CHAPTER 3

Economic Power

At the end of the Cold War, some analysts proclaimed that "geo-economics" had replaced "geopolitics." Economic power would become the key to success in world politics. Carrots were becoming more important than sticks. As one scholar put it, "In the past it was cheaper to seize another state's territory by force than to develop the sophisticated economic and trading apparatus needed to derive benefit from commercial exchange with it."[1] Many people thought this would usher in a world dominated by Japan and Germany. Today some equate the rise in China's share of world product as a fundamental shift in the balance of global power without considering other dimensions of power.

Political observers have long debated whether economic power or military power is more fundamental. Marxist tradition casts economics as the underlying structure of power and political institutions as a parasitic superstructure. Nineteenth-century liberals believed that growing interdependence in trade and finance would make war obsolete. Realists reply that Britain and Germany were each other's leading trade partners in 1914, but that did not prevent a conflagration that set back global economic integration for a half-century. They note that markets depend upon a political structure

to keep order. What was called "free trade" in the nineteenth century rested upon British naval preeminence.[2] Moreover, the workings of markets are often slower and less dramatic than the exercise of military force.

Both sides have a point, but as we saw in Chapter 1, whether one or another type of resource produces power in the sense of desired behavior depends upon the context. A carrot is more effective than a stick if you wish to lead a mule to water, but a gun may be more useful if your aim is to deprive an opponent of his mule. Military force has been called "the ultimate form of power" in world politics,[3] but a thriving economy is necessary to produce such power. Even then, as we have seen, force may not work on many crucial issues, such as financial stability or climate change. Relative importance depends on context.

Economic resources can produce soft power behavior as well as hard. A successful economic model not only produces the latent military resources for exercise of hard power, but it can also attract others to emulate its example. The soft power of the European Union (EU) at the end of the Cold War and the soft power of China today are enhanced by the success of their economic models. A large successful economy produces not only hard power resources, but also the soft power gravitational pull of attraction. The basic economic *resources* that underlie both hard and soft power are such things as the size and quality of gross domestic product (GDP), per capita income, the level of technology, natural and human resources, political and legal institutions for markets, as well as a variety of shaped resources for special domains, such as trade, finance, and competition.

Economic power *behavior* rests on the economic aspects of social life—"the production and consumption of wealth that is measurable in terms of money."[4] Some economists are skeptical about whether these activities produce anything that can be called economic power. As one puts it, "There is no politics in a purely economic exchange."[5] In the tradition of liberal market economics, if bargains

are freely struck between buyers and sellers under perfect competition, there is a joint gain from the trade rather than a power relationship. But it is a mistake to focus only on the absolute gain in economic relationships. Absolute gain can enhance the capabilities of both parties, but in traditional political competition, states have often worried about relative gains more than joint gains.[6] Nineteenth-century France may have benefited from trade with a growing German economy, but it also feared the military threat that enhanced economic growth was producing across the Rhine. Moreover, few markets are perfect, and power relationships may affect the division of the joint gain. Economic growth produces a bigger pie to be divided, but relative power often determines who gets the largest slice.

Other economists accept the reality of economic power as "economic strength used so as to achieve domination or control."[7] Some see it as "the capability decisively to punish (or to reward) another party" but still remain skeptical about its utility. "Apart from its possible connection to national military power through a country's tax base, [economic power] is largely local or ephemeral or both. It is difficult to wield on a global scale. The basic reason is that the locus for most economic decision-making is households and firms, and is thus highly diffuse. . . . Firms are subject to competitive pressures which penalize them, possibly severely, if they deviate too far from what the 'market' will permit."[8] Some even argue that economic power is based on monopoly (being the only seller) or monopsony (being the only buyer), and such power is held by nonstate actors such as individuals and businesses, not by states.[9] Although it is true that governments often have difficulty using potential economic power because of resistance from domestic interests, transnational corporations, linkages among issues, and international institutional constraints such as membership in the World Trade Organization (WTO), it does not follow that states lack economic power. But, again, how much power depends on the context, particularly the nature of the market.

In a perfect market, buyers and sellers are price takers who feel the structural power of market forces of supply and demand that are beyond their control. But if they can differentiate their product enough to create an imperfect market, they can gain pricing power and become price makers rather than takers. Advertising that creates a brand loyalty is a case in point. A key aspect of hard economic power behavior is efforts by actors to structure markets and thus increase their relative position. This is close to the second face of power described earlier. The other key modality of economic hard power is illustrative of the first face of power—the provision (or withdrawal) of payments that comprise positive and negative sanctions. The long list of instruments that states use to structure markets and make payments includes tariffs, quotas and rules that control access to their markets, legal sanctions, manipulation of exchange rates, creation of natural resource cartels, "checkbook diplomacy," and aid for development among others.[10] We shall look at a few of the more significant here, but an important underlying dimension of economic power behavior is to make others more dependent on you than you are on them.[11]

ECONOMIC INTERDEPENDENCE AND POWER

As states become connected by market forces, they seek to structure their interdependence both to achieve joint gains and to create asymmetries that provide a larger share of the gain and power for other purposes. "Interdependence" involves short-run sensitivity and long-term vulnerability.[12] "Sensitivity" refers to the amount and pace of the effects of mutual dependence; that is, how quickly does change in one part of the system bring about change in another part? For example, in 1998 weakness in emerging markets in Asia had a contagious effect that undercut other emerging markets as distant as Russia and Brazil. Similarly, in September 2008 the collapse of Lehman Brothers in New York quickly affected markets around the world.

A high level of sensitivity, however, is not the same as a high level of vulnerability. "Vulnerability" refers to the relative costs of changing the structure of a system of interdependence. Vulnerability produces more power in relationships than does sensitivity. The less vulnerable of two countries is not necessarily the less sensitive, but rather the one that would incur lower costs from altering the situation. In 1998, the United States was sensitive but not vulnerable to East Asian economic conditions. The financial crisis there cut 0.5 percent off the U.S. growth rate, but with a booming economy the United States could afford it. Indonesia, in contrast, was both sensitive and vulnerable to changes in global trade and investment patterns. Its economy suffered severely, and that in turn led to internal political conflict. Vulnerability involves degree. In 2008, given the bubble conditions in the country's subprime mortgage market and its growing deficits, the United States proved more vulnerable than it had been when its market was flourishing a decade earlier.

