, there are steps the United States can take.

For Europe and Japan, instituting a U.S.–Europe trade and investment agreement and a U.S.–Japan trade and investment agreement can help spur productivity gains and economic growth. The current iterations of these agreements are the Trans-Atlantic Trade and Investment Partnership and the Trans-Pacific Partnership (discussed in Chapter Five). The European agreement is still under negotiation, whereas the Pacific agreement has been signed but is awaiting congressional approval. An agreement with Japan is wrapped into the Pacific agreement, since the United States and Japan are the two largest partners in that agreement. Although the TPP and eventual TTIP agreements will need to be examined in detail, what is clear is that agreements lowering barriers to international exchange will have beneficial overall effects and should be instituted.

Beyond economic integration, policy coordination also can help. As already noted, there are a number of venues in which the United

³ Steven W. Popper, “Europe Must Spend More on Arms to Deter Putin,” *Newsweek*, March 3, 2015.

States meets with allies, friends, and partners; the Federal Reserve, in particular, was essential in international efforts to respond to the global financial crisis. Finally, the United States can get its own economic house in order and serve as a better source of innovation and global growth in the world.

Assisting Developing Countries

The United States has more ability to influence and assist developing countries because of two mechanisms: aid and trade preferences.

Assisting with Aid

Since at least 1960, and likely before, the United States has been the leading provider of official development assistance among developed countries.⁴ The United States also has been the largest economy, but as a share of GDP, U.S. aid has been at the lower end. In 2014, U.S. bilateral official development assistance of \$33 billion was only 0.19 percent of U.S. GDP. In contrast, such assistance amounted to 1.09 percent of Sweden's GDP, 1.02 percent of Norway's GDP, and 0.88 percent of Denmark's GDP.

However, the United States is also notable for providing large amounts of private capital flows, beyond official development assistance; these are categorized by the OECD's Development Assistance Committee as part of total aid.⁵ When all forms of bilateral aid are included in the total, the U.S. government and U.S. entities provided almost \$239 billion worth of aid, or 1.37 percent of GDP. Out of the 28 individual member countries of the Development Assistance Committee (the EU is also a member), only five provided a higher level of

⁴ OECD, "International Development Statistics (IDS) Online Databases," December 22, 2015.

⁵ The OECD defines *private flows* as flows at market terms financed out of private-sector resources and private grants. In more disaggregated terms, these include FDI to countries on the OECD's Development Assistance Committee's list of official development assistance recipients; private export credits; securities of multilateral agencies; and bilateral portfolio investment, including bank lending and the purchase of shares, bonds, and real estate (OECD, "DAC Glossary of Key Terms and Concepts," Paris, undated).

aid relative to GDP. And the total level of U.S. aid was almost four times higher than that of the next largest donor, Japan.⁶

Setting aside aid levels, serious questions have been raised about the usefulness of aid. The United States piled tens of billions of dollars into the reconstruction of Iraq, with questionable results.⁷ In contrast, Plan Colombia, a U.S. program that started in 2000 and has continued for a cumulative cost of \$10 billion, is hailed as a success. In February 2016, President Obama said he wanted to increase aid to Colombia to \$450 million for fiscal year 2017, building on a track record that is credited with helping Colombia become a good destination for foreign investors, reduce violence, and improve its overall development profile (although Colombia remains the world's top cocaine exporter).⁸

Although the idea of aid sounds good—the more fortunate helping the less fortunate—there are legitimate concerns about its efficacy, especially in generating economic growth. Because of the multiple reasons aid might be sent to a country, it is extremely difficult to establish causality regarding aid and growth. And even if it can be established that aid might have caused growth, establishing exactly why and how it did so is also difficult.⁹

This has not stopped people, including leading economists, from trying to establish causal mechanisms. One careful analysis found that there is little evidence on average of a “robust positive correlation” between aid and growth, with different institutional environments and types of aid making little difference.¹⁰ Others have noted that for-

⁶ OECD, 2015.

⁷ Special Inspector General for Iraq Reconstruction, *Hard Lessons: The Iraq Reconstruction Experience*, Washington, D.C.: U.S. Government Printing Office, 2009.

⁸ Karen DeYoung, “Colombia President Arrives in D.C. as a Peace Accord Appears Imminent, but Some Grumble at the Cost,” *Washington Post*, February 3, 2016; Nahal Toosi, “Obama Reveals Plans to Boost Aid to Colombia to \$450 Million,” *Politico*, February 4, 2016.

