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SECURITY CHALLENGES ARISING FROM THE GLOBAL FINANCIAL CRISIS

COMMITTEE ON ARMED SERVICES
HOUSE OF REPRESENTATIVES
ONE HUNDRED ELEVENTH CONGRESS
FIRST SESSION

HEARING HELD
MARCH 11, 2009

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SECURITY CHALLENGES ARISING FROM THE GLOBAL FINANCIAL CRISIS

HOUSE OF REPRESENTATIVES,
COMMITTEE ON ARMED SERVICES,
Washington, DC, Wednesday, March 11, 2009.

The committee met, pursuant to call, at 10:03 a.m., in room 2118, Rayburn House Office Building, Hon. Ike Skelton (chairman of the committee) presiding.

OPENING STATEMENT OF HON. IKE SKELTON, A REPRESENTATIVE FROM MISSOURI, CHAIRMAN, COMMITTEE ON ARMED SERVICES

The CHAIRMAN. Good morning.

Our committee meets today to hear from a very distinguished panel of experts about security challenges arising from the global financial crisis.

November 2008, our committee initially set out to hold a hearing on this topic, but for a variety of reasons, we were not able to make the schedule work. Consider briefly what has happened in the intervening months.

The U.S. financial crisis has widened into a global economic crisis. Our unemployment rate increased from 6.8 percent in November to 8.1 in February. The governments of Iceland and Latvia have fallen as a result of the crisis and others are likely to follow. Three of our most important partners in the Muslim world—Turkey, Indonesia, Pakistan—all face acute balance of payment crises. And the Director of National Intelligence (DNI), Admiral Dennis Blair, has concluded that the crisis represents the single greatest threat to our national security.

[The information referred to can be found in the Appendix on page 87.]

The CHAIRMAN. In short, we face a world that has been suddenly transformed and not for the better.

Students of history know that hyperinflation in Germany was a significant factor in the rise of Adolf Hitler. The economic decay of the Soviet Union led to the regime change across Eastern Europe. So we know that economic crises can have consequences of national security of the highest order.

Here in the United States, our economic strength has been the foundation of our national power and our national security. It is reasonable to assume that economics play no less important a role in the fate of many other nations. At a minimum, the global financial crisis will exacerbate an already growing set of political and economic challenges facing the world.

In country after country, the crisis is increasing citizen discontent and anger toward their leaders and providing an excuse for authoritarian regimes to consolidate their power. It is causing emerging nations to question the Western model of market capitalism. It heightens the always ongoing tug-of-war over budgetary resources and international assistance at a time when millions are being pushed into poverty. It distracts and strains our allies, generates conditions that could provide fodder for terrorism. Financial turmoil can loosen the fragile hold that many countries have on law and order and increase the number and size of ungoverned spaces.

Perhaps most serious at a time when United States leadership is sorely needed, our international credibility is at an unprecedented low.

In my view, our response to these challenges must be to restore our economy, maintain and enhance our key instruments of national power, including the Department of Defense, and take an approach with the world that reestablishes our credibility and claim to world leadership.

Let me be clear, in today's world a strong national defense is not a luxury. It is an imperative. I will be interested to hear our witnesses' views on the likely demand of our national defense capabilities in the current environment.

Let me pause for a moment. And I see in the audience friends we met yesterday, parliamentarians from the country of Pakistan. And we hope you get a lot out of our hearing.

And why don't you stand so we can—would you, please? Our Pakistan parliamentarians.

We welcome you and hope you have an excellent stay here in our Nation's capital.

Let me briefly introduce today's witnesses before turning to my friend, my colleague John McHugh, for opening remarks. Today, we have with us Dr. Richard Haass, President of the Council on Foreign Relations and former Director of Policy Planning for the State Department; Dr. Richard Cooper, Professor of International Economics at Harvard University, former Chairman of the National Intelligence Council and former Chairman of the Federal Reserve Bank of Boston; Dr. Dov Zakheim, whom I call the real Dov Zakheim—his son is one of our excellent members of our staff; former Under Secretary of Defense and Chief Financial Officer for the Department of Defense—in essence, the Comptroller thereof; David Rothkopf, visiting scholar at the Carnegie Endowment for International Peace and former Acting Under Secretary of Commerce for International Trade.

Gentlemen, we welcome you all. We look forward to your testimony and your insights on today's topic.

So now I recognize my colleague, the gentleman from New York, John McHugh.

STATEMENT OF HON. JOHN M. MCHUGH, A REPRESENTATIVE FROM NEW YORK, RANKING MEMBER, COMMITTEE ON ARMED SERVICES

Mr. MCHUGH. Thank you, Mr. Chairman. Pardon me.

Let me begin by adding my words of welcome to our distinguished panelists—some are welcomed back, actually, being no stranger to this full committee. We deeply appreciate your contributions, that we are looking forward to hearing you make today.

Also, Mr. Chairman, I want to add my words of greeting and deepest hellos again to our Pakistani counterparts. It was a pleasure, as you and I shared amongst other Members yesterday to have some lunch with these real champions of democracy. And it is inspirational for—at least for me; I will speak on my own behalf—to have the chance to see the struggles and the courage and the fight for a nation that these good folks represent. And we are honored by their presence.

Mr. Chairman, I would ask that my statement be entered in its entirety in the record; and I would note, as always, you——

The CHAIRMAN. Without objection.

Mr. MCHUGH [continuing]. You covered much of the waterfront with respect to the comments I wanted to make. But let me just say that I certainly join you in your assessment of the seriousness of this topic today as a national security concern.

You mentioned. As I was prepared to, the DNI, Director Blair's comments with respect to the importance of this challenge to our near-term security. And clearly, again as you noted, Mr. Chairman, we read the newspaper, we listen to the news, the data tells us—whether through unemployment insurance or unemployment rates and the fall of the stock market and other indexes—the very outward and discernible aspects of this challenge.

But I would suggest the national security implications of this issue were far less overt, and like you, I am looking forward to hearing our witnesses develop further DNI Blair's comments. And perhaps they could discuss with us today other ways in which the economic crisis will impact upon our security.

History has proven to us, it seems to me, time and time again that instability often follows financial crisis. The intelligence community rightly raises concerns over the security of our friends, our allies. And the crisis also invites opportunism by rogue states and terrorist organizations, as you noted, Mr. Chairman.

So the question I would also like our witnesses to address today is, what do we do with this intelligence. In other words, what steps, if any, I suppose, should the Department take to deal with the risks of this crisis?

My first concern, as it is so often, Mr. Chairman, is defense spending. Though the top line defense numbers for Fiscal Year 2010 show a four percent increase in spending, by moving war costs out of the supplemental and into the base budget, the reported growth is much less than that. And I would note, as an aside, I support the end of supplementals and the masking effects that they have on defense budgets. But we have to be, I think, very clear and sober with respect to the mathematical effects of that effort. And that is why I suspect, in part, Secretary of Defense Robert Gates greeted the budget's release by saying he would have to make, as he called them, "tough choices."

The story is even bleaker in future years when the real cost of our baseline defense requirements will no longer—appropriately, but no longer—be masked by supplemental appropriations. Let's

just take the growth of the military as one example. Supplemental funding bought the Army and Marine Corps over 50,000 active duty personnel from 2001 through 2008. The price tag for that growth was roughly $6.8 billion in additional basic defense costs. Future defense budgets will have to absorb these costs, and that is why I am concerned what impact flat-lining defense spending will have on national security policy in the midst of this global financial uncertainty.

Missile defense policy offers yet another good example. Many are calling for deep cuts in these programs, and while I may understand their perspective, I would argue that strategic deterrence may be exactly what will be required to bolster our allies and friends at this time. A weakened global economy is unlikely to lead competitors and adversaries to increase their strategic capability as some may hope. In fact, I think it can be argued that the opposite may be more plausible.

Faced with fiscal constraints, will Iran double down on its ballistic missile program? The question, it seems to me, merits our most careful consideration.

In contrast to the 1990s, today we more fully understand where our security challenges reside: The wars in Iraq; Afghanistan; the fight against al Qaeda; Iranian and North Korean nuclear weapons programs; the return of a more aggressive Russia; the rise of China—all require not just words but resources as well. Diplomacy, soft power, to be sure, is a necessary condition, but that effort will ring hollow, in my judgment, absent a strong commitment on defense. And it seems to me this will be particularly true during the current economic crisis.

Mr. Chairman, with that and the rest of my statement entered into the record, I would once again welcome our witnesses and say how anxious and happy I am to hear their comments. And I would yield back to you for the rest of the hearing.

The CHAIRMAN. I thank the gentleman.

[The prepared statement of Mr. McHugh can be found in the Appendix on page 45.]

The CHAIRMAN. Let's begin. Once again, Dr. Haass, please.

STATEMENT OF RICHARD N. HAASS, PRESIDENT, COUNCIL ON FOREIGN RELATIONS

Dr. HAASS. Thank you, Mr. Chairman, for the opportunity to testify before this committee. And let me applaud you and your colleagues on holding these hearings.

Let me say at the outset, the economic crisis was not inevitable. It was just a result of flawed policies and poor decisions and questionable behavior. The problem lies with the practice of capitalism, not the model.

But, nevertheless, I believe we need to face the reality that the perception in many places is otherwise. And that one consequence of the economic crisis is that market economies have lost much of their luster, and the United States has lost much of its credibility in this realm. And this only adds to the importance that the U.S. economy get back on track, lest the lasting casualty of the crisis be the perception of modern capitalism itself.

The impact of this crisis will be varied and profound. Let me begin with the developed world. Many governments, including several in Central and Eastern Europe outside the Eurozone, will require substantial loans. The economies of Japan, much of Europe, the United States and Brazil are all contracting. World economic growth will be anemic, if it manages to be positive, which is increasingly unlikely. There will be fewer resources available for defense and foreign assistance. That is obviously the purview of this committee, but I would think the pressure on defense resources will make it even more critical that our priorities are determined and are clear.

Developing states around the world may appear to be better off as their growth, on average, is down by roughly half from previous years and it is still positive. But this growth is measured from a low base, and the reduction in the growth in the developing world has, in many cases, been dramatic. Their exports are down as demand is down. In the developed world, aid flows are reduced and investment flows are much reduced. Let me single out a couple of countries. One is China. Absent renewed robust economic growth, the chances are high that the government will react to, among other things, the high unemployment by clamping down somewhat more on the population, lest economic frustration lead to meaningful political unrest.

Secondly, I would single out Russia. Russia is quite characteristic of countries that are dependent on raw material exports for much of their wealth. The economy there is contracting sharply after a boom; and again, I believe we can expect a greater assertion of political control domestically, and I would not rule out the possibility that Russia's leaders will look to overseas crises to divert attention.

Iran and Venezuela are two other countries that are heavily reliant on energy exports. Obviously, their foreign policies have been counterproductive from our perspective. The good news here that it is possible that one or both of these countries will pull in their horns at least for a while.

Iraq, yet another energy-producing country, here the effects of the crisis are going to be undesirable. There is a real danger that disorder in Iraq will increase as unemployment there goes up, as prospects for sharing revenues goes down, and as the ability of the central government to dispense cash also goes down.

We have, as you noted, visitors from Pakistan. And I would simply say that Pakistan's economic performance is down for many reasons, but one is the reduction in foreign investment and the reduction in Pakistan's exports. The problem is that Pakistan has little margin for error. The possibility that it could fail with all that that would mean for terrorism, for the future of Afghanistan, and for nuclear stability is all too real.

Also North Korea is another nuclear arms state whose stability is worsened by the economic crisis; and I think there are real questions about the ability of South Korea, in particular, to intervene economically on a scale that will be required to potentially stave off collapse.

Another serious issue of the global economic crisis affects every country, which is protectionism. Some 17 of the 20 governments set to meet in London in early April have already increased barriers

to trade. Negotiated free-trade agreements, as you know, with Colombia, Panama, and South Korea continue to languish in the Congress. The President lacks trade promotion authority essential to the negotiation of complex multilateral trade accords. Prospects for a Doha global trade pact appear remote. The volume of world trade is down for the first time in decades.

I would simply say the costs of this are high—the economic cost, but also the strategic cost, the subject of today's hearing. Trade is a major source of political as well as economic integration. I would suggest that one reason China acts as responsibly as it does in the political realm is because of its need to export; and it would—without this economic integration—it would have less incentive, I believe, to act responsibly.

Trade is also a principal engine of economic growth. A Doha Round alone might generate something on the order of $500 billion in economic output to the world, one quarter of which would be in the United States. To use the language of the day, trade may be the purest form of noninflationary stimulus available to the United States or any other government. Exports are a source of millions of relatively high-paying jobs. Imports can be anti-inflationary and can spur innovation.

What then should be done to limit the adverse strategic effects of the economic crisis? Let me quickly suggest five things the United States should do or consider doing.

First, I would suggest that the United States should do all in its power to resist the growth in protectionism. This means resisting buy American provisions in stimulus legislation. On balance, more American jobs are likely to be sacrificed than preserved.

I also believe we should resist "lend national" provisions that are springing up around the world, and instead, we ought to look for ways to bring countries into an expanded world trading system, in particular, bring them into the World Trade Organization (WTO).

Secondly, we cannot allow recession to become this country's energy policy. We must continue to look for ways to decrease U.S. consumption of oil, imported or otherwise, despite the temporarily lower prices.

Thirdly, the United States should work with other developed countries and reserve-rich countries to increase the capacity of the International Monetary Fund (IMF) to assist governments in need of temporary loans. We cannot afford to have a rash of essentially failed governments around the world.

Fourth, the aid budget should be protected to the extent possible. It is needed on a large scale not just for humanitarian reasons and not simply to build human capital, but also to substitute for trade, to substitute for investment flows. Again, absent aid, we are likely to see a larger number of failing or failed states which will give, among other things, terrorist groups, drug cartels, and the like greater room for operation.

Fifth, the upcoming Group of 20 (G–20) summit in London is an important opportunity to address some of the issues I mentioned. Europe and Japan, in particular, should be pushed to take steps to stimulate their economies, but guidelines also need to be adopted so that stimulus programs do not become mechanisms for unwar-

ranted subsidies and "buy national" provisions that are simply protectionism by another name.

The London summit is also an opportunity to increase IMF capacity to make loans, to generate commitments to making aid available to developing countries, and to agree on at least some regulatory principles for national banking and financial systems.

That said, I don't think we ought to get too ambitious. We are not going to have the opportunity in London to remake the architecture of the international economy, to solve the problems of countries that run chronic balance-of-payments surpluses, or to revamp the system of exchange rates.

Let me close, Mr. Chairman, with one final thought. Much of this hearing is focused on the question of the consequences of the economic crisis for global security. But developments in the political world can and will have an effect on the global economy. In short, things can go in the other direction as well.

Just imagine for a second the economic consequences of, say, a Taiwan crisis; or fighting between India and Pakistan; or an armed confrontation between the United States and/or Israel and Iran over Iran's nuclear ambitions. And I would single out this last one. This last possibility of an Iran crisis is the most worrying geopolitical possibility, I would think, in the near term. And it underscores the importance of trying to negotiate limits on Iran's enrichment program lest the United States and the world be confronted with the unsavory option of either living with an Iranian near or actual nuclear weapons capability or mounting a preventive military strike that, whatever it accomplishes, would be sure to trigger a wider crisis that would lead to energy prices several times their current level.

In short, again, it is right that you are addressing the economic crisis. But it is also important, I think, at the same time to think about developments in the traditional national security realm, either in their own right or, again, how they can affect the trajectory of our efforts to get out of this economic crisis and restore economic growth.

Thank you. And I look forward to your questions and to hearing the testimony of my extraordinarily able colleagues.

The CHAIRMAN. Dr. Haass, thank you.

[The prepared statement of Dr. Haass can be found in the Appendix on page 47.]

The CHAIRMAN. Now we turn to Dr. Cooper. Thank you so much for being with us, Doctor.

STATEMENT OF RICHARD N. COOPER, PROFESSOR OF INTERNATIONAL ECONOMICS, HARVARD UNIVERSITY, AND FORMER CHAIRMAN, NATIONAL INTELLIGENCE COUNCIL AND THE FEDERAL RESERVE BANK OF BOSTON

Dr. COOPER. Thank you, Mr. Chairman, for having me here.

I would like to start by noting that during the——

The CHAIRMAN. Doctor, you will have to speak very closely into that microphone. The acoustics in here are not very good on this end. So as close as you can get, we would appreciate it.

Dr. COOPER. I would just like to recall that the period 2002 to 2007 was an extraordinary period for the world economy, arguably

the best half-decade in history. Growth was high and widespread, inflation was low in most countries, and this exceptional performance before the recent crisis may have created unsustainable expectations about the future, particularly in young adults who do not recall earlier, less buoyant periods of economic activity.

Now, the impact of the current global recession on U.S. national security—I interpret it broadly—is extremely complex. There are pluses and minuses. Let me start with a few of the pluses.

It will be easier to recruit and retain desired persons for the U.S. armed services at unemployment rates of 8 to 10 percent than at unemployment rates of 4 to 5 percent, with lower signing bonuses.

Second, one year ago, a major source of anxiety in many countries around the world was the rapid rise and continuing rise of food prices and of oil prices insofar as it affects ordinary urban dwellers. With the slowdown in the world economy, food prices are now way down, not compared with six years ago, but compared with one, two, and three years ago; and this is a source of major relief to many countries in the world who will benefit. The World Bank estimates that over half of developing countries will benefit from the lower food prices.

Third, the oil revenues of all oil exporting countries, again, while higher than they were a decade ago, have declined sharply from the elevated levels of 2007 and early 2008. And this includes, in particular, the revenues of Russia, Iran, and Venezuela, each of which in different ways has posed problems for the United States. All three countries have become fiscally undisciplined, and all will have to cut their expenditures sharply in view of their declines in revenue unless they are willing to countenance a sharp increase in domestic inflation, which would increase domestic disaffection with their respective governments.

The decline in oil prices is directly linked to the slowdown of world economic activity. So in this respect, the slowdown can be said to benefit U.S. national security. Concretely, Iran will have to balance more carefully its financial and material support for outfits like Hezbollah against pressing requirements for domestic expenditure. So there are some pluses, but there are also some serious negatives.

The recession implies a decline in demand and particularly a demand for labor-intensive products made in many developing countries. World trade is likely to fall for the first time in a quarter century this year and more deeply than it fell since the 1930s. And this contrasts with an annual growth in trade volume in excess of seven percent over the last several years.

Thus, a major source of new jobs, pulling people from the countryside into urban areas in many countries will disappear and perhaps go into reverse. There will be disappointed migrants and millions of workers laid off.

For example, it is said that in China already 20 million migrants have lost their jobs. These are internal migrants mainly in low-skilled manufacturing and in construction, both of which have declined sharply. And, in addition, several million newly graduated students will have difficulty finding jobs in the current economic environment.

The Chinese authorities are greatly concerned about the eruption of social unrest and have already taken a number of steps to head it off, for example, by providing loans for self-employment by new college students and by improving life in the rural areas.

It is worth noting that in the oil exporting countries of the Persian Gulf, the impact of the decline in new jobs will fall mainly on foreigners, rather than on residents, since most of the work in the private sector in those countries and much of it in the public sector is performed by temporary migrants from other countries.

Now the recruiting ground for terrorists and for criminal gangs is typically among idled, disaffected, alienated young men. They are not typically from among the poorest people of the world, but from people that, by world standards, would be considered "lower middle class," if one can use that categorization. The recession will increase the numbers of such people, but probably not massively unless the recession becomes much worse than is now generally expected.

Some countries are more vulnerable than others. Pakistan has already been mentioned. Large numbers of Pakistanis work in the Gulf Area. Some may lose their jobs, returning to Pakistan and depriving that country of their extensive remittances.

The most important effect of the financial crisis and the subsequent recession may be the least tangible: a serious, worldwide erosion of confidence in American competence, a confidence that was previously carried, almost a sense of invincibility. The rest of the world typically placed more confidence in American competence than Americans deserved, as most Americans knew better. But the events of the last six years have brought American competence under severe doubt, starting with the post-combat phase of the war in Iraq, which the United States is generally, around the world, viewed as having bungled.

This, was reinforced by the perceived debacle over the handling of Hurricane Katrina; and now the subprime mortgage crisis at the heart of the seemingly invincible American financial system has led to a wider financial crisis and, now, a global recession, and that further undermines confidence in American competence. This crisis clearly started in the United States, not in some emerging market or, as in 1992, in Europe.

This loss of a perception of invincibility may embolden existing hostile groups to try, through some dramatic act, to bring the system of American capitalism, now vulnerable, crashing down for good. And I think that is probably the most serious immediate threat to come out of the current financial crisis.

Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

[The prepared statement of Dr. Cooper can be found in the Appendix on page 51.]

The CHAIRMAN. Now our old friend, Dr. Dov Zakheim.

Dr. Zakheim.

STATEMENT OF DOV S. ZAKHEIM, FORMER UNDER SECRETARY OF DEFENSE (COMPTROLLER)

Dr. ZAKHEIM. Chairman, I hope I am not that old. But thank you. And thank you, Mr. McHugh. It is so good to be back in front

of this committee and actually appear with such distinguished colleagues.

The CHAIRMAN. Excuse me, the witness is going to have to really just talk right into it.

Dr. ZAKHEIM. Can you hear me better now, sir?

The CHAIRMAN. That is a lot better. Thank you.

Dr. ZAKHEIM. All right. I will start the clock over. It is a pleasure to be here.

Thank you, Mr. Chairman, and thank you for your kind words.

And, Mr. McHugh, it is good to be back again before the committee, especially with such a distinguished panel of experts.

Like you, I am deeply concerned that the financial and economic crisis that has affected our country in particular and the international community generally poses a major threat to American national security interests. That threat is likely to manifest itself in a number of distinct ways.

First, it is going to create major pressures, already has, on the defense budget, most notably the acquisition—that is procurement in Research and Development (R&D) accounts;

Second, it is likely to result in a further contraction of defense spending and, therefore, operations, as well, and modernization, on the part of key allies and friends;

Third, it could prompt nations that are ambivalent about their relationship with America, most notably China and Russia, to act in a way that is deleterious to our own American interests;

Fourth, it could prompt even more hostile behavior on the part of nations such as Iran that already don't really like us at all; and

Fifth, it could further destabilize states that are already vulnerable to internal unrest.

Finally, it could spur further international criminal behavior that could undermine internal American stability. I have addressed each of my—each of these concerns—in my written testimony, which I request be inserted in the record.

For now, I want to concentrate on the impact of the economic crisis on the defense budget and, as time permits, to add a few remarks about the implications of the crisis for other states.

The defense budget is already under pressure as a result of this crisis. Real growth in defense spending, if the supplemental is included, is about 1.4 percent because next year's supplemental is lower than the plan total of supplemental expenditures in fiscal year 2009. These figures represent a sharp drop in the growth of annual defense spending over the past eight years, which averaged 4.3 percent in real terms.

The lower rate of defense budget growth will manifest itself most sharply in the acquisition accounts—procurement and R&D. It has been by means of spending funds from these accounts that America has been able to assure itself of long-term military superiority regardless of the capabilities of a potential foe. When these accounts were assaulted, as they were in the late 1970s, not only did our leading adversary, the Soviet Union, become far more reckless, invading Afghanistan; but others, like Iran, also exploited what they perceived to be American weakness and introversion. If we go through another such reduction, can we say with confidence that in one or two decades' time no powerful adversary will act upon the

perception of American weakness and threaten one of our vital interests?

It is a truism that since World War II virtually every war we have fought was unforeseen. It is equally true that we have consistently structured our future force posture on the basis of a war that we had recently fought or were still fighting.

I worry that we are falling into the same trap now. The result could well be, as in Korea or Iraq, many years of bloodshed and lost treasure until we righted ourselves; or as in Vietnam, outright failure. The opportunity cost of reductions in planned acquisition budgets are, therefore, exceedingly high and, if not reversed, will far outweigh any supposed short-term benefits from budget savings.

Cuts in procurement, in particular, will have more immediate repercussions as well. They are going to result in the loss of jobs, in particular for skilled blue collar workers, engineers, and physicists—the very people who earn far less than $250,000 a year, and at whom the Administration is targeting its recovery plan.

Moreover, it is most likely that as jobs dry up, firms will apply the traditional "last in, first out" principle; in other words, those who have benefited from the most up-to-date education and training will be lost to the nation's vital defense industrial base. And it is ironic that even as our young engineers will find themselves unable to contribute to our national security, the United States will continue to train foreign students, such as those from China, in the engineering and hard sciences, enabling them to go back to their countries and help their countries modernize their military.

Members of the committee might also consider that the impact of a flattening of acquisition spending will be unevenly distributed around this country. Those states with major defense industrial activities, including hard-hit areas in Michigan, the Northeast and the South will suffer more than other parts of the country. This couldn't be what the Administration intends as it pours hundreds of billions of dollars into job creation programs.

Finally, because the Administration is ratcheting up the national debt so severely, once the economic turnaround does occur and there is a growing demand for dollars and a resulting rise in interest rates on government paper, the cost of servicing that debt will rise dramatically. Budget deficits will increase sharply as a result, and the government will be forced to cut back on discretionary programs.

Well defense accounts for more than half of the entire U.S. discretionary budget and has been increasing its percentage of discretionary spending in the past eight years. It is going to be the most likely target for real cuts, which is not merely a flattening of the growth rate in order to manage the ballooning deficit, but actual cuts. The impact on our national security spending will be profound and negative.

In her testimony before the House Budget Committee on January 27th, Alice Rivlin, my former boss when I was at the Congressional Budget Office (CBO), underlined the difference between a short-term stimulus and what she called—and I am quoting here—"a more permanent shift of resources into public investment and future growth." She also said, again a quote, "The first priority is an

anti-recession package that can be both enacted and spent quickly to create and preserve jobs in the near-term and not add significantly to long-run deficits."

The defense budget offers several ways to meet her prescription. Vast spending, job-creating programs include: reducing deferred maintenance; accelerating ship overhauls and aircraft and ground vehicle rework; advanced procurement of subsystems to make units like warships—such procurement would preserve the second and third tier industrial base, which is most vulnerable in the current downturn—and finally; expanding and accelerating military construction (MILCON) and family housing programs. Of these three elements, only the third is part of the $787 billion stimulus package.

There is considerable merit in the $7.4 billion for military construction and operations and maintenance (O&M) in military facilities for family housing, military hospitals, and the homeowner assistance program.

But the stimulus should and could go further. Additional plans to support both rework and overhauls, as well as advanced procurement, will create and sustain critical jobs in hard-hit areas.

I don't want to overrun my time.

You have heard from my colleagues some of the difficulties that apply to the allies who, for many years, have not spent as much as they could and now are not in a position to spend as much as even they would like. From countries that we clearly have ambivalent relationships with—Russia, by the way, has just announced, its deputy defense minister announced, that regardless of the economic crisis, they are going to modernize their strategic nuclear program and their anti-satellite program.

Historically, we have seen you can have a basket-case economy and still be a military threat. North Korea is an example. And, by the way, when we talk about adversaries like North Korea, remember that it doesn't really cost Iran that much to support Hezbollah or to support Hamas, and for that matter, its economy has been unbalanced since 1979 and it still has developed a nuclear program.

So the restrictions that are imposed on us, given our goal, are not the same as the constraints on potential adversaries—and real adversaries—because their objectives are different and because their approach is far more asymmetrical.

Let me finally say a word about unstable states or—Dr. Richard Haass mentioned some of that. Remember also, Mexico may be in that category, as well, and we need to worry very much about what goes on there. Again, our contingencies have rarely been foreseen, and there are a lot of unstable countries in this world about which we have to worry.

So let me conclude by saying, the national security implications of this crisis are both broad and profound. They will affect our alliance relationships, our interactions with major states whose intentions towards us remain unclear. They will affect the behavior of unfriendly states and the stability of weak and failing states. Most importantly, the economic crisis could have a major and deleterious impact on our national defense budgets and, therefore, our national

security posture, which would complicate and, in fact, exacerbate relationships we have worldwide.

Nevertheless, the ultimate impact of the crisis on our national security posture remains in our own hands. We can forge ahead with defense modernization, we can protect the jobs of our young engineers and skilled blue collar workers, we can continue to signal our determination to fight for our values and freedom.

The budget is policy and the policy choice is ours. Thank you.

The CHAIRMAN. Thank you, Dr. Zakheim.

[The prepared statement of Dr. Zakheim can be found in the Appendix on page 55.]

The CHAIRMAN. Mr. Rothkopf, please.

STATEMENT OF DAVID ROTHKOPF, VISITING SCHOLAR, CARNEGIE ENDOWMENT FOR INTERNATIONAL PEACE

Mr. ROTHKOPF. Thank you, Mr. Chairman, Mr. McHugh.

The CHAIRMAN. Again, get very, very close. And turn it on.

Mr. ROTHKOPF. I will do both those things.

Thank you, Mr. Chairman, Mr. McHugh and members of the committee, for inviting me here today.

It is worth looking, as we consider this issue, as we do with many issues nowadays, back to September 11, 2001, and remember that the reason that we were attacked on Wall Street was that terrorist enemies considered that to be a symbol of our national strength. Naturally, we followed after the terrorists and we took our eye off of the source of that natural strength in this country.

The damage has not just been done to our markets or our 401(k)s, but to our national security for many of the reasons that we have outlined here today. We have been weakened, we have been distracted, and at the same time, a host of new problems have been created as a result of the damage done here.

I would argue that there are two kinds of core challenges that we face from a national security perspective. The first of these is what I might characterize as a great hollowing out of the forces upon which we depend to stabilize. In other words, we have heard about the forces that are likely to have us spending less money on defense in the United States. Related to those are forces that will distract us from attending to issues associated with security. But our allies are going through the same thing.

