The Bush Legacy for America's International Economic Policy[1]

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1. Introduction

In many areas of foreign policy, the Bush doctrine marks a break with the approaches of earlier administrations. At first glance this seems true of the Bush Administration's foreign economic policy as well. President Bush and his advisors brought to Washington a powerful ideology, that of limited government, to inform and shape policy decisions. This noninterventionist, free-market approach had led candidate Bush to campaign as a supporter of free trade. It led his inner circle to conclude that intervening in the foreign exchange market, however acceptable for Europe or Japan, was inappropriate for the United States. Bush and his advisors opposed using government influence and taxpayer money to intervene in emerging markets suffering financial crises. They were skeptical that government largess could be an agent of change in less developed countries.

But there was little opportunity to pursue this ambitious vision once 9/11 intervened. The idea that government should be limited rested uncomfortably with this reminder of the paramount responsibility of any administration for national security. The wish to limit discretionary trade policy and foreign aid butted up against the realization that these could be valuable devices for supporting allies in the war on terrorism. The fallout from 9/11 meant that a tremendous amount of U.S. Treasury resources were diverted toward terrorism-related issues such as the economic and financial

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reconstruction of Iraq. Rather than striving for a more focused IMF, the administration pushed to make the institution responsible for rooting out terrorist-related money laundering.

Even in the absence of 9/11, attempts to fundamentally reshape U.S. foreign economic policy would have had to overcome powerful interests and long-standing structures. Concluding multilateral trade agreements could be easily stymied by other countries. Free trade could antagonize special interests on whose support reelection prospects depended, forcing domestic concessions to protectionism. Leaving emerging market economies like Turkey or Argentina to their financial fate might have negative repercussions for the region or destabilize global financial markets. Denying foreign aid to countries with weak governments could contribute to the further breakdown of their economic and political systems and render them breeding grounds for terrorism.

In these and other connections, the existence of powerful lobbies and special interests forced the Bush Administration, now having to maneuver in the policy arena, to adopt a more pragmatic tone. The existence of structures like the World Trade Organization, which constrains the president's trade policy-making options, and international capital markets, which have too much destabilizing capacity to simply be left to their own devices, required the administration to modify or abandon the more radical elements of its agenda.

Reflecting these constraints, actual policies differed less from those of earlier presidents than the administration's rhetoric would have led one to suppose. Where political scientists and diplomatic historians are apt to see the Bush presidency as a

distinctive epoch in American foreign policy, we argue that there was no Bush Doctrine in international economic policy.

This leads us to expect that there will be continuities with future policy as well. Neither the new foreign policy concerns created by 9/11 nor long-standing structural constraints on international economic policy making will go away. They will similarly prevent the next administration from undertaking radical changes to U.S. foreign economic policy – much as they constrained the administration of George W. Bush. Many of the challenges facing the next president are not new – trade negotiations with other countries, the large current account deficit, economic frictions with China – but levers for dealing with them will be limited.

Indeed, the next administration will have less room for maneuver than the Bush administration had when it came to office. With trade negotiations deadlocked at the WTO and the domestic consensus in favor of trade liberalization in tatters, the next administration is unlikely to have any grandiose plans for trade policy. With the United States dependent upon foreign capital inflows to finance its current account deficit, and the International Monetary Fund less powerful and relevant today than a decade ago, the next administration will not be in a strong position to promote reform of the international economic institutions. And the U.S. economy remains just as vulnerable to an oil price shock and an abrupt change in international capital flows as five or ten years ago. The next administration is likely to have to manage existing difficulties within the existing policy framework rather be in a position of proposing new policies or institutions to deal with the changing world..

This chapter lays out the constraints that will affect the conduct of the next administration's international economic policy. We begin by reviewing how the ambitious plans of the Bush administration in the areas of international trade and finance were scaled back as a result of the pitfalls and roadblocks that it encountered. We then turn to the specific international economic policy challenges that will confront the next administration and show how they too will face similar constraints that will limit its ability to influence events to its liking.

2. Trade Policy

In the field of trade policy, the Bush administration has behaved like almost every other post-World War II presidential administration: it linked trade policies to broader foreign policy goals, supported the multilateral trading system's goal of reducing trade barriers, and sought trade negotiating powers from the Congress to conclude trade agreements with other countries. Also like previous administrations, the administration made exceptions to this approach by giving temporary trade protection to politically-influential sectors, such as steel and agriculture. Thus, although some policy details have departed from previous experience, particularly the energetic pursuit of bilateral free trade agreements, the Bush administration does not stand out as being markedly different in its trade policy stance: the policy continuities dominate the departures.

The current trade-policy framework was established by the Reciprocal Trade Agreements Act (RTAA) of 1934. The RTAA came into existence during the Roosevelt administration at a time when world trade had collapsed due to protectionism and the Great Depression (Irwin 1998). Under the RTAA, Congress delegated some of its

constitutional powers over trade policy to the executive branch, allowing it to negotiate agreements with other countries. Under this authority, the United States helped create the GATT in 1947, which became the WTO in 1995. Multilateral trade agreements were initially infused with an important, bipartisan foreign policy rationale: the strengthening of Western Europe and the fight against communism.[2] A bipartisan consensus on the importance of open trade policies meant that Congress rarely allowed the trade negotiating authority of the RTAA to lapse.

This framework leaves a presidential administration little scope for developing a distinctive trade policy. Every president since Franklin Roosevelt has believed that the open world trading system and trade liberalization are fundamentally in America's economic and foreign policy interest. Every president has sought Congressional authority to negotiate trade agreements that would open up foreign markets to U.S. exports in exchange for a reduction in U.S. trade barriers. And every president has bowed to political considerations by accommodating the demand by domestic trade-affected interests for protection from foreign competition.[3] But without a strong foreign policy rationale, as has been the case in the post-Cold War era, persuading Congress to embrace policies to open trade has been difficult.

