Preface

The volume and quality of resources mobilized for use in foreign affairs depends on two factors: first, the productive capacity and wealth of the country, i.e., manpower, capital, and land, and second, the share of these resources, or their outputs, allocated to foreign policy.

—Klaus Knorr

The discovery that banks could . . . create money came very early in the development of banking. . . . The process by which banks create money is so simple that the mind is repelled. Where something so important is involved, a deeper mystery seems only decent.

—John Kenneth Galbraith

SCENARIO

It has been the best of times. Now it seems the worst of times. Several months of political wrangling have been ongoing in Washington—legislative calls by a powerful minority in the House and Senate for even deeper budget cuts, coupled with a threat to block any effort to raise the national debt ceiling. These threats to shut government down or force default on government obligations have spooked the markets, already resulting in another rating downgrade for U.S. Treasuries.

The crisis begins with a two-pronged attack on the New York Stock Exchange (NYSE). The first shock begins innocuously enough with a coordinated phishing attack at 11:30 a.m.—hacker e-mails mimicking different offices in the New York Federal Reserve Bank that, because of their apparent identity, get ready access. These are not ordinary hackers with only short-term purposes in mind. No, the hackers are part of an insurgent group that wants to bring down American capital and, with it, the prominent position the U.S. dollar still enjoys in the global economy.

The phishers now have unfettered access to the NYSE secure server. Implanting malicious software, the phishers are not interested in downloading NYSE and corporate data. They want to delete information on record, destroying the massive archives of current past data in the NYSE server's memory. The phishers have also activated a botnet—tens of thousands of computers linked by the phishing attack—that overwhelms the NYSE server, causing it to freeze and then crash completely.

The NYSE is paralyzed and in complete turmoil. Panic erupts, spreading to other exchanges in the global market. Stock prices are down at least 20 percent worldwide—some more, others a few points less. The NYSE closes at noon, but since the server is down there is no way to communicate that through normal electronic channels to trading firms with seats on the exchange, not to mention investors who continue trying to place buy and sell orders. Television, radio, private e-mails, texts, phone calls, and social media are the principal outlets for communicating with trading houses and investors. If that were not enough, just as traders are clearing from the floor of the stock exchange, a high-explosive car bomb detonates in front of the exchange, killing pedestrians and bystanders and severely damaging the building's façade.

This two-pronged attack—combining the impact of cyber and high explosives—has devastating effects. Stock markets take a dive worldwide as people try to liquidate their assets. When the attack is understood as having been directed principally against the United States, where most damage was done, foreign markets gradually recover. The NYSE and other U.S. stock exchanges remain closed. There is a run, mostly on American banks. The president intervenes and, using Roosevelt's Depression-era precedent, declares a bank "holiday"—effectively closing the banks and other financial institutions until order can be restored to capital markets.

Notwithstanding market interventions by European, Japanese, Chinese, and other treasuries and central banks, market forces overwhelm their capabilities and genuine, well-intended, collaborative efforts to hold the dollar's position. These events undermine confidence in the U.S. economy and bring the dollar down to half its value vis-à-vis other major currencies. Unable to rely on the dollar for daily transactions—not to mention its loss as a store of value—corporate America is in disarray both at home and abroad.

OPEC countries quickly shift to euro-pricing of oil, promising they also will accept dollars once stability returns to currency markets. Meanwhile, the U.S. Treasury reluctantly imposes exchange controls, trying to stem the flood of depreciated dollars into already swamped global currency markets. Airlines have reduced international flights and shipping companies are holding many ships in port as they work to ensure necessary financing.

To keep international commerce from declining precipitously, a joint National Security Council (NSC) task force including representatives from the Treasury, the Federal Reserve, and Commerce and State departments meets to explore the feasibility of special trading arrangements organized regionally—Latin

America, Europe, Asia, and the Pacific. Bilateral arrangements will be sought to sustain trade with other countries in central and south Asia, the Middle East, and Africa.