Vulnerability depends on more than aggregate measures, and this is where the earlier cautionary remarks apply to economic power. It also depends on whether a society is capable of responding quickly to change. For example, private actors, large corporations, and speculators in the market may each look at a market situation and decide to hoard supplies because they think shortages are going to grow worse. Their actions will drive the price even higher because they will make the shortages greater and put more demand on the market. Governments often find it difficult to control such market behavior.

"Symmetry" refers to situations of relatively balanced versus unbalanced dependence. Being less dependent can be a source of power. If two parties are interdependent but one is less so than the other, the less dependent party has a source of power as long as both value the interdependent relationship. Manipulating the asymmetries of interdependence is an important dimension of economic power. Perfect symmetry is quite rare, so most cases of economic interdependence also involve a potential power relationship.

In the 1980s, when President Ronald Reagan cut taxes and raised expenditures, the United States became dependent on imported Japanese capital to balance its federal government budget. Some argued that this gave Japan tremendous power over the United States. But the other side of the coin was that Japan would hurt itself as well as the United States if it stopped lending to the Americans. In addition, Japanese investors who already had large stakes in the United States would have found their investments devalued by the damage done to the American economy if Japan suddenly stopped lending to the United States. Japan's economy was little more than half the size of the American economy, and that meant the Japanese needed the American market for their exports more than vice versa, although both needed each other and both benefited from the interdependence.

A similar relationship has developed today between the United States and China. America accepts Chinese imports and pays China in dollars, and China holds American dollars and bonds, in effect making a loan to the United States. China has amassed $2.5 trillion of foreign exchange reserves, much of it held in U.S. Treasury securities. Some observers have described this as a great shift in the global balance of power because China could bring the United States to its knees by threatening to sell dollars. But in doing so, China would not only reduce the value of its reserves as the price of the dollar fell, but it also would jeopardize American willingness to continue to import cheap Chinese goods, which would mean job loss and instability in China. If it dumped its dollars, China would bring the United States to it knees, but might also bring itself to its ankles. As one Chinese economist puts it, "We live in an interdependent world, in which we will probably harm ourselves if we take unilateral action aimed at harming another side."[13]

Judging whether economic interdependence produces power requires looking at the balance of asymmetries, not just at one side of the equation. In this case, the balance of asymmetries resembles a "balance of financial terror" analogous to the Cold War military in-

terdependence in which the United States and the Soviet Union each had the potential to destroy the other in a nuclear exchange but never did. In February 2010, angered over American arms sales to Taiwan, a group of senior Chinese military officers called for the Chinese government to sell off U.S. government bonds in retaliation, but their suggestion was not heeded.[14] Instead, Yi Gang, China's director of state administration of foreign exchange, explained that "Chinese investments in US Treasuries are market investment behavior and we don't wish to politicize them."[15] If they did, the pain would be mutual.

Nonetheless, this balance does not guarantee stability. Not only is there the danger of accidents with unintended consequences, but also both countries maneuver to change the framework and reduce their vulnerabilities. After the 2008 financial crisis, the United States pressed China to let its currency float upward as a means of reducing the American trade deficit and the dollar imbalance. At the same time, officials of China's Central Bank began making statements about America's need to increase its savings, reduce its deficits, and move toward a long-term future in which the dollar would be supplemented by International Monetary Fund (IMF)–issued special drawing rights as a reserve currency. But China's growl was louder than its bite. Despite dire predictions about the power of creditors, China's increased financial power may have increased its ability to resist American entreaties but had little effect on its ability to compel the United States to change its policies.[16] Even though China took minor measures to reduce the increase in its holdings of dollars, it was not willing to take the risks of making its currency fully convertible because of domestic political reasons. Thus, the yuan is unlikely to challenge the dollar's role as the largest component of world reserves (more than 60 percent) in the next decade. Nonetheless, as China gradually increases domestic consumption rather than relying on exports as its engine of economic growth, Chinese leaders may begin to feel less dependent than they are now on access to the American market as the source of employment that

is crucial for their internal political stability. Political bargaining may then reflect perceived marginal shifts in the degree of symmetry.

Asymmetries in currency markets are a particularly important and efficient aspect of economic power because they underlie the vast systems of trade and financial markets. Monetary power can come from currency manipulation, a fostering of monetary dependence, and a capacity to disrupt the system.[17] By limiting the convertibility of its currency, China avoids discipline over domestic economic decisions that could come from international currency markets, while creating a competitive trade advantage.

When a currency is widely held as a means of exchange and a store of value, it becomes known as a world reserve currency, and this can convey a degree of power. Compare, for example, the discipline that international banks and the IMF were able to impose on Indonesia and South Korea in 1998 with the relative freedom that the United States had in adjusting during the 2008 financial crisis because American debts were denominated in the country's own currency. Rather than collapse, the dollar appreciated as investors regarded the underlying strength of the United States as a safe haven. A country whose currency represents a significant portion of world reserves can gain economic power from that position, both in easier terms for adjustment and in the ability to influence others who are in need. For example, after the British and French invasion of Egypt in the Suez Canal crisis of 1956, sterling came under attack in financial markets, and the United States conditioned its support of the pound upon a British withdrawal from Suez.[18] Britain was unhappy but could do little about it.