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[2] The logic was straightforward: the expansion of world trade would promote economic recovery in Western Europe and secure the foundations of democracy, thereby enabling those countries to resist Soviet communism and thus promote the national security interests of the United States. Similarly, Bush repeatedly made the case that free trade is an uplifting policy that not only spreads prosperity and hope to places where both were in short supply, but would ultimately lead to political freedom as well. "Free trade is also a proven strategy for building global prosperity and adding to the momentum of political freedom . . . . And greater freedom for commerce across the borders eventually leads to greater freedom for citizens within the borders." (August 12, 2002).

[3] The WTO now provides an important constraint on the use of such discretionary protection. The Bush administration imposed safeguard duties on imported steel in March 2002, but after the EU and others won their case against the tariffs in the WTO dispute settlement system, the administration removed the tariffs in December 2003. See Read (2004).

Indeed, the tragic events of 9/11 gave a jump-start to world trade negotiations. After the attack, other countries rallied around the United States and sought to ensure that world trade would be kept open and free despite the terrorist attacks by supporting the Bush administration's efforts to launch the Doha Round of WTO trade negotiations in 2001. The Bush administration then enlisted the "war on terror" as part of the push to gain Trade Promotion Authority (TPA) from the U.S. Congress. Just nine days after 9/11, U.S. Trade Representative Robert Zoellick published an op-ed in the *Washington Post* entitled "Countering Terror with Trade" in which he argued that "[e]conomic strength -- at home and abroad -- is the foundation of America's hard and soft power. Earlier enemies learned that America is the arsenal of democracy; today's enemies will learn that America is the economic engine for freedom, opportunity and development. To that end, U.S. leadership in promoting the international economic and trading system is vital. Trade is about more than economic efficiency. It promotes the values at the heart of this protracted struggle. . . . . Congress needs to enact U.S. trade promotion authority so America can negotiate agreements that advance the causes of openness, development and growth. It is a sad irony that just as the old world of bipolar blocs faded into history and the new world of globalization fast-forwarded, the United States let its trade promotion authority lapse" in 1995. These efforts persuaded Congress to enact TPA in 2002.

Yet, in the subsequent six years the Doha Round failed to come close to a successful conclusion. WTO negotiations operate on the basis of consensus, meaning that a few large countries or a group of smaller countries can block agreement. The reluctance of OECD countries to reduce agricultural subsidies and developing countries to open their markets to foreign competition has made the conclusion of the Doha round

seemingly impossible.[4] Since 2001, many ministerial meetings have ended and deadlines have passed with agreement.

Given the difficulties of reaching an agreement at the WTO, Zoellick was not content to wait for the slowest countries to agree to open up markets. He endorsed the doctrine of "competitive liberalization," in which the United States would bypass the WTO and pursue bilateral and regional trade agreements as a way of putting pressure on other reluctant reformers in the world trading system.[5] In an article published in *The Economist*, Zoellick (2002) explained: "We will promote free trade globally, regionally and bilaterally, while rebuilding support at home. By moving forward on multiple fronts, the United States can exert its leverage for openness, create a new competition in liberalization, target the needs of developing countries, and create a fresh political dynamic by putting free trade onto the offensive. . . . To multiply the likelihood of success, the United States is also invigorating a drive for regional and bilateral free-trade agreements (FTAs). These agreements can foster powerful links among commerce, economic reform, development, investment, security and free societies. . . . The United States is combining this building-block approach to free trade with a clear commitment to reducing global barriers to trade through the WTO. By using the leverage of the American economy's size and attractiveness to stimulate competition for openness, we will move the world closer toward the goal of comprehensive free trade."

Prior to the Bush administration, the United States had signed just a few FTAs: the U.S.-Israel FTA in 1985, the U.S.-Canada FTA in 1989, the North American Free

[4] For a sharp analysis of the WTO's difficulties, see Collier (2006).

[5] The term "competitive liberalization" was first used by Fred Bergsten (1996) to describe the process of Asian trade liberalization during the early 1990s and was adopted by Zoellick as a description of his approach.

Trade Agreement (NAFTA) in 1993, and the U.S.-Jordan FTA in 2001 (signed by Bush but initiated by the Clinton administration). In a break from past practice, Zoellick aggressively increased the number of bilateral negotiations pursued by the United States. He concluded agreements with Australia, Chile, Singapore, and five Central American countries (Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua), that eventually became known as CAFTA-DR (Central American Free Trade Agreement with the Dominican Republic.) Negotiations were also undertaken with Morocco, Bahrain, four Andean countries (Colombia, Peru, Ecuador, and Bolivia) and five nations in southern Africa, as well as Panama, Malaysia, Thailand, and South Korea.[6]

The domestic problem raised by FTAs is that they force the Congress to vote frequently on trade bills, which most members find uncomfortable given that the domestic politics of trade focuses on workers who might potentially lose their job as a result of imports. Some FTAs (Australia, Singapore, Morocco, and Bahrain) were uncontroversial and passed through the Congress easily, while others (CAFTA-DR, Oman) encountered stiff opposition and required much arm twisting to ensure passage. The partisan nature of these trade votes gives individual members of Congress an incentive to keep their position ambiguous until they obtain some other political favor from the president in exchange for their vote.

Yet even the distinctive Bush turn toward bilateral FTAs was brought to a halt with the Democratic capture of the Congress in the 2006 midterm elections. Democrats

[6] The shift toward more bilateral and regional trade agreements has received mixed reviews from economists. Some, such as Bhagwati and Panagariya (1995), tend to support the non-discriminatory most-favored nation principles of the GATT and WTO and believe that multilateral negotiations were the only way to deal with the troublesome issue of agricultural and export subsidies. Proponents of FTAs argue that they are a useful alternative if the multilateral option is not viable, given the difficulties of reaching an agreement at the WTO. According to the proponents, the FTA or "like-minded" country approach bypasses the hold-up problem at the WTO, is likely to create more trade than it diverts, and hence may put pressure on reluctant trade reformers to change their approach.

tend to be more skeptical of measures to expand trade and have resisted FTAs, particularly with developing countries, which they believe should include stronger labor and environmental provisions if they should be pursued at all. They allowed the president's Trade Promotion Authority to expire in June 2007 without any commitment to renew it.