At the same time, there has been enormous crisis of confidence with regard to the international institutions which have been such a stabilizing force. Whether those institutions are the European Union (EU), the International Monetary Fund (IMF), the World Bank, the United Nations (UN) system, all of those institutions are now being weakened for economic reasons and being doubted because of this sweeping crisis of confidence in our institutions.

At the same time, there is a rise of new threats, threats that are associated with this crisis and come in a variety of flavors. Let me very briefly outline some of those and then come to a set of priorities and recommendations.

The first set of threats that we are going to face are what might be characterized as the destabilizing internal effects of the crisis in countries around the world. This is, countries have rising unemployment, and the International Labor Organization (ILO) esti-

mates that in 2009 unemployment as a result of this crisis worldwide may hit 50 million or may exceed that.

This causes unrest. Dwindling budgets reduce the ability of governments to deal with that unrest and then you have a kind of domino effect as viable states become weak states, and weak states become failed states; and we know what the creation of failed states leads to both in terms of the creation of new threats and in the creation of regions to harbor threatening nonstate actors like terrorists.

Another set of issues are associated with destabilizing bilateral or regional effects of the crisis. One—which Dr. Zakheim touched upon a minute ago—which is a serious one for us, is, if Mexico loses control of a number of states to narco cartels, as it seems to be doing, and that creates further unrest in the country, we have an immigration crisis in the United States. This holds true elsewhere in the world as well.

Also, historically, opportunistic politicians have sought to lash out at favored enemies across borders to distract from domestic issues. We have seen that in Russia, whether it is in the context of Georgia or in the context of the recent baiting of Ukraine, which could grow much more dangerous.

And then there are, as I mentioned earlier, the destabilizing global effects of the crisis. Richard Haass made this point well, first, and it was repeated several times. Protectionism is corrosive and undercuts the kind of international relationships upon which we have historically depended and, I might add, the kind of interrelationships upon which we need to depend going forward simply because our resources are going to be limited. We are going to need to find ways to improve burden sharing if we have less capability internally.

In terms of individual cases, in terms of the destabilizing group, or countries about which we should be specifically concerned, some have been mentioned here. Pakistan, Ukraine, Turkey, Egypt, Iran, Russia, Venezuela, Argentina, Indonesia, the Philippines, China, and North Korea are all countries where internal forces associated with this crisis could produce either a backlash internally, political crisis internally, or crises that spill across borders.

In the issues between nations, I mentioned Russia; and in the interest of time I will skip forward, and we can come back to that or you can review it in the remarks that are in the record.

On the risks on a global scale, I would say that we are at a moment where virtually every international institution we have either is facing renovation or requiring reinvention. The IMF, the World Bank, the WTO, the nuclear nonproliferation regime, we are going to have to create a new institution with regard to global climate issues; and the United Nations (UN) also comes into question. This could be a moment for reimagining the international system, and I agree with Richard, it is not all going to be fixed on April 2nd. But over the course of the next several years, one of the legacies of this Congress and this Administration could be to reinvent that system.

At the same time, there is a very real threat that concerns about budgets, an inward turn on the part of political leaders, and tensions across borders as a result of these things could lead to further

weakening of those institutions, which will take away the ability that we might have to share burdens and to resolve problems before they become crises. This is a legitimate threat.

Now, very quickly, let me go to a prioritization of how you might see these threats and the response to them because clearly one of the big issues that you face as a committee and that the government faces is a series of asset allocation decisions because we have limited assets.

The number one issue here, if we are going to address the national security issues caused by this crisis, is to address the economic and political constraints placed on the United States of America, to address our economic crisis here and also to maintain a forward-looking and -leaning political stance internationally.

Another of the threats—the remaining set of threats that I think need to be prioritized would include the economic and political constraints placed on the European Union (EU), China, and other potentially stabilizing actors; the crisis of confidence in institutions worldwide and the threats to the international system; the exacerbation of critical threats associated with proliferation of weapons of mass destruction—failed states become conduits for networks of nonstate actors; this can make that problem a lot more difficult to deal with—the consequences of protracted crisis for the world's weakest states and the threats to weaken weakened states directly, impacting U.S. national interests—of which Mexico, I think, is a good example. Haiti is another example in this neighborhood.

As a consequence of this system—or this series of challenges that we face, we might want to prioritize our recommendations for response as follows:

We need to be strategic about marshaling and maintaining U.S. resources. This includes fiscal restraint and restoring thought to fiscal restraint. Being indebted to overseas nations weakens us; we lose leverage internationally. We are going in the wrong direction on that.

We also need to rethink defense budgeting. Dr. Zakheim has talked about this, and I will not.

Maximizing the means of leveraging U.S. power, which means maintaining critical institutions and alliances is going to be key, given the restraints on us.

Leading a coordinated proactive global effort to reduce or eliminate or contain threats, beginning with economic threats, is going to be another priority.

Maintaining a credible deterrent against bad actors. We are going to be tested. We are already being tested. You have this incident with the U.S. ship off the coast of China. You have had statements by Iran about their nuclear program. You have had statements by the Russian Government that are somewhat provocative. This continues around the world.

If we seem to be back on our heels, if we seem to be reluctant to engage, if people perceive weakness as a consequence of this crisis, they will take advantage of that weakness.

We need to recognize the likelihood of crises emerging beyond the Iraq and Afghanistan and Pakistan conflicts. That is where our focus is now, but as has been indicated here, whether it is in Mexico or whether it is in the Ukraine or whether it is the central part

of Africa in battles over vital resources, we are going to have serious problems in other regions to which we have not devoted attention, planning, or sufficient resources.

Finally, we need to fight the temptation to turn inward, and we need to remain focused on issues abroad. That is hard to do, and there are mixed signals right now about how the United States is going to deal with those impulses to turn inward and balance them with the requirement that we stay focused on a world that has grown considerably more dangerous as a consequence of this crisis, which is nowhere near ending.

There are very likely to be another set of downturns later this year, whether it is related to the consumer credit crisis in the United States or the collapse of a number of emerging economies around the world, that will destabilize markets further.

I know that the stock market going up 378 points yesterday left everybody here a little cheerier, but I wouldn't read too much into that. The stock market is not linked to events in the real world, as we have learned over the course of the past several years.

So I am happy to answer your questions and get into any of the issues over which I have skimmed. Thank you very much.

Mr. ORTIZ. [presiding.] Thank you so much.

[The prepared statement of Mr. Rothkopf can be found in the Appendix on page 67.]

Mr. ORTIZ. This has been an eye opener to many of us. This has been very, very interesting testimony; and it just goes to prove that the world is in a hell of a shape right now, economically.

But, you know, maybe from each of you could answer this question. Do you believe the crisis will increase or reduce security threats to the United States in the short term? And what about when we look at the long-term aspects of it, maybe you can touch a little bit on that.

Anybody that wants to go first, no problem.

Dr. HAASS. It was that famous strategist, Yogi Berra, who said that predictions are always difficult, particularly about the future.

This is no exception, but I would suggest, on balance, there is more downside than upside here. Yes, there are some pockets of upside: the fact that the Iranians and the Venezuelans are paying a price, given their budgeting and their expectations of high oil prices and so forth.

So, yes, there are pockets of upside: the fact that certain poor countries which are dependent upon imports of fuel and food and other commodities, their import bills are reduced—yes, another upside.

But, on balance, this will hurt us and others more than it will help us.

It will increase the number of challenges in several ways. One is, just objectively, it is going to create a larger number of weaker and potentially failing and failed states. And as has been pointed out, those are the potential places where terrorists, criminals, those involved in the drug trade tend to congregate. In a global world, what happens anywhere does not stay there. So we can expect greater problems, if you will, a messier—a messier world.

Second of all, we ourselves are likely to have fewer resources to bring to bear. And by "we," I mean not just the United States, but

the developed world. We are going to be concerned with our own situations; but investment flows will go down; there will be pressure on the resources available for foreign assistance programs; there will be pressures on the resources available for defense programs.

So if you add up a situation where challenges are likely to increase and available resources are likely to be pressured, again it reinforces, to me, the likely future of a somewhat more disorderly world, overall.

Dr. ZAKHEIM. I am inclined to agree. Problems are going to be very much of a kind that are not really the sorts we are used to. This always tends to be the problem in the end.

Let me give you an example of what I mean. The last couple of years, China has been buying up American firms—spent over $6 billion in 2008 doing that. Now the Chinese have moved their holdings of U.S. Treasuries from longer-term to shorter-term. It gives them a lot of flexibility. It allows them to hedge.

They are not going to bring the economy crashing down. There is a much better way to do it: Keep buying up companies.

What does that mean when you have a country that is ambivalent about us and that just announced it—at its Party Congress—that it absolutely rejects moving to the kind of system we have. It thinks our system is a failing system.

Buying up our companies, it is that sort of problem that we have not fully thought through.

We have heard about a bunch of failing states. And nine times out of ten, it is the one state that we didn't think about that we wind up sending our troops into. How many people thought about Somalia? How many people thought about Afghanistan, for that matter?

So if we are not prepared and we are restraining our own defense capabilities; and other countries will have new and different strategies to cope with their problems, as we will with ours—I suspect Western Europe will see coping with their problems as cutting back even more on defense.

And how many of our major allies—I am not talking about the minor ones—but how many of the major ones spend three percent of their Gross Domestic Product (GDP) on defense? Not very many at all. How many do you expect to spend as much as they are spending now in the next 10 years? I wouldn't bet on it. That puts a greater burden on us at the very time that we are going to have to contract our capabilities somehow.

So the ramifications—the second-, the third-, the fourth-order ramifications are such that we can't really predict except to say, it doesn't look good.

I agree with Richard Haass.

Mr. ROTHKOPF. I think Richard has said that it is dangerous to predict and that it doesn't look good, and Dov has said it doesn't look good and it is dangerous to predict; and from that I am going to derive a prediction, which is that it doesn't look good.

You know, things are going to get worse before they get better. And we have only seen the economic tsunami emerge. It is going to hit political villages. And, you know, it takes a lot of different ways—with deference to the delegation here from Pakistan, you

know, there is a saying in Pakistan that no government in Pakistan has ever survived an IMF bailout.

You know, sometimes the solutions that we bring to countries create political tensions that themselves create problems.

So over the short term, we are going to have to deal with the fact that governments in Eastern Europe and Central Europe are insolvent; that the Government of Mexico is losing control over key states within that country; that Africa which, you know, was desperately poor and fighting for its survival before, is going to get worse, and this is going to happen even as we identify resources within that continent that are important to us and are important to the Chinese. And it is going to be linked, and other growing economies, and it is going to be linked to resource conflict.

And I think that we also ought to consider, because your question addressed the longer-term consequences of this, that one of the great sources of American strength for as long as any of us can remember was the easy availability of capital on Wall Street—our ability, when we had an idea, to turn it into an action. If the changes on Wall Street, which are structural—they will be regulatory, but they will also be attitudinal and cultural—produce a contraction there and less of a willingness to lend for a protracted period of time, that is going to weaken us in a fairly substantial way.

At the same time, when we come out on the other side of this, it is quite likely that emerging economies will recover faster than we do. Because of this crisis, less money is going right now into oil production, which was a bottleneck before. So what happens when demand goes up? The price of oil goes right back up on the other side of this crisis, and oil-producing nations start building up big reserves of cash that they can use to buy political influence around the world.

And so there may be a shift in sort of geoeconomic power that has got longer-term consequences to this and that we need to be very aware of because that kind of economic power is the foundation of our national strength.

Dr. COOPER. I also agree with Richard Haass's able summary. It is hard to believe that with 50 million more unemployed people in the world than last year that is good for U.S. security.

I would suggest, however, that the main threats to U.S. security will come via greater instability in other countries, rather than through willful actions by the governments of other countries. I think that is the main thing that we have to be concerned about.

I do want to put a nuance on what Dov Zakheim said about China, at least the report that I read did not say that the Chinese rejected the American system. It said that the Chinese rejected the American systems of contested elections and democracy. The fact that they are investing in our companies is, in a sense, a vote of confidence in our system. And I have to say this is the wrong—I don't have to tell this group—anyone who looks at campaign financing in this country has got to think that there is something not quite right with the American electoral system.

Zhu Rongji, no longer an official of China, was very clear that he thought the financing of contested elections was at the core of difficulty of the American political system. But that is a much nar-

rower statement than rejecting the American system. The Chinese do not reject the American system. In fact, they have been shaken by the financial crisis. But the fact that they invest so much in the United States is a vote of confidence.

Mr. ORTIZ. Mr. Chairman, if I could just have a follow-up question.

The CHAIRMAN. The gentleman is recognized for a follow-up.

Mr. ORTIZ. You mentioned and this is a trend that we are beginning to see, foreign countries coming in, buying companies, doing joint ventures, what can we do to be prepared in the long term. I mean, what are the security problems that we might have, if any? Maybe you all can touch a little bit on that?

Dr. COOPER. My general stance is one that is supportive of foreigners buying American companies. By the way it is completely reciprocal; Americans buy a lot of foreign companies. One the trends in the last quarter century has been tremendous amount of cross border investment, both ways, Mexicans in the United States, American firms in Mexico, et cetera, et cetera, et cetera. And I don't exclude the Chinese in this process.

We do have legitimate concerns, I think, about two dimensions, one is militarily sensitive technology. And we have a process which is designed to screen out foreign investments that might represent a source of leakage of that technology. And as far as I can tell, the process works reasonably well.

The other concern I think is that foreign governments where they own firms at least have the possibility of engaging in non-commercial activity, leave aside the military as a separate area, in non-commercial activity. We actually have not seen anything of that, but it is a potential that I think we have to keep our eye on because it is a possibility. This of course goes particularly to state-owned firms of which there are many in China, but I will remind you there are many state-owned firms still in Europe also. So I think we have to have our antennae out and from time to time make noises about the illegitimacy of using commercial channels for political objectives. Of course, the main guilty party on that score is actually the United States worldwide. We use American firms to execute American foreign policy.

Dr. ZAKHEIM. I agree with Dick Cooper about foreign direct investment, and the key really is how you protect against it being exploited. By the way, China's investments haven't always been good. They invested in Bear Stearns, the one year anniversary of Bear Stearns' collapse. There are some holes in the CFIUS system which is what we are talking about, the Committee on Foreign Investment in the United States that we need to all think about. One is, how do you handle joint ventures? Second of all, you have got issues and I have only heard about this anecdotally, but it is something perhaps this committee might want to look at. If someone is affiliated with some criminal organization and the criminal organization has connections to a government, and we know that there are quite a few places like that. The impact on a company is stultifying. And after all is said and done, no chief executive officer (CEO) wants to have somebody who is a member of his board who is packing a pistol and they are terrified of this, and there are ways to get around CFIUS rules and still be able to get people into

companies like that. And by definition, criminals don't play fair. So there are some issues to really consider about this.

I agree by the way that China has invested in our economic system, and when I was speaking about our system, I meant our political system, not our economic system. But we do have to watch this carefully. And I think that there are some areas where right now hedge funds, by the way, were another one, but they are less of a problem right now. They could reemerge where the system we now have doesn't cover every eventuality.

Mr. ROTHKOPF. We also need to be careful here of the risks of that an overreaction to this can create. We have seen examples in the past few years, whether it was the China National Offshore Oil Corporation (CNOOC)/UNOCAL example, or the Dubai Ports example, where it became politically expedient to react against something which was not actually dangerous. And you know over the course of the past few months, we have seen the United States systematically abandon a whole set of the market principles which we have been preaching to the world for a number of decades. And the result has been that opportunistic politicians around the world have started to say, look, they threw it out the window, we don't have to play by these rules.

If we start being protectionists on this front, we will engender precisely the same kind of reaction overseas. It will limit the ability of our companies to grow, it will limit our ability to create jobs, it will limit our influence internationally.

Mr. ORTIZ. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. McHugh.

Mr. MCHUGH. Mr. Chairman, I don't know if I have said this in 17 years on this committee but I would commend all of the written testimony to my colleagues, it is a fascinating collection of very interesting and I think timely and, important thoughts. I thank all four of you gentleman for putting the time into compiling them.

Dr. Cooper, you said on the very last line of your written as well as your spoken testimony, "This loss of invincibility may embolden existing hostile groups to try through some dramatic act to bring the system of American capitalism now vulnerable crashing down for good."

That is a very profound and dramatic statement. And I didn't want the politicians of Washington, D.C. filling out your thoughts. Could you perhaps expand a bit on what type of hostile groups you may be thinking about and what kind of dramatic act you may have had in mind?

Dr. COOPER. Well, one need not speculate in this area, one can just think of history. 9/11 was a dramatic act designed to hit the heart of American capitalism. They also tried to hit the White House, but the heart was the towers in New York. And I can well imagine folks sitting in probably Pakistan now or Somalia thinking the system is much more fragile than I, for example, think it is, and one more dramatic act like that is enough to bring it crashing to its knees.

And I think our intelligence system needs to have its sensors doubly out to pick up any tendency of that. My own view is that while the financial system has proven itself to be much more fragile than most people thought a couple of years ago, the funda-

mental economic system is actually very robust and we are just going through a bad patch which we have been talking about. But that optimistic view of mine may not be shared universally around the world.

Mr. MCHUGH. So obviously, then, you see a potential link between this crisis and particularly the world's view of the United States role in this crisis and increased national security challenges?

Dr. COOPER. That is correct, yes.

Mr. MCHUGH. Which brings me over to Dr. Zakheim's testimony and he spoke of this, but it is also in his written testimony when he talked about the 1970s when the acquisition accounts, procurement and research and development accounts, of the armed services were somewhat put into suspension. And he makes the conclusion that as that happened, not only did our leading adversary the Soviet Union become far more reckless, invading Afghanistan, but others like Iran also exploited what they perceived to be American weakness and introversion.

The question I have extrapolating both from Dr. Cooper's statement and Dr. Zakheim's observation is that as I theorized in my opening comments there is at least a calculation we need to do as to the adventurism of others vis-à-vis our national security as we consider our defense accounts. Is that a fair statement?

Dr. ZAKHEIM. I certainly would agree, on the question of the impact of the acquisition in the 1970s, I was actually chatting with a friend of mine who reminded me that in the 1970s, after the Vietnam war there were an awful lot of engineers running around without jobs because they had been laid off in the cutbacks.

And one of the sort of statements that a lot of people made in those years was well, they can convert to the civilian sector. And you may recall it didn't really happen. People stopped taking engineering courses. People dropped out of engineering and we felt the impact of that for a long time. In fact, we may still be feeling the impact of that, look at our math and science scores and look at the value of math and science in this country. So it seems to me that if we move ahead without taking this into account, there is almost like a double-whammy. We hurt ourselves, the world sees we are hurting ourselves. It then takes advantage of the fact that they perceive that we are weaker and it becomes a very, very vicious cycle.

Mr. MCHUGH. Any other comments from the other panelists?

No. Let me, if I may, Mr. Chairman, you know what, we have taken a lot of time. Let me yield back and we have got a lot of other very interesting colleagues here, and I look forward to their comments as well. Thank you gentlemen.

The CHAIRMAN. Thank you very much. Let's turn to the history books for a minute. What lessons can we derive from past economic crises that we can apply now? Of course, the immediate answer is Weimar Republic, open the door to a fellow named Adolf Hitler and his followers.

Are there other lessons of history where crises brought on authoritarian rule or severe problems akin thereto? Who is the historian with you all?

Dr. HAASS. We are probably all amateur historians here. I would think when it comes to looking at history and its relevance, we

have to make sure we choose the right history. I am not particularly concerned, sir, for the foreseeable future about the rise of challenges to the United States on the scale of Nazi Germany or imperial Japan. Another way of putting it, I am not particularly concerned for the foreseeable future that the economic crisis we are seeing will have that destabilizing effect on great powers, or that sort of hyperaggressive, hypernationalist foreign policy.

I would think that the historical parallels are much more in the direction of middle-size and weaker states. And the sorts of scenarios that I would think about that are relevant we have seen in recent years are, say, the Somalias and the Balkans where periods of extensive and deep economic hardship wore down societies, created weak or failing states, massive internal and then external refugee flows, led governments to more populist approaches and so forth.

So it is less, again, that the United States is going to face a China or Russia or anyone else on a massive scale akin to the 20th century. But instead, it is much more consistent with the disorderly future of medium- and small-size states, either breaking down internally, which in a global era can create all sorts of challenges to us given the nature of globalization as a giant conveyer belt; or medium-size states which given their access to weapons of mass destruction could cause terrible local or even global possibilities.

And here, the most worrisome scenarios, again, I would think, are breakdowns of authority in a place like Pakistan, an Indo-Pakistani relationship that gets seriously off track. And obviously, the challenges that are posed by countries such as Iran and North Korea. North Korea can be a breakdown of authority. Iran which is not a single, simple government; I can imagine scenarios where its nuclear program could lead to a conflict which again could lead to disruption of energy supplies or conceivably even a situation where Iran would hand off materials. So I think the parallels, if you will, are less great-power 20th century parallels, more so some recent parallels or even going back farther in time, 19th, 18th century to situations where you had local pockets of instability.

Mr. ROTHKOPF. Let me, if I may, just build on what Richard said because I think the right way to look at this in the context of history is also to note how it is different from what has happened in the context of history. And what we have got here is the first global economic crisis of the global era, requiring a global response. And the jury is out about how well we respond to that globally, combining with Richard's point that we live in an era in which the threats are more likely to come in weak states, and this is a crisis that is likely to lead to a proliferation of weaker or failed states and those two things taken together have a fairly profound consequence that makes this different from the past.

The third is that while I agree with Richard's point that this is not likely to produce the kind of immediate great power conflict that you saw coming out of your Weimar analogy, you are likely to see coming out of this a fairly significant shift in the powers that we consider to be major powers in the world. And we have already seen this as in this crisis we have moved from deliberations from the G8 to G20. You have seen it in the past 12 months as the BRIC

countries, Brazil, Russia, India and China, have actually gotten together on a regular basis politically at the head of state level and at the foreign minister level to coordinate their policies and try to assert themselves as key players.

It is very likely that the world that emerges on the other side of this will be a world that has a different array of leading powers in it than the one we are accustomed to.

Dr. ZAKHEIM. I take a slightly different tack. First of all, I think it is fair to say that the crisis in the 1930s was global. You had a lot of colonies in those days, but otherwise it was global. But there are two medium-sized countries that I think ought to make us pause and think. One is Mexico, medium-size country, but of course, it is next door and that changes everything.

So if oil prices turn around and go all the way up, that might help, but I don't know what the relationship is between when they go up and the problems they are having right now with drug lords and the killings, Ciudad Juarez and everywhere else. They have had a decline in manufacturing. People had started to come back to Mexico which affects remittances. So that country is in a very difficult situation, plus it is very sensitive about us. We cannot just go in there and tell them what to do. So this is a major challenge for us.

The other middle-sized country, and this goes to your question about history, there was a country that went through a revolution on the slogan of peace, land and bread. It was called Russia in 1917. It was a middle-sized country, it was not the world's leading power by any stretch of the imagination. It was getting clobbered by the Germans actually in World War I. And it did not become a threat to the United States for 28 years. Between 1917 and 1945 they were no threat to us, we recognized them in 1933 and we fought alongside them for 4 years. So what might be a middle-size power today might not be a middle-sized problem, it might be a major league problem in 25 years' time. And which country that might be, heaven only knows.

The CHAIRMAN. Thank you, any further comments?

Dr. COOPER. Mr. Chairman I don't know how serious you are about historical analogies, and as Richard says, we are all amateur historians, but I thought somebody, at least in the historical context, should mention the French revolution. France was in a serious economic crisis in the 1780s. It had a revolution which started out being entirely domestic, but it was very, very dramatic, and it very rapidly became a world war. We don't call it a world war, but it actually was focused in Europe, but there were battles all around the world between France, Napoleonic France, and the other countries. But I would emphasize the very strong differences today between our situation and our understanding about how to manage macroeconomic crises. Certainly then in the 18th century, but even in the first half of the 20th century. Macroeconomics as a subject did not exist in 1931. It was invented as a result of the Great Depression. Our understanding is not perfect, but it is much, much better than it was in former times.

The CHAIRMAN. I thank the gentleman. Mr. Bartlett.

Mr. BARTLETT. Thank you very much.

Dr. Haass, our chairman's opening comment caused me to look again at the caution that you give in your closing paragraph of your written testimony. Enormous stimulus measures here at home coupled with equally unprecedented increases in the current account deficit and national debt make it all but certain that down the road the United States will confront not just renewed inflation, but quite possibly a dollar crisis as well.

I have been concerned, sir, that our profligate spending will not be satisfied with borrowing, because the money just won't be there to borrow. And so the Fed will simply print the money. My wife and I went through Europe in 1973 and I seem to remember that in Italy, the new Lire was worth 1,000 old Lire. That means your $10 bill today is a penny in our new currency. I would like each of you to tell us what you think the possibility is that this kind of thing could happen in our country. And if it does, what are the positives, and I can think of one. The national debt as monetized will just disappear, there may be no others. And what are the negatives? What would this do?

Dr. HAASS. I will say one of two things since you mentioned my statement and then I will quickly defer to Richard Cooper, who is one of this countries most distinguished economists. I am not particularly worried about hyperinflation on the historical scales you have mentioned. What I am worried about is a situation where doubts gradually grow around the world about the wisdom of continuing to accumulate massive holdings of dollars.

And the United States obviously has and will continue to have for decades a need to import large numbers of dollars in order to finance our various deficits and our debt. At some point, we may find ourselves with the need to raise interest rates in order to persuade those who were holding dollars to continue to send them our way.

The need to raise interest rates before we were fully out of a recession would be a disastrous choice for the Fed or the U.S. Government to have to make. Ideally, this would be sequenced. We would find ourselves well on the road to recovery, some inflation would kick in, and then we could exercise the tools to deal with inflation that we are fairly familiar with. Again, the nightmare is that we would have to consider raising interest rates before recovery is underway, and that is a truly unattractive choice which we want to avoid. It is one of the reasons that I think we need to look very hard at the content of stimulus packages to make sure what we are doing is essential and gives us the stimulus we would like to think that we obviously need. But secondly we need to look at parts of our economy to openly reign in spending. I do not believe there is any sustainable policy answer to avoid the sort of situation you have been talking about without a serious restructuring of our approach to entitlements. If we are going to be serious about containing Federal spending, if we are going to be serious about getting this budget of ours back on track, regardless of what we feel we need to spend in the way of stimulus, it has to involve above all Medicare and, to a lesser extent, Social Security reform.

Dr. ZAKHEIM. Again, I find myself in agreement with Richard. I think one of the keys, and this goes to what Dick Cooper just said about macroeconomics, is that everybody plays the same game

around the world. One of the great threats and worries is that they won't. We won't play the game if people don't listen to Dick and we close our trade doors. Everybody's going to retaliate. It goes against everything that we set up in 1945. That does not, in any way, conflict with watching how people invest in us. On the contrary, it means if you have the right safeguards, you can actually foster more investment. But if we don't trade or don't foster investment, if the European Union (EU) starts to crack up and there is talk about that, then it becomes much more difficult to manage this globally, and then you really start running into problems.

We are still the world's reserve currency, we are still the most powerful economy. What we do is going to influence what others do.

Dr. COOPER. I think, Mr. Bartlett, I don't know exactly what you had in mind, but I think that the prospects of very high inflation in the United States are remote. It is absolutely true that the liability side of the Federal Reserve System has gone up, more than doubled in the last six months. And by traditional standards that might be thought to be potentially very inflationary, but of course it went up because we are not living in a traditional period of time. The demand for highly reliable assets on the part of public has just shifted way to the right. I mean it has gone way, way up. And the Fed, I think, properly responded to that by increasing the money supply. The Fed needs an exit strategy, I know the staff of the Fed is working on an exit strategy as we return to normal, the Fed has to work that back down again, but the staffs of the Fed are thinking about that already. Although unhappily we are not anywhere near close to that at the present time.

So I think the prospect of, you mentioned Italy, of sort of a 1,000 to 1 conversion for the United States any time in my lifetime is remote in the extreme.

Now, on the question of global imbalances, I have written a paper on that which is not especially for this committee, but if you are interested, I can give it to the staff. But the bottom line of that paper is I think these global imbalances are entirely explicable in terms of two factors, one is globalization of financial markets and the other is demographic developments.

We are living through a demographic revolution. We don't notice it because demography always moves slowly from year to year. But Europe and East Asia both are in serious demographic decline. And among the rich countries, the United States stands out as an outlier. Our birth rates have declined but they remain markedly higher than in other rich countries. And in addition, we have immigration which we are still, I think, very good at bringing people in and making their kids Americans.

On both counts, the U.S. stands out on demographic grounds. When you work through the economics of those two things, what do you get? Large surpluses in the rapidly aging societies, Germany, Japan, China. And you get large deficits in the secure, robust economies like the United States. Now, this was all, of course, before September of 2008. Our deficit is going to go way, way down this year. But my forecast is that it will come back as the recovery takes place for these basic long-term demographic reasons. By long-term, I don't mean forever, but for another decade or so.

Mr. ROTHKOPF. We tend to be concerned about sudden dramatic shifts because they make headlines and they make people nervous. But I think long, slow shifts are also worth noting. And it is almost impossible to imagine a circumstance in which a country like the United States building debt at the rate that the United States is building debt has a strong currency any time soon. And I think that some inflation seems highly likely. I think a weaker dollar for the foreseeable future seems highly likely. And that then leads to a question, because this debate or this question has come up in the press over the course of the past couple months. And one of the common retorts is well, we are the only reserve currency in the world, we are the only port in the storm. Look at how people have come in here now. That will always be the case.