French president Charles de Gaulle complained that "since the dollar is the reference currency everywhere, it can cause others to suffer the effects of its poor management. This is not acceptable. This cannot last."[19] But it did. A decade later, French president Valéry Giscard d'Estaing complained that the role of the dollar gave the United States "an exorbitant privilege."[20] In the words of one economic historian, "Economic and political power tend to go hand

in hand in a world that is insecure and at the same time places a high value on security and growth."[21] The military strength of the United States reinforces confidence in the dollar as a safe haven. As one observer puts it, "The combined effect of an advanced capital market and a strong military machine to defend that market, and other safety measures such as a strong tradition of property rights protection and a reputation for honoring dues, has made it possible to attract capital with great ease."[22]

We should not overestimate, however, the economic power that a country gains from having its currency held as a reserve by other countries. Seignorage (the gap between the cost of producing money and its face value) applies only to the $380 billion of banknotes held internationally, not to Treasury obligations that must pay competitive interest rates (although confidence in the dollar can allow Treasury to issue bonds at lower interest rates than would otherwise be the case). Before fiscal problems in Greece and other countries caused a loss of confidence in Europe in 2010, "simply by enhancing the size and liquidity of financial markets the euro may have helped to lower real interest rates across Europe, and not just for government borrowers."[23]

Against the ease of adjustment and financing deficits described previously, there are potential costs. For example, Treasury is constrained by international opinion about the dollar when it formulates policies. In addition, to the extent that demand for the reserve currency is raised by its international role, the currency's value rises and producers in the reserve currency country may find their products less competitive in world markets than would otherwise be the case. Many American producers would welcome a diminished role for the dollar. Because of the scale of the American economy and the comparative depth and breadth of its financial markets, the dollar is likely to remain a major international reserve currency for the next decade or longer, but the economic power that comes from being a reserve instrument in currency markets should not be ignored or, as is more often the case, exaggerated.[24]

Even though neither the United States nor China is willing to destroy the balance of asymmetries that locks them together, the United States has allowed a gradual increase in Chinese influence in international forums (as well as greater influence for other emerging economies). Thus, the G-8 forum (where four of the eight countries are European) has been effectively supplemented by a G-20 summit that includes economies representing 80 percent of world product. Such meetings have discussed the need to "rebalance" financial flows, altering the old pattern of U.S. deficits matching Chinese surpluses. Such changes would require politically difficult shifts in domestic patterns of consumption and investment, with America increasing its savings and China increasing domestic consumption. Such changes are not likely to occur quickly, but, interestingly, the G-20 has already agreed that Europe should reduce the weight of its votes in the IMF and that China and other emerging economies should gradually increase their weight.

This again shows the importance of the limitations on economic power. Although China could threaten to sell its holdings of dollars and damage the American economy, a weakened American economy would mean a smaller market for Chinese exports, and the American government might respond with tariffs against Chinese goods. Neither side is in a hurry to break the symmetry of their vulnerability interdependence, but each continues to jockey to shape the structure and institutional framework of their market relationship. Moreover, as other emerging economies such as India and Brazil find their exports hurt by an undervalued Chinese currency, they may use a multilateral forum such as the G-20 in a way that reinforces the American position.[25]

When there is asymmetry of interdependence in different issue areas, a state may try to link or unlink issues. If each issue were a separate game and all games were played simultaneously, one state might have most of the chips at one table and another state might have most of the chips at another table. Depending on a state's interests and position, it might want to keep the games separate or

create linkages between the tables. Therefore, much of the political conflict over economic interdependence involves the creation or prevention of linkage. States want to manipulate interdependence in areas in which they are strong and avoid being manipulated in areas in which they are relatively weak.

By setting agendas and defining issue areas, international institutions often set the rules for the trade-offs in interdependent relationships. States try to use international institutions to set the rules that affect the transfer of chips among tables. Membership in the WTO, for example, restricts certain policy instruments that states might use and subjects others to a dispute resolution mechanism. Ironically, given the rhetoric of antiglobalization protesters, international institutions can benefit the weaker players by keeping some of the conflicts in which the poorer states are relatively better endowed separated from the tables where strong states dominate. The danger remains, however, that some players will be strong enough to overturn one or more of the tables. In 1971, for example, as the American balance of payments worsened, President Nixon abruptly announced that the United States would no longer convert dollars into gold, thus overturning the Bretton Woods monetary system that had been created by a multilateral agreement in 1944.

The largest state does not always win in the manipulation of economic interdependence. If a smaller or weaker state has a greater concern about an issue, it may do quite well. For instance, because the United States accounts for nearly three-quarters of Canada's foreign trade, whereas Canada accounts for about one-quarter of America's foreign trade, Canada is more dependent on the United States than vice versa. Nonetheless, Canada has often prevailed in a number of disputes with the United States because Canada was willing to threaten retaliatory actions, such as tariffs and restrictions, that deterred the United States.[26] The Canadians would have suffered much more than the Americans if their actions had led to a full dispute, but Canada felt it was better to risk occasional retaliation than to agree to rules that would *always* make Canada lose.

Deterrence via manipulation of economic interdependence is somewhat like nuclear deterrence in that it rests on a capability for effective damage and credible intentions. Small states can often use their greater intensity, greater focus, and greater credibility to overcome their relative vulnerability in asymmetrical interdependence. In terms of the concepts discussed in Chapter 1, they may develop a greater power-conversion capability. The asymmetry in resources is sometimes balanced by an opposite asymmetry in attention and will.

NATURAL RESOURCES

Sometimes people equate a rich endowment in natural resources with economic power, but the relationship is complicated. Japan, for example, became the second richest country in the world in the twentieth century without significant natural resources, and some well-endowed countries have not been able to turn their natural resources into national wealth or power. For example, some oil-producing countries remain weak, and because of oil's sometimes perverse social and economic effects, observers refer to an "oil curse." To the extent that oil wealth leads to corrupt institutions and an unbalanced economy that discourages broader entrepreneurship and investment in human capital, it may inhibit the development of national power.[27]

States struggle to shape the structure of markets to their advantage by manipulating market access with tariffs, quotas, and licenses; diversifying supply chains; pursuing equity shares in companies; and using aid to gain special concessions. Success varies with the asymmetries in particular markets. For example, for decades the annual price-setting negotiations between big suppliers of iron ore and leading steelmakers were dull as prices rose only gradually. But after China emerged as a buyer of more than half of all iron ore exports, prices quadrupled between 2002 and 2008. The Chinese government was nervous about its dependence because just three firms (BHP, Rio Tinto, and Vale) dominated trade in iron ore. So China's government, acting through state-controlled companies,

tried to overturn the oligopoly "by encouraging Chinese customers to negotiate purchases in unison, by hunting for alternate supplies and even by buying a stake in Rio, all to little effect."[28] In this case, buoyant demand and limited supply restricted Chinese government power to restructure the market, though China later brought bribery charges against officials of Rio Tinto.[29] In other cases, which depend upon direct investment or access to the internal Chinese market, the situation is reversed, and the government has wielded its economic power. And in September 2010, after a maritime dispute, China curtailed its export of rare earth minerals to Japan.