Hence, two backlashes against Bush's agenda: foreign (reluctance of other countries to liberalize) and domestic (reluctance of Congress to pass trade agreements). This resistance is likely to persist and constrain future administrations.

3. Monetary and Financial Policies

In keeping with its free-market, free-trade rhetoric, the Bush administration came to office skeptical of activist international financial policies, such as IMF bailouts in emerging market financial crises, foreign exchange intervention, and World Bank development assistance. In 2000 candidate Bush made critical remarks about how the Clinton Administration had repeatedly run to the rescue of crisis countries. Administration officials were skeptical about the efficiency and intentions of a European-led bureaucracy like the IMF. They signaled that the Bush Administration would not engage in bailouts and would seek significant reforms of the IMF and World Bank.

In fact, Treasury Secretary O'Neill and his undersecretary for international affairs John Taylor had complex views of the bailout question. In a 1998 interview that remained obscure so long as he was a member of the Stanford faculty but gained notoriety once he was nominated to be deputy secretary, Taylor had echoed the views of his mentor George Shultz that the world would be better off without the IMF. O'Neill

was known for the observation that the IMF was "associated with failure" and that its resort to international rescues had been "too frequent."[7] But the two Treasury officials were pragmatic. O'Neill had praised the Clinton Administration's 1995 bailout of Mexico in his confirmation hearings. If there was a problem, O'Neill believed that smart, hard-working officials could solve it. Taylor for his part was anxious to avoid precipitous actions that might roil the markets.

The first test of the Bush Administration's approach to foreign monetary and financial affairs was the crisis in Argentina. Argentina had an enormous program with the IMF, but when Bush took office there had been three years of economic stagnation, reflecting domestic problems compounded by devaluation in neighboring Brazil. Argentine voters and foreign bondholders were losing patience, raising the specter that a combination of political backlash and capital flight might bring both the government and the financial system tumbling down.

This would have been an appropriate time for the IMF and the U.S. government to signal that no more assistance would be extended, forcing Argentina to restructure its debts and put in place wage and exchange rate policies making for a more flexible economy. The country would have been forced to address the domestic roots of its mess. Investors would have learned that indiscriminate lending had costs.

The golden opportunity to make this point was in the summer of 2001, when the Argentine government leaked to the press the idea that the IMF would not only accelerate disbursal of the $1.25 billion to be paid out at the end of the second quarter assuming satisfactory performance but also augment its program. This not being the way the IMF normally operates – it is not typically forced into additional lending by public

[7] Blustein (2005), p.118.

announcements by the borrower, especially when there are very limited prospects of success – this would have been a fine time to pull the plug. But the State Department worried about the consequences of failing to support a fledgling South American democracy. Taylor worried that forcing Argentina to restructure could undermine investor confidence in the debts of other emerging markets and damage the banks and investment funds that had built their portfolios on conventional assumptions about U.S. and IMF policy. O'Neill believed that money was leverage and that with sufficient leverage the U.S. could force reforms of Argentine policy. In the White House, Hubbard and Lawrence Lindsey (head of the National Economic Council) were skeptical of the merits of forbearance. With the economists divided, the arguments of the State Department tipped the balance. Thus, the U.S. agreed to disbursal of the $1.25 billion already committed subject to meeting performance criteria. It agreed to consider augmenting the program by an additional $8 billion.

O'Neill was impressed by the contrast between how companies and countries could deal with debt-sustainability problems. Corporations could restructure under the protection of the bankruptcy court. The burden was shared by the creditors, not even bondholders with seniority being immune. Its finances having been reorganized in orderly fashion, the enterprise could continue as a viable entity. The problem was that there existed no analogous procedure for countries, which forced the IMF to lend and gave rise to moral hazard. O'Neill was not alone in this observation. The analogy with Chapter 11 bankruptcy had been made in academic circles.[8] Similar ideas had circulated within the Fund. But O'Neill's insistence on results made these abstract ideas very real.

[8] A comprehensive account of the prehistory is Rogoff and Zettelmeyer (2002).

The scheme eventually concocted was that $3 billion of the $8 billion of new IMF credits extended to Argentina would be used for an orderly, market-based debt restructuring. But how it would work was never specified. In fact, why earmarking $3 billion of IMF assistance for this purpose should have significantly changed creditors' calculus is unclear. $3 billion was a drop in the bucket when gauged against the country's $95 billion of debt to private creditors, especially when one recalls that the IMF's $3 billion was not free money – Argentina would have to pay it back. Nothing would be changed simply by replacing $3 billion of private debt with $3 billion of official debt, which was the implication of using the earmarked funds to retire outstanding obligations. And there was no obvious way that the earmarked funds could be leveraged beyond that. In effect, locking up more than a third of the IMF's $8 billion in this way only limited the liquidity of its assistance. It diminished the credibility of the IMF program, given that observers had not the slightest idea of the content of this $3 billion restructuring-related initiative. In all, this affair did not enhance the reputation of either the Treasury or the Fund.