Well, we have all lived long enough to know that things that we have assumed would always be the case, whether it is the gold standard, or that there would never be a common currency in Europe, or that there would always be a Soviet Union don't always remain the case. That doesn't mean that suddenly the new, new Lire will become the reserve currency of the world. In fact, I think the odds of that are pretty close to zero. But it does mean that it is quite possible that the dollar's traditional place in the vaults of central banks around the world is likely to decline. And that is likely to have quite an impact on our influence internationally.

The CHAIRMAN. I thank the gentleman. Dr. Snyder.

Dr. SNYDER. Thank you, Mr. Chairman. All your written testimony today and your statements I was reminded of, I believe it was in November 2007, when Secretary Gates made his speech at Kansas State in which our Secretary of Defense called for dramatic increases in both numbers of personnel and in dollars for the State Department and U.S. Agency for International Development (USAID). His point being that we have gotten too lopsided in the instruments of national power to achieve the policy objectives that we want to.

Several of you discussed in your statements our defense budget. It seems to me it would be it would more appropriate to be discussing this in terms of a national security budget. During this time of belt tightening, in which we all recognize it is a time of figuring out where our priorities are, we need to be sure that we are not going to continue the problems that Dr. Gates was talking about which was to shortchange USAID and the State Department to our detriment as a national power. So any comments you might have on that aspect of looking at an overall national security budget, not just a defense budget.

Separately, I met yesterday with our friends from Pakistan. And one of the concerns they had was in their view some three years ago or so there had been some promises made from this country by the Bush Administration in terms of some development dollars. They feel like those monies have not been forthcoming. It seems like the world is pretty good about making promises at national aid conferences and then not following through. Given what is going on, it seems like this is even a better time for us to make sure that we as a nation and we as a world community do indeed follow through on what we say we are going to do with regard to foreign aid and development.

Any comments you have on anything I said there until my time runs out. I note the clock is not on, Mr. Chairman. I hate to point that out, but it might be a good time to—thank you, go ahead.

Dr. HAASS. Let me just say one thing, protecting aid levels is obviously going to be difficult given that it is discretionary and those aspects of budgets are going to come under pressure, though obviously where we can, particularly for humanitarian reasons, I believe we should and to help some of these states get through these difficult times. But I don't believe we should or can have an aid-centric foreign policy, either when it comes to the United States or others.

Far more valuable than aid flows is trade, if you really want to help poor countries in Africa, allow them to export into the United States. It creates more jobs and is much less prone to corruption and far more efficient than any amount of aid flows.

If you want to think about national security spending, I agree we need to increase capacity particularly on the civilian side for nation-building or state-building. Again, we should not lose sight that probably the single most important thing we can do to improve national security would be to reduce our dependence on import oil and our use of oil. That would have a tremendous—we don't think of it as the national security budget, but if you take a national security writ-large point of view—we have to get beyond, I think, spending levels, be it Defense, State Department, foreign aid, what have you.

Trade and energy issues, again, we don't think of as narrowly national security, but a greater openness on trade and a reduced use of oil would probably be two things that, if you will, are off-budget, that would probably do more to contribute to national security over the next decade than any amount of dollar to dollar spending we would do on aid or anything else.

Dr. SNYDER. I will make a comment and move to other people. Dr. Gates' comments in November 2007 remember was in the context that we had been expanding trade and trade agreements and things were going well economically. I think his point was we still even in the face of robust, positive trade policy and I have been a supporter, he still thinks it was important to dramatically increase funding for USAID and the State Department.

Dr. ZAKHEIM. I certainly agree with what Mr. Gates said. I think the Administration has made a good start by reorganizing the National Security Council (NSC) to recognize that Treasury and Energy and Commerce are all part of our national security approach. And I think that is right. There is a huge imbalance and it starts actually on Capitol Hill, not in any Administration. The State Department has loads of authority and Defense has loads of dollars. And when I was coordinator for Afghanistan, I felt that restriction severely. There were all kinds of things I wanted to do, I had the money to do it but I had no authority to do it. This was back in 2003 and 2004, I was the defense coordinator and Richard was the overall coordinator. And as a result of that, things did not get done at all, and I think we are paying the price right now.

There is another question though, and Richard mentioned it, and that is state-building. And we really need to ask ourselves, even with these capacities which we clearly have to get in terms of the

civilian side, how much of state-building do we really want to do? It is not a matter of being isolationists, it is a matter of looking at the record. Our regard at state-building isn't exactly great. There are times when we are forced to do it, I think in Afghanistan we were absolutely forced to do it. But the record: Somalia; Haiti; you can go back Haiti in the 1930s; Nicaragua; over and over again. We flatten countries and then we rebuild them, that is fine, but that is only Germany and Japan. And so we need to think carefully about that before we commit resources, which, by the way, right now on the civilian side, we don't have, and I agree with you and Mr. Gates on that.

Mr. ROTHKOPF. I was the Haiti economic recovery coordinator in the Clinton Administration, you can hold your applause. And as a consequence of that experience I agree with Dov's assessment that we don't have capability here yet. Most frequently, the mission that the United States has been asked to do since the Second World War has had an emergency economic intervention component. Nobody wants to do it in the United States Government. We don't have the ability to do that. And there are a host of issues on the economic side that would benefit from a look at whether we can do them better, whether that is a Goldwater-Nichols on the civilian side of the U.S. Government, which I think is a good idea, or other kinds of restructuring.

But to go very briefly back to the response that Richard offered, I agree with what he said. I think there is one area that we have got to look at very, very closely in the very near term, and that has to do with the replenishment or recapitalization of international financial institutions. Given our limited resources we are going to have to find ways to leverage our investments up, while the IMF and World Bank and the regional development banks are ill-constructed in some respects and will need some possible reshuffling in terms of their ownership structures, they are the only available mechanisms to leverage up.

There are estimates right now that if things go bad $138 billion will be needed by the 49 poorest countries in the world as a consequence of this, and it could go as high as a trillion dollars. The World Bank is having a hard time raising $10 billion right now. So if we don't support that, we are inviting deterioration.

Dr. SNYDER. Thank you.

The CHAIRMAN. I thank the gentleman. Mr. Jones.

Mr. JONES. Thank you very much, I want to thank you and Mr. McHugh and the gentlemen for being here today. This has been very, very educational and also very helpful. I represent the third district of North Carolina, home of Camp Lejeune Marine base, the Outer Banks some of you might be familiar with.

The income of the people in my district, I think I am close to it, the average income of a family of 3 or 4 is somewhere around $38,000–$40,000, gross, not net. Frequently I get the question of the fact that we are, and you touched on this many times, this is a debtor Nation. We are a Nation that owes China $800 billion and they buy financial notes and certainly they don't want to see us fail. But when you look at history of the great nations of the past, that this is just one example, England, at one time, thought it

could go into Iraq and make it some type of a nation. They decided that wasn't worth the effort.

Mr. Obama, and I wish him well, I am one of the Republicans who wish him well, unlike some that feel the other way that are on the radio, I wish him well because we need to rebuild America. I understand he is saying that we are going to send 17,000 troops to Afghanistan. I know as a fact, most members of this committee know as a fact that our military is worn out. I won't say the military is broken, but it is worn out.

Does there come a time for a country, not to become an isolationist but for a country to just say within itself, so to speak, it wouldn't be within itself, but let me use that as a word, that we cannot continue to police the world. We are borrowing money every day, we are wearing out our military. And yet I think some of these countries like NATO, they have not stepped up as of today to help us in Afghanistan. They have not done that.

Is it to the detriment for the future for a nation to say within itself, its leadership, that we have got to have a period of time to rebuild our self. Because every day that we continue to borrow money from foreign governments to help other countries, and I don't think we can become an isolationist, I really do not. But there has to come a time that the percentage of investment, in my humble opinion, has to be reduced because we can't even fix our own streets. And the money that Mr. Obama, the stimulus package, I hope it works, I didn't vote for it, but I hope it works, but I will tell you that what I see happening to this country concerns me more than what is happening in other countries. Again, I don't want to be an isolationist, but we need a time-out to fix America and stop trying to police the world.

Mr. Chairman, that is my question.

Dr. HAASS. Can I respectfully disagree with you, sir? We may want to have a time-out from the world, but the world doesn't grant times out. We can blow the whistle, but the world won't stop playing to push the metaphor.

Mr. JONES. Mr. Haass, real quick. I want you to finish on that. Why in the world won't North American Treaty Organization (NATO) send its fair share? Why doesn't England, why don't these other countries just join us in all these fights and in taking care of the world?

Dr. HAASS. I'll come back to the NATO issue in the second.

When we get involved in the world we do it not just as a favor to them, but as a favor to ourselves. The reason that we care about say Afghanistan's achieving some level of stability is not necessarily as a favor to them or out of simply humanitarian concerns, but we learned the hard way in 9/11 that a lack of stability and a lack of central control in Afghanistan could have repercussions for us here in the United States that to me is a fact of globalization.

I think though where I don't disagree with you, we have to set limits on what we do. We can't necessarily define success in places like Afghanistan or Pakistan or Iraq as creating what Bob Gates called a Valhalla or others would call a shining city on a hill. Sometimes success has to be defined quite modestly as simply the avoidance of failure or state collapse. We may have to content our-

selves with simply propping up to some extent weak states to avoid state failure rather than trying to create strong states which I think would take too much in the way of resources.

It does argue for policies based upon training, state-building and all of that so we don't have to do it all ourselves. The question of what allies and others are willing to do for us, I share your frustration, but my reading of history and my sense of where these other countries are is we are going to continue to be frustrated, that they are not going to do all that they can and should. That is the nature of their economy, it is more important. It is nature of their will and their domestic politics. So at times we will have do more than our share simply because it is in our interest to get it done.

Dr. COOPER. Mr. Chairman, once again, I agree with what Richard has said. But what I want to add is it doesn't have to be either or. We can do both and. We are a fabulously rich country, both by our own historical standards, the standards of my parents and my grandparents, for example, and by international standards. And what most Americans don't appreciate is, we have company in Japan, of all the rich countries we are the most lightly taxed, by a long margin. Switzerland which is hardly a country by normal standards, the Swiss tax themselves more than we do. If we decide we want to do something domestically, for heaven's sakes, let us do it and let us pay for it through higher taxes. And that is where this body becomes very important. We can do both.

Mr. JONES. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Mr. Andrews.

Mr. ANDREWS. Thank you, Mr. Chairman. I would like to thank the panel for making a very persuasive case that we have to strike a balance between reducing the possibility of strife in the world by encouraging global growth, I think that point has been made very, very well, and making sure that we are in possession of adequate resources to make sure that when strife occurs we can handle it. I think those are complementary, not conflicting goals. I agree with Dr. Haass on that.

Dr. Zakheim, I want to explore with you the resource side of the equation. And on page three of your testimony, you talk about the defense budget being under pressure. I want to read what you say. Real growth in defense spending excluding the wartime supplemental is but 1.7 percent. If the supplemental is included in the growth, the spending is some 1.4 percent. And then you compare that to the 4.3 percent real growth of the last eight years.

I am going to ask you in a bit about how you are accounting for supplementals and whatnot. But if my back of the envelope calculations is correct the annual difference between 1.4 percent real growth and 4.3 is just shy of 3 percent, 2.9 percent, which in terms of our present top line is about $15 billion a year. You are worried about that $15 billion delta and so am I.

Isn't one of the places we should look to deal with that delta, the waste in the procurement system, there is very authoritative information that indicates that of the major weapon systems recently acquired, they had $295 billion in cost overruns. By my calculation that would buy us, what, 20 years' worth of the delta that is there had we done that correctly. I mean, what would you suggest to someone who has occupied the Comptroller's position during that

time. What would you suggest as ways that we could fund that difference between what you evidently think we need and what has been proposed by making these procurement reforms?

Dr. ZAKHEIM. Well, I agree with you that there is a lot of spending in the acquisition accounts that probably could be done a lot better. There are all sorts of panels, the Defense Science Board has a panel right now that I am on that is looking at that. Jack Gansler, who chairs that one, just chaired a major one for the Army.

One of the difficulties we have is that any fixes we make are not going to have real short-term impact. Part of problem, and this comes out of the Gansler Commission Report is that our acquisition corps, the people who actually do the contracting, do the buying, are not as well trained as they used to be. And the ones who really know what they are doing are older and retiring. And the younger ones don't have the right experience and the right training.

Mr. ANDREWS. I read that report and I understand it is made very persuasively. And I don't mean my question at all to be combative, but I would like you to answer it. Why didn't we spend some of that 4.3 percent annual real growth on training the acquisition corps so they would have the tools to make these purchases better? What did we do with the money in the last eight years?

Dr. ZAKHEIM. For a start, the money that doesn't include supplementals went to fight the wars, number one. If you look at what we actually bought, we are buying less per unit than we did years ago, that is why the Navy has shrunk to 200 some odd ships. Whereas 20 years ago when I was at the Pentagon, it was at 600.

Mr. ANDREWS. In your comparison between the 4.3 and 1.4 do you take into account policy change where we are disengaging from a combat role in Iraq?

Dr. ZAKHEIM. Oh, sure, that brings you down to 1.4 because your supplementals are going to decline. Therefore relative to previous years, you would see a decline.

My concern though, is that we know very well that the supplementals did two things, one that people didn't like and one that people didn't know about. The part that they didn't like was there was a lot of procurement in the supplementals, and it didn't, therefore, cover real programs of record and every year you had to keep the procurement going, that is just not a good way to procure. The part people didn't know about is they didn't really cover all the operations and maintenance. So you had a lot of O&M money moving around inside the defense budget to cover the operations themselves. You can't predict what is going to happen in an operation. We do a budget today for something that we are going to be spending in 21-months' time.

Mr. ANDREWS. I hear you. I guess my only point would be in sort of challenging your hypothesis about the 2.9 percent spread, I am much more confident that the difference in policy in Iraq and aggressive procurement reform effort could close that delta rather sooner than you think, and your hypotheses that we are somehow underbuying resources is not true.

Dr. ZAKHEIM. Again, the supplementals do take account of what is going to happen in Iraq. And we all hope that we will only need 50,000 or less, I am not arguing with you there. But if you are

going have real procurement reform and you are dealing with the personnel side of it, you can't do it quickly.

Mr. ANDREWS. I hear you. Thank you very much.

The CHAIRMAN. The gentleman from South Carolina, Mr. Wilson.

Mr. WILSON. Thank you, Mr. Chairman. And thank all of you for being here today, this is such a serious issue and one that affects so many different countries. I am particularly happy to see Secretary Zakheim here. I appreciate your service, I appreciate your family's service to our country. Additionally, I appreciate your efforts in Afghanistan and Iraq.

I am particularly interested as a cold warrior in the success of the countries of Central and Eastern Europe. It has been so inspiring to me to see countries that were frozen in time, that now have dynamic economies, functioning democracies, but I am concerned as to the financial crisis and how this could affect their ability to continue to grow. In particular, last August I visited in Bulgaria, I am the co-chair founder of the Bulgaria Caucus. And I was there 20 years ago to see the phenomenal advance economically of that country and additionally, I visited Romania several times to see what a dynamic country that is, too. For any of you, what is the consequence from Poland to—or from the Baltic states to the Black Sea?

Dr. ZAKHEIM. I'll start, first of all, thank you so much for your kind words, I really appreciate it, and there is someone else in this room who does too I think. These economies are clearly vulnerable, they are not all alike. And they are all different—to different extents—vulnerable not only to their internal issues, but also to how Russia deals with them, whether we are talking about gas or other things like the Estonians faced.

In the first instance, I suspect it is the EU that will try to do whatever it can, and there are tensions within the EU itself. So this goes back to Richard Haass' point and Dick Cooper's point, that we really need to work together with the EU on this. I don't see how the kind of issue that concerns you, which is a very legitimate issue because these are new NATO allies and it goes to the heart of what NATO is about as well. I don't know how that gets dealt with unless we and the EU have some common plan to work together. Most of the big economies outside obviously Japan and Canada and one or two others—and China, are in the EU. So it is very, very important that we work together.

Dr. COOPER. I would just echo that these countries are very vulnerable at the present time. They have grown very, very well during the last decade. And a lot of that growth has been on the strength of private capital inflows from all over the world, mainly from western Europe, but including American firms, including Japanese and Korean firms. In today's circumstances that capital flow will diminish very sharply. They all have current account deficits. Hungary has already gone to the International Monetary Fund, Latvia, I guess, has applied to the International Monetary Fund. And I agree very strongly with Dov that we can rely on the international community but it needs to have the full support both of Europe and of the United States to make sure that these countries do not falter seriously. They are quite vulnerable. I have the current account deficits of the major ones, they are all above three

percent, Czech Republic, Hungary, Poland. And the smaller ones have bigger current account deficits so there is an issue.

Dr. HAASS. Congressman, we had a meeting the other day at the Council on Foreign Relations about this. And I would say there was not quite consensus, but a lot of people thought the single most concrete outcome and important outcome of the April 2nd G–20 meeting in London could be a commitment to significantly increase the scale of resources available to the IMF to tide countries over to deal with the balances of payments shortfalls to basically replenish the IMF significantly.

The CHAIRMAN. I thank the gentleman, Mr. Marshall.

Mr. MARSHALL. Thank you, Mr. Chairman. I don't mean to bait and switch here, but the topic is appropriate to the longer-term problems that are facing the United States. It seems to me and to many others that the long-term budget deficits that we have been running now for decades present a real threat to our future security simply because they present a threat to our economy and our economy drives our ability to adequately defend ourselves and assist the rest of the world in defending itself from threats. I would like your comments about this long-term systemic issue that we face, and particularly about the proposed budget that you all have read about from the Administration, and whether the Administration's budget appropriately takes into account how we are going to address the long-term budget shortfalls, the long-term deficits, the long-term increase in debt of the country, as that constitutes, it seems to me, a very substantial long-term security threat to the country, and it is a financial threat, so I am pretty close to the subject matter of this particular panel. And you are all experts, and you all thought about this, and I would like your opinions about the proposed budget.

Mr. ROTHKOPF. If it is all right, I will start out with that. You put your finger on a critical issue, and it was really the issue I started off with here, which is that the wellspring of our strength is a functioning, healthy U.S. economy. And that if we don't get our fiscal house in order, it will weaken our dollar and it will weaken our economy. We need to address that. We have had a hard time this year balancing the short-term needs of stimulus with the longer-term needs of dealing with 11, 12, 13, you count it, trillion dollars of debt in this country. And I don't, to be honest, think that any U.S. budget of the recent past has dealt with this problem sufficiently, has focused on balance.

Richard Cooper made the excellent point that we are going to need to tax in order to address this problem, even as we need to cut spending. And Richard Haass earlier put his finger on the point that until we deal with health care expenses in the United States, which is the elephant in the room on this thing, we are not going to be able to deal with that. There are projections that have been done that show that if you simply take entitlement spending, and defense spending at pre-war levels and carry them out to 2017, and you take our revenue, there is not money left for anything else. And we can't wait until 2017 in order to resolve that issue.

Mr. MARSHALL. And I am familiar with all that. By the way, I have read all of your testimony, heard your testimony and found it very helpful. It is consistent with what we have been hearing

from other experts. Those are the immediate threats. The longer-term security issue that is presented by the economy is what I would like you to address. And then specifically the President's proposed budget, which is a budget that projects 10 years' worth of spending and revenues.

Mr. ROTHKOPF. Well, in terms of the longer-term threats, I mean, it is inevitable that you guys are going to sit in this room over the course of the next four years and you are going to grapple with your obligation to cut the defense budget of the United States, because it is the one big moving part in this budget. And once we get to the other side of this crisis, there is going to be pressure to do that in a way that no one in this room has experienced before. So cutting the defense budget is going to have that kind of a consequence on our ability to address issues overseas. And similarly, the contraction of our resources for soft power pursuits, whether it is aid or to fund international institutions, is going to have a similar effect in the United States' role——

Mr. MARSHALL. I appreciate it. I am going to run out of time here. I want to, if it is possible, to get comments on the proposed Administration budget from the other panelists.

Dr. COOPER. I am not going to comment on the budget because I am not familiar enough with it. Let me just say that I think the fundamentals of the U.S. economy—I know it is funny to say that in the spring of 2009—are very, very sound. We can handle lots of debt. We can handle growing debt. We have one huge unsolved political problem, the one Richard Haass mentioned, which is medical expenses. Medical science is advancing so rapidly, Americans think that they have a right to anything once it exists and that somebody else should pay for it. We need to have a serious discussion in this country, and no politician and most of the public don't want it, about death, because death is becoming an option, but it is very expensive to prolong life in the older years. That is a huge unsolved problem. If we solve that problem, the rest of the problems are all manageable. They are all manageable, and our economy is strong enough to handle it.

Dr. ZAKHEIM. I'd agree that the fundamentals are sound. I am not going to get into life and death issues, but I do think that precisely because the economy is sound, we need to think about investing today in the defense area in order to be stronger over the long term. This isn't either/or. But, for instance, when I was just asked about acquisition. If we don't train our people, if somebody can join the civil service with a masters degree and not take another course in physics or mathematics or systems analysis or anything for 40 years before they retire, there is something fundamentally wrong, and that is why you have some senior civil servants who don't know how to use computers as well as their grandchildren. That is a problem. That is an investment. That is something we need to do now. We couldn't do those kinds of things or some of the things I wrote about in my testimony if we didn't have sound fundamentals. But we do. And so, therefore, I think we can do it.

Dr. HAASS. We have essentially reached a point where we have exercised all of our monetary instruments. We can't lower interest rates any more effectively. We are going to have to continue to spend. So we are going to, in the short run, have to increase stim-

ulus. For all I know, there will have to be another package. In that sense things are going to get worse as a necessary price of getting out of the deep recession we are in.

The challenge, though, is that while we do that—and 30 more seconds of that. Part of what makes it so complicated is it is impossible to know in advance exactly what will be the consequences of certain kinds of spending, and we are literally, as I watch it, in the position of throwing a lot of things against the wall and hoping some things stick and have the impact that we want.

But at the same time, while we experiment with stimulus packages, there is no reason we can't address some other things, whether it is Medicare reform or things that would reduce our need to use energy or whether we can get growth out of other things other than stimulus like trade. So we have got to address other policy things.

But I think, in the short run, the requirement of getting out of the economic situation we are in requires probably the running enormous deficits and increasing the Federal debt for the next couple of years. I don't know any way to avoid that. But, again, we could do everything else at the same time, in terms of, you know, we could start introducing regulatory reform, entitlement reform, energy and security reforms and so forth which, in the long run, I think will address your concerns.

The CHAIRMAN. I thank the gentleman.

Mr. Coffman.

Mr. COFFMAN. Thank you, Mr. Chairman.

Dr. Haass, you had mentioned something about North Korea and that you were concerned due to the current global economic climate that North Korea might, in fact, be further destabilized. But isn't North Korea a fairly insular nation? It certainly doesn't have a market-based economy. Is it the aid flows you are concerned about it? What is it that might destabilize North Korea?

Dr. HAASS. I am not necessarily known for my modesty. But when it comes to North Korea, I begin with it simply because it is arguably the most opaque country in the world. And any analyst looking at North Korea is constrained by that reality. But it seems to be clear that something is going on that is different there, that there is something going on with the political leadership that has increased the odds of instability and various forms of transition from the current leadership. Parallel to that, we are seeing the North Koreans getting somewhat more bellicose even by their fairly bellicose standards. The big governor, if you will, on the trajectory of North Korea has been two things. One has been China, its willingness to stay engaged sufficiently so North Korea does not collapse. The Chinese do not want to have the refugee flows and I think the uncertainties on the peninsula and don't necessarily want to see a united Korea that looks a lot more like Seoul than Pyongyang. And the other part of it is the South Koreans, that they have been, to a lesser extent the Japanese but mainly the South Koreans have been a source of resources again to stave off collapse. Because as much as they would like unification in the abstract and in the future, they are worried about something that is convulsive and what that would mean in terms of refugee flows and simply the strains it would place upon their economy.

All I am suggesting is, in particular, the South Korean ability to pump resources in is, I believe, is going to be constrained given their economic contraction. If it is not in double digits already on an annualized basis, it likely soon will be. And I think it just adds to the dynamic of uncertainty in North Korea. That is my only point.

Mr. COFFMAN. Thank you.

I was having, in our relationship with the issues of the People's Republic of China, I was having a meeting several years ago with a senior diplomatic official from Taiwan. And I asked him what his greatest concern was in their difficulties that they were having with mainland China, and his response was, I am concerned that if they have an economic downturn, that that will create greater friction between our two countries. Could any of you comment on your view of his assessment, if given, if in fact—and this was three years ago—that an economic downturn in China would in fact maybe raise the specter of conflict with Taiwan?

Dr. HAASS. I for one don't think it would appreciably. It is a little bit from the Chinese point of view—I know there are analysts who think that. It is a bit of the wag the dog theory, that in times of economic hardship, governments often look to foreign ventures to divert attention. But I would simply argue that China is too economically integrated with the world and needs the ability to export, needs the ability to import funds and so forth to keep its unemployment levels down. I do not believe that absent the major—that the Chinese would perceive as a provocation or a change of status on the part of Taiwan—I do not believe they would risk increasing their economic isolation dramatically. So, on my short list of crises that keep me up at night, given the economic situation we are in, that is not high on my list to be honest.

Dr. ZAKHEIM. I agree with that. China right now is the source of a lot of Taiwanese investment. They have moved closer to each other. This is a politically driven conflict, and I am not even sure that China sees Taiwan as an overseas adventure anyway. They have argued the whole time that they are not; they are part of China. The trends actually look pretty good right now, and I would agree that that is not the one that keeps me up at night.

Mr. COFFMAN. Thank you.

Mr. Chairman, if I could, one more question.

And that is, what would be the net impact if America were to much more aggressively move towards energy independence, and energy independence as being defined as no longer importing foreign oil, what is the impact in terms of the economic and national security of this country?

Dr. HAASS. Well, you will forgive me, but the phrase energy independence is a nonstarter. The United States is not going to be energy independent in our lifetimes, and short of a major technological breakthrough. It need not be energy independent.

What it needs to be is energy secure. What that means is considerably reduce use of oil. What energy security, though, would do for us would it would throw—it would reduce the flow of funds to unsavory regimes, particularly Iran and Venezuela. It would dramatically reduce the balance of payment pressures. It would ease some of the problems we talked about here on the dollar. Reduced use

of energy would obviously contribute to progress towards climate change issues and so forth. So it is one of those issues that would help us in multiple domains simultaneously.

But independence can't become the yardstick because it really is beyond reach, and it ought not to discourage all the things we can and should do that are within reach.

Mr. COFFMAN. Thank you, Mr. Chairman.

The CHAIRMAN. I thank the gentleman.

We have three votes. I respectfully ask that the gentlemen stay for a few additional questions and those that are here and have not asked questions, please return. Someone else will be presiding. I understand I have to manage a bill on the floor. So as soon as the three votes are over, and Mrs. Davis, if you are in a position to return and preside for me, I would appreciate it.

Mr. Coffman, I appreciate your being ranking again.

We have a few minutes, and we can ask you to ask your questions now. But my request is, when I have to preside or handle a bill on the floor, would you be in a position to preside for me?

We will get someone else then. Go ahead with your questions, please.

Mrs. DAVIS. Thank you, Mr. Chairman. And just quickly, following up on the issue of oil, we know that Iraq's revenues are going down considerably. I mean, it is more than half what it was. Do we believe that they will have the ability to really provide the services for their people that are required with that reduction in revenue, and how are we factoring that into our work in Iraq?

Dr. ZAKHEIM. Well, you know, part of the problem in Iraq for quite some time was that the money was actually flowing out of Iraq into the wrong places. As long as there appears to be some decent management of Iraq's revenues, they are going to be able to provide services. And remember, the oil, the oil production itself still is nowhere near its capacity.

So you have really two ways of dealing with this. One is to increase production, which would obviously recover some of the losses. Secondly, it is to be more efficient about how their resources are used and less corrupt about it. And finally, one other thing, it very much depends on what they were assuming in terms of their budgets. We know Russia assumed $70 a barrel. So they are being hit. No one, as far as I can make out, assumed $80 or $90 a barrel. So it may not be as bad as you think.

Dr. HAASS. But it will be bad. It is going to be extraordinarily hard with oil in the mid $40s to get the investment to increase production. And even if you got the investment, it would take years before it kicked in. You still don't have the arrangements for revenue-sharing in Iraq. And what it will do is decrease the ability of the central government to essentially use money, quite honestly, to purchase loyalties. So when you add up the plusses and minuses in Iraq, I would put this on the negative side of the ledger. As happy as we are that energy prices are going down, this is actually one of the places where there is a price to be paid for that.

Mrs. DAVIS. Thank you.

And also quickly, you all mentioned Mexico in one way or another. And I am wondering how you see, then, the impact of the government of the growing war with the cartels and what role, if

any—you mentioned, you know, there are obviously a limited amount of help and assistance that we can provide, and yet it is a growing threat, and those of us who live very close to Mexico, of course, are concerned about that reality.

Dr. ZAKHEIM. Well, the government made one major decision in Mexico, which was to use the Army, which is far less corrupt than the police were and actually less vulnerable than the police are. We have all heard the horror stories about police being killed and police chiefs not wanting to take jobs and so on. So that is a major factor.

Beyond that, how much we can do is really a function of how much Mexico wants to let us help them. We cannot, I don't think, just go to them and say, here is what we think you ought to do. It is just much too sensitive a relationship. On the other hand, if it is done right, if we cooperate closely with the Mexicans pretty much on their terms, I think that would be a different story precisely because they did make that decision to use the Army and that was a huge decision to make.