Even where natural resources are scarce within a nation's borders, their absence is not an index of low economic power. Much depends on a country's vulnerability, and that depends on whether substitutes are available and whether there are diverse sources of supply. For example, in the 1970s some analysts expressed alarm about the increasing dependence of the United States on imported raw materials and therefore its vulnerability. Of thirteen basic industrial raw materials, the United States was dependent on imports for nearly 90 percent of aluminum, chromium, manganese, and nickel. The ability of oil producers to form a cartel (OPEC) was taken as a harbinger for other commodities. Power was seen as shifting to the producers of natural resources. But over the next decade, raw materials prices went down, not up. What happened to the prediction? In judging vulnerability, the analysts failed to consider the alternative sources of raw materials and the diversity of sources of supply that prevented producers from jacking up prices artificially. Moreover, technology improves over time. Projections of U.S. vulnerability to shortages of raw materials were inaccurate because they failed to adequately consider technology and alternatives.

OIL, GAS, AND ECONOMIC POWER

Mao Zedong once said that power comes out of the barrel of a gun, but many people today believe that power comes out of a barrel of

oil. It turns out that oil is the exception, not the rule, in judgments about economic power derived from natural resources, and thus it is worth a more detailed analysis. Oil is the most important raw material in the world, in both economic and political terms, and it is likely to remain a key source of energy well into this century. The United States consumes 20 percent of the world's oil (compared to 8 percent for China, though Chinese consumption is growing more rapidly). Even with high Chinese growth, the world is not running out of oil anytime soon. More than 1 trillion barrels of reserves have been proven, and more is likely to be found. But more than 66 percent of the proven reserves are in the Persian Gulf and are therefore vulnerable to political disruption, which could have devastating effects on the world economy.

The framework of rules, norms, and institutions that affect oil markets has changed dramatically over the decades.[30] In 1960, the oil regime was a private oligopoly with close ties to the governments of the major consuming countries. Seven large transnational oil companies, primarily British and American in origin and sometimes called the "seven sisters," determined the amount of oil that would be produced. The price of oil depended on how much the large companies produced and on the demand in the rich countries where most of the oil was sold. Transnational companies set the rate of production, and prices were determined by conditions in rich countries. The strongest powers in the international system in traditional military terms occasionally intervened to maintain the unequal structure of oil markets. For example, in 1953 when a nationalist movement tried to overthrow the shah of Iran, Britain and the United States covertly intervened to return the shah to his throne.

After the 1973 oil crisis, there was a major change in the international regime governing oil markets. There was an enormous shift of power and wealth from rich to relatively weak countries. The producing countries began to set the rate of production and therefore had a strong effect on price, rather than price being determined solely by the market in the rich countries. A frequently offered ex-

planation is that the oil-producing countries banded together and formed OPEC, but OPEC was formed in 1960 and the dramatic change did not occur until more than a decade later in 1973. In 1960, half the OPEC countries were colonies of Europe; by 1973, they were all independent. Accompanying the rise in nationalism was a rise in the costs of military intervention. It is much more expensive to use force against a nationalistically awakened and decolonized people. When the British and Americans intervened in Iran in 1953, it was not very costly in the short term, but if the Americans had tried to keep the shah on his throne in 1979 in the face of the Iranian Revolution, the costs would have been prohibitive.

The relative symmetry of economic power in oil markets also changed. During the two Middle East wars of 1956 and 1967, the Arab countries tried an oil embargo, but their efforts were easily defeated because the United States was producing enough oil to supply Europe when it was cut off by the Arab countries. Once American production peaked in 1971 and the United States began to import oil, the power to balance the oil market switched to such countries as Saudi Arabia and Iran. The United States was no longer the supplier of last resort that could make up any missing oil.

The "seven sisters" gradually lost power over this period. One reason was their "obsolescing bargains" with the producer countries.[31] When a transnational corporation goes into a resource-rich country with a new investment, it can strike a bargain in which the multinational gets a large part of the joint gains. From the point of view of the poor country, having a multinational come in to develop its resources will make the country better off. At the early stages when the multinational has a monopoly on capital, technology, and access to international markets, it strikes a bargain with the poor country in which the multinational gets the lion's share. But over time, the multinational inadvertently transfers resources to the poor country and trains locals, not out of charity but out of the normal process of doing business. Eventually, the poor country wants a better division of the profits. The multinational could

threaten to pull out, but now the poor country can threaten to run the operation by itself. So over time, the power of the transnational company to structure a market, particularly in raw materials, diminishes in terms of its bargaining with the host country. The seven sisters were joined by "little cousins" when new transnational corporations entered the oil market. Although they were not as large as the seven sisters, they were still big, and they began to strike their own deals with the oil-producing countries. That competition further reduced the power of the largest transnational corporations to structure the market. Today, the six largest transnational corporations control only 5 percent of world oil reserves; state-owned companies control the rest.[32]

There was also a modest increase in the effectiveness of OPEC as a cartel. Cartels restricting supply had long been typical in the oil industry, but in the past they had been private arrangements of the seven sisters. Cartels generally have a problem because there is a tendency to cheat on production quotas when markets are soft and the price drops. With time, market forces tend to erode cartels. OPEC was unable to enforce price discipline from the year it was founded, 1960, until the early 1970s. But after oil supplies tightened, OPEC's role in coordinating the bargaining power of the producers increased.