To keep U.S. national security commitments abroad, the State and Defense departments (coordinating with Treasury and the Federal Reserve) get key allies to agree as a stopgap measure to facilitate U.S. government expenditures in local currency purchased from their respective central banks at 90 percent of the precrisis, dollar-euro or dollar-yen exchange rates. Nevertheless, talk in the Congress turns quickly to bringing American forces home from overseas deployments. Following an NSC meeting, the administration counters that bringing the fleet back to home ports, coupled with precipitous withdrawal from Japanese, South Korean, central Asian, Middle East, and European bases, would destabilize these regions and thus undermine American national security.

Could this happen? How realistic is this scenario? What are the adverse security and other implications of such a calamity? Could the euro or other key currencies face the same fate? Would worldwide depression be the outcome in any event? How dependent is maintaining national security on multilateral, collaborative actions that sustain the global monetary regime and the viability of currencies within it?

This book is about money and security. Defense establishments and the armed forces they organize, train, equip, and deploy depend upon the security of capital and capital flows that have become increasingly globalized. Military capabilities thus are closely tied not only to the size of the economic base from which they are drawn but also to the viability of global convertibility and exchange arrangements. We miss at our peril the potential for disruption of capital flows that can undermine U.S. economic security as well as the ability both to deploy military units, sustaining their operations worldwide, and to maintain the network of U.S. diplomatic missions and the programs they administer abroad.

Economic, military, and other capabilities do not exist in a vacuum as if they were objective realities "out there." Yes, a currency's (like the dollar's) exchange value is a function of supply and demand, but these are essentially *subjective* judgments in markets about its relative worth in relation to other currencies. Although mass publics at home and abroad have a stake in these technical matters, the interests and interpretive understandings held by policy elites matter most—in particular those among the *owners or managers of capital* (or OMC),

who focus on international finance and the international monetary regimes that sustain global commerce and their capital positions.

Included in their ranks are the finance ministers, central bankers, private-sector bankers, and others who own or manage large concentrations of capital—the decisive factor of production in the present world economy. Their judgments—especially those held by monetary officials who manage global capital flows—are heavily influenced by subjective appraisals of a country's economic base and growth potential relative to other national economies. Also influential are the rules or accepted norms of the international monetary regime within which the currency operates (and which they and those among the transnational OMC who preceded them have constructed).

References in this volume to the owners or managers of capital that appear throughout this volume are an empirically grounded shorthand for net creditors, mainly those institutions or individuals with large capital holdings as well as those who may be less wealthy personally but manage capital held by others in relation to the capital flows that now occur globally. They are identifiable as real people. The category includes individuals in their private capacity or in their governmental or non-governmental roles in corporations, banks, and other groups. In our treatment of the relation between the dollar and national security in this book, however, our focus is primarily on banking and treasury officials (and those who advise or influence them)—all policy elites or experts who manage capital for central banks and governmental treasuries or finance ministries.

Because they deal with so important a factor of production as capital, especially its monetary representation, their decisions and actions are inherently political—as, indeed, most important and often contentious things are (or quickly become)! Just because the owners and managers of capital are an identifiable category does not mean that they are of one mind or that they always see their interests the same way.

Conflicts, formation of coalitions and countercoalitions among capital owners and managers, decisions (and the authority to make them) are the stuff of politics, whether one is acting domestically or globally. Authoritative choice about the dollar, its relation to other currencies, and the economy on which the currency is based are what matter to us here. Both mass publics and capital elites matter in financial and other markets, but on monetary policy decisions our focus is on the financial segment constituted by bankers (particularly central bankers) and Treasury officials.

Economic and national security is the objective we explore in the pages that follow, explicitly underscoring *cooperative security* as the most propitious means to that end. The Introduction, on Money and Security, sets the stage conceptually for what follows on the U.S. dollar, security, and monetary exchange. Subsequent chapters provide an historical narrative that underscores what is often overlooked—how *security* and *money* are inextricably linked. Most commentaries on international monetary matters focus on the implications for trade, investment, and economic growth of exchange-rate changes and the overall stability of a currency. Although these are an important part of economic security, few accounts take up how security in the broader sense can be advantaged or set back.