⁹ Angus Deaton, “Instruments of Development: Randomization in the Tropics and the Search for the Elusive Keys to Economic Development,” the Keynes Lecture, British Academy, October 9, 2008. Deaton was the 2015 Nobel Prize winner for economics.

¹⁰ Raghuram G. Rajan and Arvind Subramanian, “Aid and Growth: What Does the Cross-Country Evidence Really Show?” *Review of Economics and Statistics*, Vol. 90, No. 4, November 2008, pp. 643–665. Rajan was a University of Chicago professor who, in 2013, became

eign aid might undermine the development of government capacity in developing countries.¹¹

Where there does seem to be a broad consensus is that aid has helped advance social welfare, especially health and education.¹² Furthermore, a broad range of recent research has found a positive effect of aid on growth and on institutional improvement.¹³ A specific case study can illustrate this. The U.S. Millennium Challenge Corporation limits its aid to countries that “demonstrate a commitment to just and democratic governance, investments in its people and economic freedom as measured by different policy indicators.”¹⁴ It turns out that developing countries have engaged in reforms so they can meet these criteria, especially those related to control of corruption, fiscal policy, business startup, and primary education expenditures; in contrast, the indicators for political rights, civil liberties, and voice and accountability do not have this effect.¹⁵ Pending further research, evidence suggests that aid can improve health and education outcomes and might improve growth and governance outcomes, at least on average. It is difficult to justify stronger statements than that.

Beyond the effect of aid, there are serious questions about its delivery. Many aid agencies that preach transparency and openness are themselves opaque in terms of costs and staffing. Aid is fragmented, creating heavy demands on policymakers in developing countries who must not only work on national policy problems but also please

the 23rd governor of the Reserve Bank of India, which is the central bank of the world’s second-most-populous developing country.

¹¹ Angus Deaton, “Weak States, Poor Countries,” *Project Syndicate*, October 12, 2015, originally published September 2013.

¹² Tony Addison and Finn Tarp, “Lessons for Japanese Foreign Aid from Research on Aid’s Impact,” United Nations University—World Institute for Development Economics Research, WIDER Working Paper 2015/058, August 2015.

¹³ Sam Jones and Finn Tarp, “Does Foreign Aid Harm Political Institutions?” United Nations University—World Institute for Development Economics Research, WIDER Working Paper 2015/094, September 2015.

¹⁴ Millennium Challenge Corporation, “Who We Fund,” undated.

¹⁵ Bradley C. Parks and Zachary J. Rice, “Does the ‘MCC Effect’ Exist? Results from the 2012 MCA Stakeholder Survey,” *MCA Monitor*, Center for Global Development, February 2013.

multiple aid agencies. Aid often goes to corrupt governments, despite global anticorruption sentiments, and it sometimes is used by developed countries to fulfill their own domestic policy goals while actually harming recipient countries—especially in the case of food aid.¹⁶

The literature on aid thus suggests two issues for the United States to address as it acts to improve growth and development prospects among the world's poorer countries. First, it needs to decide the extent to which it should and will provide aid to developing countries, and under what conditions. Second, it will need to ensure that its own aid delivery systems are effective.

The United States will benefit from continuing to provide aid and should consider increasing its level of assistance, especially as the world enters an unsettled period of what appears to be slowing growth and a possible new recession.¹⁷ This aid can go toward helping countries provide public goods, such as health, education, and security. Aid also may help with infrastructure, as long as systems are put in place for the host country to maintain that infrastructure. And aid can help with policy reform, especially when such reforms might create temporary budget problems.

The direst challenge is reviving growth in parts of the Middle East and South Asia, where instability creates a variety of security challenges and where the presence of large populations means higher growth could dramatically reduce global poverty rates. Both those regions have shown reasonable growth rates in the aggregate. For example, aside from India, which has been growing rapidly, South Asian countries as a group have grown faster than the world as a whole,¹⁸ although per

¹⁶ William Easterly and Tobias Pfutze, "Where Does the Money Go? Best and Worst Practices in Foreign Aid," The Brookings Institution, Global Economic and Development Working Paper 21, June 2008.

¹⁷ This is in the context of advancing U.S. interests. There is a strong argument to be made that there is humanitarian justification, beyond whether aid will benefit the United States. The humanitarian justification was one of the prime motivations of the President's Emergency Plan for AIDS Relief, started by President George W. Bush and continued by President Obama.