What debt restructuring and Argentina were for the administration's first two years in office, external imbalances were for the subsequent period. The U.S. current account deficit rose from $413 billion in 2000 to roughly $800 billion in 2005, expanding to an unprecedented 6 per cent of U.S. GDP. Among economists, explanations for the U.S. deficit included low U.S. savings, reflecting the Bush tax cuts of 2001 and the run-up first of high-tech stocks and then of real estate values (Roubini and Setser 2004); high U.S. investment, responding to the attractions of a flexible U.S. economy (Cooper 2004); high foreign saving, mainly in Asia, reflecting the underdevelopment of markets in

consumer credit and social safety nets (Bernanke 2005); and depressed foreign investment, reflecting the slow pace at which the East Asian economies recovered from their financial crisis (Rajan 2006). In the public mind and those of politicians, however, there was no question but that China was at the center of the equation. The emergence of China was the most dramatic international economic event of this period; the Chinese economy was fully 50 per cent larger in 2005 than in 2000, and the country's exports nearly doubled over the period. U.S. producers of manufactures seemingly could not compete with Chinese exporters paying their labor only a fraction of American wages.

Thus, the Bush Treasury and the U.S. Trade Representative had to contend with the threat of protectionist sanctions, notably in the form of a bill by Senator Charles Schumer (D-NY) that, in the absence of an initiative to allow the renminbi to appreciate, would have slapped a 27.5 per cent tariff on imports from China. But to do so would have cast doubt on the U.S. commitment to a rules-based World Trade Organization and jeopardized prospects for getting the Doha Round back on track (see above), not to mention risking Chinese cooperation on North Korea. To their credit, Secretary Snow and his colleagues instead urged China to allow more currency flexibility on the assumption that a flexible renminbi would appreciate and thereby cut the bilateral Chinese-U.S. surplus. From the summer 2003, Treasury pressed the case for renminbi adjustment in public statements and bilateral discussions with Chinese officials. The Administration asked Schumer and the Congress to wait for it to produce results.

The question was whether it would. The Chinese were reluctant to adjust the exchange rate, their policies of export-led growth depending, in the dominant view, on the maintenance of a stable and competitively valued currency. Since the late 1970s the

legitimacy of the regime had depended on its ability to deliver the goods, and since the mid-1990s this had meant, in practice, delivering them to the United States. Social stability hinged on creating millions of additional jobs in urban manufacturing annually, something with which a sharp appreciation and sharp slowdown in export growth were not compatible. And simply revaluing the renminbi might have little effect on the U.S. deficit if other countries did not go along.

Finally, it was not clear that American tactics were well designed for getting the Chinese to move. U.S. officials pushed for free floating rather than offering to settle for a transitional revaluation. They spoke of the desirability of a "market-determined exchange rate," reflecting uncertainty about the extent of the renminbi's undervaluation and their preference for shunning intervention in foreign exchange markets. But China, lacking deep and liquid markets and hedging instruments for their banks and firms, was in no position to let its currency float freely. This "market-determined exchange rate" rhetoric seemingly asked them to do the impossible. In any case, focusing on the renminbi exchange rate made little sense insofar as what was needed was a package of policy changes (increased spending on infrastructure and public services, the development of financial markets and a social safety net, and increased domestic demand to soften the impact of lower net exports) and parity adjustments not just by China but by a range of U.S. trading partners. Nor was the U.S. in a position to offer anything in return, other than avoidance of punitive tariffs. Finally, it was it not clear that the Chinese would react favorably to badgering.

There are multiple explanations, then, for why direct pressure produced little, other than Chinese statements of willingness to move to a more flexible exchange rate

"eventually." In early 2005 the Administration switched tactics: from public pressure to private diplomacy; from exclusive focus on the exchange rate to the need for a coordinated set of Chinese policy adjustments (developing financial markets, augmenting the social safety net, and getting state-owned enterprises to pay dividends); and from preoccupation with the bilateral relationship to encouraging China to become a "responsible stakeholder" in multilateral institutions in which international economic policy outcomes were shaped. This last tactic was the culmination of a long journey for an administration that had come to office with attitudes that ranged from distain to outright hostility toward the IMF and World Bank but now sought to enlist them as key mechanisms for advancing its foreign economic policy.

Robert Zoellick invoked this responsible-stakeholder rhetoric both publicly and privately. Henry Kissinger, Brent Scowcroft and William Rhodes were briefed by Treasury and enlisted to carry the message to Beijing. That aside from Rhodes (senior vice-chairman of Citigroup) these individuals were not financial specialists pointed to the fact that the administration sought to encourage China to assume more responsibility for the operation of the international system generally, and not just for the imbalances problem. But even from this narrowly financial perspective, the new approach paid at least some dividends: the Chinese revalued by 2.1 per cent on July 21st, 2005 and announced that henceforth the renminbi would be allowed to fluctuate more freely.

Movements in the currency were still tightly controlled by the People's Bank, resulting in little further appreciation and explosive growth in the Chinese surplus through the first half of 2007. Still, this could be advertised as a down payment. Snow's successor Henry Paulson continued to press the Chinese for greater currency flexibility

and appreciation. On his inaugural trip to China as treasury secretary in September 2006, Paulson met with the party secretary of fast-growing Zhenjang Province and dined with the central bank governor, himself a well-known proponent of flexibility. Paulson thus sought to reframe the debate as not between the U.S. and China but between pro- and anti-liberalization forces in both countries.

To redirect attention away from the bilateral imbalance and to further encourage China to assume greater responsibility for the problems of the international system, the Bush Administration reluctantly embraced the IMF's Multilateral Consultations Initiative, announced in the spring of 2006. The idea was that, with the IMF providing projections and serving as honest broker, and with Europe, Japan and Saudi Arabia (as a representative of the oil-exporting surplus countries) also at the table, it was more likely that the major players could agree on a coordinated package of policy adjustments to increase the likelihood of a smooth unwinding of global imbalances. In particular, the onus would not be on China alone to offset any compression of U.S. demand; with China, Europe, Japan and the oil exporters expanding demand simultaneously, there would be less need for sharp adjustments by any one economy. This was also a way of cloaking U.S. demands in multilateral cloth and lending international legitimacy to the country's call for Chinese adjustment. The IMF, and not the Treasury through its semi-annual report on exchange rate manipulation, would be responsible for determining whether currencies like the renminbi were significantly undervalued. There is an obvious parallel with the Bush Administration's initial reluctance to deal with Saddam Hussein through the United Nations but its subsequent efforts to enlist the organization in Iraq.