Mr. ROTHKOPF. I think what you are going to see is some effort towards some Merida 2.0 where we are going to be asked and will end up spending considerably more money assisting them because they will ask for some kind of assistance. You will also see a lot more activity on our own border. I mean, you did see the Governor of Texas send 1,000 National Guard troops to the border of Texas last week to address this issue, and you are going to see more like that.

But one other thing that you should expect, and I have started to hear this rumbling out of Mexico, is an argument from them that this is due to the demand in the United States, and to the degree to which, you know, we want to help this problem, we are going to have to reinvest in controlling demand for drugs from Mexico in this country.

Mrs. DAVIS. In addition to arms as well.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. We have one additional member, and maybe we can wrap this up before we go vote.

Mr. Sestak.

Mr. SESTAK. Thanks, Mr. Chairman.

When I heard the DCI [DNI] speak about instability in other nations being the nearest near threat to us, for the Armed Services Committee, what brought me to mind was Tajikistan, for example, and all the 'stans where hundreds of thousands of young Muslim men work in Russia, and now Russia is having a challenge, so they are coming home. They are young. They can't afford to get married. They are Muslim. They are right next to Afghanistan. Things are a little amok there.

So as I hear that $25 billion is needed for nations if a number of the developing nations aren't going to go into default, and I understand that $270 billion to $800 billion, depending upon who you want to read, is going to be the government shortfalls of developing nations, what is it, sir, if I might ask you, because I have three quick questions, that the U.S. Government cannot do now or is not doing now to address that security issue? Not the giving the money, like 0.7 percent that the World Bank is talking. But what

can we do as an example of that one example, of what I gave? Because that to me is what Blair was really talking about, Admiral Blair.

Mr. ROTHKOPF. Well, I think it is a central issue, and I think that it is going to end up being development assistance primarily from international financial institutions, and, you know, if I were going to pick one place in the world for the incident that Dov was talking about, that we don't expect it and we are not terribly well prepared for, it would be somewhere in Central Asia for precisely the reason you are talking about. So maintaining relationships there, maintaining base capacity there is also related to that because I think this is where the——

Mr. SESTAK. How about USAID? Does it—developmental assistance, Vietnam days had 15,000 Foreign Service officers, 5,000 in Vietnam. Today it has less than a 1,000. Is that something we need to look at, or do we just continue to contract out to RTI International, or what are those—I am asking, what can we do to address this developmental assistance? Because I honestly think that is what we can do in this government of ours.

Mr. ROTHKOPF. I think we can expand it a lot. Before the crisis hit, there was a lot of discussion in the transition about, should there even be a new agency there? We are not going to have that.

Mr. SESTAK. Should it be Cabinet level?

Mr. ROTHKOPF. I think that there—I actually think that the better approach is some kind of Goldwater-Nichols on the civilian side that creates the ability to mobilize people in all the relevant agencies, including trade agencies, Overseas Private Investment Corporation (OPIC), U.S. Export-Import Bank (Ex-Im Bank), Commerce, USAID, Treasury, across the board because I think all of these places have a role to play.

Mr. SESTAK. Let me move over, if I could, on the defense budget to the question that was asked. To some degree, I have looked at the supplementals like crack. I mean, when we had in those supplementals, helicopters that hunt submarines and a Joint Strike Fighter (JSF) aircraft that is not going to be online until 2013, we have got a real problem weaning ourselves off of that. But when I look at the defense budget, it has risen from 7 percent in 2001 to 21 percent at the end of 2006. So it is probably about 26 percent of Overseas Development Assistance (ODA) funding overseas. So that is probably $9 billion to $10 billion. Why don't we just kind of—we kind of gave that to you for some of Iraq's money, didn't we? Why don't we just take that over and move it on over to USAID?

Dr. ZAKHEIM. Well, first of all—actually, when I was Comptroller, I moved some money over there. I had to do it via the Office of Management and Budget (OMB). Part of it, again, is the authorities. We don't have the authorities. And——

Mr. SESTAK. Should we effect that—is that a good move to move that—I mean, Congress can do that.

Dr. ZAKHEIM. I think, Congressman, that there is a lot of sense in looking at this as a comprehensive whole. I think that is what Mr. Gates was talking about. Frankly, we could avoid sending our troops to lots of places if we had people in our civilian agencies that got to them first. So—I don't know the numbers though.

Mr. SESTAK. My take is, I hear what Mr. Gates has said and the chairman, but words are words. It is not what is the defining coin of the realm here, resources. If it is to be a comprehensive whole, and I am not looking at fixing our financial system, the experts will do that in Finance and Ways and Means; should we really look at, not because it used to be 4.5 percent increase in Department of Defense (DOD), but can we prevent our men and women from going overseas in a better investment of moving moneys over to USAID?

Dr. ZAKHEIM. I agree, but it is an issue of authorities.

Mr. SESTAK. Which we can legislate.

The CHAIRMAN. Gentlemen, thank you very much.

Mr. Sestak, I suppose that was it.

Gentlemen, we appreciate it very, very much. It has been excellent, one of the best hearings we have had in this committee. And we will adjourn and proceed to the floor to vote. Thank you.

[Whereupon, at 12:20 p.m., the committee was adjourned.]

A P P E N D I X

March 11, 2009

PREPARED STATEMENTS SUBMITTED FOR THE RECORD

MARCH 11, 2009

McHugh Opening Statement for Hearing on the National Security Challenges Arising from the Global Financial Crisis

Thank you, Mr. Chairman and welcome to our witnesses. I commend you, Mr. Chairman, for holding today's hearing on the national security challenges arising from the global financial crisis. This is a timely hearing that will help the Committee prioritize initiatives as we prepare FY 2010 National Defense Authorization Act.

The financial crisis is viewed by many, and I count myself amongst them, as a serious national security concern. This is clearly the view of Director of National Intelligence (DNI) Blair who recently testified before the Congress that the crisis is having a far reaching impact and is the 'primary near-term security concern of the United States.'

While the impact of the crisis is manifest in the almost daily devaluation of the stock market, the effect on our national security is less overt. I'm looking forward to our witnesses developing the comments of DNI Blair and discussing other ways the economic crisis will impact on our security.

History has proven time and time again that political instability often follows financial crises. The intelligence community rightly raises concerns over the security of our friends and allies. The crisis also invites opportunism by rogue states and terrorist organizations. So the question I would like our witnesses to address is what we do with this intelligence? In other words, what steps—if any—should the Department take to deal with the risks of the crisis?

My first concern is defense spending. Though the top line defense numbers for Fiscal Year 2010 show a four percent increase in spending, by moving war costs out of the supplemental and into the base budget the reported growth is in fact minimal. This is why Secretary of Defense Robert Gates greeted the budget release by announcing that he would have to make some 'tough choices.'

The story is bleaker in future years when the real costs of our baseline defense requirements will no longer be masked by supplemental appropriations. Take the growth of the military, for example. Supplemental funding bought the Army and Marine Corps over 50,000 active duty personnel from 2001 through 2008. The price tag was roughly $6.8 billion in additional, basic defense costs. Future defense budgets will have to absorb these costs. Thus, I'm concerned what impact flat lining defense spending will have on national security policy in the midst of global financial uncertainty.

Missile defense policy offers a good example. Many are calling for deep cuts into these programs, yet strategic deterrence may be exactly what will be required to bolster our allies and friends. A weakened global economy is unlikely to lead competitors and adversaries to decrease their strategic capability as some may hope. In fact, it can be argued the opposite is more plausible. Faced with fiscal constraints, will Iran double down on its ballistic missile program? The question merits our most careful consideration.

In contrast to the 1990s, today we more fully understand where our security challenges reside. Wars in Iraq and Afghanistan, the fight against al-Qaeda, Iranian and North Korean nuclear weapons programs, the return of a more aggressive Russia and the rise of China all require not just words, but resources as well. Diplomacy, to be sure is a necessary condition, but that effort will ring hollow absent a strong commitment on defense. It seems to me this is particularly true during the current economic crisis.

The emerging approach of fiscal restraint for defense comes on the heels of our recent efforts to spend our way out of the economic crisis on the domestic front. Through the stimulus bill, expanded Troubled Asset Relief Program funding, and the omnibus appropriations bill, we have acted to ensure that this year's total discretionary spending will surpass the $1 trillion mark—more than we have spent on Iraq, Afghanistan and Katrina combined.

In this light, I question whether there is wisdom to the inverse relationship between domestic and defense spending as we confront the world in economic crisis?

Some have held that increasing defense dollars is an effective means to stimulate our economy. As Harvard economist Martin Feldstein points out, one of the best ways to induce rapid spending—the purported objective of the various bailouts—is to increase defense outlays. I'm interested whether our witnesses share this view.

I look forward to a candid discussion on these important issues. Thank you again for being here this morning.

Statement of
Richard N. Haass
President of the Council on Foreign Relations[1]
Before the Committee on Armed Services
U.S. House of Representatives
Washington, DC
March 11, 2009

Mr. Chairman:

Thank you for this opportunity to testify before the House Committee on Armed Services on security challenges arising from the global financial crisis.

Let me first commend you and your colleagues for holding this hearing. Most of the analysis and commentary on the global economic crisis has focused on the economic consequences. This is understandable, but it is not sufficient. The world does not consist of stovepipes, and what happens in the economic realm affects political and strategic policies and realities alike.

It is also important to say at the outset that this crisis, which began in the housing sector in the United States, is now more than a financial crisis. It is a full-fledged economic crisis. It is also more than an American crisis. It is truly global.

I would add, too, that the crisis is unlike any challenge we have seen in the past. It is qualitatively different than the sort of cyclical downturn that capitalism produces periodically. This crisis promises to be one of great depth, duration, and consequence.

This crisis was not inevitable. It was the result of flawed policies, poor decisions, and questionable behavior. It is important that this point be fully understood lest the conclusion be widely drawn that market economies are to be avoided. The problem lies with the practice of capitalism, not the model. Nevertheless, the perception is otherwise, and one consequence of the economic crisis is that market economies have lost much of their luster and the United States has lost much of its credibility in this realm. It is inconceivable in these circumstances to imagine an American official preaching the virtues of the Washington Consensus. This is unfortunate, as open economies continue to have more to offer the developing world than the alternatives. It also adds to the importance that the U.S. economy get back on track lest a lasting casualty of the crisis be modern capitalism itself.

The impact of the economic crisis will be varied and go far beyond the image of capitalism and the reputation of the United States. Director of National Intelligence Dennis Blair was all too correct when he testified recently that the primary near-term security concern of the United States is the global economic crisis and its geopolitical implications. The crisis will have impact on conditions within states, on the policies of states, on relations between states, and on the thinking of those who run states. I have already alluded to this last consideration. Here I would only add that initial reactions around the world to the crisis appear to have evolved, from some initial gloating at America's expense to resentment of the United States for having spawned this crisis to, increasingly, hopes that the American recovery arrives sooner and proves to be more robust than is predicted. This change of heart is not due to any change of thinking about the United States but rather to increased understanding that the recovery of others will to a significant extent depend on recovery in the United States. In a global world, what happens here affects developments elsewhere and vice versa. Decoupling in either direction is rarely a serious possibility.

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[1] These views are my own and not those of the Council on Foreign Relations, which takes no institutional position on matters of public policy.

The crisis is clearly affecting the developed world, mostly as a result of the centrality of banking-related problems and the high degree of integration that exists among the economies of the developed world. Iceland's government has fallen; others may over time. Many governments (including several in Central and Eastern Europe but outside the Eurozone) will require substantial loans. The economies of Japan, much of Europe, and the United States are all contracting. World economic growth, which averaged 4 to 5 percent over the past decade, will be anemic this year even if it manages to be positive, which is increasingly unlikely. It is worth noting that the most recent World Bank projection predicts negative growth for 2009.

Change of this sort will have consequences. There will likely be fewer resources available for defense and foreign assistance. Reduced availability of resources for defense makes it even more critical that U.S. planners determine priorities. Preparing to fight a large-scale conventional war is arguably not the highest priority given the enormous gap between the relevant military capabilities of the United States and others and the greater likelihood that security-related challenges will come from terrorism and asymmetric warfare. State-capacity building, the sort of activity the United States is doing in Iraq, Afghanistan, and Pakistan, will continue to place a heavy burden on U.S. military and civilian assets. Also remaining highly relevant (and deserving to be a funding priority) will be standoff capabilities designed to destroy targets associated with terrorism and weapons of mass destruction.

Developing states may appear to be better off than wealthier countries at first glance. Their growth on average is down by half from previous years, but still positive. Appearances, however, can be deceptive. This growth is measured from a low base in absolute and relative terms. The reduction in growth in some instances has been dramatic. Developing country exports are down as demand is down in the developed world. Also reduced are aid flows and most importantly investment flows to the developing world. Commodity prices are much lower, a boon to those who rely on imports but a major problem for the many who are dependent on the income from one or two exports.

A few countries merit specific mention. One is China. China's economic success over the past few decades constitutes one of history's great examples of poverty eradication. This process, one that has involved the migration of millions of people every year from poor rural areas to cities, will slow considerably. The already large number of domestic political protests in China over such issues as land confiscation, corruption, environmental degradation, and public health, is likely to grow. Absent renewed robust economic growth, the chances are high that the government will react by clamping down even more on the population lest economic frustration lead to meaningful political unrest.

Russia is in a different position, one characteristic of countries dependent on raw material exports for much of their wealth. The Russian economy is contracting after a period of boom. As is the case with China, this suggests the likely assertion of greater political control. But Russia is not as fully integrated as China is with the world economy. There is thus a greater (although impossible to quantify) chance that Russia's leaders will turn to the time-honored resort of manufacturing an overseas crisis to divert attention than will China's.

The same holds true for Iran and Venezuela, two countries that are heavily reliant on energy exports and whose foreign policies have been counterproductive (to say the least) from the U.S. perspective. But at the same time, it is possible that one or both will pull in their horns. Venezuela is already showing some signs of this, with its more welcoming stance toward international oil companies. This may well be simply a tactical adjustment to immediate needs. And at least in principle, Iran's government might find it more difficult to make the case to its own people for its continued pursuit of a nuclear weapons option if the Iranian people understood that it was costing them dearly with respect to their standard of living.

Iraq is another oil producing country whose wealth is closely associated with the price of oil. Here the effects are sure to be unwanted. There is the danger that disorder will increase as unemployment rises, prospects for sharing revenue shrink, and the ability of the central government to dispense cash to build broad national support diminishes. In light of the multiple challenges already facing the United States, the last thing the Obama administration needs is the specter of an unravelling Iraq.

Two other countries are worth highlighting. One is Pakistan. Pakistan's economic performance is down sharply for many reasons, including a decrease in both foreign investment in the country and exports from Pakistan to other countries. Pakistan has little margin for error; the possibility that it could fail is all too real. The worsened economic situation makes governing all that much more difficult. The consequences of a failed Pakistan for the global struggle against terrorism, for attempts to prevent further nuclear proliferation, for the effort to promote stability in

Afghanistan, and for India's future are difficult to exaggerate. North Korea is a second nuclear-armed state whose stability is worsened by the economic crisis. At issue is the extent to which South Korea (along with China and Japan) can provide resources to the North to help stave off collapse.

Another serious consequence of the global economic crisis, one that affects both developed and developing countries, is the reality that protectionism is on the rise. One realm is trade; some seventeen of the twenty governments set to meet in London early next month have increased barriers to trade since they met late last year. Negotiated free trade agreements with Colombia, Panama, and South Korea continue to languish in the U.S. Congress. The president lacks the Trade Promotion Authority essential for the negotiation of complex, multilateral trade accords. Prospects for a Doha round global trade pact appear remote. The volume of world trade is down for the first time in decades.

The economic but also strategic costs of this trend are high. Trade is a major source of political as well as economic integration; one reason China acts as responsibly as it does in the political sphere is because of its need to export its products lest potentially destabilizing unemployment jump sharply. Trade has other virtues as well. More than anything else, trade is a principal engine of global economic growth. The completion of the Doha round might be worth as much as $500 billion to the world in expanded economic activity. One-fourth of this expanded output would occur in the United States. This is the purest form of stimulus. For the United States, exports are a source of millions of relatively high-paying jobs; imports are anti-inflationary and spur innovation. Alas, the economic crisis will make it difficult if not impossible to conclude new trade pacts and to gain the requisite domestic support for them. Economic nationalism is on the rise, and when this happens, the will and the ability of political leaders to support policies that are perceived to hurt large numbers of their citizens (but which in reality help many more) invariably goes down. What is more, the economic crisis may also make it more difficult to reach agreement on a global climate change pact when representatives of most of the world's countries gather in Copenhagen late this year. Developed and developing countries alike will resist commitments that appear to or in fact do sacrifice near-term economic growth for long-term environmental benefit.

What, then, should be done to limit the adverse strategic effects of an economic crisis that is certain to get worse and persist for some time?

The United States – the Obama administration and the Congress – should resist protectionism. "Buy America" provisions in the stimulus legislation will increase costs to American consumers and all but make certain that other countries will follow suit, thereby reducing the prospects for American firms to sell abroad. More American jobs are likely to be sacrificed than preserved. Increased protectionism will also dilute the strategic benefits that stem from trade and its ability to contribute to international stability by giving governments a stake in stability. Similar arguments hold as to why "lend national" provisions are counterproductive. Bringing countries into the world trading system (best done through WTO accession) makes strategic sense, too, as it gives them a stake in maintaining order at the same time it opens government decision-making to greater degrees of transparency.

Recession cannot become this country's energy policy or a reason not to decrease U.S. consumption of oil, imported or otherwise. Lower prices will dilute any economic incentive to consume less oil. Regulatory policy will be the principal means of discouraging demand and encouraging the development of alternative energy sources and technologies. Reduced demand is essential for strategic reasons (so as not to leave the United States highly dependent on imports and so that countries such as Russia, Venezuela, and Iran do not benefit from dollar inflows), for environmental reasons, and for economic reasons, i.e., not to increase the U.S. balance of payments deficit. The goal should be to use this moment of temporarily-reduced prices to decrease the chances we as a country again find ourselves in a world of high energy prices once the recession recedes.

The United States should work with other developed and reserve-rich countries to increase the capacity of the IMF to assist governments in need of temporary loans. Current capacity falls short of what is and will be needed.

It would be helpful if aid budgets were not victims of the economic crisis. Aid is needed on a large scale not just for humanitarian reasons (to fight disease, etc.) but also to build the human capital that is the foundation of economic development. Aid will also be a necessary substitute in the short and medium run for investment. Absent such flows we are likely to see greater misery and an increased number of failing or failed states.

The upcoming G-20 summit in London provides an opportunity to adopt or encourage some useful measures in many of these realms. It is essential that others, including Europe and Japan, take steps to stimulate their economies. It is equally important, though, that guidelines be promulgated so that stimulus programs do not become a convenient mechanism for unwarranted subsidies and "buy national" provisions that are simply protectionist measures by another name. The London meeting is also an opportunity to increase IMF capacity, to generate commitments to provide aid to developing countries, and to agree on at least some regulatory principles for national banking and financial systems. There is not time, however, to try to rebuild the architecture of the international economic system, solve the problems caused by countries that run chronic surpluses, or revamp the system of exchange rates.

Let me close with two final thoughts. Much of this hearing and statement is focused on the question of the consequences of the economic crisis for global security. But it is important to keep in mind that the relationship is not only one way. Developments in the political world can and will have an effect on the global economy. Imagine for a second the economic consequences of, say, a Taiwan crisis or fighting between India and Pakistan or an armed confrontation with Iran over its nuclear ambitions. This last possibility is the most worrying in the near term and underscores the importance of trying to negotiate limits on Iran's enrichment program lest the United States be confronted with the unsavory option of either living with an Iranian near or actual nuclear weapons capability or mounting a preventive military strike that, whatever it accomplished, would be sure to trigger a wider crisis that could well lead to energy prices several times their current level.

Finally, getting through this economic crisis should not be confused with restoring prolonged calm in the markets or sustainable growth. Enormous stimulus measures here at home coupled with equally unprecedented increases in the current account deficit and national debt make it all but certain that down the road the United States will confront not just renewed inflation but quite possibly a dollar crisis as well. At some point central banks and other holders of dollars will have secnd thoughts about continuing to add to their dollar holdings, currently larger than ever given the desire for a safe harbor. Ongoing U.S. requirements for debt financing, however, will likely mean that interest rates would need to be raised, something that could choke off a recovery. This underscores the importance of limiting stimulus packages to what is truly essential to reviving economic activity and to taking other measures (such as entitlement reform and the already discussed steps to reduce oil use) lest the current crisis give way to another one.

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Global Recession and US National Security

Testimony Before the House Armed Services Committee

Richard N. Cooper
Harvard University

March 11, 2009

We should start by noting that during the five years preceding the current downturn, 2002-2007, the world economy performed exceedingly well, one of the best half decades in history. Growth was high and widely spread, inflation was low in most countries. This exceptional performance may have created unsustainable expectations about the future, particularly in young adults who do not recall earlier, less buoyant periods.

The impact of the current global recession on US national security, interpreted broadly, is extremely complex. There are pluses and minuses. Start with some of the pluses.

It will be easier to recruit and retain desired persons for the US armed services at US unemployment rates of 8-10 percent than at unemployment rates of 4-5 percent, with lower signing bonuses.

One of the characteristics of the 2002-2007 global boom was a sharp rise in the prices of primary products – especially petroleum (used for cooking in many poor countries in the form of kerosene, and for transport) and staple foods such as rice, wheat, corn, and vegetable oils. This created great anxiety in many countries about major social unrest, leading often to large government subsidies. Such prices have greatly receded

since mid-2008, although they generally remain significantly higher than they were six years ago. Social pressures from this source have greatly eased. Of course, producers of these products – assuming the rise in world prices was passed on to farmers –will have lower incomes. But the potential social problems were mainly in urban areas, where consumers predominate. The World Bank has estimated that more than half of developing countries will benefit from the price declines (Global Economic Prospects, 2009, p.45).

Third, the oil revenues of all exporting countries, while higher than early in the decade, have declined sharply from the elevated levels of late 2007 and early 2008, when oil prices briefly exceeded $140 a barrel. This includes in particular the revenues of Russia, Iran, and Venezuela, each of which in different ways has posed problems for the United States, greatly facilitated by high government and foreign exchange revenues. All three countries have become fiscally undisciplined, and all will have to cut their expenditures sharply in view of their declines in revenue, unless they are willing to countenance a sharp increase in domestic inflation – which would increase domestic disaffection with their respective governments. The decline in oil prices is directly linked to the slowdown in world economic activity, so in this respect the slowdown can be said to benefit US national security. Concretely, Iran will have to balance more carefully its financial and material support for Hezbollah against pressing requirements for domestic expenditure.

On the other hand, the recession implies a decline in demand, including demand for labor-intensive products made in many developing countries. According to World Bank projections, world trade is likely to fall in 2009 for the first time since 1982, the last

major recession. This contrasts with an annual growth in trade volume in excess of seven percent a few years ago. Thus a major source of new jobs, pulling people from the countryside into urban areas in many countries, will disappear, and perhaps briefly go into reverse. There will be disappointed migrants, and millions of workers laid off. For example, it is said that in China already over 20 million migrants have lost their jobs, mainly in low-skilled manufacturing and in construction; in addition, several million newly graduated students will have difficulty finding jobs in the current economic environment. The Chinese authorities are greatly concerned about the eruption of social unrest, and have already taken a number of steps to head it off, e.g. by providing loans for self-employment by new college graduates, and by taking steps to increase real living standards in rural areas.

It is worth noting that in the oil-exporting Gulf Arab countries the impact of the decline in new jobs will fall mainly on foreigners rather than on residents, since most of the work in the private sector, and much in the public sector, is performed by temporary migrants from other countries. Of course budget reductions may have an impact on the incomes of residents, although these countries typically have substantial public savings on which they can draw to avoid any major reduction.

The recruiting ground for terrorists – and for criminal gangs –is among idle, disaffected, and alienated young men. They are not typically from among the poorest people in the world, but from people that by world standards would be considered "lower middle class." The recession will increase the numbers of such people, but probably not massively unless the recession becomes much worse than is now generally expected.

Some countries are more vulnerable than others. Large numbers of Pakistanis working in the Gulf area may lose their jobs, returning to Pakistan and depriving that country of their remittances. Pakistan has a large current account deficit that will need to be financed as exports and remittances decline, if a sharp decline in domestic output is to be avoided.

. The most important effect of the financial crisis and subsequent recession may be the least tangible: a serious worldwide erosion of confidence in American competence, a confidence which previously almost carried a sense of invincibility. The rest of the world typically placed more confidence in American competence than was warranted – most Americans knew better. But the events of the past six years have brought American competence under severe doubt, starting with the post-combat phase of the war in Iraq, which the United States is generally viewed as having bungled. This was reinforced by the perceived debacle over handing Hurricane Katrina. Now the subprime mortgage crisis, at the heart of the seemingly invincible American financial system, leading to a wider financial crisis and now a global recession, further undermines confidence in American competence. This crisis clearly started in the United States, not in some emerging market or (as in 1992) in a feckless Europe. This loss of invincibility may embolden existing hostile groups to try through some dramatic act to bring the system of American capitalism, now vulnerable, crashing down for good.

SECURITY CHALLENGES ARISING FROM THE GLOBAL ECONOMIC CRISIS

Dov S. Zakheim

Statement Before the House Committee on Armed Services

March 11, 2009

SECURITY CHALLENGES ARISING FROM THE GLOBAL ECONOMIC CRISIS

Dov S. Zakheim

Chairman Skelton, Mr. McHugh, it is a distinct privilege for me to appear again before this Committee. Like you, I am deeply concerned that economic crisis that has affected the United States in particular and the international community generally poses a major threat to American national security interests. That threat is likely to manifest itself in four, and possibly five, distinct ways.

First, it will create major pressures on the defense budget, most notably the acquisition—that is, the procurement and research and development accounts.

Second, it will likely result in a further contraction of defense spending, and therefore operations as well and modernization, on the part of key allies and friends.

Third, it could prompt nations that are ambivalent about their relationship with America, most notably China and Russia, to act in ways that are deleterious to American interests.

Fourth, it could prompt even more hostile behavior on the part of nations such as Iran and Venezuela that already bear deep antipathy toward the United States.

Fifth, it could further destabilize states that are already vulnerable to internal unrest.

Finally, it could spur further international criminal behavior that could undermine internal American stability.

Please permit me to address each of these concerns in turn.

The Defense Budget

Economists have long debated whether measuring defense spending as a percentage of the Gross Domestic Product has any real utility. Among those who do see this measure as having either economic or political significance, or both, some have argued that defense spending is too high a percentage of GDP, others have taken the opposite view. Whatever the validity of all of these arguments during so-called "normal" times, during the current economic crisis, in which the GDP is slipping far more sharply than was predicted even two months ago, the issue must be seen in a very different light. Increasing the percent of GDP spent

on defense when GDP is declining may simply mean nothing more than not standing still, or worse, declining with the GDP itself.

The defense budget is already under pressure as a result of the economic crisis. Real growth in defense spending, excluding the wartime supplemental, is but 1.7% If the supplemental is included the growth in spending is some 1.4%, because next year's supplemental is lower than the planned total of supplemental expenditures in FY 2009. These figures represent a sharp drop in the growth of annual defense spending over the past eight years, which averaged 4.3 per cent. in real terms.

Moreover, the lower rate of defense budget growth will manifest itself most sharply in the acquisition accounts, procurement and research and development. It has been by means of spending funds from these accounts that America has been able to assure itself of long term military superiority, regardless of the capabilities of a potential foe. When these accounts were assaulted, as they were in the late 1970s, not only did our leading adversary, the Soviet Union, became far more reckless, invading Afghanistan, but others, like Iran, also exploited what they perceived to be American weakness and introversion. We were saved from a similar fate in the 1990s because the Soviet Union had collapsed, and because the defense budget recovery of the 1980s enabled us to put powerful forces in the field from Operation Desert Storm onwards. If we do go through another reduction in defense procurement spending, however, can we say with confidence in one or two decades' time no powerful adversary will act upon a perception of American weakness and threaten one of our vital national interests?

It is a truism that, since World War II, virtually every war we have fought was unforeseen. It is equally true that we have consistently structured our future force posture on the basis of a war we had recently fought, or were still fighting. I worry that we are falling into the same trap today; the result could well be, as in Korea, or Iraq, many years of bloodshed and lost treasure until we righted ourselves, or, as in Vietnam, outright failure. The opportunity cost of reductions in planned acquisition budgets are therefore exceedingly high, and, if not reversed, will far outweigh any supposed short-term benefits from budget savings.

Cuts in procurement in particular will have more immediate repercussions as well. They will result in the loss of jobs, in particular, employment for skilled blue collar workers, engineers, and physicists, the very people who earn far less than $250,000 a year, and at whom the Administration claims it is targeting its recovery plan. Moreover, it is most likely that as jobs dry up, firms will apply the traditional "last-in, first-out" principle. In other words, those who have

benefited from the most up-to-date education and training will be lost to the Nation's vital defense industrial base.

Ironically, even as young American engineers in particular will find themselves unable to contribute to our national security, the United States will continue to train foreign students in the engineering and the hard sciences, thereby enabling them to contribute to military modernization in their own countries. In particular, it is well known that brilliant young Chinese students are populating the top science and engineering programs of our major universities. While American graduates of those programs will find the doors of defense industry closed to them, China's expanding military will welcome Chinese graduates of these programs with open arms.

Members of the committee might also consider that the impact of a flattening of acquisition spending will be unevenly distributed around the country. Those states with major defense industrial activity, including hard hit areas in Michigan, the Northeast and the South, will suffer more than other parts of country. Surely, this cannot be what the Administration intends as it pours hundreds of billions of dollars into job creation programs.