¹⁸ These countries include Bangladesh, Bhutan, Nepal, Pakistan, and Sri Lanka. With Maldives and India, they constitute the original members of the South Asian Association for Regional Cooperation. Data for Maldives were unavailable for 1991 to 2000.

capita economic growth has been less impressive. Pakistan's economy grew 3.1 percent annually from 2007 to 2014, but it grew only 1 percent annually in per capita terms. Global per capita GDP during the period grew only 0.7 percent annually, but Pakistan's per capita growth has been far lower than that of any other country in the region. India's, in contrast, was 5.5 percent annually.

As with South Asia, growth in the Middle East and North Africa region excluding the countries of the Gulf Cooperation Council has been above world averages in the aggregate. As with South Asia, there are weaknesses, especially among key U.S. allies. In particular, Jordan's per capita GDP has grown only 1.5 percent annually from 2007 to 2014. Although this rate is above the global average, it is far too low to alleviate Jordan's many economic problems. Furthermore, it was that high only because of strong growth through 2009. Growth since then has been less than 1 percent each year. Other countries with lagging growth in per capita GDP include Tunisia, at 1.6 percent annually from 2007 through 2014, Algeria, at 1.0 percent annually from 2007 through 2014, and Yemen, at -2.4 percent annually from 2007 through 2013. Incomes in Syria have plummeted as the economy has been shrinking due to the civil war.

While growth problems in developed countries are largely a result of economic policy choices, other issues compound poor policy choices in the case of the developing countries. Some are facing insurgency and terrorism threats (Pakistan and Iraq), while others are facing civil war and terrorism (Yemen and Syria), and still others are flooded with refugees (Jordan). These security issues can make restoring growth extraordinarily difficult.¹⁹ Moreover, reforms generate winners and losers; those at risk of losing work hard to derail them. Additionally, direct U.S. involvement in reforms could create local opposition. As in any country, working through the legitimate political authorities will be necessary. Beyond that, efforts should be multilateral, include greater market access and

¹⁹ Pakistan in recent years has grown despite its security problems. Although growth of per capita GDP was below 1 percent from 2008 through 2011, and was actually negative in 2008 and 2010, it has since picked up, hitting 1.3 percent in 2012, 2.2 percent in 2013, and 2.6 percent in 2014.

greater help with facilitating trade and investment, and include an aid component contingent on taking positive policy steps.

Aid to Africa should also be maintained, at minimum—and preferably increased, especially with the global growth slowdown as of early 2016. From a security perspective, Africa’s ungoverned spaces have the potential to create threats to the United States. But from an economic perspective, Africa’s large population and growth record throughout the 2000s suggest it could be a larger trade and investment partner—and with that, an active supporter of the global, rules-based system the United States currently leads.

As for delivery of aid, U.S. innovations have included providing aid via the Millennium Challenge Corporation to countries that meet specific governance standards, and trying to improve the evaluation of the efforts of the U.S. Agency for International Development, the United States’ main aid agency. An evaluation of aid agencies around the world in 2008 found U.S. aid efforts to be largely transparent but also to fund a large share of corrupt countries and to give less consideration to the least-developed countries in aid choices, and to provide a good deal of ineffective aid.²⁰ Whether these are the right criteria is unclear, but they do point to the idea that U.S. aid practices should be evaluated regularly for their effectiveness and that policymakers, particularly Congress and the president, should be open to experimentation for the purposes of improvement, expecting at least some new efforts to fail.

Assisting with Trade Preferences

The United States has a long history of giving trade benefits to help developing countries. Among these are the Generalized System of Preferences, the African Growth and Opportunity Act, the Andean Trade Preference Act, the Caribbean Basin Initiative, and numerous free trade agreements. As of early 2016, 15 of the 20 countries with which the United States had free trade agreements in force were developing countries.²¹

²⁰ Easterly and Pfitze, 2008.

²¹ Vivian C. Jones, *Generalized System of Preferences: Background and Renewal Debate*, Congressional Research Service, RL 33663, August 17, 2015; Office of the U.S. Trade Represent-

The Generalized System of Preferences provides a good example of the reach of trade preferences. Started in 1974, it provides duty-free entry to the United States for up to 5,000 types of products imported from 122 beneficiary countries.²² Other developed countries provide similar preferences, resulting in a worldwide effort to help developing countries export products.