The administration understood, however, that the multilateral consultation was a two-edged sword. Allowing the IMF to become adjudicator of exchange rates and external imbalances was fine and good except when the Fund concluded that the U.S. deficit was unsustainable and the dollar would have to fall significantly. Convening a multilateral consultation inevitably raised the question of what the U.S. would bring to the table. Other countries were unanimous in identifying low U.S. savings as contributing to the imbalances problem. Raising taxes or even just sun-setting the Bush tax cuts of 2001-2 were obvious ways of raising public saving, but there was reluctance to do so on ideological and practical political grounds. Sharper increases in interest rates might encourage private saving, but this grew less attractive as the U.S. expansion entered its late stages. Not surprisingly, when the results of the first consultation were released in April 2007, they turned out to be weak soup. The U.S. government acknowledged the desirability of cutting its budget deficit and raising household savings but without committing to any new policies designed to do so. China acknowledged the desirability of greater exchange rate flexibility, as it had in the past, without committing to any actual changes in policy.

By early 2007 the trade-weighted value of the dollar had fallen by 17 per cent since the beginning of 2002. Demand had begun picking up in Europe and Japan, and there were some signs that the U.S. deficit had peaked, leading the IMF to back off the issue. The problem was that China had only allowed the renminbi to appreciate by a cumulative 7 per cent against the greenback, placing most of the burden on other countries that were forced to absorb the bulk of the adjustment and rendering them reluctant to do more. Thus it was important for the soft-landing scenario that in early

2007 the Chinese authorities indicated a willingness to contemplate greater flexibility if the country's external surplus continued to grow.[9] Precisely what this means and whether it will support a smooth unwinding of global imbalances remain to be seen. If it does, the Administration's approach of relying on words rather than deeds – avoiding both trade conflicts with China and measures that would have interfered with U.S. expansion – will have been vindicated.

By the administration's second term there had thus developed an appreciation of the advantages of attempting to advance U.S. foreign monetary and financial interests through the IMF rather than relying exclusively on bilateral initiatives.[10] Working through the Fund was a way of depersonalizing and depoliticizing the international debate over policy adjustments. More strikingly, the administration evidently realized that the U.S. could more effectively advance its interests within the Fund only by agreeing to boost the representation of emerging markets. The institution would be seen a legitimate venue for policy debate and action, it realized, only if rapidly growing countries were adequately represented in terms of quotas (which determined voting rights) and seats on the Executive Board. The U.S. government led the charge for governance reform at the Fund starting in 2004. The summer of 2006 saw agreement on a 1.8 per cent quota increase for four egregiously underrepresented emerging markets – China, Korea, Turkey and Mexico – and on the principle of more comprehensive quota revision designed to reflect changes in the global economic landscape, to be completed by September 2008, in which the U.S. quota would not be increased. This was a turnaround for an administration initially so hostile to the Fund – again demonstrating

[9] See inter alia Bloomberg (2007).
[10] Again it is not hard to see an analogy with other forms of foreign policy and with the evolution of the Administration's attitude toward the United Nations.

how deeply locked in the existing institutional framework is and how it continues to condition U.S. policy.

This brings us to World Bank reform. One can readily imagine that George W. Bush himself was no fan of indiscriminate assistance for poor countries, which he likened to welfare. Secretary O'Neill insisted that the aid apparatus needed to be overhauled before being given more money. The world had spent "trillions of dollars [on development] and there's damn little to show for it," he complained, implying that the Bank was inefficient and poorly run.[11] O'Neill complained that World Bank President James Wolfensohn had no second in command and that the institution lacked priorities. It did not have adequate systems for assessing results.

John Taylor writes how he was sympathetic to the goal of poverty reduction.[12] Like O'Neill, he pushed for more measurement of results. He urged that the Bank focus on its core competency, namely measures to reduce poverty in the poorest countries – that it "graduate" middle-income countries like Brazil and Turkey that now enjoyed access to capital markets. And he pushed for shifting from loans to grants to avoid burdening poor countries with still more debt-servicing obligations. To the extent that the reflow of interest from earlier loans allowed the Bank to lend more, it was simply double counting the transfers made to poor countries – adding new loans to its list of achievements without subtracting the repayments. Eventually Taylor concluded in favor of forgiving the debts of the poorest countries.[13]

[11] Mallaby (2004), p.289
[12] Taylor (2007), chapter 5.
[13] In formulating this agenda Taylor was influenced by the Meltzer Commission, which had considered World Bank as well as IMF reform. Its report had called for curtailing bank operations in middle-income countries and for replacing loans with grants; Meltzer knew both O'Neill and Taylor, as noted above, and once had an office on the same corridor as Lindsay and Hubbard at the American Enterprise Institute.

Bush rolled out his plan for replacing loans with grants at a speech on the eve of the G8 Summit in Genoa in July 2001. The result was a tug of war between the Bush Administration on one side and its European counterparts and Bank staff on the other, which suspected the administration of using these proposals as cover for scaling back the Bank. The Europeans opposed graduating middle-income countries, since this meant limiting Bank involvement in many parts of the world. They opposed shifting from loans to grants since, in the absence of new resources, there would be no money for new loans unless previous recipients paid back what they had borrowed.

At this point 9/11 intervened. Soon after the attacks on the World Trade Center, Wolfensohn began emphasizing the contribution of the Bank's antipoverty mission to the Administration's war on terror. He spoke with NSC chair Rice and ramped up Bank missions in the strategic region around Afghanistan. O'Neill resisted calls from Britain and suggestions from Wolfensohn to back these initiatives with increased aid flows, insisting that the Bank first demonstrate that it could put more money to good use.