Finally, because the Administration is ratcheting up the national debt so severely, once the economic turnaround does occur, and there is a growing demand for dollars, and a resulting rise in interest rates on government paper, the cost of servicing that debt will rise dramatically. Budget deficits will increase sharply as a result, and the government will be forced to cut back on discretionary programs. Because defense accounts for more than half of the entire US discretionary budget, and has been increasing its percentage of discretionary spending in the past eight years, it will be the most likely target for real cuts, not merely a flattening of the growth rate, in order to "manage" the ballooning deficit. The impact on our national security will be profound, and negative.

Defense Spending as an Economic Stimulus

In her testimony before the House Budget Committee on January 27th, Alice Rivlin, who was Director of the Congressional Budget Office when I was an analyst there, underlined the difference between a short-term stimulus and what she called "a more permanent shift of resources into public investment in future growth." She went on to say that "the first priority is an "anti-recession package that can be both enacted and spent quickly to create and preserve jobs in the near-term, and not add significantly to long run deficits." The defense budget offers several ways to meet her prescription.

Fast spending, job creating programs include:

o Reducing deferred maintenance, accelerating ship overhauls, and aircraft and ground vehicle rework

o Advance procurement of subsystems for major units like warships. Such procurement would preserve the second and third tier industrial base, which is most vulnerable to the current downturn

o Expanding and accelerating military construction and family housing programs.

Of these three elements, only the third is part of the $787 billion stimulus package that the President signed on February 17th. There is, of course, considerable merit in the $7.4 billion in defense programs that have been approved, most of which are directed at military construction and operations and maintenance at military facilities; family housing, military hospitals; and the Homeowners' Assistance Program for military families that must sell their homes when undergoing a Permanent Change of Station. But the stimulus does not go far enough in the defense realm, and additional programs to support both rework and overhauls, as well as advance procurement, will create and sustain critical jobs in hard-hit areas.

Alliance Relations

The economic crisis is likely to further diminish the already weak appetite of allies and friends both to increase or even maintain their current levels of defense expenditure, and to contribute to coalition operations in Afghanistan. Few of our major allies and friends spend as much as three per cent. of their Gross Domestic Product on defense. Their GDPs, like ours, are in decline and in several cases, such as Japan, are declining at a far faster rate than ours. Korea and Taiwan, like Japan, are suffering from a drop in exports, notably in the automobile sector. Iceland's financial collapse has received widespread attention.

Economic constraints have at times been an excuse for allies not to do more for the common defense of the West; today, that excuse is being buttressed by reality. Whether excuse or reality, the net result will be exactly the same: the United States will be forced to bear an even heavier burden to defend Western interests, at a time when it will have fewer resources enabling it to do so.

The case of the F-35 provides a distinct example of the interplay between pressures on the US defense budget and alliance relationships. The F-35 program could be one of those affected by the redistribution of defense spending

priorities. There are eight countries that currently are co-developing this aircraft, including key allies Britain, Canada and Australia, and many more planning to purchase it, among them Israel, Singapore and many of the European allies that currently fly F-16s. Any slowdown of the program will increase its costs, and could put it beyond the purchasing power of several F-35 partners. It could also could embitter states that have contributed to its development, furnishing them with yet another reason to be even less inclined to contribute to coalition efforts if Afghanistan, and potentially elsewhere, than they are today.

Ambivalent States

The United States has a complex relationship with two of the world's most powerful states, China and Russia. Neither is an outright adversary, neither is an ally, or even partner, in the sense that describes the relationship of other countries that are not formal American allies. China is particular has significant leverage over the American economy, because of its trade surplus with the United States and its vast holdings of dollars. It has now surpassed Japan as the single largest foreign holder of U.S. Treasury bonds, which totaled nearly $696.2 billion by the end of 2008.

There has been much recent discussion regarding China's readiness to disrupt the American economy by refusing to accept American Treasury notes or dumping its dollars on the world market. China has done neither, and generally has behaved like a responsible partner as the world financial crisis has deepened, and even as its own GDP is declining from 8-9% to 6 per cent and perhaps even lower. Yet China has taken some major steps to hedge against American economic trends. In particular, it has begun to move its dollar holdings into shorter maturities, giving it more flexibility should it choose to withdraw from the American market.

This flexibility could also enable China to buy into American industry in a major way. That process actually began a few years ago. Indeed, in 2007, well before the financial crisis seriously weakened the American economy, Chinese investments had jumped to $9.6 billion from the previous year's $66 million. In 2008 China continued to buy small and larger firms, though some have not played out well, such as the ill-fated stake in Bear Stearns, and underperforming investments in the Blackstone Group and Morgan Stanley. Nevertheless, China is likely to continue to buy American firms, which, when combined with its dollar holdings will give it the kind of economic leverage that it could easily translate into political leverage if it perceives that America's willingness to spend money on its national security is beginning to ebb.

In addition, China's military continues to expand and diversify its capabilities, which are becoming increasingly sophisticated. While China may not match the level of GDP growth its has sustained for neatly two decades, even if its military expands at the same rate as national GDP growth, its modernization program will continue apace.

Russia has not nearly the same economic relationship with the United States as China's, and little economic leverage to speak of. But Russia has become increasingly assertive on the international scene. The cyber bullying of Estonia in May 2007, the August 2008 invasion of Georgia , the naval exercises with Venezuela in the Caribbean in November, and the successful pressure on Kyrgyzstan to close the American airbase at Manas, all point to a Moscow that is determined to recover its former superpower status, and to do so at the expense of the United States and its allies.

Russia cannot yet be called an adversary, and there are many areas where American and Russian interests converge, most notably countering international terrorism and Islamic extremism. Nevertheless, its international behavior is troubling, and even if its oil revenues fail to meet projected levels (Moscow's budgets assumed $70/barrel, far higher than current prices), it might still choose to continue the military modernization program it recently began.

In particular, Russia appears ready to continue its nuclear modernization, which in absolute terms consumes fewer resources than modernizing its conventional forces. Indeed, only last Thursday deputy defense minister, General Valentin Popovkin explicitly stated that the government would not permit the current financial crisis to slow down its plan to accelerate the modernization of its nuclear forces and its anti-satellite capabilities. He also said that Moscow would procure new missiles to deploy near Poland if the U.S. proceeded with its plans to deploy missile defenses in Poland and the Czech Republic. His statements can hardly be seen as reassuring in the context of a cutback in American military modernization.

Hostile States

The economic crisis, and in particular, the drop ion the price of oil, might be expected to limit the military expansion of states unfriendly to America. Yet that need not be the case at all. As appears to be the case with Russia, and as it was with the Soviet Union, a weak economy nevertheless can sustain a military threat to American interests. North Korea's economy has been a basket case for decades; that has not inhibited Pyongyang from sustaining a nuclear weapons program and maintaining a military that, while weaker than its South Korean counterpart, could still inflict significant damage on the ROK if it chose to do so.

Iran's economy likewise has been out of balance since the 1979 revolution, and its heavy dependence on petroleum revenues that are in decline will no doubt slow down its conventional force modernization. Whether it will truly slow down its nuclear program is quite another matter; previous slowdowns have been due to technical difficulties rather than resource constraints.

Resource constraints also are unlikely to prevent Iran from pursuing its policies of supporting terrorist groups like Hamas and Hezbollah. Indeed, as the financial crisis begins to affect the Middle East, Iran may encourage more unrest among minority Shi'a populations throughout the region, most notably in states like Bahrain, which has a Shi'a majority. Again, any indication of American downsizing of its own defense efforts will simply serve to encourage Iran's destabilizing policies.

Venezuela, like Iran, has an unbalanced, petroleum-driven economy. It too is feeling the pressure of declining oil prices. Like Iran, however, it can be expected to continue, and even intensify its efforts to destabilize states that are friendly to the U.S. and are suffering from the consequences of the world economic meltdown. Hugo Chavez' left-wing populist economic agenda, coupled with his anti-American diatribes, may resonate well with the less well privileged classes in Colombia and elsewhere in Latin America who will suffer most form the effects of the economic crisis and will blame America for it. Chavez already has acolytes in the Presidential palaces of Ecuador and Bolivia. There can be little doubt that he will seek to expand his influence in other Latin American states affected by the crisis, to the detriment of American economic and national security interests.

Threats to Marginally Stable States

The majority of America's most recent military interventions have resulted from instability in states that had failed or were failing: Haiti, Somalia, the Balkans, and to a great extent, Afghanistan, all fall into this category. The economic crisis is likely to exacerbate the political vulnerability of many other states, and lay them open to the kind of destabilizing activities that are practiced by Iran and Venezuela.

Mexico is already in the throes of a major crisis prompted by the increasingly brazen activities of drug lords. The decline in oil prices, coupled with a declining level of oil production, a reduced level of remittances from the United States, and a decline in manufacturing will further weaken the central government's ability to fight the drug lords both directly with its military and police forces, and indirectly through programs that would improve the lives of its people.

Pakistan's internal stability has always been tenuous. For the past few years its growing economic strength provided the government a vehicle with which to counter the rising power of Islamists not only in the Federally Administered Tribal Area, but throughout the country. The economic downturn has already weakened the government's hand vis a vis the Taliban, and will continue to undermine the government's ability to assert its control over the country. Given Pakistan's nuclear arsenal, and its continuing friction with India, which the Islamists continue to fuel, the prospect for a major conflagration in South Asia is very real.

Over the past eight years, the Bush Administration poured considerable resources into Africa; its programs won bipartisan support. America's initial successes in many of the continent's unstable countries are likely to be undermined by the economic crisis. The conflicts in Sudan and Central Africa continue to rage on, while tensions in oil producing states, notably Nigeria, are likely to intensify. One area where American defense spending could have a direct impact on African stability is that of piracy off the Horn of Africa. A stretched United States Navy must have sufficient funds to continue its anti-piracy operations, even as it is called upon for other missions, both long standing deployments, and potential new operations, such as enhancing Israel's missile defense capabilities in the face of a potential Iranian nuclear threat.

International Criminal Activity and the Economic Crisis

An April 2008 report by the Department of Justice highlighted the many ways that international organized crime poses a strategic threat to the United States. These include criminal penetration of global energy and strategic material markets that are vital to American national security interests; logistical and other support to terrorists and foreign intelligence services; weapons smuggling into and out of the United States, often in support of terrorist organizations and corrupting public officials in the U.S. and abroad.

The current international financial crisis is likely to facilitate these and other criminal activities, particularly if declining national budgets in friendly states result in cutbacks in law enforcement capabilities. All too often, criminal activities are viewed in a different compartment from that of national security. Today and while the economic and financial crisis persists, they must be seen ad part of a seamless whole that must be addressed in an integrated fashion.

Conclusion

The national security implications of the economic crisis are both broad and profound. They will affect our alliance relationships, our interactions with major

states whose intentions toward us remain unclear, the behavior of unfriendly states, the stability of weak and failing states, and the prospects for fighting international organized crime. Most importantly, the economic crisis could have a major and deleterious impact on our national defense budgets, and therefore, our national security posture, which would complicate, and indeed exacerbate, the relationships we have worldwide. Whether the crisis indeed has such an impact on our defense posture remains very much in the hands of America itself. We can forge ahead with defense modernization. We can protect the jobs of our young engineers and skilled blue collar workers. We can continue to signal our determination to fight for our values and freedoms. The budget is policy. And the policy choice is ours, and our alone.

Honorable Dov S. Zakheim

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From 2001 to April 2004 he served as the Under Secretary of Defense (Comptroller) and Chief Financial Officer for the Department of Defense, acting as the Secretary of Defense's principal advisor on financial and budgetary matters, developing and managing the world's largest budgets, overseeing all aspects of the Department's accounting and auditing systems, and negotiating five major international defense agreements. From 2002-2004 Dr. Zakheim was DOD's coordinator of civilian programs in Afghanistan. He also helped organize both the June 2003 UN donors' conference on Iraq reconstruction and the October 2003 Madrid Donors' Conference.

From 1987 to 2001 he was both corporate vice president of System Planning Corporation, a technology, and analysis firm based in Arlington, Va. and chief executive officer of its subsidiary, SPC International Corp.. During the 2000 presidential campaign, he served as a senior foreign policy advisor to then-Governor Bush.

From 1985 until March 1987, Dr. Zakheim was Deputy Under Secretary of Defense for Planning and Resources in the Office of the Under Secretary of Defense (Policy), playing an active role in the Department's system acquisition, strategic planning, programming and budget processes. Dr. Zakheim held several other DOD posts from 1981 to 1985. Earlier, he was a principal analyst in the National Security and International Affairs Division of the Congressional Budget Office.

Dr. Zakheim has served on a number of government, corporate, non-profit and charitable boards. His government service includes two terms on the United States Commission for the Preservation of America's Heritage Abroad(1991-93); the Task Force on Defense Reform (1997); the first Board of Visitors of the Department of Defense Overseas Regional Schools (1998); and the Defense Science Board task force on "The Impact of DOD Acquisition Policies on the Health of the Defense Industry" (2000). He currently is Chairman of the National Intelligence Council's International Business Practices Advisory Panel, and a member of the Defense Business Board, which he helped establish, the Commission on Wartime Contracting, the Secretary of the Navy's Advisory Board, the Defense Science Board task force on "Fulfillment of Operational Needs," the Chief of Naval Operations Executive Panel and the Council on Foreign Relations.

A 1970 graduate of Columbia University with a B.A., summa cum laude, Dr. Zakheim also studied at the London School of Economics. He holds a doctorate in economics and politics at St. Antony's College, University of Oxford, where he held three fellowships. Dr. Zakheim is a Senior Advisor at the Center for Strategic and International Studies and was an adjunct Senior Fellow of the Council on Foreign Relations and an adjunct Scholar of the Heritage Foundation. He has been an adjunct professor at the National War

College, Yeshiva University, Columbia University and Trinity College, Hartford, Conn., where he was a Presidential Scholar. The author of a dozen books or monographs, and of numerous articles, Dr Zakheim has lectured and provided print, radio and television commentary on national defense and foreign policy issues domestically and internationally. He is the recipient of numerous awards for his government, professional and civic work, including the Defense Department's highest civilian award in 1986, 1987 and 2004.

A WORLD TRANSFORMED: THE GREAT HOLLOWING OUT AND THE RISE OF NEW THREATS

The Security Consequences of the Current Global Economic Crisis

By David Rothkopf, Visiting Scholar, Carnegie Endowment for International Peace

Prepared as Testimony for the Armed Services Committee of the U.S. House of Representatives

Wednesday, March 11, 2009

Mr. Chairman, members of the committee, thank you for inviting me to be here today with you. It is a privilege to have this opportunity to appear with the other extremely distinguished individuals testifying before you to address what is likely to be the single biggest driver of geopolitical change impacting the world for the foreseeable future: the consequences of the global economic crisis that began over a year ago. As of now, there is no end in sight to this once in a lifetime event and the best minds...many of whom missed the onset of this crisis to begin with and whose views therefore must be taken with a grain of salt...are agreed about little except that things are likely to get worse worldwide before they get better.

Overview

We have only experienced the first wave of shocks associated with the international economic collapse. It is still too early to say how long the economic dimensions of the global downturn will continue to challenge leaders and populations worldwide, and while it is impossible to predict how much further conditions will deteriorate before the global economy begins to recover as it inevitably will, one set of consequences of the crisis can be predicted with a high degree of confidence. A crisis of this severity, one that according to the most recent estimate by the World Bank will produce net global contraction in 2009, that has already brought U.S. stock markets to 12 year lows stripping away over half their value, that has deeply eaten into world trade cutting volumes by almost a third and into capital flows and shaken the global financial system to its very foundations, will unavoidably produce a series of political aftershocks.

A recent report for the Asian Development Bank suggests the crisis has already obliterated approximately $50 trillion in asset value worldwide - the equivalent of roughly a year of global economic output. We have already seen political reactions in public demonstrations and other violent episodes in a diverse list of countries including Greece, China, Haiti, Latvia, Bolivia, Bulgaria, Russia, Italy, Ireland, Iceland and Lithuania. But these events are just the first rumblings of upsets that almost certainly will ultimately be far more serious and will have important national security consequences for the U.S.. Further, the crisis may in the longer run produce lasting geopolitical shifts as power is concentrated in the hands of nations with available capital, drawn away from those who are net borrowers, and greater and greater constraints limit the options of nations who are likely to spend years seeking to work down the debts incurred during this time of severe global contraction.

This new reality was reflected in the fact that Director of National Intelligence Blair in his February 12, 2009 testimony to the Senate Select Committee on Intelligence on the Intelligence Community's Annual Threat Assessment cited the crisis as the primary driver of concerns in today's world. As he clearly stated, "The primary near-term security concern of the United States is the global economic crisis and its geopolitical implications."

In fact, during the past few months, as the crisis has brought down governments (Iceland) and threatened others (across Eastern Europe), it has also had more pernicious effects that are harder to see. Greatest of these is certainly its impact on the United States, reducing the resources available to this country as well as seemingly eating away at the political will that would be required if the U.S. were to play the active, broad-ranging internationally stabilizing role that has marked our foreign policy since the end of the Second World War. Adding to this is the weakening of our core alliances, not in terms of the desire to collaborate, but rather because allies have been preoccupied by challenges at home. Some leading allies, notably the EU, have in recent weeks seen the viability of their core institutions questioned. The weakening of international institutions has been a related consequence of the crisis. Without a degree of financial support and political flexibility for vital organizations like the IMF and the World Bank that seems unlikely at the moment, we may well find ourselves at a true crossroads for the international system. At precisely the instance that the crisis has revealed a need for greater global regulatory oversight and stronger financial institutions to prevent and to respond to crisis, rising nationalism, the political imperative of turning inward, and limited resources threaten existing institutions with irrelevance and needed new ones with being stillborn.

Given other weaknesses in this system, such as the dubious value- added of much of the United Nations, the unsettling recent track record of the global non-proliferation regime, the troubles at the WTO with the Doha Round and the failure to establish, as yet, a global environmental organization to address climate change, it is possible to see the crisis neutralizing much of the system built up since the end of the Second World War. The challenges the system faces are made all the more complex by the need to rethink the steering committee for this system and recognize the rise of emerging powers and the declining relevance of some established powers. That this economic crisis has also produced a global crisis of confidence in institutions from national governments to financial markets, from international economic coordination mechanisms that have failed to big corporations, only further exacerbates these already daunting challenges.

Beyond threats to stabilizing forces and the international system, individual countries and key regions are also likely to see decline and unrest brought on by the crisis. Some of this unrest is likely to take the form of regime changes or social instability. Other risks associated with the crisis will come as opportunists seek to use anger at the failures in a system that is closely associated with the U.S. to foment hatred, to fuel recruitment for extremist and anti-US organizations and to simply produce distractions from local problems via the time-tested means of identifying foreign or domestic scapegoats and lashing out against them.

In short, the international security environment is likely to deteriorate over the next several years both because of a great hollowing out and weakening of the stabilizing forces in the world as well as from the emergence of new, destabilizing factors.

This committee is to be commended for undertaking its investigation of how the crisis is likely to impact the national security interests of the United States. The short answer is: sweepingly, enduringly and perhaps irreversibly (if we remain burdened with debt and resource-constrained in ways that can only weaken us as a nation). What follows is a brief discussion of how to look at the different ways that the crisis is likely to impact geopolitics and U.S. national security interests first in terms of a taxonomy of threats and then in terms of some specific potential flashpoints that illustrate broader trends or are likely to be of special significance.

Risk Drivers and a Framework for Considering the Threats Likely to Arise

There are a host of drivers associated with the global economic crisis that are likely to produce increasing geopolitical tension and create security problems worldwide. Among these are:

- ***Destabilizing Internal Effects of the Crisis***: The crisis eats away at the foundations of stable governments. Reduced growth produces reductions in tax revenues making it more difficult to provide security or social programs. Reduced capital inflows undercut growth and the ability to create or maintain jobs. Substantial losses of jobs and savings produce social tensions, anger, unrest, resentment toward the "haves." Current estimates suggest as many as 50 million people may lose their jobs as a result of this recession by the end of 2009. This may include pressures leading to internal migration of people seeking employment or better conditions, which in turn may be destabilizing as it produces competition for resources and unsafe living conditions, and tensions associated with hardship. Governing parties are seen as complicit in the downturn and lose political credibility. Etc. As a consequence, viable states will become weaker and some weak states will become failed states, unable to keep the peace, combat crime, etc. At the same time, opposition groups including legitimate political opposition, rebel groups and criminal cartels will seek to use the crisis as a wedge issue or to mobilize support for their anti-government views. Finally, as noted above, global or regional actors such as the U.S., the EU or China which may have played a stabilizing role through diplomatic, military, aid or other forms of intervention may feel resource-constrained or may lack the political will to prevent or contain emerging or active conflicts. Should the weakening or retreat of these actors become chronic or permanent taken along with the potential weakening of international institutions and alliances (see above and below), a void may be created that itself will invite, prolong or deepen the threats to U.S. national interests worldwide.

- ***Destabilizing Bilateral or Regional Effects of the Crisis***: The weakening of states can produce instability that spills across borders or can produce social pressures that increase migration and create associated tensions along borders. The rise of opposition groups can create an opportunity for like-minded neighbors to support their activities and thus cause rifts and

potential conflicts to spread. Political and economic weakness in nations can be seen by opportunistic neighbors (some wishing to produce distractions from their own crises) as an invitation to intervene in their neighbors politics or even to step in and take control of neighboring territories or to seek to use force to resolve in their favor long-simmering disputes. In the same vein, old animosities may be inflamed by the crisis either because they produce tensions that play into the origins of old rivalries or because political leaders seek to play on those rivalries to produce a distraction from their inability to manage the economic crisis. Need may enhance tensions and produce conflicts over shared or disputed resources. A desire to preserve national resources, jobs, or capital may produce reactive economic, border or other policies that can increase tension with neighbors. This can include both trade and capital markets protectionism (in traditional and new forms—see below), closed or more tightly monitored borders, more disputes on cross-border issues and thus both an increase in tensions and a decreased ability to effectively cooperate with neighbors on issues of common concern.

- ***Destabilizing Global Effects of the Crisis***: Quite apart from the global impact of the economic downturn itself—reduction of growth, reduction of liquidity, reduction of capital flows, reduction of trade—there are a number of secondary effects, consequences of these primary problems, that will happen internationally impacting many countries, inter-regional relationships, international institutions, and the overall international mood/ability of the international community to function optimally. An example would be a generalized impulse among countries toward trade protectionism, capital markets protectionism, and to reevaluate effectiveness of and relationships with the existing international institutions if their precepts or rules run contrary to what internal political and social pressures demand (or if the institutions become seen as costly, politically unpopular luxuries.) Tension between regions may also result whether these are along traditional lines (North-South) or emerging lines (the U.S. as capital importer vs. Asia as capital provider). Another set of tensions may result from efforts to remake the international system to respond to the crisis and to what is perceived as a new, mid-crisis or evolving post-crisis balance of power, which is likely to create fault-lines between those who once dominated, led or participated in key institutions and those who feel it is now their right or time to assume new roles. Another set of global tensions may be created as large numbers of countries realign in support of "solutions" or ideological positions they see as likely to promote recovery or a better future and others take opposing views or as groups identify causes of the crisis and perceived bad actors or flawed systems and seek to either lash out at them or to isolate them (either on the merits or for opportunistic reasons). Consequences of the next order may arise as nations are divided over how to respond to some of the geopolitical consequences (including military conflicts) that may be spawned by the crisis.

A Question of Degree: How Bad Might it Get?

That the global economy is in dire straits is no longer open to dispute. In recession for essentially all of 2008, the key questions to ask with regard to how the crisis might drive geopolitics are how bad might it get and how long will it last? While this testimony is not the place for in-depth economic

analysis (and while there are a wide range of viewpoints out there), we can settle on some useful guidelines for those whose job it is to anticipate geopolitical risks and prepare for them. First, there is almost no credible set of estimates anticipating an economic rebound before the second half of 2009 and many expect the downturn to last into 2010 and beyond. Next, the proximate causes for this crisis—the collapse in the U.S. housing market, the subsequent collapse in mortgage-backed securities markets and the resulting meltdown in the international financial system which has destroyed some institutions, weakened many others and created a global liquidity crisis—are far from being resolved. The U.S. government has yet to unveil a program likely to establish a "bottom" in U.S. housing markets, to help mortgage-holders restructure their debt or meet their obligations, or to help banks get "toxic" loans off their balance sheets. Liquidity provided to banks has not made its way into the markets. Major banks like Citibank and Bank of America appear to remain at risk. There is something close to a consensus that most banks continue to under-report their bad assets. Falling housing prices in the U.S. may well have exacerbated the problem by putting many millions more homes "under water." And the contraction in the economy and the increases in unemployment to levels not seen for a quarter century are seen as likely triggers of a consumer credit crisis that may produce a second wave of bank failures. Further, the entire global financial system has sustained a blow that has called into question the viability of many of the world's largest institutions, the viability of the current international regulatory regime and the very structure of finance. In the US, the UK, and around the world, institutions are being partially or substantially nationalized, the day of highly-leveraged, trader-driven "universal banks" deeply involved in derivatives markets and trading for their own accounts is clearly over. A new model with more Glass-Steagall-like restrictions on institutional activities is likely to emerge as are more restrictive regulations. Private equity firms are on the ropes or substantially subdued and the entire industry is bent on preserving capital rather than lending it in order to protect their ratings and their stock prices. Sorting this out will take time and the result will be severely constricted liquidity well into the future. The consequences of this are clear. A new study from the Institute for International Finance projects that net private sector capital flows to the world's emerging markets (recently considered the engines of global growth and "decoupled" from developed world markets) will fall to $165 billion in 2009. That is one-fifth what flows were in 2007. That is a stunning collapse that will deal a powerful blow to economies in which rapid growth is key to social and political stability. Further, if growth in the biggest of those markets such as China and India slows as expected, it will have a secondary impact on commodity prices, many of which were driven by the rapid growth of these markets. If that is the case, many other emerging economies which are heavily dependent on commodity prices will suffer serious decreases in exports and reserves of hard currency. Given concerns that many of the financial institutions in these markets do not currently have the ability to meet their financing obligations of $20 billion a month in 2009 (the IIF study estimates they have only half what they need) this may trigger serious financial market crises in these markets as well as traditional crises associated with the inability to meet government debt obligations due to balance of payments problems. Because most of the world's security hot spots are in the emerging world and in particular in countries that are primarily commodity exporters, this particular secondary wave of financial shocks is likely to have acute geopolitical consequences. That the developed world will

be stretched thin paying for their own bailouts makes it less likely that they will be able to provide sufficient aid in the event that an emerging world economic tsunami strikes. (U.S. and other industrialized economies are likely to require second and third tranches due to the aforementioned global shocks as well as problems such as the potential consumer credit crunch and the wave of corporate and financial institution bankruptcy that are predicted for the year ahead. In one estimate, Standard and Poors projects that U.S. "speculative grade" companies at risk of default on their bonds could surpass the previous peak in 1990 and may well hit modern era historic highs of almost 20 percent.)

Of course, it is possible that the pessimistic estimates overstate the problems we will encounter and that recovery will come more quickly, but it would be unwise to count on such an outcome. Further, the severity of the current situation is such that many if not all of the following risks have already been created and/or seriously exacerbated by the crisis as it has unfolded so far. (The IMF projects world economic growth in 2009 will be the lowest since the Second World War, reducing late 2008 estimates by over 2 percent to only .05 percent. Their chief economist said, "We now expect the global economy to come to a virtual halt." Most major economies will contract by an average of 2 percent, the first big contraction across this group since the Great Depression. At the same time, the latest set of estimates from the International Labor Organization projects that in its worst case scenario as many as 51 million people worldwide may lose their jobs in 2009, pushing global unemployment to 7.1 percent. The ILO's most "positive" scenario—only about 18 million new unemployed—was based on the now invalid IMF estimate of 2.2 percent growth. Just as importantly, the ILO estimates that the number of people who work for the most meager wages (less than $2 a day) may rise to 1.4 billion. This number represents almost half (45 percent) of all those employed in the world. This well illustrates how precarious the social and political situation is likely to be in much of the world.

Near Term Examples of Consequences and Potential Flashpoints

While it is impossible to predict with great accuracy where the pressures of the economic crisis are likely to translate into geopolitical problems, it is possible to offer a series of illustrations of cases in which current conditions make future problems likely. These examples cover not only a range of countries and regions but a range of problems of varying degrees and natures. I will offer the examples using the three categories of potential risks outlined earlier.

Risks Within Nations

Fragile states, countries with current economic or political problems that are likely to be hard-hit by the current crisis dominate this list. One prime example of special resonance for the U.S., cited recently in a Pentagon study, is Mexico. The country faces a host of challenges. One set are associated with the crisis, with decreasing trade flows, decreasing investment flows, decreasing flows in remittances (for the first time since such flows were tracked), and associated challenges meeting budget targets or possibly, meeting debt-service obligations in the future. Another set are

associated with declining internal resources, notably the projection of an end to oil revenues within a decade due to the limits of their reserves, dwindling financial and technical resources and the related mismanagement of PEMEX the state-owned oil company. Finally, a third set are associated with the federal government's gradual loss of control in key provinces where drug cartels and other criminal organizations have stepped in to fill the void. It is these weakened provinces that have led some to draw analogies with Colombia, where the central government lost control of the periphery of the country to the FARC and other rebel groups as part of a 40 year civil war and the expansion of drug cartels in that country. The Mexican example is apt because it underscores that countries can appear to be relatively stable at the center, but in the current circumstances may deteriorate in outlying regions, creating a hybrid weak state-failed state. Naturally, the realization of such a scenario in Mexico is likely to pose multiple challenges for the U.S., including those associated with immigration, the spread of crime across the border, the possibility that criminal avenues into the U.S. might create terrorist avenues into the U.S., deterioration of trade relations or cooperation on border issues, a demand for financial aid and the spread of these problems into other nearby countries such as those of Central America. If the U.S. were to react harshly to the threat, closing the border and confronting the Mexican government, it could lead to a political shift in that country and an alignment of it with other more anti-U.S. elements in the region.