The Generalized System of Preferences also provides a good example of how the United States can improve its delivery of these preferences. Specifically, it needs to be renewed periodically, and delays in renewal lead to policy uncertainty for exporters: Renewal usually includes retroactive benefits, but these are never guaranteed before renewal. Therefore, if the United States wants these programs to be more effective, policy-makers should ensure renewal or changes before they expire.

The system of free trade agreements also can be improved, although doing so may be difficult. As noted in Chapter Five, a multiplicity of agreements leads to a multiplicity of rules and greater complexity. The United States and its partners might benefit if these agreements could be wrapped in a broader agreement extending similar rules to larger sets of countries. At the same time, the United States should explore negotiating new agreements with groups of developing countries.

Balancing Sanctions and the Economy

Aid is giving. The United States also can take away. Because of its enormous economy and the central role U.S. banks play in the global financial system, the United States can use economic and financial sanctions as an instrument short of military action to punish opponents and reshape behavior. However, overuse of such sanctions could lead other

tative, "Free Trade Agreements," undated-a. The 15 countries are Bahrain, Chile, Colombia, Costa Rica, Dominican Republic, El Salvador, Guatemala, Honduras, Jordan, Mexico, Morocco, Nicaragua, Oman, Panama, and Peru. The United States has free trade agreements with an additional five developed countries: Australia, Canada, Israel, Singapore, and South Korea.

²² Office of the U.S. Trade Representative, "Generalized System of Preferences (GSP)," undated-b.

countries to try to dilute their effectiveness by developing alternative institutions. Analysts speculate that may be one of the outcomes of the New Development (BRICS) Bank or the AIIB.

The U.S. government considers sanctions to be “powerful weapons in the fight to safeguard our economy and security, but their success requires the active participation and support of every financial institution.”²³ As of May 2016, the U.S. Treasury’s Office of Foreign Assets Control administered more than 28 sanctioning programs, such as those against Iran, North Korea, Russia (for its aggression in Ukraine), and other countries with which the United States has disputes.²⁴ Although the issue of sanctions is not as important as the other policy issues already mentioned, the use of sanctions has become more prominent as U.S. security challenges have increased. In addition, if military options are progressively taken off the table, other options—including sanctions—will rise in importance and their use might be expanded.

Sanctions are generally targeted against individuals or entities to fight terrorist financing, money laundering, corruption, narcotics trafficking, and other illicit activities and to counter foreign policy actions the United States opposes, such as Russia’s annexation of Crimea. Financial sanctions are intended to freeze the assets of designated entities and prevent these entities from conducting transactions through U.S. financial channels.²⁵ Many transactions around the world pass in some way through U.S. banks, and U.S. banks will not transact with noncompliant banks, so the sanctions can have the power to exclude entities from the formal global financial system. Economic sanctions may include trade restrictions and even travel bans. For example, as of late February 2016, even with the Iran nuclear agreement in place,

²³ Office of Foreign Assets Control, “OFAC Compliance: A Perspective for Community Banks,” *ABA Bank Compliance*, November/December 1998, pp. 39–48.

²⁴ Office of Foreign Assets Controls, “Sanctuary Programs and Country Information,” Resource Center, U.S. Department of the Treasury, May 19, 2016.

²⁵ Office of Foreign Assets Control, *OFAC Regulations for the Financial Community*, Washington, D.C.: U.S. Treasury, January 24, 2012; Office of Foreign Assets Control, Sanctions Compliance and Evaluation Division, “OFAC Compliance in the Securities and Investment Sector,” *Journal of Investment Compliance*, Vol. 13, No. 3, September 2012, pp. 21–26.

U.S. entities were still prohibited from trading with Iran, and despite warming relations with Cuba, the Cuba embargo was still in place.²⁶ In both cases, the United States opposes the actions and policies of both countries (for example, Iranian proxy militias in Iraq and Syria) and so has kept a variety of sanctions in place.

Sanctions have had some impressive successes.²⁷ They are extremely powerful when they are multilateral and participating countries account for a large share of the activities on which the sanctions are applied. For example, before Iran returned to negotiations on its nuclear program, the Society for Worldwide Interbank Financial Telecommunications (SWIFT) disconnected several major Iranian financial firms. SWIFT is the system that facilitates most cross-border payments in the world, handling more than \$6 trillion worth of transactions each day. Disconnection, therefore, makes it almost impossible for a sanctioned bank to engage in international transactions, limiting the ability of firms across all sectors to import and export because of the lack of ability to send or receive payments electronically.²⁸ Between 2010 and 2013, Iran's per capita GDP grew at an arithmetic average of only 0.2 percent per year, compared with 1.7 percent for the world and 2.3 percent for the Middle East and North Africa region. Although sanctions were not the sole cause, they contributed to this poor growth record.