But O'Neill's influence was in decline, and the argument that foreign aid was more than an act of altruism – that it was now a mechanism for enhancing the national security – was compelling in the wake of 9/11.[14] In the spring of 2002, the Bush Administration performed a U-turn. At the Monterrey summit it promised an extra $5 billion in aid over three years (later changed to an extra $5 billion a year, indefinitely). Evidently Wolfensohn's line that Bank assistance was critical to the war on terror trumped O'Neill's skepticism. This was the origin of the Millennium Challenge

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Taylor cites the Meltzer report in his book when discussing the need for World Bank reform. Taylor (2007), p.135.

[14] This idea was explicitly incorporated into successive national Security Strategies. It was also the motivation behind Secretary Rice's "transformational diplomacy" push.

Corporation (MCC), an Administration initiative to tilt aid toward countries that met 16 benchmarks of good governance and policy.

The problem was the difficulty of finding countries and projects that satisfied these conditions. It was as if lending would be limited to countries that had removed the fundamental obstacles to growth and development – thereby rendering development assistance redundant.[15] The underlying ideas may be appealing – that only countries with reasonably strong controls and policies can make productive use of additional grants in aid – but the result has been to limit actual disbursements to a trickle. Other initiatives have produced greater results: these include the Emergency Plan for AIDS Relief in Africa (Pepfar) and more attention to problems like malaria. Thus, no matter how much the administration may have wanted to get out of the "welfare for poor countries" business, the realities and constraints were too complex.

Nor was the war on terror an unmitigated blessing for the World Bank. In the summer of 2003, the U.S. pushed Wolfensohn and the Bank to lend to Iraq. Snow called for this publicly. Taylor telephoned to request that the Bank pledge billions in loans to Iraq's budget. Wolfensohn objected that there was no recognized government (no government that had been recognized by a UN resolution) to which to lend. It is hard to see how this initiative could have done anything but undermine the Administration's emphasis on lending only to countries with efficient governments.

It was against this background that the nomination of Paul Wolfowitz to succeed James Wolfensohn as president of the Bank was so controversial. Wolfowitz incited controversy for his campaign against corruption and graft. To be sure, this emphasis was

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[15] The Administration addressed this by creating Threshold Program Agreements, or contracts between the U.S. government and a country that provide for financial assistance to help improve a low score one one of the MCC's 16 policy indicators.

consistent with earlier Administration attacks on the Bank: Secretary O'Neill had pointed to these and other problems when criticizing the Bank's inefficiency, and control of corruption had been one of the 16 indicators enumerated by the Millennium Challenge Corporation. And Wolfensohn had already highlighted the corruption issue during his tenure. But it became controversial once Wolfowitz charged his personal advisors, Americans with Republican Party ties, with heading up the program and failed to develop an open process and transparent criteria. Bank staff referred to an atmosphere of suspicion and criticized program administrators for their failure to consult. Countries like South Africa complained that the anti-corruption agenda threatened to compromise the Bank's key mission of poverty reduction. Once this spat went public, the Development Committee (of governmental overseers of the Bank) insisted on revisions in the anti-corruption paper.

That said, there were achievements. The Bank strengthened its systems to measure the results of its programs. European opposition to substituting grants for loans was partially overcome. The decision that 21 per cent of IDA funds would be used for grants was a compromise between European insistence of using no more than 10 per cent of Bank resources in this way and the Administration's opening bid of 50 per cent. There was agreement on the U.S. proposal to forgive the IDA debt of the poorest countries over initial European objections that this would further limit World Bank resources. To make this palatable the Administration agreed to increase its funding for IDA and tabled its proposal to graduate middle income countries.

4. Agenda for the Next Administration

Given our thesis that U.S. foreign economic policy is significantly constrained by existing interests and inherited structures, we suspect that the agenda of the next administration will again be dominated by familiar issues and that its options will be similarly limited. The next administration, like its predecessors, will confront WTO ministerial meetings (two year cycle), domestic farm bills (five year cycle), protectionist pressures from particular industries (trade law enforcement), and the desire to renew its negotiating authority. It will have some latitude in how it responds, but it will have to respect the existence of long-standing U.S. government positions on these issues. That long-standing position is based on the view that America's economic engagement with the world is in the national economic and foreign policy interest.

The next administration will inherit many unresolved issues from the Bush administration. One notable unresolved trade issue is the loss of trade promotion authority and the fate of the Doha round. Although administration officials had hoped for an "early harvest" from the Doha round, they were powerless to produce such a result without a willingness on the part of the European Union to compromise on its agricultural subsidies and India and Brazil to agree on market opening. With a divided WTO membership of 150 countries, reaching any agreement has proven difficult and will continue to do so.[16] There is little that a new administration can do about this situation, even if it wanted to.

While deadlock at the multilateral level is nothing new, a more important problem is the increasingly sour domestic political environment for trade. Here, a constellation of factors portends a long pause in activist U.S. trade policies geared toward trade

[16] Multilateral trade negotiations are notoriously slow to complete. The Kennedy Round took four years (1964-67), the Tokyo Round took six years (1973-1979), while the Uruguay Round took seven years to finish (1986-1993).

liberalization.[17] The incoming president is likely to lack trade promotion authority. Although trade negotiations can conceivably take place even if the president does not have such authority from Congress, U.S. negotiators will lack credibility with their foreign counterparts and those negotiations will lack a sense of urgency without it.

The next administration will almost certainly want trade promotion authority as an arrow in its quiver, so the question is whether Congress can be persuaded to go along. Congress has become increasingly hostile to pro-trade measures: the trade agenda has been complicated by fears about offshoring of American service jobs, growing concerns about income inequality and the distribution of the gains from globalization, and the large bilateral trade deficit with China. These issues may affect many administrations to come. Each defies easy solution.