Other countries that might fall into this category (and the list is quite long) might include strategically important actors such as Pakistan, Ukraine, Turkey, Egypt, Iran, Russia, Venezuela, Argentina, Indonesia, the Philippines, China, or North Korea. Much of Africa also does. Each case is, of course, different. In Pakistan, it is said no government has ever survived an IMF deal. In other words, the people of the country are so anti-western in their orientation that when governments are compelled due to financial circumstances to turn to international institutions (perceived as western/U.S. dominated) for assistance, it undercuts their political viability. Pakistan has already, late in 2008, come to the brink of financial collapse and there is no reason to assume that the fixes that were put in place by the international community are up to withstanding the additional pressures that might come from a further global deterioration. With the country deeply divided, home to radical jihadist elements, in a permanently tense posture toward India, inextricably tied to the U.S. conflict in Afghanistan (or more properly the U.S. war against the Taliban and Al Qaeda, many of whom have relocated into Waziristan and neighboring regions of Pakistan) and continuing concerns about the security of the country's nuclear arsenal, it is clear that there are few more precarious situations in the world. Economic pressure could topple the Zardari government, create fodder for radical elements seeking to incite political or terrorist action among the people, create a motivation for populists to scapegoat India, or other steps which could produce upheaval, localized conflict or worse.

Ukraine (like a number of other countries in Eastern and Central Europe) has been feeling the downturn and has been at risk of financial default already. It has also felt pressure from its neighbor to the East, Russia, on the issue of payment for (and provision of) natural gas. Should the crisis undercut the current regime, it cannot be ruled out that Vladimir Putin might see the void created

as an opportunity either to be filled through the support of a Russia-leaning new leadership in Kiev, or alternatively through more forceful action either akin to another shut off of energy resources leading to a negotiation regarding a different relationship between the countries or something more akin to the confrontation with Georgia. Given dwindling resource export-related revenues (and other problems such as his country's demographic contraction) Putin himself will likely seek ways to distract from the problems and enhance his status as a strong leader. In the past, he has done this through aggression in Chechnya and Georgia and striking a tough, independent, anti-US pose on the international stage.

In the cases of Turkey, Egypt and Iran, economic vulnerability of the current regimes creates the possibility of major shifts in leadership or in the positioning of current leadership that might be problematic. A more fundamentalist government in Turkey, given that country's strategic position, or a more aggressive stance from Turkey regarding either Israel (see the contretemps between the Prime Minister and Israel's Shimon Peres in Davos) or the Kurds (to distract and stir up nationalist feeling) could shift the balance of power in the region in ways that would be most troubling for the U.S. and the West. Iran's case is different. If oil continues to fall and the government is more strapped, it is possible that the current regime may see it as in its interest to stir regional confrontation for both populist reasons and because it may reflate the price of oil. (Alternatively, it may weaken the current regime creating the opportunity for a change and an opening for the U.S.) In Egypt, given the potential for volcanic unrest that could topple the comparatively moderate regime, the issues are similar to those in Turkey.

Venezuela's case is similar to that of Iran. Falling oil prices could undercut Chavez' hold on power and might lead him to seek closer ties with potential partners whose interests do not align with the U.S. (Russia, Iran, Syria, China). It could also trigger confrontation with the U.S. for populist reasons. On the other hand, it may weaken the regime in ways that could, a la Iran, be an opportunity. In other countries on the list economic crisis could topple regimes (all), trigger the rise of extremist elements (Indonesia, Philippines), foment the creation of tension with neighbors to create distraction or increased global bargaining power (North Korea is good example in this case), etc. In the case of China, the reports of tens of thousands of uprisings related to the economic crisis (80,000 in one estimate), significant job losses, massive internal migration of workers, and related factors will put the central government and provincial governments on the defensive, may trigger crack-downs, may trigger bigger protest movements, etc. Further, it should be noted that should instability peak in ways that the international community feels threaten the current order in China, it is not impossible that this in turn could trigger a bigger market sell-off and a possible financial meltdown in that country, which would have global consequences given China's position as the world's third largest economy and one of the principal drivers of global growth over the past decade.

Africa, home to the most deadly conflict in the world over the past decade, that in Congo, and a host of other major conflicts, such as those in Somalia and Sudan, and major national calamities like that in Zimbabwe, is likely to find itself a recipient of less aid and attention. Conflict, disease, poverty

and instability there are likely to only grow worse in the context of the global crisis. (Remember, if you make 3 dollars a day and you lose a third of your income, the choice is between food and shelter, allowing children to go to school or forcing them to work, etc. Millions will die because of this economic crisis and that will produce not only a great human tragedy but it will depress economies and upset local stability in severe and myriad ways.)

Risks Between Nations

Many of the risks between nations stem from the types of problems cited/illustrated above. So, a weakening of federal control in Mexico is very likely to trigger tensions with the U.S. A crisis in Pakistan will have serious complications for Afghanistan and, should there be instability in Pakistan and a shift toward a more hard-line government, there would be major implications for Pakistani-Indian relations and potentially for Indian financial markets. Should there be an event in which even a tiny portion of the country's nuclear arsenal is put at risk, the implications worldwide are even greater and may require the U.S., China and other countries to step in. (It should be noted—perhaps under the heading of "risks on a global scale", below--that many of the most vulnerable nuclear facilities in the world are in the emerging world and two-thirds of all nuclear facilities in construction currently are in the emerging world. Thus, should there be a downturn in governments' ability to secure these facilities and a concurrent uptick in radical activity the risks of WMD terror-related breaches will rise substantially.) Russia's potential rationale for intervening in the affairs of Ukraine or other nations in that region was noted, as was the potential for enhanced tensions in the Middle East, were problems in Turkey, Egypt or Iran, for example, to provoke an increase in tensions with Israel, other neighbors, or produce flare-ups among non-state groups that have cross-border components (Sunni-Shiite tension, Kurdish issues, Muslim brotherhood, activities of state-sponsored entities like Hezbollah, ties of entities like Hezbollah to Hamas, etc.) Historically, when countries like Argentina or Indonesia have had serious economic problems, this has caused contagion in neighboring states, as well (Brazil, in Argentina's case, or the rest of ASEAN in Indonesia's.)

Were China's domestic challenges to force more spending of national reserves to create local jobs or provide emergency economic support of other types, this in turn could lead to a sell-off of Chinese holdings of U.S. Treasuries or at least a policy to purchase fewer such securities. The inability of the U.S. to find debt financing would weaken the country and force it into a position of printing money, fostering inflation, as its only remaining option to meet the financial needs it may associate with the crisis and recovery from it.

This is the first economic crisis of the global era and requires a global response. If we get our recovery plan right, but China gets theirs wrong, we are likely to continue to falter and vice versa. The same holds true for our interdependence with many other significant economies. If we do not rise to the challenges of effective coordination on this front it may foment tension, divisions and further difficulties as individual countries will be seen as the source of enduring problems for others. Here, the failure to do something new and complex and urgent could result in the erosion of

relationships and a period in which it is increasingly difficult to act in the multilateral way that most major global problems of today require.

Risks on a Global Scale

If some of the cross-border issues cited above are played out in terms of likely consequences, it raises the possibility of problems spreading to many nations and taking on global or inter-regional scale. One often discussed possibility in this respect is growing protectionism, which not only could have negative economic consequences (as it did during the 1930s) but which also could enhance tensions between nations making cooperation in confronting other challenges more difficult. Protectionism is not just economically self-defeating as it provokes a cycle of action, retaliation and contraction, but it is also diplomatically corrosive. Related concerns have arisen that nations which face capital scarcity are placing pressure on financial institutions to direct available capital flows within their borders. For example, EU Central Bank President Jean-Claude Trichet warned that (per the FT) "the wave of bank bail-outs in Europe and the U.S. could usher in a new era of financial protectionism that could lead to a deeper economic slump." This problem could be exacerbated by the impulse of banks simply to hold on to capital in order to enhance reserves and because there is so little forward visibility in markets. This problem has led observers to wonder whether this downturn might see financial protectionism leading to a drying up of global capital flows akin to what we saw during the Great Depression when trade protectionism crushed global trade flows. Clearly, as noted earlier, reduced availability of capital will only exacerbate problems, particularly in emerging markets which depend on the capital for stabilizing growth. Similarly, the protectionist impulse may lead to the creation of a new round of trade barriers. Two examples here include barriers that come in response to perceptions of currency manipulation (see the current US-China dialogue on this issue) or barriers related to other divides, such as that between developed and developing nations on global warming. If the developed world implements provisions to preserve the climate then there will be great pressure on their governments from effected sectors to impose duties on goods imported from countries with less strict laws or requirements. Again, these impediments to trade flows can inflame relationships. They are also likely to lead to the unraveling of global trade talks and a possible new set of challenges to the effectiveness and legitimacy of the WTO.

Similarly, the advent of the crisis has already seen a number of nations seeking to use it as a justification to "reseat the global head table", to move away from the leadership structure of the international community that is largely a vestige of the post-World War II environment and to move toward one more suited to the current environment. The rise of the BRICs has coincided with an effort among the leaders of Brazil, Russia, India and China to assume greater roles within a variety of organizations ranging from a potential successor to the G8 to a revised permanent structure to the

UN Security Council to changed ownership structures at multilateral financial institutions. Other major emerging powers (such as the other members of the G20...given a leadership role in addressing the financial crisis through the November 15 summit in Washington) will seek the same. These aspirations will cause tensions on several levels. First, some leaders, like Putin and Wen Jiabao at the recent Davos meeting...and French, German, Iranian, Venezuelan, Chinese, Japanese and other politicians during the Fall phases of the crisis...will cite the U.S. (or the West) as the cause of the problems, use this to create new divisions and alliances, and seek to use it to undermine the credibility of the U.S. and the system we have long advanced. Next, rising powers will inevitably seek to displace some nations that have traditionally held leadership roles but may not in the future. Next, different leadership means different priorities and the transition may undercut the effectiveness of multilateral institutions at precisely the moment they are needed most.

Finally, growing tensions and unrest are likely to feed transnational threats from terrorism, to proliferation of weapons of mass destruction, and to the expansion of global criminal networks. Migration caused by the crisis may lead to the spread of disease, ethnic conflict and the creation of new extra-legal networks that will be difficult to track and contain. Further, as nations turn inward to address domestic problems and as their resources dwindle, the attention devoted to international institutions, the funds directed to those institutions and thereby their effectiveness are all likely to decline.

A Note on Medium to Long Term Examples of Consequences

While the request was that this testimony focus on relatively near-term threats, it is important to note other significant threats that may have a longer time horizon. These include but are in no way limited to:

- Threats associated with opportunity costs of the current crisis. In other words if we are directing resources and attention to the current problem, we may be ignoring other important issues. In the case of the U.S., for example, this may be failing to bring our fiscal house in order or address the long-term debilitating costs of an inefficient health care system, or it may mean (as it may in many other countries) failing to devote sufficient attention to issues like global warming which in turn may have devastating long-term consequences. Similarly, funds for addressing issues like global poverty, development, or the containment of disease will dry up and the long-term consequences of an erosion of programs in these areas may be prolonged poverty, stalled growth, a generation without education, and consequent impacts on stability.

- This period of crisis is likely, as noted above, to correspond to a remaking of the international system. Change is likely to be required not only in areas pertaining to the crisis (fixing multilateral banks, creating global regulatory regimes and perhaps authorities) but it is also likely to be required within the UN, within the NPT, within the WTO and in new groups such as that which will be required once a global climate agreement is reached. If

these institutions are born of tension, undercapitalized, conflict laden, or developed precipitously in response to the crisis, the international system/order will suffer and it may take years to recover. Also, fault-lines may be institutionalized within these institutions as they have been within others in the past (see complaints re: North-South, East-West issues in the IFIs or the UN).

- If capital flows dry up and capital sources shift, so too will power. Much US power in the past several decades has been related to our role as the leading capital market/resource in the world and to the position of the dollar as the unassailable reserve currency of the world. If we have less capital available here, if other currencies take away our share in reserves worldwide, we will become weaker. Similarly, other countries might emerge with a better position in the balance of geoeconomic power (if China is, for example, able to maintain their reserves or once the recovery begins oil prices rise precipitously and oil rich nations once again build up their sovereign wealth). If not exactly destabilizing, it does change the equation by which stability may be achieved.

- In this tensions will come to existing alliances and new alliances may be formed around positions associated with the crisis or with conflicts that may emerge from the crisis.

- The costs of "bail-outs" and crisis related measures will create fiscal burdens for the U.S. and other countries that will limit their resources and therefore their policy options for many years to come and which may ultimately compel the U.S. and these other countries to cut spending in areas like defense, foreign aid and other categories associated with our international roles and influence.

- Finally, while I do not subscribe to the notion that this is the beginning of the end for capitalism or for U.S. global leadership, it is virtually certain that the formulas offered during the past 25 years ("leave it to the markets", the Washington Consensus, etc.) will be challenged in unprecedented ways. Change is inevitable. "European" or "Asian" versions of capitalism may gain traction. America may see other nations rise in relative power. It is very unlikely that the global balance of power at the conclusion of this crisis will be precisely what it was at its onset.

Implications for the United States

For the U.S., these threats and likely changes ensure that the next years will be extraordinarily challenging. Our national economy is the wellspring of our strength and is a critical engine of the global economy. To remain strong and a force for good internationally, we must restore vitality to that economy. However, if we spend too much to do that we may create fiscal burdens that handcuff us in the future and thus undercut the objective of preserving/restoring our strength and influence. We must make domestic problems a priority, but if we fall into the trap of allowing such an approach to open the door to traditional or new forms of protectionism, we will hurt ourselves both at home and abroad. We must recognize that multilateralism and burden-sharing are key to

our ability to achieve our goals in a time of resource constraints, but that to do so successfully will involve understanding and accepting a new order with all the disruptions and changes that may require. We must rise to meet the most urgent security threats with sufficient force but we must also recognize the fragility of the global situation increases the likelihood that miscalculations will cause problems to spread and multiply. We must focus squarely on the critical issues of today without losing sight of the great long-term challenges that also require our attention. We will need to lead in the creation of a new global institutional system at precisely the time many of our basic beliefs are in question (and at a time when our international standing is still damaged from missteps of the past decade.)

Each challenge is great and virtually all carry with them other contradictory or complicating challenges. As a result we cannot help but see the period ahead as one that is fraught with dangers. That said, it is also one that is contains considerable opportunity. The Depression and World War II produced tragedy and mayhem...and then led to the creation of the international system that has served the world well in many ways for the past sixty years. We stand at a point where nations are truly compelled to work together better, recognize their interdependency more clearly, and share in the shaping of a common vision for the planet. The sheer range of the potential risks we collectively face can lead us to turn inward or it can motivate us to lead in the shaping of a new more stable, more just international system. We will be judged as a generation and perhaps ultimately as a country by the choices we make.

Conclusions: Top Priorities and Recommendations

A crisis such as this one produces such a welter of challenges that a form of policy triage is required. While there is often a misconception in the U.S. government that we can...and perhaps worse, that we should...be dealing with every issue confronting us in the world, the reality is that not only is that not possible, it's less possible today than at any time in the recent past. Two on-going wars and the severity of the domestic consequences of the economic crisis at home explain that point irrefutably.

As a consequence, it is important that we recognize the top threats associated with the crisis and address those. Based upon the preceding discussion, the greatest threats associated with the crisis are as follows:

--The Economic and Political Constraints Placed on the United States

The greatest sea change associated with the crisis may be as a result of the decisions by American policymakers over the past decade that will effectively place the country in fiscal handcuffs for the foreseeable future. We will be dependent on foreign creditors such as China, now the largest of the countries to which the U.S. is beholden. As we saw for the first time during the Fannie Mae-Freddie Mac crisis last fall, this can mean having Chinese borrowers call U.S. policymakers and bully them into positions to protect the value of China's holdings, with the leverage being the threat of a move away from the dollar by China's investors. Long-term inflation is another risk of our current deficit-building policy tack, especially if foreign investors have a diminished appetite for U.S. dollar

denominated assets. Ultimately, these pressures will lead to budget cuts and given the heavy demands of health care and other entitlements in an aging nation, this will certainly and unavoidably lead to cuts in U.S. defense spending. If the process of defense budgeting and acquisitions does not become more efficient and the concept of how our military is structured is not dramatically rethought, this can only weaken the U.S. (Although that is not the only possible outcome.) In addition, in such circumstances, American soft-power will suffer dramatically as the checkbook diplomacy of the past will simply no longer be affordable or politically palatable. Finally, an economically wounded U.S. will be preoccupied at home and less inclined to risks abroad. In short, while the U.S. will remain the world's preeminent power, this power may well be more limited than in the recent past, which may be perceived as an opportunity by our rivals and enemies.

--The Economic and Political Constraints Placed on the EU, China and Other Potentially Stabilizing Actors

The same kind of issues with which the U.S. will grapple will dominate the attentions of political leaders in countries with whom we have close alliances and with others that are large enough to be stabilizing forces regionally or even farther afield. In the past week, the Economist magazine has noted the first rumblings of questions about the viability of an EU that cannot effectively act together to manage the crisis. China, while possessing more cash than any other country in the world, may feel obligated to spend more of that cash to maintain stability at home...more even than currently committed if, as widely thought, Chinese growth estimates remain over-optimistic. This weakening of the great powers can only be seen as creating something of a void in the world's less stable regions suggesting a period during which political brushfires may be expected to break out more frequently than in the past when major power intervention kept a lid on conflicts.

--The Crisis of Confidence in Institutions Worldwide and the Threats to the International System

As noted earlier, the economic crisis is also very much a crisis of confidence in our leading institutions. If this in turn leads to countries stepping back from the international system or to a failure to muster the political will to recast the international system to better meet the challenges of the current era, another major set of stabilizing forces could be put at risk and ultimately recede or disappear. While we might expect the crisis to produce a stronger international system, this may come only after a resurgence of economic and political nationalism and real resource constraints undercut efforts at multilateral reform. Almost inevitably however, it should also be noted that when changes do occur, a new leadership structure—reflected in the shift from the G8 to the G20 as the central steering mechanism for response to this crisis—will be put into place and the U.S. will be forced to adapt its worldview and its diplomacy to adjust to this new reality.

--The Exacerbation of Critical Threats Associated with Proliferation of Weapons of Mass Destruction

The proliferation of weapons of mass destruction remains the greatest threat to global security that we face. While there is no direct linkage between the economic crisis and the technical aspects of

proliferation per se, the crisis could well lead to a recruitment bonanza for anti-U.S. non-state actors, greater tensions with hostile nations seeking to lash out at the U.S. as a means of distracting from economic despair at home, reduced resources for sufficient security to prevent proliferation, and the creation of more failed states which become homes to terrorists and criminal organizations that can play a role in WMD proliferation due to their lack of functioning institutional structures.

--The Consequences of Protracted Crisis for the World's Weakest States

These consequences include mass starvation, disease, tribal conflict, and warfare as we historically have seen in the most deprived parts of the world. In Africa, where such unhappiness is a seemingly permanent condition, further instability may intersect in troubling ways with the world's growing recognition of the importance of resources found in the region. In fact, as in the case of WMD proliferation, deterioration in the weakest states may blend with growing resource competition to create a particularly dangerous cocktail.

--The Threats to Weak and Weakened States Directly Impacting U.S. National Interests

As we prioritize threats, we clearly must reserve a special place atop our lists for countries where collapse will produce an immediate impact on the U.S. This could be countries that are nearby that can produce waves of unwanted immigration in a crisis or which can be the source for growing criminal activities that spill into our borders. (Mexico and Haiti immediately come to mind.) Or they can be countries that produce resources on which we are heavily dependent. (Here the greater Middle East and Central Asia top the list.)

With regard to these priority concerns, the principal recommendations that can be made to this committee are:

--Be Strategic About Marshalling and Maintaining U.S. Resources (Fiscal Restraint and Rethinking Defense Budgeting)

We are realizing almost too late that attentiveness to the structural integrity and wellsprings of growth within the U.S. economy must always be our primary national security concern. Ensuring that recovery happens as quickly as possible and then that we aggressively seek the kind of fiscal balance that reduces foreign dependencies is key. This will however, inevitably mean raising U.S. taxes and cutting spending...including defense spending. The development of a new paradigm for the structure and asset allocation approach to our defense establishment is key here. We can no longer afford the redundancies, the waste or the outmoded "a third, a third and a third" spending habits of the past.

--Maximize the Means of Leveraging U.S. Power (Maintaining Critical Institutions and Alliances)

We must lead in the reform of global institutions. Whether it is in the area of financial regulation or emergency economic intervention, containing proliferation or combating climate change, fostering development or ensuring fair trade, peacekeeping or managing global resources, institutional

reform, renovation or rethinking is urgently needed. Unless the U.S. leads this process, spends the necessary capital to ensure the relevance of global financial institutions, invests the necessary political capital to create organizations that can truly manage global challenges, others will not follow and we will all suffer the dire effects of the ensuing institutional void. This will require communicating effectively to the American people that in the post-crisis world the more effective burden sharing that strong international institutions can bring must be a key to a new U.S. foreign policy. It will also require persuading some of our historic allies that a new leadership structure for the global system is needed. The move from the G8 to the G20 is encouraging but we shall soon conclude that the G20 is too large and unwieldy and we will have to formulate a smaller group including at least the U.S., the EU, Japan, China, India and Brazil.

--Lead a Coordinated, Proactive Global Effort to Reduce, Eliminate or Contain Threats (Beginning with Economic Threats)

The preceding point is meaningless if we do not then use the institutions we have to meet the challenges we face. First, we must produce and coordinate the unprecedented global effort that will be needed to deal with the first truly global recession. Next, we will have to install the financial mechanisms to ensure such crises do not occur again in the future. But we cannot afford to be distracted from the other urgent global security challenges we face, notably containing the proliferation of weapons of mass destruction and combating climate change.

--Maintain a Credible Deterrent against Bad Actors

We cannot allow a U.S. weakened by economic crisis and division over an unpopular war in Iraq to be seen as a nation drifting from what my co-panelist Richard Haass once called the "Reluctant Sherriff" to becoming the "Absent Sherriff." There will remain issues that require our intervention and the use of force or the credible threat of the use of force and we should not underestimate the factors that will make such a stance difficult in the immediate future. But absent a real sense that the U.S. might under certain circumstances intervene we will have a very difficult time indeed dealing with the greatest security threats we face such as those in Iran, Pakistan and North Korea.

--Recognize the Likelihood of Crises Emerging Beyond the Iraq and Afghanistan-Pakistan Conflicts that Currently Preoccupy the U.S.

The purpose of this hearing, I believe, has been to underscore this point. We must closely monitor vulnerable regions of the world and anticipate that crises will emerge that have not dominated or even maintained much of our attention in the recent past. Whether these are in Mexico, in Central and Eastern Europe, in Africa or in Central Asia, they will come and we must be nimble and ready to respond.

--Fight the Temptation to Turn Inward at Home and Abroad

We remain the indispensible nation even as other rising powers, such as China, are emerging as indispensible to our future. If America turns inwards and away from engagement internationally, we guarantee a world that is less stable, more hostile, and home to a spreading wave of human tragedies that we can ill afford. Even in a crisis, we must invest in our vital institutions, recognizing that now is a time for greater vigilance and strength, even as economic pressures might lead some to take a step back and disconnect.

This calls for political vision and leadership. Hearings such as this one are a constructive, timely and much needed step in that direction.

Thank you for the opportunity to submit this testimony to the committee today and, of course, I would be happy to answer any questions you may have.

DOCUMENTS SUBMITTED FOR THE RECORD

MARCH 11, 2009

Annual Threat Assessment of the

Intelligence Community

for the House Permanent Select Committee on Intelligence

Dennis C. Blair

Director of National Intelligence

25 February 2009

February 2009

HOUSE PERMANENT SELECT COMMITTTEE ON INTELLIGENCE

FEBRUARY 2009

INTELLIGENCE COMMUNITY ANNUAL THREAT ASSESSMENT

UNCLASSIFIED
STATEMENT FOR THE RECORD

Chairman Reyes, Ranking Member Hoekstra, Members of the Committee, thank you for the invitation to offer my assessment of threats to US national security. As in previous years, the judgments I offer the Committee in these documents and remarks and in my responses to your questions are based on the efforts of thousands of patriotic, highly skilled professionals, many of whom serve in harm's way. I am proud to lead the world's best Intelligence Community and would like to acknowledge the assistance provided by all the intelligence agencies in preparing this report, in particular the National Intelligence Council and CIA's Directorate of Intelligence, which contributed a substantial portion.

Far-Reaching Impact of Global Economic Crisis

The primary near-term security concern of the United States is the global economic crisis and its geopolitical implications. The crisis has been ongoing for over a year, and economists are divided over whether and when we could hit bottom. Some even fear that the recession could further deepen and reach the level of the Great Depression. Of course, all of us recall the dramatic political consequences wrought by the economic turmoil of the 1920s and 1930s in Europe, the instability, and high levels of violent extremism. Though we do not know its eventual scale, it already looms as the most serious global economic and financial crisis in decades.

Forecasts differ significantly over the depth of the downturn. Industrialized countries are already in recession, and growth in emerging market countries, previously thought to be immune from an industrialized country financial crisis, has also faltered, and many are in recession as well. Even China and India have seen their dynamic growth engines take a hit as they grapple with falling demand for their exports and a slowdown in foreign direct and portfolio investments. Governments worldwide are initiating monetary and fiscal stimulus programs designed to stabilize and recapitalize their financial sectors, cushion the impact of stalling economic activity, and eventually jumpstart a recovery, perhaps as early as late 2009. The IMF, which recently released its revised forecast for 2009 projecting an anemic 0.5 percent increase in the global economy, warns that the risks to the global economy are on the downside.

The financial crisis and global recession are likely to produce a wave of economic crises in emerging market nations over the next year, prompting additional countries to request IMF or other multilateral or bilateral support. Since September 2008, ten nations committed to new IMF programs intended to provide balance of payments support. All face the task of tackling economic problems in a less benign global economic environment. Unlike the Asian financial crisis of 1997-98, the globally synchronized nature of this slowdown means that countries will not be able to export their way out of this recession. Indeed, policies designed to promote domestic export industries—so-called beggar-thy-neighbor policies such as competitive currency devaluations, import tariffs, and/or export subsidies—risk unleashing a wave of destructive protectionism.

Time is probably our greatest threat. The longer it takes for the recovery to begin, the greater the likelihood of serious damage to US strategic interests. Roughly a quarter of the countries in the world have already experienced low-level instability such as government changes because of the current slowdown. Europe and the former Soviet Union have experienced the bulk of the anti-state demonstrations. Although two-thirds of countries in the world have sufficient financial or other means to limit the impact for the moment, much of Latin America, former Soviet Union states and sub-Saharan Africa lack sufficient cash reserves, access to international aid or credit, or other coping mechanism. Statistical modeling shows that economic crises increase the risk of regime-threatening instability if they persist over a one to two year period. Besides increased economic nationalism, the most likely political fallout for US interests will involve allies and friends not being able to fully meet their defense and

humanitarian obligations. Potential refugee flows from the Caribbean could also impact Homeland security.

The dramatic decline in oil prices—more than a two-thirds decline from the July peak of $147 per barrel—is partially a result of the market betting on a deep and perhaps protracted global recession. A serious supply crunch is possible down the road if sustained low prices lead to major cuts or delays in investment by national and international oil companies, especially high cost unconventional oil sources like oil sands. Nevertheless, lower prices benefit consumers, and declining revenues may put the squeeze on the adventurism of producers like Iran and Venezuela.

The crisis presents many challenges for the United States. It started in the United States, quickly spread to other industrial economies and then, more recently, to emerging markets. The widely held perception that excesses in US financial markets and inadequate regulation were responsible has increased criticism about free market policies, which may make it difficult to achieve long-time US objectives, such as the opening of national capital markets and increasing domestic demand in Asia. It already has increased questioning of US stewardship of the global economy and the international financial structure.

The November G-20 financial summit in Washington also elevated the influence of large, emerging market nations. As was the case in the Asian financial crisis, China has an opportunity to increase its prestige if Beijing can exert a stabilizing influence by maintaining strong import growth and not letting its currency slide. But the United States also has opportunities to demonstrate increased leadership domestically, bilaterally, and in multilateral organizations such as the WTO, APEC, and ASEAN. Recessions are a relative game, and historically the United States has proven more adroit at responding to them than most. The US tradition of openness, developed skills, and mobility probably puts it in a better position to reinvent itself. Moreover, in potentially leading recovery efforts in coordination with the G-20, Washington will have the opportunity to fashion new international global structures that can benefit all. Global coordination and cooperation on many fronts will be required to rebuild trust in the global financial system and to ensure that the economic and financial crises do not spiral into broader geopolitical tensions.