PART ONE: THE EUROPEAN CENTER—STERLING, THE DOLLAR, AND SECURITY BEFORE WORLD WAR II

The first part of the book takes up national and global security in relation to monetary exchange in the late nineteenth century, before and during World War I, and the interwar period that followed. We begin this story in Chapter One ("Money, Empire, and Prewar Security") with current challenges in the European Union, but quickly flash back to the nineteenth century when Britain depended on the global acceptance of sterling (the pound, defined as equal to a fixed quantity of gold) for securing its worldwide empire, upon which, figuratively, "the sun never set." Indeed, globes well into the last half of the twentieth century standardized with pale rose color those parts of residual empire and commonwealth.

The chapter chronicles the years leading up to World War I. Then, as now, intervention by central and private banks and other financiers among the owners or managers of capital was key to maintaining international liquidity—an essential component of security in the late-nineteenth- and early-twentieth-century years before the outbreak of war in 1914.

In monetary finance things were never left purely to market forces then any more than they are today. Faced with crises, banks "too large to fail" now turn to governmental authorities for assistance, the latter understanding that allowing massive failures in the banking sector with spillover to the entire economy is contrary to the national interest. Notwithstanding laissez-faire, liberal sentiments in the ideological rhetoric of the day, economic- and military-security stakes were (and are) too high for the OMC to leave national currencies entirely at risk to market forces beyond their control. *Plus ça change, plus c'est la même chose.*

The money and security story continues in Chapter Two ("Wartime Security and Monetary Exchange in the Great War"). During the "Great War" the Allies and the Central Powers refashioned their monetary regimes to sustain their war efforts. The warring parties also shared an interest in securing currency exchange between the rival camps. Even in the midst of world war, the adversaries found ways to exchange each other's currencies, particularly on the neutral ground offered by Swiss and Dutch banks. Access to an enemy's currency for intelligence, espionage, or other purposes was a sideline activity, but one in which both sides had a vested interest.

World War I devastated European countries—both the defeated and the "victorious," the latter left with substantial war debts owed in particular to the United States. It also marked the beginning of the end of the British Empire, though few understood this at the time. It would take a depression, World War II, and its aftermath to bleed Britain's global capital position still further.

Chapter Three ("Restoring Sterling, Commerce, and Security after World War I") addresses the immediate task after the war ended in 1918: to return, if possible, to what was understood as normalcy—restoring the sterling-gold exchange standard as foundation for global commerce and for the security of Britain and its global-imperial position. British and American central bankers worked collaboratively to make this happen, the dollar linked to sterling, the latter remaining the global benchmark.

Monetary collaboration between Britain and the United States was the foundation for cooperative security efforts between the two in the immediate postwar years. Understandings among capital owners or managers in and out of government over their commercial and security interests inspired the effort to restore the pre-1914 gold-exchange standard as the cornerstone of a new international monetary regime.

PART TWO: THE UNITED STATES MOVES TO THE CENTER: DOLLAR PRIMACY AND AMERICAN NATIONAL SECURITY

Part Two of the book continues the monetary-security story, chronicling the dollar's rise to preeminence from World War II to present-day challenges. Indeed, the dollar has played an instrumental role in American economic and national security over the past seven decades, the euro joining it in center stage in the first years of the new century.

Efforts in the 1920s to restore security and stabilize international monetary exchange so essential to international commerce ran amok when the stock

market crashed in 1929 and a decade of economic depression began. Cooperative security on monetary matters fell apart during the 1930s, which we discuss in Chapter Four ("Money and Cooperative Security, the Interwar Years, and World War II"). So weakened was its capital position during the 1930s (the Great Depression years), Britain was unable to sustain its international monetary leadership and the U.S. proved unwilling at the time to assume the role.