As already suggested, however, using the formal financial system in a noneconomic way—to punish or influence opponents—creates the risk of loss of trust in the formal financial system by certain actors. Repeatedly using the financial system to sanction countries provides an incentive for countries that are likely to be sanctioned to use informal systems, when possible, or to create alternative systems. As of now, it is unlikely that any group of countries likely to be subject to U.S. sanc-

²⁶ U.S. Department of the Treasury, "Frequently Asked Questions Related to Cuba," January 26, 2016a; U.S. Department of the Treasury, "Frequently Asked Questions Relating to the Lifting of Certain U.S. Sanctions Under the Joint Comprehensive Plan of Action (JCPOA) on Implementation Day," January 16, 2016b.

²⁷ Juan C. Zarate, *Treasury's War: The Unleashing of a New Era of Financial Warfare*, New York: PublicAffairs, 2013.

²⁸ Philip Blenkinsop, Sebastian Moffett, Martina Fuchs, et al., "Payments System SWIFT to Expel Iranian Banks Saturday," Reuters, March 15, 2012.

tions would have the ability or the financial clout to create such an alternative system, but it is a risk that bears watching.

Another risk of economic sanctions is that they will be ineffective, not harming the targeted country because all other countries are trading with it, and instead harming Americans who want to trade with the targeted country. Accordingly, acting multilaterally will enhance the effectiveness of both economic and financial sanctions, and that will involve active diplomacy to ensure that allies and partners have foreign policy goals similar to those of the United States, or at least have incentives to cooperate with sanctions.

A second risk is that they will end up harming the population of a country without harming its leaders. The global sanctions regime against Iraq during the 1990s ended up causing tremendous deprivation among the population while helping the regime of Saddam Hussein further strengthen its totalitarian control. Such deprivation could erode global support for a particular sanctions effort, or even sanctions generally.

The harm they may do to the target country highlights a third risk. The United States often ends up paying to undo the damage once the regime in question changes. Much U.S. aid to Haiti and to Iraq was directed toward undoing the effect of years of hard sanctions. If Cuba ever gets a democratic government, U.S. aid will again be employed to reverse the effect of a 50-year embargo. All of this argues for a judicious use of sanctions and an effort to target regimes and leadership in a way that causes minimal pain for the population.

A review of 174 cases found that sanctions work some of the time and in some cases. Sanctions with limited goals were more likely to succeed; sanctions aimed at regime change or to cause major policy change sometimes worked; and sanctions to disrupt minor military actions worked least often.²⁹ This is further support for the idea that sanctions are not an all-powerful solution in lieu of other diplomatic and military means, but can be effective under the right circumstances and thus should be used judiciously.

²⁹ Peterson Institute for International Economics, *In Brief: Economic Sanctions Reconsidered*, 3rd edition, Washington, D.C., November 2007.

Because of their successes in some cases, using sanctions as a tool of policy is certainly in the United States' interest, and can be cheaper and even more effective than other mechanisms, particularly military force. But like any policy, they merit continuous evaluation. Sanctions not having their intended effect should be eased, and new forms of sanctions can be experimented with.

Conclusion

By virtue of its size, the United States can have positive and negative effects on the global economy. Its long track record of doing so since the end of World War II indicates that it can help spur country and global economic growth through a number of mechanisms. These include policy coordination, the reduction of trade and investment barriers, and aid.

It also can deter or reshape behavior through sanctions, but these actions must be used judiciously because they are not always effective and can harm the populations of target countries. Accordingly, there is room for evaluation and experimentation in the delivery of sanctions.

Both of these actions—spurring growth and deterring undesirable behavior—are likely to be needed in the short and medium terms. The expected global growth slowdown means policymakers worldwide will be looking for solutions to alleviate the ill effects of recession and to move the world more quickly out of recession. In addition, aid and sanctions have proven to be useful tools in U.S. security policy. Given their cost relative to military action, they are likely to remain so, and if security challenges mount, they will likely expand.