The Middle East war of 1973 gave OPEC a boost, a signal that now it could use its power. The Arab countries cut off access to oil during the 1973 war for political reasons, but that created a situation in which OPEC could become effective. Iran, which is not an Arab country, was supposed to be the American instrument for policing the Persian Gulf, but the shah moved to quadruple oil prices, and the other OPEC countries followed suit. Over the long term, OPEC could not maintain permanently high prices because of market forces, but there was a stickiness on the downside that was an effect of the OPEC coalition.

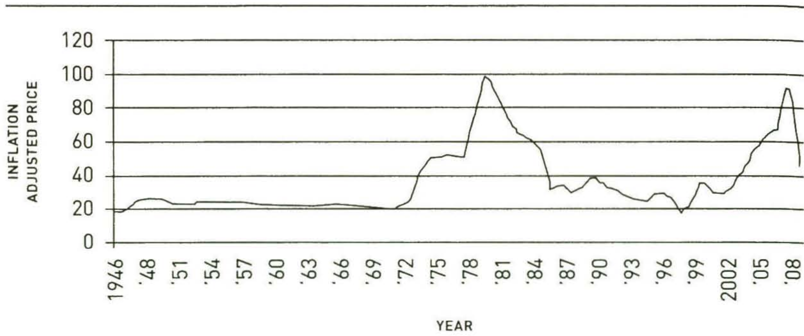
At one point in the crisis, Secretary of State Henry Kissinger said that if the United States faced "strangulation," military force might have to be used. Fifteen percent of traded oil had been cut, and the

Arab embargo reduced oil exports to the United States by 25 percent. However, oil companies made sure that no one country suffered much more than any other. They redistributed the world's traded oil. When the United States lost 25 percent of its Arab oil imports, the companies shipped it more Venezuelan or Indonesian oil. They smoothed the pain of the embargo so that the rich countries all lost about 7–9 percent of their oil, well below the strangulation point. The companies, acting primarily out of their own interest in maintaining stability, helped prevent the economic conflict from becoming a military conflict.[33]

How powerful was oil as an economic weapon at the turning point of 1973? By cutting production and embargoing sales to countries friendly to Israel, Arab states were able to bring their issues to the forefront of the U.S. agenda. The oil weapon encouraged the United States to play a more conciliatory role in arranging the settlement of the Arab-Israeli dispute in the aftermath of the Yom Kippur War. However, the oil weapon did not change the basic policy of the United States in the Middle East.

Why was the oil weapon not more effective, and what are the lessons for today? Part of the answer is symmetry in overall interdependence. Saudi Arabia, which became the key country in oil markets, had large investments in the United States. If the Saudis damaged the U.S. economy too much, they would also hurt their own economic interests. In addition, Saudi Arabia depended on the United States in the security area. In the long run, the United States was the only country able to keep a stable balance of power in the Persian Gulf region. The Saudis knew this, and they were careful about how far they pushed the oil weapon. At one point, they quietly made sure that the American Sixth Fleet in the region was supplied with oil.[34] The Saudis were benefiting from the long-run security guarantee provided by the United States. There was an indirect linkage between the security interdependence and the oil interdependence. Force was too costly to use overtly, but it played a role as a power resource in the background. In other words, the outcome of the crisis involved asymmetries caused by changes in the structure of the market, but

FIGURE 3.1 Real Domestic Crude Oil Prices (1946–2008)*



* *Adjusted for CPI to November 2008 prices*

Source: Data from Illinois Oil and Gas Association and U.S. Bureau of Labor Statistics.

the outcome was not determined by economic power alone. This complex set of factors persists today in creating and limiting the power that comes from possessing oil resources.

By the late 1990s, oil prices had plummeted. Efficiency gains stimulated by high prices cut demand, and on the supply side the emergence of new non-OPEC oil sources meant that OPEC faced more competition on the world market. Advances in technology led geologists to gain access to oil that had previously been impossible to reach. After 2005, however, oil prices spiked again, partly in response to disruptions from war, hurricanes, and terrorist threats, but largely because of projections of rising demand accompanying rapid economic growth in Asia. The two most populous nations on earth, China and India, are experiencing rapid increases in demand for energy as they modernize and industrialize. Both countries are making mercantilist efforts to buy and control foreign oil supplies, though the lessons of the 1970s crisis suggest that oil is a fungible commodity and markets tend to spread supplies and even out the pain no matter who owns the oil. In any event, the rapid economic growth of these two countries will contribute significantly to the

global demand for oil, and this means that the biggest global oil-producing regions, such as the Persian Gulf, will still play an important role in world politics. Because Saudi Arabia is the world's number one producer and source of reserves, any major changes in its political stability could have widespread consequences.

It is interesting to compare the markets in oil and natural gas. Russia is a major producer of both, but Russia's efforts to gain power by structuring market asymmetries is more obvious in the area of natural gas than in oil. As we have seen, oil is a relatively fungible commodity with multiple sources of supply and relative ease of transport, whereas until recently gas has been regarded as scarce and more dependent upon fixed pipelines for supply. Although this may change in the future because of liquefied natural gas shipments and new technologies for producing gas from plentiful fields of shale rock, until now Russia has been a major supplier of natural gas to Europe. The Russian government has consolidated ownership of gas fields and pipelines in one company, Gazprom, and used it to structure markets in Russia's favor. When Russia had disputes with neighbors such as Ukraine over gas prices, it did not hesitate to cut off gas supplies as a form of economic power. Later, when a more sympathetic government came to power in Ukraine, Russia used the lure of heavily discounted gas prices to obtain the extension of its lease of a naval base in Ukraine, thus complicating the prospect that Ukraine might one day join NATO.[35]

Germany depends on Russia for a third of its natural gas, but the German government claims not to be overly concerned because it regards the interdependence as symmetrical.[36] In German eyes, German customers are such a large group that Russian income depends on the security of German demand just as much as German customers depend on the security of Russian supply. Thus, when the European Union has tried to stimulate interest in a pipeline to route Caspian gas to Europe without crossing Russian territory, Germany has expressed less interest. Instead, Germany supported a pipeline

under the Baltic Sea that will increase its dependence on Russian supply and allow Russia to bypass Ukraine and Poland.