An unfortunate characteristic of the Bush years has been sharply divisive, partisan Congressional votes on TPA and various FTAs. The Bush administration did not seriously attempt to build a domestic consensus in favor of open trade but pushed through its legislative initiatives by the brute force of marginal votes. A domestic consensus on trade might be restored with greater social insurance measures to help those adversely affected by imports, or by coupling trade agreements with stronger labor and environmental provisions, as many Democrats propose. Yet the catch is that a move by Congress to require meaningful labor and environmental standards in trade agreement will be greeted with suspicion if not outright hostility by developing countries. They

[17] Even if an internationalist Democrat such as Bill Clinton succeeds in taking the White House, economic nationalism is rampant among Congressional Democrats, potentially blocking any action on trade. Such Democratic divisions are not be new; the Roosevelt administration was deeply divided between liberal internationalists such as Secretary of State Cordell Hull and other economic nationalist New Dealers who thought trade liberalization would undermine domestic price supports and other measures to regain full employment. Hull battled long and hard to ensure his views became established administration policy.

have resented Western demands for such standards in the past, viewing such requirements as merely providing an additional avenue for the United States and other developed countries to close their market.

Because of domestic discontent on trade, it is easy to imagine a new U.S. president simply deciding that it is not worth spending political capital on pushing for new trade initiatives. If such initiatives encounter domestic resistance and lack a compelling foreign policy rationale, trade could easily be put on the back burner. The United States could enter a long period of disengagement on trade.

All this portends a long pause in activist U.S. trade policies geared toward trade liberalization. At best, this would mean the status quo remains intact. Ongoing technological change and foreign investment will continue to bring the world's economies closer together. Continued drift in or even a collapse of the Doha round could mean a missed opportunity, but nothing more. Even if it encounters stiff domestic resistance to trade-expansion policies, the next administration will almost certainly will not seek to withdraw from the WTO. And the rules and procedures of the WTO will continue to constrain domestic trade policy.

The greater risk is that, without forward progress on trade, the past gains from liberalization will get whittled away as countries backslide on previous commitments. If the domestic political climate for trade liberalization deteriorates further, with greater domestic income inequality and job losses getting linked in the public mind to factors emanating from the world economy, Congress may be tempted to enact anti-trade protectionist legislation. Although most presidents would be expected to veto such legislation, containing such pressures would still be a formidable challenge.

And if legislation was enacted that seriously violated America's commitments under the WTO, the United States could not only face retaliation from abroad but trigger a weakening of WTO commitments by other countries, leading to a general unraveling of the open multilateral system of world trade. Although the large economic stakes make a full-blown trade war seem unlikely, a gradual breakdown in the WTO disciplines would take many years to repair and could have grave economic consequences for the United States. Thus, the next president may end up playing a defensive trade policy against Congress rather than pursuing an offensive trade policy with other countries.

As other chapters in this book have discussed, some of the most difficult challenges for American foreign policy are located in the Middle East, where the problem of Islamic extremism remains acute. Because of its dependence on imported oil, America is tied to the region in a way that it is not tied to other areas of the world, such as South America. Although every president since Richard Nixon has made statements about the need to reduce America's dependence, none has actually taken serious steps to encourage alternative energy sources. As a result, although the amount of energy need to produce a dollar's worth of GDP has fallen considerably since the 1970s, the U.S. economy remains at risk of an oil price shock. Even worse, the huge revenues associated with Middle Eastern oil exports creates the problem of vast financial resources falling into hands of extremist regime with which they could purchase weapons of mass destruction or fund terrorist campaigns across the world. The domestic solution – higher taxes on the consumption of fossil fuels – may seem obvious to economists, but has yet to find a strong political constituency.

A long-term goal of the United States has been to enable the countries of the Middle East to diversify their economies away from oil and generate economic growth that brings about shared prosperity for all citizens in the region. The Bush administration has proposed free trade agreements in the greater Middle East as one means to this end. The hope is that opening up a repressed Middle Eastern economy to the world will unleash beneficial economic as well as societal changes. But it has found few willing partners. Countries such as Saudi Arabia, Syria, and Iran have relatively closed societies and oppressive political systems and are not hospitable to the rough and tumble of foreign investment (Momani 2007). Thus, there are severe constraints on what American power can do to help the economies of the Middle East. Even if the United States believes that improved economic performance in the Middle East will reduce the threat of terrorism, it lacks the capability of doing so without a willingness on the part of those countries to bring about change.

America's continuing large current account deficit and ongoing dependence on foreign central banks for finance will continue to be a source of vulnerability going forward. The fact that critical finance is provided by the central banks and governments of countries like China and Saudi Arabia means that anything that upsets U.S. relations with these countries could upset the U.S. economy as well. In turn this gives foreign governments a lever with which to demonstrate their displeasure with U.S. foreign policy.

Imagine a conflict with China over Taiwan or Saudi displeasure over U.S. policy in the Middle East. If these countries curtail their ongoing accumulation of dollars and shift the composition of their reserve portfolios away from dollars in favor of, say, euros,

the dollar will fall sharply and the U.S. current account deficit will have to be compressed. The mechanism would be higher inflation that leads the Federal Reserve to raise interest rates and, quite possibly, a recession. This is not to argue that American foreign policy will be dictated by foreign financial leverage over the U.S. economy but to suggest that this additional source of dependence will complicate the efforts of the next administrations to pursue an independent foreign policy.

More generally, the country's external deficit and dependence on foreign finance heightens economic risks. One can equally imagine that foreign central banks, seeing the U.S. external deficit as unsustainable, might shift out of dollars in order to avoid capital losses on their reserve portfolios. In the longer run a chronically weak dollar will encourage foreign central banks, governments and corporations to consider alternatives to the dollar as the medium in which to hold reserves, price petroleum, invoice trade, etc. Estimates of the value to the United States of the dollar's international currency status vary, but the country clearly will be no better off when that status is history.