Turning the Corner on Violent Extremism

I next want to focus on extremist groups that use terrorism. The groups with the greatest capability to threaten are extremist Muslim groups. In 2008 terrorists did not achieve their goal of conducting another major attack in the US Homeland. We have seen notable progress in Muslim opinion turning against terrorist groups like al-Qa'ida. Over the last year and a half, al-Qa'ida has faced significant public criticism from prominent religious leaders and fellow extremists primarily regarding the use of brutal and indiscriminate tactics—particularly those employed by al Qa'ida in Iraq (AQI) and al-Qa'ida in the Lands of Islamic Maghreb (AQIM)—that have resulted in the deaths of Muslim civilians. Given the increased pressure posed by these criticisms, al-Qa'ida leaders increasingly have highlighted enduring support for the Taliban and the fight in Afghanistan and Pakistan and in other regions where they portray the West being at

war with Islam and al-Qa'ida as the vanguard of the global terrorist movement. A broad array of Muslim countries is nevertheless having success in stemming the rise of extremism and attractiveness of terrorist groups. No major country is at immediate risk of collapse at the hands of extremist, terrorist groups, although a number—such as Pakistan and Afghanistan—have to work hard to repulse a still serious threat. In the next section I will discuss at length the challenges facing us in Pakistan and Afghanistan where militant have gained some traction despite the successes against al-Qa'ida.

Because of the pressure we and our allies have put on al-Qa'ida's core leadership in Pakistan and the continued decline of al-Qa'ida's most prominent regional affiliate in Iraq, al-Qa'ida today is less capable and effective than it was a year ago.

In **Pakistan**'s Federally Administered Tribal Areas (FATA), al-Qa'ida lost significant parts of its command structure since 2008 in a succession of blows as damaging to the group as any since the fall of the Taliban in late 2001. Key leaders killed over the past year include Khalid Habib, al-Qa'ida's military chief and the fourth man in its chain of command; Abu Layth al-Libi, who directed cross-border attacks against our forces in Afghanistan and was a rising star in the organization; Abu Khabab al-Masri, the group's leading expert on explosives and chemical attacks and a driving force behind its terrorist plotting against the US Homeland and Europe; and Usama al-Kini who was involved in the bombings of our Embassies in East Africa in 1998 and later became the chief planner of al-Qa'ida's terrorist attacks in Pakistan.

- The loss of these and many other leaders in quick succession has made it more difficult for al-Qa'ida to identify replacements, and in some cases the group has had to promote more junior figures considerably less skilled and respected than the individuals they are replacing.

Sustained pressure against al-Qa'ida in the FATA has the potential to further degrade its organizational cohesion and diminish the threat it poses. If forced to vacate the FATA and locate elsewhere, the group would be vulnerable to US or host-country security crackdowns as well as local resistance, and probably would be forced to adopt an even more dispersed, clandestine structure, making training and operational coordination more difficult. Without access to its FATA safehaven, al-Qa'ida also undoubtedly would have greater difficulty supporting the Taliban insurgency in Afghanistan. It is conceivable al-Qa'ida could relocate elsewhere in South Asia, the Gulf, or parts of Africa where it could exploit a weak central government and close proximity to established recruitment, fundraising, and facilitation networks, but we judge none of these locations would be as conducive to their operational needs as their location in the FATA.

In **Iraq,** we judge the maturation of the Awakening movement, Iraqi Security Forces gains, and the subsequent spread of Sons of Iraq (SOI) groups, in combination with Coalition operations against AQI leaders, have reduced AQI's operational capabilities and restricted the group's freedom of movement and sanctuaries. Nevertheless, we judge the group is likely to retain a residual capacity to undertake terrorist operations for years to come. I will focus on AQI in greater detail when I discuss Iraq.

Saudi Arabia's aggressive counterterrorism efforts since 2003 have rendered the Kingdom a harsh operating environment for al-Qa'ida, but Riyadh is now facing new external

threats from al-Qa'ida elements in the region, particularly from Yemen. Senior al-Qa'ida leaders are focused on resurrecting an operational presence due to Saudi security actions over the past five years that have resulted in the death or capture of most identified Saudi-based al-Qa'ida senior leaders and operatives. Senior al-Qa'ida leaders view the Kingdom as a strategic target owing to Bin Ladin's longstanding objective of unseating the al-Saud family and the symbolic value of attacking Western and Saudi targets in the land of the two holy mosques.

The Saudi Government counterterrorism approach includes law enforcement efforts coupled with a complementary long-term program to stem radicalization. Riyadh's multi-faceted "counter-radicalization" and "de-radicalization" strategy uses detainee rehabilitation programs, the media, and religious scholars to combat terrorism and build public support for its strong security posture.

Counterterrorism efforts by **Indonesia**, in some cases with US assistance, have led to the arrests and deaths of hundreds of Jemaah Islamiya (JI) operatives, including top leaders and key operatives. In November, Indonesia executed three JI terrorists—Imam Samudra, Mukhlas, and Amrozi—for their role in the 2002 Bali bombings. While the Intelligence Community continues to assess that JI in Indonesia and the Abu Sayyaf Group (ASG) in the Philippines are the two terrorist groups posing threats to US interests in Southeast Asia, efforts by Southeast Asian governments against both groups in the past few years have degraded their attack capabilities.

The primary threat from **Europe**-based extremists stems from al-Qa'ida and Sunni affiliates who return from training in Pakistan to conduct attacks in Europe or the United States. We have had limited visibility into European plotting, but we assess that al-Qa'ida is continuing to plan attacks in Europe and the West. Al-Qa'ida has used Europe as a launching point for external operations against the Homeland on several occasions since 9/11, and we believe that the group continues to view Europe as a viable launching point. Al-Qa'ida most recently targeted **Denmark** and the **UK,** and we assess these countries remain viable targets. Al-Qa'ida leaders have also prominently mentioned **France**, most likely in reprisal for the 2004 headscarf ban.

The social, political, and economic integration of Western Europe's 15 to 20 million Muslims is progressing slowly, creating opportunities for extremist propagandists and recruiters. The highly diverse Muslim population in Europe already faces much higher poverty and unemployment rates than the general population, and the current economic crisis almost certainly will disproportionately affect the region's Muslims. Numerous worldwide and European Islamic groups are actively encouraging Muslims in Europe to reject assimilation and support militant versions of Islam. Successful social integration would give most ordinary Muslims a stronger political and economic stake in their countries of residence, even though better educational and economic opportunities do not preclude radicalization among a minority. Visible progress toward an Arab-Israeli settlement, along with stability in Iraq and Afghanistan, would help undercut radicals' appeal to Muslim foreign policy grievances.

European governments are undertaking a wide range of policies to promote Muslim social integration and counter radicalization. In addition to pursuing socioeconomic initiatives aimed at all immigrants, **France**, **Germany**, **Italy**, and several smaller European countries have

established various types of religious-based consultative councils composed of leading Muslim groups. Additionally, the **United Kingdom** has established the most diversified and energetic official outreach program to Muslims, largely reflecting concern about homegrown terrorism since the July 2005 London attacks. Among other initiatives, the UK Government has promoted the creation of an advisory board on mosque governance, a committee of Muslim theologians, and consultative bodies of Muslim women and youth. It also has held multiple high profile conferences with Islamic scholars and government representatives from the Muslim world. British police have made a conscious decision to seek the cooperation of non-violent radicals even while political authorities have encouraged former radicals and Sufis to speak out against hardline political Islam.

Core Al-Qa'ida

Despite these successes, al-Qa'ida and its affiliates and allies remain dangerous and adaptive enemies, and the threat they could inspire or orchestrate an attack on the United States or European countries. Under the strategic direction of Usama Bin Ladin and his deputy, Ayman al-Zawahiri, al-Qa'ida remains intent on attacking US interests worldwide, including the US Homeland. Although al-Qa'ida's core organization in the tribal areas of Pakistan is under greater pressure now than it was a year ago, we assess that it remains the most dangerous component of the larger al-Qa'ida network. Al-Qa'ida leaders still use the tribal areas as a base from which they can avoid capture, produce propaganda, communicate with operational cells abroad, and provide training and indoctrination to new terrorist operatives.

- We lack insight into specific details, timing, and intended targets of potential, current US Homeland plots, although we assess al-Qa'ida continues to pursue plans for Homeland attacks and is likely focusing on prominent political, economic, and infrastructure targets designed to produce mass casualties, visually dramatic destruction, significant economic aftershocks, and/or fear among the population.

- Increased security measures at home and abroad have caused al-Qa'ida to view the West, especially the United States, as a harder target than in the past, but we remain concerned about an influx of Western recruits into the tribal areas since mid-2006.

- Al-Qa'ida and its extremist sympathizers in Pakistan have waged a campaign of deadly and destabilizing suicide attacks throughout Pakistan, including the bombing of the Marriott Hotel in Islamabad in September, which killed 60 people and wounded hundreds.

AQIM. Al-Qa'ida's other robust affiliate, al-Qa'ida in the Lands of the Islamic Maghreb, is the most active terrorist group in northwestern Africa and, in our assessment, represents a significant threat to US and Western interests in the region. AQIM has continued to focus primarily on Algerian Government targets, but since its merger with al-Qa'ida in September 2006 the group has expanded its target set to include US, UN, and other Western interests and has launched progressively more sophisticated attacks, employing vehicle-borne improvised explosive device (VBIEDs), near-simultaneous bombings, and suicide bombings.

- AQIM has conducted nearly a dozen attacks against Western targets to include a near-simultaneous VBIED attack against United Nations facilities and the Algerian Constitutional

Court in Algiers in December 2007, killing at least 47 and wounding more than 100. AQIM associates also attacked the Israeli Embassy in Mauritania in February 2008.

- AQIM Europe-based cells act as financial support and facilitation nodes, but these cells could possibly become operational at the direction of AQIM leadership.

We assess that over the next year AQIM will continue to demonstrate its increased capability and commitment to senior al-Qa'ida leadership by attacking local and Western interests throughout North Africa and the Sahel. AQIM traditionally has operated in Algeria and northern Mali and has recruited and trained an unknown number of extremists from Tunisia, Morocco, Nigeria, Mauritania, Libya, and other countries. We assess some of these trainees may have returned to their home countries to plot attacks against local and Western interests.

Al-Qa'ida in Yemen. Yemen is reemerging as a jihadist battleground and potential regional base of operations for al-Qa'ida to plan internal and external attacks, train terrorists, and facilitate the movement of operatives. Al-Qa'ida leaders could use al-Qa'ida in Yemen and the growing presence of foreign jihadists there to supplement its external operations agenda, promote turmoil in Saudi Arabia, and weaken the Salih regime.

- Al-Qa'ida in Yemen on 17 September 2008 conducted an attack against the US Embassy in Sana'a. The coordinated attack used two explosives-laden vehicles, suicide bombers, and small-arms fire and killed six guards and four civilians. As of September 2008, the group had conducted 20 attacks against US, Western, and Yemeni targets, most carried out by the splinter faction, Jund al-Yemen.

East Africa. We judge the terrorist threat to US interests in East Africa, primarily from al-Qa'ida and al-Qa'ida-affiliated Islamic extremists in Somalia and Kenya, will increase in the next year as al-Qa'ida's East Africa network continues to plot operations against US, Western, and local targets and the influence of the Somalia-based terrorist group al-Shabaab grows. Given the high-profile US role in the region and its perceived direction—in the minds of al-Qa'ida and local extremists—of foreign intervention in Somalia, we assess US counterterrorism efforts will be challenged not only by the al-Qa'ida operatives in the Horn, but also by Somali extremists and increasing numbers of foreign fighters supporting al-Shabaab's efforts.

The Homegrown Threat

We judge any homegrown extremists in the United States do not yet rise to the numerical level or exhibit the operational tempo or proficiency we have seen in Western Europe. A range of factors inside the United States may contribute to a lower incidence of homegrown cells developing. Nevertheless, we remain concerned about the potential for homegrown extremists inspired by al-Qa'ida's militant ideology to plan attacks inside the United States, Europe, and elsewhere without operational direction from the group itself. In this regard, over the next year we will remain focused on identifying any ties between US-based individuals and extremist networks overseas. Though difficult to measure, the spread of radical Salafi Internet sites that provide religious justification for attacks; aggressive and violent anti-Western rhetoric; and signs that self-generating cells in the US identify with Bin Ladin's violent objectives all point to the likelihood that a small but violent number of cells may develop here.

- Al-Qa'ida's propaganda efforts include messages in English and those aimed specifically at an American audience either in translated form or directly by al-Qa'ida's second-in-command, Ayman al-Zawahiri, such as with his November 2008 video message following the US Presidential elections. US-born al-Qa'ida members such as Adam Gadahn, who was indicted by a US grand jury in October 2006 on charges of treason, providing material support to a designated foreign terrorist organization, and aiding and abetting terrorists, also participated in making these English-language propaganda messages.

The Threat from Lebanese Hizballah

Lebanese Hizballah continues to be a formidable terrorist adversary with an ability to attack the US Homeland and US interests abroad. Hizballah is a multifaceted, disciplined organization that combines political, social, paramilitary, and terrorist elements, and we assess that any decision by the group to resort to arms or terrorist tactics is carefully calibrated. At the same time, we judge armed struggle, particularly against Israel, remains central to Hizballah's ideology and strategy.

We assess Lebanese Hizballah, which has conducted anti-US attacks overseas in the past, may consider attacking US interests should it perceive a direct US threat to the group's survival, leadership, or infrastructure or to Iran. However, we judge Hizballah would carefully weigh the decision to take any action against the United States. Hizballah probably continues to support proxy groups and individuals, which could provide the group plausible deniability for possible attacks against the West or Israel.

We assess Hizballah anticipates a future conflict with Israel and probably continues to implement lessons learned from the conflict in the summer of 2006. In a potential future conflict, Hizballah is likely to be better prepared and more capable than in 2006.

The "Arc of Instability"

The large region from the Middle East to South Asia is the locus for many of the challenges facing the United States in the twenty-first century. While we are making progress countering terrorism, the roots and the issues related to the many problems in this region go deeper and are very complicated. The United States has strong tools—from military force to diplomacy in the region and good relationships with the vast majority of states. There is almost universal recognition that the United States is vital to any solutions, and these can be brought to bear in ways that benefit the United States and the region. I will begin with looking at individual states, but the Intelligence Community analysis I present here emphasizes the regional linkages exacerbating problems and providing opportunities that are available for tackling the problems.

The Changing Geopolitical Landscape in the Middle East

In the Middle East, the revival of Iran as a regional power, the deepening of ethnic, sectarian, and economic divisions across much of the region, and looming leadership succession among US allies are shaping the strategic landscape. Hizballah and HAMAS have successfully seized the mantle of resistance to Israel from moderate regimes with secular Arab nationalists being discredited in the popular mind. Battle lines are increasingly drawn not just between Israel

and Arab countries but also between secular Arab nationalists and ascendant Islamic nationalist movements inside moderate Arab states. Iran's influence in Iraq, its enduring strategic ties to Syria, pursuit of a nuclear weapons capability, and the success of Tehran's allies—HAMAS and Hizballah—are fueling Iran's aspirations for regional preeminence. Arab Sunni leaders are struggling to limit Iran's gains; Saudi Arabia's more activist regional diplomacy falls short of significantly constraining Iran's freedom of maneuver. Iran's ambitions combined with unresolved conflicts in Iraq, Lebanon, and the Palestinian territories represent the principal flashpoints for intensified conflict in the region.

Iran's longstanding foreign policy goals are to preserve the Islamic regime, safeguard Iran's sovereignty, defend its nuclear ambitions, and expand its influence in the region and the Islamic world. Iranian leaders perceive that regional developments—including the removal of Saddam and the Taliban, challenges facing the Untied States in Iraq and Afghanistan, the increased influence of HAMAS and Hizballah, and, until recently, higher oil revenues—have given Tehran more opportunities and freedom to pursue its objective of becoming a regional power. This perception has produced a more assertive Iranian foreign policy in which Tehran has focused on expanding ties in Iraq, Afghanistan, and the Levant to better influence and exploit regional political, economic, and security developments. Iran's pursuit of nuclear weapon capability is another element in its more assertive foreign policy—an aspect that I will discuss later.

In Tehran, Iran's conservative faction continues to dominate the government. Supreme Leader Khamenei has consolidated political power in his office, but his reliance on hardline conservative elements—the IRGC, war veterans turned politicians such as President Mahmud Ahmadi-Nejad, and selected clerics—to bolster his authority has upset the earlier factional balance in Iranian politics.

- Although the regime still comprises many competing factions, only those that support the concept of a powerful Supreme Leader and advocate revolutionary values now have a significant voice in decisionmaking.

President Ahmadi-Nejad faces less than certain prospects for reelection in June because his management of the economy and aggressive foreign policy rhetoric have become sources of significant domestic criticism and political friction. Ahmadi-Nejad's economic policies have reduced unemployment marginally, but have fueled significant inflation, providing his critics ample ammunition to question his competence. The sharp fall in global oil prices will add to Iran's economic problems, but Tehran has a substantial cushion of foreign reserves to support social and other spending priorities. Less energy revenues may also help to dampen its foreign policy adventurism.

We expect Khamenei will attempt to manipulate the presidential election, largely by limiting the range of candidates. As he has in past elections, the Supreme Leader probably will attempt to influence the decisions of individuals to run, monitor the vetting and approval of candidates, and influence media coverage of the campaign.

- We do not know if Khamenei will actively support Ahmadi-Nejad's re-election. The Supreme Leader publicly has expressed support for Ahmadi-Nejad's administration, but we judge his statements are intended more to minimize criticisms of the regime than to endorse the President.

- Although we expect that whoever is elected will be a strong supporter of the Islamic Republic, we note that the election of a more pragmatic figure may, over time, produce some moderation of Iranian behavior by introducing into the decisionmaking process a wider range of options than those presented under Ahmadi-Nejad.

Militarily, Iran continues to strengthen the three pillars of its strategic deterrence: surface-to-surface missiles, long-range rockets and aircraft for retaliation; naval forces to disrupt maritime traffic through key waterways; and unconventional forces and surrogates to conduct worldwide lethal operations. Although many of their statements are exaggerations, Iranian officials throughout the past year have repeatedly claimed both greater ballistic missile capabilities that could threaten US and allied interests and the ability to close the Strait of Hormuz using unconventional small boat operations, anti-ship cruise missiles, and other naval systems. Some officials, such as Islamic Revolutionary Guard Corps Commander Major General Mohammad Ali Jafari-Najafabadi, have hinted that Iran would have a hand in attacks on "America's interests even in far away places," suggesting Iran has contingency plans for unconventional warfare and terrorism against the United States and its allies.

Iran's goals in Iraq include preventing the emergence of a threat from Iraqi territory, either from the government of Iraq itself, or from the United States. To achieve this, Iran probably seeks a government in Baghdad in which Tehran's Shia allies hold the majority of political, economic, and security power. Iran also has sought to make the United States suffer political, economic, and human costs in order to limit US engagement in the region and to ensure that Washington does not maintain a permanent military presence in Iraq or use its military to pressure or attack Iran.

- Iranian efforts to secure influence in Iraq encompass a wide range of activities, including using propaganda, providing humanitarian assistance, building commercial and economic ties, and supporting Shia elements fighting the Coalition. Iran has provided a variety of Shia militants with lethal support including weapons, funding, training, logistical and operational support, and intelligence training.

- We judge Iran will continue to calibrate its lethal aid to Iraqi Shia militants based on the threat it perceives from US forces in Iraq, the state of US-Iran relations, Tehran's fear of a Ba'thist resurgence, Tehran's desire to help defend Iraqi Shia against sectarian violence, and to maintain the ability to play a spoiler role in Iraq if Iran perceives the government of Iraq has become a strategic threat.

- Despite Tehran's efforts, we judge Iraqi nationalism and the growing capabilities of the Iraqi government will limit Iranian influence in Iraq. Baghdad, for example, signed the US-Iraq security agreement despite Iranian opposition.

In Afghanistan, Iran has focused on promoting a friendly central government in Kabul and limiting Western power and influence. Iran's policy in Afghanistan follows multiple tracks, including providing political and economic support to the Karzai government and developing relationships with actors across the political spectrum.

- Iran has opposed Afghan reconciliation talks with the Taliban as risking an increase in the group's influence and legitimacy.

- We judge Iran distrusts the Taliban and opposes its return to power but uses the provision of lethal aid as a way to pressure Western forces, gather intelligence, and build ties that could protect Iran's interests if the Taliban regains control of the country.

In the Levant, Tehran is focused on building influence in Lebanon and expanding the capability of key allies. Tehran continues to support groups such as Hizballah, HAMAS, and Palestine Islamic Jihad (PIJ), which it views as integral to its efforts to challenge Israeli and Western influence in the Middle East.

- Hizballah is the largest recipient of Iranian financial aid, training, and weaponry, and Iran's senior leadership has cited Hizballah as a model for other militant groups. We assess Tehran has continued to provide Hizballah with significant amounts of funding, training, and weapons since the 2006 conflict with Israel, increasing the group's capabilities to pressure other Lebanese factions and to threaten Israel.

- Iran's provision of training, weapons, and money to HAMAS since the 2006 Palestinian elections has bolstered the group's ability to strike Israel and oppose the Palestinian Authority.

Worsening Conflict in the Levant

The Palestinian Territories and **Lebanon** are two places where the multifaceted connections of which I spoke are most pronounced in this arc of instability. Two non-state actors, HAMAS and Hizballah, play prominent roles, while individual states that oppose US interests, such as Iran and Syria, also are prominent. In both these countries, we worry about worsening conflict and the potential for growing violent extremism.

Fighting between Israel and HAMAS in the Gaza Strip subsided in mid-January, leaving in its wake hardened attitudes among Israelis and Palestinians, deepened Palestinian political divisions, and a widened rift between regional moderates—led by Egypt, Saudi Arabia, and Jordan—and hardliners, including Iran, Hizballah, and Syria. A key challenge for US policy in the coming year will be finding ways to strengthen moderates and renew the potential for peace negotiations, lest post-conflict division and anger in the region further diminish prospects for peace.

With HAMAS in control of Gaza and Hizballah growing stronger in Lebanon, progress on a Palestinian- Israeli accord is growing more difficult. With Iran developing a nuclear weapon capability and Israel determined not to allow it, there is potential for an Iran-Israeli confrontation or crisis on that issue as well. Moderate Arab states fear a nuclear-armed Iran,

want progress on Palestinian settlement—the absence of which deprives US Arab allies of crucial political capital to defend strategic ties to the US and wish to sustain a moderate, state-centered politics for the region. Progress on the Israeli-Palestinian peace track would increase opportunities for the US to broaden its engagement with Arab publics, including those aligning with the growing ideology of Islamic nationalism.

- The Israeli public appears broadly supportive of Israel's military action and believes Israel must act decisively to prevent attacks from Palestinian-controlled territory. At the same time, Israel's military actions in Gaza have deepened Palestinian anger towards Israel, both in the Gaza Strip and in the West Bank, and sparked outrage and protests throughout the Arab and Muslim world.

- HAMAS and the Palestinian Authority are engaged in an intense competition, with both sides seeking to emerge from the conflict in a stronger political position, but relations between the two organizations have been further embittered by the crisis. The Palestinian Authority (PA) accused HAMAS of needlessly provoking an Israeli attack and HAMAS, which has argued it "won" by surviving the operation and continuing its control of Gaza, accused the PA of essentially collaborating with the Israeli assault.

- The moderate Arab states and regional hardliners are competing to shape the regional developments and public attitudes in the aftermath of the Gaza crisis. The moderates seek a reconciliation of the Palestinian factions and the resumption of peace talks between Israel and the Palestinians, while hardliners are encouraging HAMAS to retain its uncompromising stance toward Israel. These opposing regional blocs are competing to take the lead in delivering humanitarian aid to Palestinians in Gaza. Moderate states support US efforts to establish a ceasefire and border security regime that will prevent the rearming of HAMAS, while Iran is likely to lead an effort to provide weapons to HAMAS to build the group's military capabilities.

Tensions between **HAMAS and Fatah** have been elevated since HAMAS seized control of the Gaza Strip in June 2007, and efforts to achieve reconciliation have failed. Both factions continue to attack, harass, and detain members of the other group in the West Bank and the Gaza Strip, deepening mutual resentment and making an accord between them difficult. Reconciliation talks between Fatah and HAMAS scheduled for November in Cairo did not occur because HAMAS refused to attend the meetings, in part to protest ongoing PA security measures in the West Bank targeting its members.

- Disagreement between Fatah and HAMAS about a range of issues such as the timing of national elections and formation of a unity government could lead HAMAS to challenge the legitimacy of Abbas's government and will remain obstacles to Fatah-HAMAS reconciliation.

In 2008, longstanding tensions worsened between anti-democratic Fatah elements, mostly but not exclusively the so-called "old-guard" and typically younger elements demanding internal reforms within the faction, worsened in 2008 amid discussions over the location of and attendance at Fatah's long-delayed sixth General Congress. These internal conflicts threaten to

fracture the party and damage its prospects in the run-up to PA presidential and legislative elections in 2009 or early 2010. There is no consensus among Fatah officials regarding a replacement for President Abbas, who has not groomed a successor, and no potential leader has gained Fatah's full support.

In **Lebanon**, after a long stalemate, the political process showed some movement last year that reasserted a fragile consensus giving Hizballah and the opposition veto power in the Lebanese Government. The Doha Accord in May ended armed clashes between Hizballah and Lebanese civilians and 18 months of political stalemate. The accord also paved the way for the election of former Lebanese Armed Forces (LAF) Commander Michel Sulayman as President on 25 May 2008. Sulayman has positioned himself as a consensus-builder between the 14 March Coalition and the Hizballah-led opposition and has made progress on some issues, including forming the national unity cabinet, drafting the cabinet statement, and reforming the electoral law.

- The Lebanese political scene has enjoyed a period of relative calm and reconciliation since May, probably because all Lebanese parties are focused on preparing and forging alliances for the National Assembly election in June 2009. Lebanese Christian voters, divided between the two political camps, will be decisive in determining who wins a majority in the election.

The security situation remains fragile in Lebanon, especially in the north, which saw fighting between the Sunni and Alawi communities last summer. The Hizballah-initiated violence in May has left all sectarian groups—the Sunnis in particular—concerned about their security. The LAF's limited response and the Hizballah-led opposition's military strength have reinforced the view that sectarian communities must defend themselves. All sides are working to develop sectarian-based militia forces. Hizballah continues to bolster its military strength; since the 2006 war, the group has rearmed and trained additional personnel in preparation for possible future conflict with Israel.

Hizballah's attempts to reconcile with other Lebanese parties are an effort to show the group's commitment to a Lebanese nationalist agenda in preparation for the election. They are also meant to reduce the damage done to Hizballah's image by its armed takeover of parts of Beirut in May.

Since becoming President of **Syria** in June 2000, Bashar al-Asad has strengthened his hold on power in Syria. Asad's standing has been augmented by his perceived success in weathering regional crises and international pressure and by the regime's ability to highlight Syria's relative insulation from violence in Iraq and Lebanon. Within Syria, Asad has preserved the pillars of regime control established by his father while gradually using personnel turnover to appoint loyalists and expand his power base.

- Syrian leaders continue to exploit "resistance" to Israel and rejection of US pressure to unify Syrians in support of the regime, despite broad dissatisfaction with economic conditions, some disappointment at the lack of political reforms, and quiet resentment by some Sunnis at domination by the Alawi minority.

Damascus continues efforts to cement its influence in Lebanon by providing economic and other support to its allies in the Lebanese opposition. Syria has exploited its role in helping secure the May 2008 Doha agreement, which ended Lebanon's political violence last spring and ushered in a unity government, to improve relations with Europe and moderate Arab states. Syria is poised to appoint an ambassador to Lebanon, and we judge Syria will continue to interfere in Lebanese affairs in pursuit of its own interests.

Syrian military cooperation with Iran, including trilateral cooperation with Hizballah, has increased during the past year. Syria views its links to Iran as a means to press and deter adversaries, particularly Israel, and create leverage for achieving its major goals of a lead role in the Arab world, maintaining influence in Lebanon, and regaining the Golan Heights. For Syria's part, Iran has proven over the last quarter century to be Syria's most reliable ally. Shared interests over the past few years—support for Lebanese Hizballah, sustaining Palestinian terrorists, and countering US regional intentions—have drawn Iran and Syria toward a closer alliance. Syrian military support to Hizballah has increased substantially over the past five years, especially since the 2006 Israel-Hizballah war. Damascus also supports Palestinian rejectionist groups, such as HAMAS, which base their external leadership in Syria.

Syria probably will adjust its approach to the Iraq insurgency as Iraq's situation evolves. As the United States withdraws, we assess Damascus will seek improved political and economic ties to Baghdad and is likely to support oppositionists opposed to a long-term US presence in Iraq. Syria will remain the primary gateway for foreign fighters entering Iraq. Syria condemned the 26 October 2008 US raid that targeted AQI foreign fighter facilitator Abu Ghadiyah and staged a temporary removal of some border guard forces. Damascus also closed US institutions in Syria, including the Damascus Community School and the American Cultural Center.

A More Stable Iraq as Counterbalance

The positive security trends over the past year have endured and expanded, and a more stable Iraq could counterbalance other negative trends in the region. Extremists in Iraq have been largely sidelined by Coalition and Iraqi operations and dwindling popular tolerance for violence, and their attacks are no longer a major catalyst for sectarian violence. Iraqis now are less inclined to resolve their differences through unsanctioned violence, and fewer Iraqis are dying at the hands of their countrymen than at any time in the past two years. Indeed, communal violence is now at the lowest sustained levels since Prime Minister Nuri al-Maliki's government came to power. Improving security conditions in Iraq have given the Prime Minister an opportunity to assert authority in previously denied areas of the country. Meanwhile, the maturation of the Awakening movement, Iraqi Security Forces (ISF) gains, and the subsequent spread of Sons of Iraq groups, in combination with Coalition operations against AQI leaders, have weakened AQI by largely forcing it out of strongholds such as Al Anbar and much of greater Baghdad.