Conclusion: U.S. Policy Choices for the Global Economy

In the realm of grand strategy, the United States' ends have been enduring—affording citizens and residents life, liberty, and the pursuit of happiness. But the ways and means have changed as demographics, economics, politics, and the global environment have changed. At most times, economic policy, both domestic and international, has played an important role in shaping and implementing the United States' grand strategy.¹

In considering any strategy, U.S. leaders will benefit by getting the domestic economic house in order. This is far easier said than done. The most important problems include opportunity in the U.S. labor market and the longer-term U.S. fiscal outlook. In the labor market, U.S. policymakers will need to address the decline of middle-skill jobs, which has resulted in stagnation of incomes for the majority of U.S. households. Options range from more-direct redistribution to increased training and regulatory reforms that favor new business formation but that may not have visible effects for quite some time. Immigration reforms are logically part of labor-market reforms, since immigration has contributed a large share of U.S. population increase and therefore of potential labor force increase and because immigrants have played an important role in the United States' most innovative sectors. Fixing the budget will involve messy, difficult political struggles over the levels and composition of government spending and taxation.

¹ Zoellick, 2012.

However, there is no other choice: Fiscal trends are unfavorable and unlikely to change, regardless of temporary increases in revenue and decreases in spending due to economic cycles.

Regardless of domestic policy choices, U.S. policymakers during the next four to ten years will face a range of international policy choices, most of which will affect the domestic economy. The remainder of this chapter recaps those choices.

The Rules-Based Global Economic System

Safeguarding, maintaining, and broadening the liberal, rules-based global economic system and its institutions present one set of choices facing U.S. policymakers. The liberalization of global trade and investment has contributed enormously to global economic growth.

With the dual goal of liberalizing trade and maintaining the legitimacy of the WTO, the United States should aim to restart a new broad-based multilateral negotiating round. Despite the demise of the Doha Development Agenda, there is value to developing sets of rules to apply to all countries. With changes in the global economy since 1995 when the last broad-based agreement was concluded, there are certainly areas that a new agreement could address.

A new multilateral round will present challenges, however. Therefore, the United States also should aim to negotiate agreements with smaller groups of countries within the WTO, but agreements that apply to all countries and that can be easily joined by new signatories after they are negotiated. Such so-called open plurilateral agreements may be all that can be achieved, even if a new multilateral round gets started.

Among regional trade agreements, U.S. policymakers should strive to complete and approve some version of broad trade and investment agreements for the Atlantic and Pacific, then turn to expanding participation in those agreements and having them supersede existing agreements to reduce complexity in the system. Ideally, the Atlantic agreement should include all of North America (Canada, the United States, and Mexico) in a unified agreement with the EU. Special atten-

tion should be paid in all agreements—multilateral, regional, and bilateral—to investment and services trade rules, since FDI has become the preferred way to serve overseas markets, and the United States has a distinct strength in services trade.

The United States also will benefit by ensuring that such global institutions as the IMF, the World Bank, and regional development banks are strong and effective. For both sets of institutions, this means better integrating growing developing countries into the governance structure so that the institutions retain legitimacy. The IMF will benefit from having enough capital and policy freedom to respond to the possibility of a new recession and increased difficulties that countries are having with the global slowdown being experienced in early 2016. The World Bank will benefit if the United States can spur reforms that increase agility and ensure changes based on the results of evaluations.

The Rise of China

Despite current economic difficulties, China is still growing and likely will continue to grow, gaining more economic influence in the world. The United States will benefit most if it can accommodate China's rise within the current global system. The two economies are intertwined, and many U.S. allies have sizable trade and investment relations with China.

Creating an on-ramp for China into the TPP or any Pacific trade deal that is finally approved should be a priority. In 2014, China was the largest exporter of goods and services in the world, slightly ahead of the United States (\$2.34 trillion for both, when rounding) and the second-largest importer of goods and services, behind the United States (\$2.87 trillion for the United States and \$1.96 for China).² Accession will be neither easy nor quick, but creating a commitment will enable both China and the incumbent members of any trade deal to treat negotiations more seriously and could strengthen forces for reform in China. The United States also may contemplate joining the pan-Asian Regional Compre-

² World Bank, 2016a.

hensive Economic Partnership if that deal is concluded, although integrating China into the TPP will be far more important.³

Another set of negotiations that will not be easy is a new bilateral investment treaty between the United States and China. There will likely be great value to both countries if an agreement represents investment liberalization in which investment into most or all sectors is not prohibited and which has strong enforcement provisions.⁴

It is less clear how the United States should approach the new China-led development institutions, specifically the AIIB and the New Development Bank. At minimum, it should monitor these institutions and report on their activities as an external and transparent check. The United States also could work to foster cooperation between these banks and the other regional development banks or U.S. development agencies, or the United States could attempt to join them. It is likely that China would welcome U.S. participation, although in a subordinate role. These options will require further study and will depend, in part, on how well the banks operate in their early years.