Competitive devaluations, raising import tariffs, and other "beggar thy neighbor" policies became the illiberal order of the day. Given an arms race between Germany and both Britain (challenging its naval supremacy) and France (threatening its ground forces) and other factors, the monetary world again divided into two opposing currency blocs between the Allies and the Axis powers. As in World War I, wartime monetary exchange was conducted not only within the two camps organized as opposing alliances, similar to the Great War, but also between them—Switzerland again a major neutral venue for such transactions. The Netherlands, occupied by Germany in World War II, no longer played the significant monetary role it had in World War I.

Officials at the international conference held in 1944 at Bretton Woods, New Hampshire, forged a political consensus to restore relatively fixed exchange rates in a new dollar-gold exchange regime. American preferences prevailed at this gathering of governmental and other capital-management experts one year before the end of the war. Now having the world's strongest capital position, U.S. officials finally took the torch of global monetary leadership from Britain, the dollar effectively displacing sterling in the new dollar-gold exchange regime.

In the minds of U.S. negotiators, it was in the U.S. (and capital) interest to do so. Given postwar opportunities (and the global responsibilities U.S. officials had assumed), the dollar as the universally accepted key currency and reserve asset allowed American decision-makers to make the substantial outlays necessary to finance the country's economic and national security objectives abroad. Even oil became priced in dollars as principal unit of account, a singular U.S. advantage in the conduct of its foreign and national security policy abroad, particularly military deployments that depend so heavily on access to energy sources.

We examine security in relation to the Bretton Woods relatively fixed exchange-rate regime (1946–71) in Chapter Five ("Cold War and the Bretton Woods Years") and, in Chapter Six ("Sustaining Dollar Primacy—From Bretton Woods to Managed Flexibility"), the present-day exchange-rate regime of

managed flexibility that succeeded it. Dollar supremacy has marked the post–World War II period, but others sought alternatives. Frustrated by post–Bretton Woods exchange-rate turbulence in the 1970s, policy elites in European Union countries coalesced in constructing a European monetary system of closely coordinated exchange rates. These arrangements ultimately led to the establishment of a European Central Bank (ECB) and emergence of the euro at the beginning of the new millennium as an alternative key currency and reserve asset alongside the dollar.

The United States, the European Union, and other countries with currencies accepted not only in payment of obligations but also held as reserves by others enjoy greater freedom in the conduct of their foreign and national security policies. We discuss in Chapter Seven ("The Dollar, the Euro, and Cooperative Security") the development of the euro in relation to the dollar and the promotion of cooperative security. As with Americans, Europeans now are much less constrained in the outlays they make abroad than they would have been had the euro not come on stage and the Bretton Woods regime of relatively fixed exchange rates not yielded to one in which they fluctuate in relation to market forces moderated by treasury and central bank interventions.

Particularly when outlays are of massive scale, financing military and other government expenditures, however necessary they may seem, quickly becomes problematic if actions are taken unilaterally in the absence of a consensus or support base among policy elites in other countries. Cooperative measures from political and monetary authorities in other countries likely will be more forthcoming when, and if, efforts taken beforehand to develop a broad multilateral consensus have met with some success.

Policy elites among capital managers, particularly treasury or finance ministers and central bankers, understand and know how to serve individual and shared commercial and security interests. Perceived individual and collective interests are the key drivers toward building the kind of durable consensus necessary to sustain the external financing of American foreign and national security policy. The same is true, of course, as decision-makers in European Union countries, China, Japan, Russia, India, Brazil, or other countries assume an even larger policy presence in global commerce, monetary, and security matters in the coming decades.

The international monetary story we relate in the pages that follow is familiar to readers of economic history. What is new in this telling, however, is its grounding in economic and national security. It is not just a matter of how

international monetary arrangements affect global trade and investment essential to economic security but also how they relate to the conduct of foreign and national security policies, especially the very expensive deployment and use of armed forces. It is this monetary component of hard power that is our focal point and that we address in the Conclusion.