This will increase the vulnerability of Ukraine and Poland. In the past, those states had bargaining power based on their ability to stop gas flowing through pipelines that crossed their territory. The pain this caused in Germany added to Ukraine and Poland's bargaining power with Russia. In short, Russia has used its pipeline diplomacy to increase its economic power. It has an incentive to keep its promise to be a reliable supplier to large customers such as Germany, but Russia can wield its asymmetrical advantage over smaller customers such as the Baltics, Georgia, Belarus, and Ukraine in what Russia sees as its sphere of influence. Similarly, Russia has tried to contract for gas from the Central Asian republics to be routed to Europe through Russian pipelines, but this market structuring is being countered by Chinese efforts to construct pipelines eastward from Central Asia. Even more important were the recent discovery and exploitation of technologies to unlock the massive amounts of gas trapped in shale rock in the United States and elsewhere. Projects designed to liquefy natural gas and ship it to the United States were no longer competitive in American markets. As this gas began to be shipped instead to European markets, it reduced the power that Russia could develop through its pipeline diplomacy.[37]

What these oil and gas examples show is that even though raw materials are less crucial in the so-called lightweight economies of the information age than they were in the industrial age, oil and gas still matter when it comes to generating economic power. But even the power that comes from the control of energy resources waxes and wanes. Economic power is highly contingent on the particular market context.

SANCTIONS: NEGATIVE AND POSITIVE

Just as many people think of fighting as the heart of military power, they often think of sanctions as the most visible instrument of economic power. Imposing sanctions is less subtle than structuring markets (though sanctions sometimes involve manipulating control over market access). "Sanctions" are defined as measures of encouragement or punishment designed to reinforce a decision or make a policy authoritative. They can be both negative and positive. As Thomas Schelling once pointed out, "The difference between a threat and a promise, between coercion and compensation, sometimes depends on where the baseline is located. We originally offered our children a weekly allowance on condition they make their own beds and do a few other simple chores. . . . But once it became standard practice and expectation that the weekly allowance would be paid, withholding it for nonperformance became in the children's eyes a punishment."[38] Perceptions affect how sanctions are experienced.

David Baldwin lists eleven examples of negative trade sanctions ranging from embargos to preclusive buying and seven capital sanctions that include freezing of assets, unfavorable taxation, and suspension of aid. Among a dozen positive sanctions, he includes tariff reductions, favorable market access, provision of aid, and investment guarantees.[39] Other recent examples of sanctions include travel bans and arms embargoes. Sanctions can be applied by and against both state and nonstate actors. What sanctions all have in common is the manipulation of economic transactions for political purposes.

States restrict access to their markets for protectionist purposes in a competition to secure a greater share of the gains from trade or to favor a politically important domestic group, but many protectionist measures are also designed to generate power. For example, when the European Union granted preferential trade access to its market for its ex-colonies, it could be seen as righting a historical injustice (and thereby seeking to generate soft power) or as exer-

cising a means of neocolonial control (hard power), but the purposes were political.

States with large markets often use threats of restructuring market access to extend their regulatory power beyond their territory. In the area of privacy regulations, for example, Brussels has taken the lead in establishing global standards because no firm wishes to be excluded from the European market. Similarly, because of the importance of the American and European markets, transnational firms adhere to the strictest set of antitrust regulations. Even when the American Justice Department approved GE's acquisition of Honeywell (both American companies), GE abandoned the deal after the European Union objected. And companies that want access to China's market find they have to agree to minority ownership rules, transfer of proprietary technology, and restrictive rules on communication. As its market size increases, China has been making stricter demands that in effect force suppliers to share their technology and adopt Chinese technical standards "as a conscious strategy to use China's economic girth to shift technology standards by making it too costly for the industry not to adapt."[40] Foreign investors have warned China about policies that undercut the climate of confidence of investment, but to little avail. During a visit to Brussels in 2009, Chinese vice premier Wang Qishan asked the European Union to keep its markets open, lift its arms embargo, and grant more visas to Chinese citizens. When the Europeans demurred, "Mr. Wang's response was dismissive: whatever you tell me doesn't really make a difference. You are going to invest in China anyway."[41] Not surprisingly, states with larger markets are better placed to control market access and to apply sanctions.

As the world's largest economy, the United States has often taken the lead in applying sanctions. The United States alone applied eighty-five new sanctions on foreign states between 1996 and 2001,[42] and some wags complained that the country had sanctions against half of humankind. Yet the conventional wisdom of most pundits is that "sanctions don't work." This judgment is reinforced

by famous cases such as the failure of League of Nations sanctions to stop Italian aggression in Ethiopia, the failure of the American trade embargo to topple Fidel Castro for half a century, or the failure of sanctions to remove Saddam Hussein from power in Iraq. Why, then, are sanctions so often used?