Supporting Partners and Deterring Unwanted Behavior

Whether or not the world moves into recession in 2016 or 2017, the United States still has an important role in fostering global growth and development. For its advanced country partners, economic integration, via the large regional trade agreements, and policy coordination can help. Otherwise, those partners will have to execute the policies they believe are needed and it will be up to them to determine whether and how the United States can help.

For developing countries, maintaining aid levels should be the minimum good policy and increases should be considered. Stronger,

³ That negotiation involves the 10 ASEAN members, Australia, China, India, Japan, New Zealand, and South Korea.

⁴ Regarding sectors, the United States is requiring a so-called negative list, meaning investment is permitted except in designated sectors, rather than a positive list, meaning investment is permitted only in those sectors named. The negative list is by far the more liberal of the two, and the more desirable.

actionable evaluations should be a component of aid delivery and forms of aid that either do not work or that benefit the U.S. economy while delivering little to the host economy should be minimized.⁵

Greater policy certainty with trade preferences also will benefit partner countries and the United States. Additionally, the United States should consider integrating more developing countries into its system of free trade agreements and unifying these agreements to lower complexity.

The United States can help the economies of other countries, but it also can hurt them, through sanctions. As of May 2016, there were 28 different sanctions programs appearing on the “Sanctions Program and Country Information” website of the U.S. Department of the Treasury’s Office of Foreign Assets Control.⁶ These programs should be evaluated regularly for their effectiveness and for how well they strike a balance between deterring or changing behavior and hurting the target country’s population.

Paving the Way for the Next Era of Global Growth

The world economy faced numerous challenges as of early 2016. Growth in most major economies either has slowed or is slowing; a major multilateral trade round has fallen through; global debt is increasing, especially that of emerging markets; and developing countries are slowing as well, stemming in part from China’s economic slowdown. In addition, parallel institutions are emerging, with unknown effect.

The United States has led the world economy for several reasons, including its economic size, its ability to formulate and execute policies, and the fact it has been in most countries’ interest to follow the U.S. lead. Unlike security policy, economic policy depends not only on

⁵ There is some thought that *tied aid* (aid that requires the recipient to purchase goods and services from the donor) and food aid are among those categories (see Easterly and Pftutze, 2008).

⁶ Office of Foreign Assets Control, 2016.

executive and legislative action and on the action of other governments and multilateral institutions, but also on the actions of the billions of businesses and consumers around the world, reducing some element of control that governments may wish to exercise over their economies.

Even with global challenges, there is no reason to think that the rules-based international system that has evolved since the end of World War II is any less useful now than it was throughout the post-war era. Furthermore, ideas for replacing it are scarce. Maintaining and expanding the liberal international order can have large, positive, cumulative effects on U.S. growth and economic performance.

Selective engagement or retrenchment may allow U.S. policymakers to focus temporarily on domestic issues, but that will also allow other countries to reshape the international trading and investing rules in a way that might work against U.S. interests and accordingly could have large, negative, cumulative effects on economic performance. Therefore, the United States should strive to maintain and improve the system, integrating growing economic powers to maintain system legitimacy, improving global rules to foster free exchange, and working to spur growth and development so that lives are improved and countries find the U.S.-led system a desirable one in which to participate. Because the United States has global economic interests, and because these are tied to its security interests, there is little choice but to engage globally.

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The upcoming U.S. presidential election presents an opportunity to confirm, better define, or redefine America's role in the world. Economic power and policy will have an important place in any conception of the United States' role in the world. This report presents the strategic choices America faces regarding the international economy over the terms of the current and next U.S. administrations. The goal of U.S. international economic policy is to contribute to national economic growth and prosperity. Although the United States faces many choices regarding the global economy, this report focuses on policy choices in the areas of maintaining and improving the rules-based international economic system; working with China and better integrating it into the existing system; supporting the economic growth of allies, friends, and partners; and using economic tools to change unwanted behavior and counter adversaries.



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