Following the 2004 presidential election, there was an opportunity to address these vulnerabilities. With the economy expanding strongly, it would have been possible to pursue what is politely referred to inside the Beltway as "revenue enhancement" to address the problem of public dissaving. But seven-plus years into the expansion, growth has slowed as the economy has come to operate close to full capacity. In turn this constrains economic policy options. Tax increases run the risk of interrupting growth. The next administration will inherit from the campaign a mandate to provide universal health care and to reform the Alternative Minimum Tax, along with other familiar spending pressures, so the idea that it will be able to solve the twin deficits problem with

expenditure discipline is naïve. Winding down U.S. involvement in Iraq will create fiscal savings, but military and homeland security-related spending is not a plausible source a source of budgetary economies overall. The window for proactive adjustment having closed, the next administration will have little choice but to hope for the best. It will have to pray that foreign finance for the U.S. current account continues to flow while the dollar declines smoothly, crowding in exports, and the absence of capital gains on housing encourage more saving by American households. Crossing one's fingers and hoping for the best is not an attractive position for a new administration to find itself in, but such is the inheritance.

An orderly adjustment that limits U.S. external vulnerabilities would be facilitated by rebalancing of demand in Asia. If U.S. spending has to decline relative to U.S. output, Asian spending should rise relative to Asian output to avoid compressing global demand and depressing global growth. This is largely a China issue.[18] A strategy for dealing with that country will be high on the foreign economic policy agenda of any future administration. Experience suggests that China-bashing is unlikely to produce the desired reforms; we suspect that a continuation of the Paulson strategy of gently encouraging reformist interests in the country has greater prospects of success. There may also be some scope for playing "good cop, bad cop" by warning that if China fails to reduce dependence on exports and stimulate domestic demand the administration may be unable to contain protectionist sentiment in Congress.[19] That said, the effectiveness of

[18] Other emerging Asian countries (South Korea, Thailand, the Philippines) have allowed their currencies to appreciate against the dollar and have already moved their current accounts toward balance. The two other emerging Asian economies in strong surplus, Singapore and Hong Kong, are too small to have a first-order impact on global imbalances. One non-emerging Asian economy, Japan, is also in strong surplus, though its high debt and lethargic growth leave little room for monetary or fiscal measures to stimulate spending.
[19] Of course, a president who had campaigned in favor of anti-China trade measures could not credibly adopt this posture.

U.S. pressure for Chinese policy adjustments will be limited by what Lawrence Summers has dubbed "the balance of financial terror." China can always push back against aggressive pressure by selling some of its U.S. treasury bonds or simply slowing their rate of accumulation. This suggests that pressure for policy adjustments in China can be more effectively applied by a coalition of like-minded countries.

This brings us to the next administration's relations with the multilateral financial institutions. The Bush Administration came to office suspicious of the IMF and World Bank and sought to address economic and financial issues with other countries primarily through bilateral channels. Its economic relations with China, not unlike its experience in Iraq, demonstrate the limitations of going it alone. This led eventually to efforts to address the China problem not only bilaterally but also through the IMF's Multilateral Consultations Initiative and by encouraging the adoption of a new surveillance decision enhancing the powers of the Fund to identify misaligned exchange rates. It led the Bush Treasury to accept the idea of a modest reduction in the U.S. quota share as its contribution to a larger package of reforms designed to enhance the legitimacy of the institution. It led it to rethink its initial hostility toward foreign aid by agreeing to the Monterrey Consensus. The next administration will almost certainly continue down this road.

But American relations with the Bretton Woods institutions, like the country's relationship to the United Nations, remain uneasy. The next administration will have more fences to mend, particularly in the wake of the Wolfowitz affair. Here the decision to nominate Robert Zoellick to replace Wolfowitz, however qualified Zoellick may have been as an individual, was an opportunity lost. By insisting on its historical privilege to

nominate the president of the World Bank, the Bush Administration did nothing to enhance the perceived legitimacy of the institution among emerging markets. It encouraged European governments to argue that sauce for the goose was sauce for the gander and that they had the right to nominate the successor to Rodrigo de Rato as managing director of the IMF. The idea that the United States can work through these institutions to advance global economic prosperity and stability, and not incidentally its own foreign economic policy agenda, presumes that these institutions have a modicum of legitimacy and are taken seriously elsewhere in the world.[20] An illegitimate leadership selection process increasingly undermines this presumption. Why, for example, should China accept the IMF as a legitimate umpire for exchange rates when it has no real say in the appointment of that institution's director? A simple and effective initiative for the next administration would thus be to announce on taking office that it would not seek to nominate Zoellick's successor when his term expires and that it expects similar concessions of Europe.

5. Conclusions

Our analysis of the Bush Administration's international economic polices stresses continuities rather than breaks from its predecessors. In trade policy the administration sought to push a free trade agenda but often found it difficult to avoid the use of protectionist measures – just like its predecessors. In financial policy the administration foreswore bailouts of financially-distressed developing countries yet ultimately yielded to the perceived necessity of lending assistance – just like its predecessors. Not unlike

[20] U.S. support for quota increases for egregiously underrepresented emerging markets and Treasury's commitment that the U.S. would not demand a quota increase itself as part of this process can be seen recognition of this fact.

previous presidents, President Bush assumed a stance of benign neglect of the country's current account deficit.

We see the next administration grappling with the same problems under the same political and policy constraints. The challenges facing it will be broadly similar to those facing the Bush Administration when it took office: deadlock at the WTO, the difficulty of encouraging EU agricultural reform, trade tensions with China, the risk of a disorderly unwinding of the U.S. current account deficit and ongoing World Bank and IMF reform. The nature of U.S. interests and the structure of international institutions and U.S. policy making suggest that there will be few sharp breaks in policy, partisan differences notwithstanding. The institutions and interests in which the policy making process is embedded shape outcomes too powerfully for any other forecast to be credible.

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