The answer may be in part that the judgment of failure is overstated. A careful study of 115 uses of economic sanctions by major countries from 1950 to 1990 concluded that in about a third of the cases, sanctions made at least a modest contribution to obtaining the goals of those using them. The study found that sanctions were most likely to be successful when the objective was modest and clear, the target was in a weakened position to begin with, economic relations were great, sanctions were heavy, and the duration was limited.[43] Others have challenged these results, with one scholar claiming that sanctions were effective in only 5 of the 115 cases, but the successes included significant instances such as South Africa and Libya.[44]

Baldwin points out that judgments about effectiveness relate only to outputs, unlike judgments about efficiency or utility, which relate instruments and outputs. The important question in any situation is, What is the alternative to sanctions? Even if the probability of reaching a desired end through economic sanctions is low, the relevant issue is whether it is higher than for alternative policy options. Military power is sometimes more effective, but its costs may be so high that it is less efficient. Take the case of sanctions against the Castro regime in Cuba. As the Cuban Missile Crisis showed, the costs of using military means to remove Castro were potentially enormous, including the risks of nuclear war. At the same time, given the bipolar Cold War, doing nothing would have been costly for America's political competition with the Soviet Union. Although it is true that sanctions were not effective in removing Castro, they were an efficient means of imposing costs and containing Castro. Military action might (or might not—witness the Bay of Pigs failure) have removed Castro, but given the potential military

costs, sanctions might have been the most efficient policy choice available.[45]

Like all forms of power, efforts to wield economic sanctions depend upon the context, purposes, and skill in converting resources into desired behavior. Judging success requires clarity about goals, and both actors and observers sometimes mix the goals together. The major goals of sanctions include behavioral change, containment, and regime change in another country.[46] Alternatively, the goals can be described as coercing, constraining, and signaling. Coercion is an effort to make the target do something, prevention means making it costly for a target to do something, and signaling indicates commitment—to the target, to domestic audiences, or to third parties.[47] One study concluded that trade sanctions rarely force compliance or subvert the target government and have limited deterrent value, but they often succeed as international and domestic symbols.[48]

To go back to the famous Cuban "failure," although sanctions did not remove Castro and only somewhat inhibited his international capabilities (because he received countervailing Soviet aid), they did allow American policymakers to signal to a domestic audience and to other countries that alliance with the Soviet Union could be costly. (Whether the sanctions outlived their purpose and became counterproductive when the end of the Cold War changed their context is a different question.) Similarly, after the Soviet Union invaded Afghanistan in 1979, President Jimmy Carter curtailed grain sales and boycotted the Moscow Olympics rather than use a threat of force, which would not have looked credible. Threats are cheap to make but costly to credibility when they fail. The fact that these sanctions were costly to the United States helped to establish some credibility in the American reaction to the Soviet invasion.

General sanctions are a blunt instrument in which the suffering may be borne by the poor and powerless rather than the elites that make decisions in autocratic countries. Moreover, as in the case of Iraq, Hussein was able to construct dramatic narratives about their

brutal effects as a way to delegitimize UN sanctions and seek concessions that undercut their effect. The prevalence of sanctions with limited results in the 1990s led to efforts to construct "smart sanctions" that would be targeted at elites rather than at the general public. Specific members of the elite were banned from travel and had overseas financial assets frozen. In 2007, the effectiveness of the American Treasury Department's freezing of North Korean assets in a Macao bank is credited with helping to bring Pyongyang back to the bargaining table. In addition, policymakers began to realize that sanctions should be regarded as one tool among many, rather than an all-or-nothing condition, and used flexibly in a bargaining relationship. For example, as America began to repair its relations with Vietnam in the 1990s, a gradual relaxation of sanctions was part of the process, along with other diplomatic tools. More recently, in relation to Burma, Secretary of State Hillary Rodham Clinton announced that "engagement versus sanctions is a false choice . . . so going forward, we will be employing both these tools."[49]

The signaling role of sanctions has often been dismissed as "merely symbolic." But if we consider legitimacy and soft power, we see clearly that signaling can impose real costs upon a target. Naming and shaming campaigns are important ways in which nongovernmental actors try to affect the policies of transnational corporations by attacking the equity they have built up in their brands. NGOs also try to shame states into action by attack on national reputation, and states themselves compete to create narratives that increase their soft power and reduce that of their opponents. Sometimes the campaigns fail and sometimes they succeed, but legitimacy is a power reality, and struggles over legitimacy involve real costs. Some observers believe that the main effect of anti-apartheid sanctions that eventually led to majority rule in South Africa in 1994 lay not in the economic effects, but in the sense of isolation and doubts about legitimacy that developed in the ruling white minority. Similarly, the success of UN sanctions in helping

to bring about a reversal in Libyan policies of support for terrorism and development of nuclear weapons were related to Libyan concerns about legitimacy as much as economic effects.[50] Because of their value in signaling and soft power, and because they are often the only relatively inexpensive policy option, sanctions are likely to remain a major instrument of power in the twenty-first century despite their mixed record.

Payments, aid, and other positive sanctions also have both a hard and a soft power dimension. As noted earlier, providing a payment and removing a payment are two sides of the same coin. Providing aid and cutting off aid are the positive and negative aspects of a similar sanction. Providing payments to secure the support of other countries has a long history in cabinet diplomacy, and it persists in today's democratic age. Indeed, the score of small countries that continue to recognize the Republic of China government in Taipei rather than Beijing receive significant economic aid from Taiwan. Similarly, if we try to understand why some nonwhaling countries vote with Japan in international forums on issues related to whaling, we must note that they receive aid from Japan.

After 2005, the rise in oil and gas prices boosted the political leverage of energy-producing countries such as Russia, Venezuela, and Iran that had suffered from the low oil prices of the 1990s. Although they did not have Saudi Arabia's economic power to structure markets, their extra cash provided money for payments and aid to advance their foreign policy objectives. President Hugo Chávez of Venezuela used his country's oil wealth to gain soft power in Latin America and even offered cheap oil to consumers in Massachusetts as a soft power propaganda ploy. Iran used its oil wealth to reinforce its influence in Lebanon and elsewhere. Russia used oil money to buy influence: It allegedly paid $50 million to the tiny Pacific island of Nauru to recognize Georgia's breakaway provinces of Abkhazia and South Ossetia—although non-oil-producing China allegedly paid only $5 million a year to Nauru to recognize Beijing rather than Taipei.[51]

Large states give foreign aid for a variety of purposes. The largest recipients of American aid (after the war-torn states of Afghanistan and Pakistan) are Israel and Egypt, and the payments are designed to influence both states with regard to security in the area. Chinese aid is often used to gain access to raw materials. A raw material concession is often accompanied by a Chinese offer to build a new stadium or airport terminal. According to some experts, "China, which is not a member of the OECD [Organization for Economic Cooperation and Development], is operating under rules that the West has largely abandoned. It mixes aid and business in secret government-to-government agreements."[52] The Chinese approach, which avoids good governance or human rights conditions, is often welcomed by authoritarian states. Rwandan president Paul Kagame compares it favorably to the Western approach.[53] Nor is China alone. India and Brazil are other emerging economies that both receive and give aid at the same time. "None of the new donors (all of which except Russia, still get aid themselves) publishes comprehensive, or even comprehensible, figures."[54]

Russian aid is designed to increase Russian influence in what Russia calls "the near abroad" of former Soviet states. Some countries, such as Great Britain, devote a large portion of their aid to development and separate its administration in a special bureaucracy—in Britain, the Department for International Development rather than the Foreign Office. When we look at American assistance programs, less than half are administered by the Agency for International Development (AID) and devoted to development.[55] As a superpower, the United States has many objectives for assistance that are not directly related to development. A quarter of American aid is administered by the Pentagon.

Even when aid is designated for development only, it can still be used to create hard economic power, for example, by building up the economic and administrative capabilities of an allied country. "Nation-building" can develop the hard power of an ally. The Marshall Plan, in which the United States contributed 2 percent of its gross domestic product to restore the economies of Europe that had

TABLE 3.1 U.S. Aid Program Composition (2008)[1]

CATEGORY	PERCENTAGE OF TOTAL AID
Bilateral development	35.5
Economic, political, security	27.1
Military	17.5
Humanitarian	14.4
Multilateral	5.5

Source: U.S. Department of State, "Summary and Highlights, International Affairs, Function 150, FY2009"; House and Senate Appropriations Committees; and CRS calculations.

1. Curt Tarnoff and Marian Lawson, "Foreign Aid: An Introduction to U.S. Programs and Policy" (Washington, DC: Congressional Research Service Report, April 2009), www.fas.org/sgp/crs/row/R40213.pdf.

been devastated by World War II, is an important case in point. By restoring growth and prosperity to Western Europe, the United States succeeded in strengthening resistance to communism and the Soviet Union—a major foreign policy goal. The Marshall Plan also helped to develop a sense of gratitude in Europe and enhanced American soft power among the recipient countries.

Occasionally, people have called for similar Marshall Plans for development in many less-developed regions, but two of the problems with such proposals are the scale of the original plan and the fact that the European economies were already developed and needed only to be restored. Moreover, they administered much of the aid effectively. Today, economists do not agree that there is a clear formula for development or if there is, that aid is always productive. Indeed, some go so far as to argue that aid can be counterproductive by creating a culture of dependency and corruption. For example, Jeffrey Sachs thinks that extreme poverty can be eliminated by 2025 through carefully planned development aid, whereas former World Bank economist William Easterly is very skeptical of foreign aid in general, and believes that it creates perverse incen-

tives.[56] Sachs has developed pilot projects in Kenya villages that work, but "Easterly and others have criticized Mr. Sachs as not paying enough attention to bigger-picure issues like governance and corruption, which have stymied some of the best-intentioned and best-fiananced aid projects."[57] Even if we do not determine the merits of the arguments among economists, we can recognize that the degree of uncertainty about development and nation-building sets limits on the way that aid can be used to generate economic power by building up allies. This does not mean that aid is always ineffective, only that we exercise caution in taking at face value overly optimistic estimates about development-oriented aid as a source of hard economic power. Indeed, when donors have strategic goals, they may lose the leverage to impose growth-promoting reforms.[58]

Aid programs may also be used for humanitarian purposes, and if properly administered, they can generate soft power. But such soft power effects are not guaranteed. Although assistance may curry favor among elites, if it leads to corruption and disruption of existing power balances among social groups, it can also engender resentment, rather than attraction, among the general populace. Moreover, conditionality designed to restrict local elites can backfire. For example, when the United States unveiled its $7.5 billion aid budget for Pakistan in 2009, it set conditions that restricted some parts for civilian development purposes, but the restrictions raised a nationalist furor in the Pakistan press.[59] Similarly, a study of aid projects in Afghanistan found that sometimes aid was not merely ineffectual but was counterproductive in terms of soft power. By disturbing local political balances and stimulating corruption, large aid projects often generated jealousy, conflict, and resentment among local groups. As one observer concluded, "If there are lessons to be drawn from the still tentative successes here, they are that small projects often work best, that the consent and participation of local people are essential and that even baby steps take years."[60] Like negative sanctions, positive sanctions of payment and assistance have a mixed record as generators of both hard and soft power.

THE FUTURE OF ECONOMIC POWER

Bargaining and power struggles occur among states, private corporations, and hybrids of the two. "Wherever you look you can see the proliferation of hybrid organizations that blur the line between the public and private sector. These are neither old-fashioned nationalized companies, designed to manage chunks of the economy, nor classic private-sector firms that sink or swim according to their own strength. Instead they are confusing entities that seem to flit between one world and another to suit their own purposes."[61] Russian firms like Gazprom, Chinese state-owned enterprises, and sovereign wealth funds like Dubai World complicate market behavior and increase the opportunities for political manipulation.

A robust and growing economy provides the basis for all instruments of power. In addition, economic tools like sanctions and aid will be crucial in this century because they are often the most efficient instruments in terms of relative costs. But it is a mistake to argue that the twenty-first century will be the age of geoeconomics. The diffusion of power to nonstate actors, including transnational corporations, sets limits on state strategies to use economic instruments. States will often find economic power difficult to wield both because market actors are difficult to control and because market conditions are variable. But even as it is a mistake to make generalizations about the dominance of economic power over military power in the twenty-first century, it is equally important to understand the full range of economic policy instruments. Structuring markets is more important than imposing sanctions and providing aid. Very often, policies that promote open market structures and diversification of sources of supply will turn out to be more effective in denying economic power to suppliers than mercantilist efforts to lock up supplies through ownership. Economic power will be one of the most important implements in the toolbox of smart power policies, but policy answers will often depend on the context of each market and its asymmetries of vulnerability.