The main factors that have contributed to these positive trends are as follows:

- First, Coalition operations and population security measures have been critical to reducing violence in Iraq. We judge Coalition support in the form of a credible, politically neutral security guarantor also has facilitated the ISF's ability to deal with ethnosectarian issues.

- Second, the Sunni insurgency has continued to wane. Most Iraqi-led Sunni insurgent groups have largely suspended operations against the Coalition, favoring engagement with the United States to protect their communities, to oppose AQI, or protect against feared domination by the Iraqi Government, although many are hedging by maintaining their organizational structures and access to weapons.

- Third, the threat from AQI has continued to diminish. AQI, although still dangerous, has experienced the defection of members, lost key mobilization areas, suffered disruption of support infrastructure and funding, and been forced to change targeting priorities. Indeed, the pace of suicide bombings countrywide, which we consider one indicator of AQI's operational capability, fell significantly during the last year.

- Fourth, the threat of violence from most Shia militants has declined. Many Shia who looked upon Sadr's Jaysh al-Mahdi (JAM) in early 2008 as defenders against Sunni extremists eventually came to see the JAM as pariahs, leading Muqtada al-Sadr to announce last summer that most of his thousands-strong militia would set aside their weapons to become a cultural organization and a counterweight to Western influence. Some Shia militant groups such as Sadrist-affiliated groups and Kata'ib Hizballah (KH) probably will continue anti-Coalition attacks and may engage in sporadic violence against Iraqi Government targets.

- Lastly, the capabilities of the ISF have continued to improve. The ISF's increasing professionalism and improvements in warfighting skills have allowed it to assume more responsibility for Iraq's internal security, as demonstrated by the successful operations against Shia militants in Al Basrah, Sadr City, and Al 'Amarah, and against Sunni extremists in Diyala and Mosul. Despite these improvements, the ISF remains dependent on the US for enabling capabilities such as logistics, fire support, and intelligence.

We assess political and security progress could be halted or even reversed by a number of factors, particularly if these challenges occur in combination.

- *Disputed internal boundaries.* Resolving disputed boundaries, primarily in northern Iraq, probably will be the most fiercely contested political issue to face Iraq in the next several years and poses the greatest threat to government stability.

- *Perceptions of Iraqi Government repression.* Policies or actions of the Iraqi Government perceived by segments of Iraq's ethnosectarian population to represent a broad and enduring campaign of repression could lead to widespread violence.

- *Increased foreign support to insurgent or militia groups.* We judge a large infusion of foreign support could deepen and intensify the ensuing conflict if Iraqi militants and insurgents sought external assistance to challenge or destabilize the Iraqi Government.

In addition to these challenges, Baghdad will confront more difficult choices about spending priorities as a result of declining oil revenues as it simultaneously grapples with security force modernization, infrastructure investment, and expanding public payrolls. Iraq's

economy will continue to depend heavily on hydrocarbon exports, government spending, and continued security improvements.

We judge Iran will expand political and economic ties to Baghdad and will continue to supply weapons and training to Shia militants to counter a Sunni resurgence, maintain leverage in Iraq, and keep pressure on US forces. Iraqi nationalism, however, acts as a check on Iran's ability to project power in Iraq. Syria will focus on improving relations with Baghdad and seek increased trade and energy exports but also will continue to support Ba'thists and other non-AQI Sunni oppositionists to try to gain leverage in Iraq. Turkey will continue to focus on countering the Kurdistan People's Congress, a Kurdish terrorist group based in northern Iraq. The Turkish military continues to conduct cross-border air and artillery strikes in northern Iraq against the Kurdistan People's Congress (KGK, formerly PKK), a Kurdish terrorist organization waging armed conflict against Turkey. The KGK appears to retain the desire to attack Turkish targets. In early October 2008, the KGK launched an attack on a Turkish military outpost that left 17 Turkish troops dead.

- Turkish officials met with Kurdistan Regional Government President Barzani in October 2008, opening the prospect of closer ties between Turkey and the KRG. Like the rest of Europe, the Turkish economy is feeling the effects of the global financial crisis. In mid-November, Standard and Poor's downgraded Turkey's credit outlook from stable to negative.

Iraq's Sunni Arab neighbors are starting to reestablish an Arab presence in Baghdad, but Arab engagement is likely to be slow and halting over the next year. Jordan's King Abdallah in August became the first Arab head of state to travel to Baghdad since the fall of Saddam; he dispatched an Ambassador to Iraq in October.

Afghan-Pakistani Linkages

In the past year, **Afghanistan's** Taliban-dominated insurgency has increased the geographic scope and frequency of attacks. Taliban reaction to expanded Afghan and NATO operations account for some of the increase in violence, but insurgents also have demonstrated greater aggressiveness and more lethal tactics. Efforts to improve governance and extend development were hampered in 2008 by a lack of security in many areas and a general lack of government capacity and competency. The ability of the Afghan government, NATO, and the United States to push back the Taliban and deliver security, basic governance, and economic development will determine the continued support of the Afghan people for the government and the international community. Afghan leaders also must tackle endemic corruption and an extensive drug trade, which erode the capacity of the government while diminishing public confidence in its already fragile institutions.

Specifically, the security situation has deteriorated in many eastern areas of the country and in the south and northwest. Taliban and affiliated insurgent groups have expanded operations into previously peaceful areas of the west and around Kabul. The Taliban-dominated insurgency has expanded in scope despite International Security Assistance Force (ISAF) and Operation Enduring Freedom military operations targeting insurgent command and control networks.

Continued progress has been made in expanding and fielding the Afghan National Army, but the shortage of international trainers in the field, high operational tempo, attrition, and absenteeism hamper efforts to make units capable of independent action. The Afghan National Police remains a largely untrained force with high rates of corruption and absenteeism. Limitations to training, mentoring, and equipping combined with an ineffective Ministry of Interior and large parts of the country that have not been effectively "cleared" hinder the progress and effectiveness of the policy.

Kabul in 2009 must work closely with the national legislature and provincial and tribal leaders to establish and extend the capacity of the central and provincial government. The country faces a chronic shortage of resources and of qualified and motivated government officials at the national and local level. In addition, continued attacks undercut the national government's image as a viable guarantor of security, persuading tribal and other influential non-state actors to either remain neutral or back insurgents. The 2009 presidential election will present a greater security challenge than the 2004 election, and the insurgents probably will make a concerted effort to disrupt it.

Kabul's inability to build effective, honest, and loyal provincial and district level institutions capable of providing basic services and sustainable, licit livelihoods erodes its popular legitimacy and increases the influence of local warlords and the Taliban. The Afghan government has launched some initiatives, such as the Independent Directorate of Local Governance (IDLG), to address governance shortcomings, but corruption has exceeded culturally tolerable levels and is eroding the legitimacy of the government. Both law enforcement and judicial capacity, although somewhat improved, remain limited, and Kabul remains constrained in its ability to deploy programs at the provincial and local levels.

The Afghan government has no coherent tribal engagement strategy, but where Pashtun tribal and government interests intersect, gains in local security, stability, and development are possible. At the provincial level, governors who have proven themselves effective mediators of local disputes among tribes and other local groups in their respective jurisdictions garner support from Afghan audiences and the donor community.

The Afghan drug trade is a major source of revenue for corrupt officials, the Taliban and other insurgent groups operating in the country and is one of the greatest long-term challenges facing Afghanistan. The insidious effects of drug-related criminality continue to undercut the government's ability to assert its authority outside of Kabul, to develop a strong, rule-of-law based system, and to rebuild the economy. Despite decreases in poppy cultivation in 2008, opium production in Afghanistan remains historically high, and the country produces over 90 percent of the world's supply with 95 percent of the crop grown in five contiguous provinces of southwestern Afghanistan and over 60 perce3nt in one province alone, Helmand. In 2008, farmers grew 157,300 hectares of poppy, potentially producing an estimated 7,700 metric tons of opium. Almost every province outside the southwest was either poppy-free or had a dramatic decrease in cultivation, due to a combination of effective local anti-poppy campaigns, better security unfavorable weather, and decreased opium prices relative to other crops, and improved governance and security in key provinces. The United Nations estimates that the total value to agricultural producers of Afghan opium in 2008 was $730 million—although the gap in

profitability has narrowed. No improvement in the security in Afghanistan is possible without progress in Pakistan.

No improvement in Afghanistan is possible without **Pakistan** taking control of its border areas and improving governance, creating economic and educational opportunities throughout the country. The government is losing authority in parts of the North-West Frontier Province and has less control of its semi-autonomous tribal areas: even in the more developed parts of the country, mounting economic hardships and frustration over poor governance have given rise to greater radicalization.

In 2008 Islamabad intensified counterinsurgency efforts, but Islamabad's record in dealing with militants has been mixed as it navigates conflicting internal and counterterrorist priorities. Pakistan's leaders are facing enormous socio-economic challenges. Economic hardships are intense, and the country is now facing a major balance of payments challenge. Islamabad needs to make painful reforms to improve overall macroeconomic stability. Pakistan's law-and-order situation is dismal, affecting even Pakistani elites, and violence between various sectarian, ethnic, and political groups threatens to escalate. Pakistan's population is growing rapidly at a rate of about 2 percent a year, and roughly half of the country's 172 million residents are illiterate, under the age of 20, and live near or below the poverty line. Among the needed reforms are measures to improve the transparency of government expenditures and impose taxes on wealthy landowners. Such reforms would reduce the opportunities for corruption among Pakistani political leaders, help to establish a more level political playing field, and help build the confidence of average Pakistanis in their government.

The Pakistani Government's current plans will require intensified and sustained efforts to orchestrate the administrative, economic, educational, legal, and social reforms required to create an environment that discourages Islamic extremism and encourages the development of human capital. This, in turn, requires effective political leadership focused on improving the capabilities of Pakistani institutions for effective governance.

WMD Proliferation Exacerbating Prospects for Middle East

The ongoing efforts of nation-states to develop and/or acquire dangerous weapons and delivery systems in the Middle East and elsewhere constitute another major threat to the safety of our nation, our deployed troops, and our allies. (The threat posed by North Korea's WMD program is assessed below, in the section on Asia.) We are most concerned about the threat and destabilizing effect of nuclear proliferation. The threat from the proliferation of materials and technologies that could contribute to both existing and prospective biological and chemical weapons programs also is real. Most of the international community shares these concerns.

WMD use by most nation states traditionally has been constrained by the logic of deterrence and by diplomacy, but these constraints may be of less utility in preventing the use of mass-effect weapons by terrorist groups. Moreover, the time when only a few states had access to the most dangerous technologies is long over. Technologies, often dual-use, circulate easily in our globalized economy, as do the personnel with scientific expertise who design and use them. Therefore, it is difficult for the United States and its partners to track efforts to acquire components and production technologies that are widely available.

We assess countries that are still pursuing WMD programs will continue to try to improve their capabilities and level of self-sufficiency over the next decade. Nuclear, chemical, and/or biological weapons or the production technologies and materials necessary to produce them may also be acquired by states that do not now have such programs; and/or by terrorist or insurgent organizations; and by criminal organizations, acting alone or through middlemen.

Iranian Nuclear and Missile Programs. The Iranian regime continues to flout UN Security Council restrictions on its nuclear programs. There is a real risk that its nuclear program will prompt other countries in the Middle East region to pursue nuclear options conducive to the development of nuclear weapons, and the advent of additional nuclear weapons programs might lead countries in other regions to reassess their nuclear options.

I want to be very clear in characterizing the Iranian nuclear program. First, there are three key parts to an effective nuclear weapons capability:

(1) Production of fissile material,
(2) Effective means for weapon delivery, and
(3) Design, weaponization, and testing of the warhead itself.

We assessed in our 2007 NIE on this subject that Iran's nuclear weapon design and weaponization work was halted in fall 2003, along with its covert uranium conversion and enrichment-related activities. Declared uranium enrichment efforts were suspended in 2003 but resumed in January 2006 and will enable Iran to produce weapons-usable fissile material if it chooses to do so. Development of medium-range ballistic missiles, inherently capable of delivering nuclear weapons, has continued unabated.

We assess Iranian military entities were working under government direction to develop nuclear weapons until fall 2003. Iranian entities are continuing to develop a range of technical capabilities that could be applied to producing nuclear weapons, if a decision were made to do so.

- Iran continues its efforts to develop uranium enrichment technology, which can be used both to produce low-enriched uranium for power reactor fuel and to produce highly enriched uranium for nuclear weapons.

- As noted, Iran continues to deploy and improve ballistic missiles inherently capable of delivering nuclear weapons.

- We assess Iran since fall 2003 has conducted research and development projects with commercial and conventional military applications, some of which would be of limited use for nuclear weapons.

We judge in fall 2003 Tehran halted its nuclear weapons design and weaponization activities and that the halt lasted at least several years. We assess Tehran had not restarted these activities as of at least mid-2007. Although we do not know whether Iran currently intends to

develop nuclear weapons, we assess Tehran at a minimum is keeping open the option to develop them.

We judge the halt was directed primarily in response to increasing international scrutiny and pressure resulting from exposure of Iran's previously undeclared nuclear work. This indicates Iran may be more susceptible to influence on the issue than we had judged in the 2005 National Intelligence Estimate.

We do not have sufficient intelligence reporting to judge confidently whether Tehran is willing to maintain indefinitely the halt of its previously enumerated nuclear weapons-related activities while it weighs its options, or whether it will or already has set specific deadlines or criteria that will prompt it to restart those activities. We assess Iran has the scientific, technical, and industrial capacity eventually to produce nuclear weapons. In our judgment, only an Iranian political decision to abandon a nuclear weapons objective would plausibly keep Iran from eventually producing nuclear weapons—and such a decision is inherently reversible. I reiterate that two activities of the three relevant to a nuclear weapons capability continue: development of uranium enrichment technology that will enable production of fissile material, if Iran chooses to do so, and development of nuclear-capable ballistic missile systems.

We assess convincing the Iranian leadership to forgo the eventual development of nuclear weapons will be difficult given the linkage many within the leadership see between nuclear weapons and Iran's key national security and foreign policy objectives, and given Iran's considerable effort from at least the late 1980s to 2003 to develop such weapons. Our analysis suggests that some combination of threats of intensified international scrutiny and pressures, along with opportunities for Iran to achieve its security and goals might—if perceived by Iran's leaders as credible—prompt Tehran to extend the halt to the above nuclear weapons-related activities. It is difficult to specify what such a combination might be.

We continue to assess Iran does not currently have a nuclear weapon. We continue to assess Iran probably has imported at least some weapons-usable fissile material but still judge it has not obtained enough for a nuclear weapon. We cannot rule out that Iran has acquired from abroad or will acquire in the future a nuclear weapon or enough fissile material for a weapon. Barring such acquisitions, if Iran wants to have nuclear weapons it would need to produce sufficient amounts of fissile material indigenously. We judge it has not yet done so.

Iran made significant progress in 2007 and 2008 installing and operating centrifuges at its main centrifuge enrichment plant, Natanz. We judge Iran probably would be technically capable of producing enough highly enriched uranium (HEU) for a weapon sometime during the 2010-2015 time frame. INR judges Iran is unlikely to achieve this capability before 2013 because of foreseeable technical and programmatic problems.

Iranian Missile Threat. Beyond its WMD potential, Iranian conventional military power threatens Persian Gulf states and challenges US interests. Iran is enhancing its ability to project its military power, primarily with ballistic missiles and naval power, with the goal of dominating the Gulf region and deterring potential adversaries. It seeks a capacity to disrupt the operations and reinforcement of US forces based in the region, potentially intimidating regional allies into

withholding support for US policy, and raising the political, financial, and human costs to the United States and our allies of our presence.

- Iran's growing inventory of ballistic missiles—it already has the largest inventory in the Middle East—and its acquisition of anti-ship cruise missiles provide capabilities to enhance its power projection. Tehran views its conventionally armed missiles as an integral part of its strategy to deter and if necessary retaliate against forces in the region, including US forces. Its ballistic missiles are inherently capable of delivering WMD and if so armed would fit into this same strategy.

The Terrorist CBRN Threat. Over the coming years, we will continue to face a substantial threat, including in the US Homeland, from terrorists attempting to acquire biological, chemical, and possibly nuclear weapons and use them to conduct large-scale attacks. Conventional weapons and explosives will continue to be the most often used instruments of destruction in terrorist attacks; however, terrorists who are determined to develop CBRN capabilities will have increasing opportunities to do so, owing to the spread of relevant technological knowledge and the ability to work with CBRN materials and designs in safehavens.

- Most terrorist groups that have shown some interest, intent, or capability to conduct CBRN attacks have pursued only limited, technically simple approaches that have not yet caused large numbers of casualties.

In particular, we assess the terrorist use of biological agents represents a growing threat as the barriers to obtaining many suitable starter cultures are eroding and open source technical literature and basic laboratory equipment can facilitate production. Terrorist chemical attacks also represent a substantial threat. Small-scale chemical attacks using industrial toxins have been the most frequent type of CBRN attack to date. The chlorine attacks in Iraq from October 2006 through the summer of 2007 highlighted terrorist interest in using commercial and easily available toxic industrial chemicals as weapons.

Al-Qa'ida is the terrorist group that historically has sought the broadest range of CBRN attack capabilities, and we assess that it would use any CBRN capability it acquires in an anti-US attack, preferably against the Homeland. There also is a threat of biological or chemical attacks in the US Homeland by lone individuals.

Rising Asia

As the terrorism and proliferation threats persist across the "arc of instability," East and South Asia are poised to become the long-term power center of the world. China and India are restoring the positions they held in the eighteenth century when China produced approximately 30 percent and India 15 percent of the world's wealth. These two countries are likely to surpass the GDP of all other economies except the United States and Japan by 2025, although the current financial crisis may somewhat slow the momentum. Japan remains the second largest global

economy and a strong US ally in the region, but the global economic slowdown is exacting a heavy toll on Japan's economy. To realize its aspirations to play increased regional and global roles will require strong leadership and politically difficult decisions. All together—Japan, the "tiger" economies like South Korea and Taiwan as well as the rising giants of China and India point to the "rise of Asia" as a defining characteristic of the 21st century. China's reemergence as a major power with global impact is especially affecting the regional balance of power.

As in the Middle East, the United States has strong relationships in East Asia—a network of alliances with Japan, South Korea, the Philippines, Thailand, and Australia, and close partnerships with other countries—and a longstanding forward military presence. Countries in the region look to the United States for leadership and for ways to encourage China to become a constructive and responsible player in the regional and global communities. Although China will have ample opportunity to play a positive role, it also poses a potential challenge if it chooses to use its growing power and influence in ways counter to US or broader international interests.

China's Transformation

China is thirty years into a fundamental transformation that will take many more decades to complete. Although there have been moments when the government's effort to maintain control seemed on the verge of failure—notably the crisis on Tiananmen Square in 1989—the government has been remarkably successful in guiding reform. China has avoided the fate of most other socialist countries, suffering neither the economic and political collapse of the Soviet Union nor the stagnation of Cuba and North Korea.

We judge China's international behavior is driven by a combination of domestic priorities, primarily maintaining economic prosperity and domestic stability, and a longstanding ambition to see China play the role of a great power in East Asia and globally. Chinese leaders view preserving domestic stability as one of their most important internal security challenges. Their greatest concerns are separatist unrest and the possibility that local protests could merge into a coordinated national movement demanding fundamental political reforms or an end to Party rule. Security forces move quickly and sometimes forcefully to end demonstrations. The March 2008 protests in Tibet highlighted the danger of separatist unrest and prompted Beijing to deploy paramilitary and military assets to end the demonstrations.

These same domestic priorities are central to Chinese foreign policy. China's desire to secure access to the markets, commodities, and energy supplies needed to sustain domestic economic growth significantly influences its foreign engagement. Chinese diplomacy seeks to maintain favorable relations with other major powers, particularly the US, which Beijing perceives as vital to China's economic success and to achieving its other strategic objectives. But Beijing is also seeking to build its global image and influence in order to advance its broader interests and to resist what it perceives as external challenges to those interests or to China's security and territorial integrity.

Taiwan as an area of tension in US-China relations has substantially relaxed since the 2008 election of Ma Ying-jeou. The new Taiwanese President inaugurated in May has resumed dialogue with Beijing after a nine-year hiatus, and leaders on both sides of the Taiwan Strait are now cautiously optimistic that a new period of less confrontational relations has begun. Many

outstanding challenges remain, however, and the two sides eventually will need to confront issues such as Taiwan's participation in international organizations. Beijing has not renounced the use of force against the island, and China's leaders see maintaining the goal of unification as vital to regime legitimacy.

PLA Modernization

Preparations for a possible Taiwan conflict continue to drive the modernization goals of the People's Liberation Army (PLA) and the Chinese defense-industrial complex. It will likely remain the primary factor as long as the Taiwan situation is unresolved.

At the same time, we judge that China over the past several years has begun a substantially new phase in its military development by beginning to articulate roles and missions for the PLA that go well beyond China's immediate territorial interests.

- For example, China's leaders may decide to contribute combat forces to peacekeeping operations, in addition to expanding the current level of command and logistic support.

- China's national security interests are broadening. This will likely lead China to attempt to develop at least a limited naval power projection capability extending beyond the South China Sea. This already has been reflected in Beijing's decision in December to participate in anti-piracy operations off the coast of Somalia.

Missile Capability. China continues to develop and field conventional theater-range ballistic and cruise missile capabilities that can reach US forces and regional bases throughout the Western Pacific and Asia, including Guam. China also is developing conventionally armed short- and medium-range ballistic missiles with terminally guided maneuverable warheads that could be used to attack US naval forces and airbases. In addition, counter-command, control, and sensor systems, to include communications satellite jammers, are among Beijing's highest military priorities.

Counterspace Systems. China continues to pursue a long-term program to develop a capability to disrupt and damage critical foreign space systems. Counterspace systems, including antisatellite (ASAT) weapons, also rank among the country's highest military priorities.

Nuclear Capability. On the nuclear side, we judge Beijing seeks to modernize China's strategic forces in order to address concerns about the survivability of those systems in the face of foreign, particularly US, advances in strategic reconnaissance, precision strike, and missile defenses. We assess China's nuclear capabilities will increase over the next ten years.

Indian Pragmatism

Like China, India's expanding economy will lead New Delhi to pursue new trade partners, gain access to vital energy markets, and generate the other resources required to sustain rapid economic growth. To sustain rapid growth, Indian governments also must maintain the political support for economic reforms needed to drive the expanding economy.

On the global stage, Indian leaders will continue to follow an independent course characterized by economic and political pragmatism. New Delhi will not automatically support

or oppose positions favored by the United States or any other major power. Nonetheless, good relations with the United States will be essential for India to realize its global ambitions. Indian leaders will seek benefits from American influence, trade, and technology. Strong ties to Washington also will give India more confidence in dealing with China and in mitigating the dangers posed by its long-time adversary, Pakistan. However, Indian leaders often will adopt positions contrary to those favored by Washington. India will be concerned about China during the coming decade because of Beijing's political and economic power and its ability to project military force regionally, but Indian leaders will strive to avoid confrontation with China.

Indian-Pakistan Relations. Within South Asia, one of the world's least integrated regions, India will strive to manage tensions with Pakistan, transnational terrorism, and spillover from instability in small neighboring states. Determined efforts by Indian and Pakistani leaders to improve relations through the so-called Composite Dialogue over the last four years could unravel unless Islamabad takes sustained, concrete, meaningful steps to allay Indian concerns about Islamabad's support to anti-Indian militant groups. This is the case particularly in light of the November 2008 terrorist attack in Mumbai. The attack has convinced many Indians that Pakistani military leaders, in an effort to undercut India's emerging international stature, now favor a strategy of allowing Pakistan-based groups to attack targets that symbolize New Delhi's growing prominence on the global stage or that could undermine India's prominence by provoking religious violence in the country. In the absence of a military response against Islamabad, the Indian public will look for visible signs that Pakistan is actively working to punish those involved and eliminate its domestic terrorist organizations. Pakistan-based groups could carry out additional attacks against India and run the risk of provoking an India-Pakistan conflict. In addition, India, which has endured a series of major terrorist attacks without major military response since 2003, is under domestic pressure to make rapid and significant improvements in its counterterrorism capabilities.

India also will look for ways to safeguard its interests in light of the concluding civil war in Sri Lanka and political uncertainty in Bangladesh and Nepal, which have experienced dramatic transformations in government during the past year. New Delhi generally will be supportive of democratic forces in its smaller neighbors, while also being sensitive to the opinions of the Tamil and Bengali communities within India.

North Korea's Nuclear Ambitions

In addition to a possible India-Pakistan conflict, Pyongyang's nuclear ambitions and proliferation behavior threaten to destabilize East Asia. The North's October 2006 nuclear test is consistent with our longstanding assessment that it had produced a nuclear device. Prior to the test, we assessed that North Korea produced enough plutonium for at least a half dozen nuclear weapons. The IC continues to assess North Korea has pursued a uranium enrichment capability in the past. Some in the Intelligence Community have increasing concerns that North Korea has an ongoing covert uranium enrichment program.

Pyongyang probably views its nuclear weapons as being more for deterrence, international prestige, and coercive diplomacy than for warfighting and would consider using nuclear weapons only under certain narrow circumstances. We also assess Pyongyang probably

would not attempt to use nuclear weapons against US forces or territory unless it perceived the regime to be on the verge of military defeat and risked an irretrievable loss of control.

Progress was made, albeit painstakingly, last year in Six Party Talks; the DPRK has shut down three core facilities at Yongbyon and has completed eight of the eleven disablement steps. However, much work remains. At the latest round of talks held in December in Beijing, the DPRK refused to agree to a Six Party verification protocol needed to verify the completeness and correctness of its nuclear declaration. Since then, Pyongyang has issued hardline statements suggesting further challenges to denuclearization.

On the proliferation side, North Korea has sold ballistic missiles and associated materials to several Middle Eastern countries, including Iran, and, in our assessment, assisted Syria with the construction of a nuclear reactor. We remain concerned North Korea could again export nuclear technology. In the October 3 Second Phase Actions agreement, the DPRK reaffirmed its commitment not to transfer nuclear materials, technology, or know-how. We assess Pyongyang is less likely to risk selling nuclear weapons or weapons-quantities of fissile material than nuclear technology or less sensitive equipment to other countries or non-state actors, in part because it needs its limited fissile material for its own deterrent. Pyongyang probably also perceives that it would risk a regime-ending military confrontation with the United States if the nuclear material was used by another country or group in a nuclear strike or terrorist attacks and the United States could trace the material back to North Korea. It is possible, however, that the North might find a nuclear weapons or fissile material transfer more appealing if its own stockpile grows larger and/or it faces an extreme economic crisis where the potentially huge revenue from such a sale could help the country survive.

We assess that poor economic conditions are fueling systemic vulnerability within North Korea. Public statements by the regime emphasize the need for adequate food supplies. A relatively good fall harvest in 2008, combined with the delivery of substantial US food aid—500,000 tons of grain have been promised and about one-third of this has been delivered—probably will prevent deterioration in the food security situation during the next few months. However, we assess North Korea is still failing to come to grips with the economic downturn that began in the early 1990s and that prospects for economic recovery remain slight. In addition to food, shortages in fertilizer and energy continue to plague the economy. Investment spending appears is negligible, trade remains weak, and we see little progress toward economic reforms. Pyongyang has long been in default on a relatively large foreign debt and we assess that badly needed foreign investment will not take place unless the North comes to terms with its international creditors and conforms to internationally accepted trade and financial norms, badly needed foreign investment will not take place.

- Pyongyang's strategic posture is not helping its economy. Trade with Japan has fallen precipitously since the nuclear and missile tests of 2006, and, while commercial trade with South Korea rose in 2008, South Korean aid and tourism to the North declined due to increased North-South tensions.

Despite this poor economic performance and the many privations of the North Korean public, we see no organized opposition to Kim Jong Il's rule and only occasional incidents of

social disorder. Kim probably suffered a stroke in August that incapacitated him for several weeks, hindering his ability to operate as actively as he did before the stroke. However, his recent public activities suggest his health has improved significantly, and we assess he is making key decisions. The state's control apparatus by all accounts remains strong, sustaining the dismal condition of human rights in North Korea.

Growing Challenges in Russia and Eurasia

Russian challenges to US interests now spring more from Moscow's perceived strengths than from the state weaknesses characteristic of the 1990s. US involvement in Iraq and Afghanistan and general anti-Americanism have created openings for Russia to build alternative arrangements to the US-led international political and economic institutional order. Russia is actively cultivating relations with regional powers, including China, Iran, and Venezuela to increase its ability to influence events. Moscow also is trying to maintain control over energy supply and transportation networks to Europe to East Asia, and protect and further enhance its market share in Europe through new bilateral energy partnerships and organizing a gas cartel with other major exporters. Russia appears to believe the continued heavy dependence of European countries and former Soviet states on Russia's state gas monopoly, Gazprom, provides Moscow with political and economic leverage.

Russia continues to rely on its nuclear deterrent and retaliatory capability to counter the perceived threat from the United States and NATO. Moscow for the past several years has also been strengthening its conventional military force to make it a credible foreign policy instrument, both to signal its political resurgence and to assert its dominance over neighboring states, like Georgia. Moscow has actively engaged in foreign military cooperation with countries such as China and Venezuela, in part to remind the United States and others of Russia's global military relevance. Despite persistent challenges, including a long-term decline in the numbers and quality of recruits and difficulties in keeping pace with the demands of weapons modernization, the Russian military defeated the Georgian military last August.

Russian leaders recently have spoken positively about the possibilities for change in the US-Russia dynamic, but issues such as NATO enlargement, the conflict over Georgia's separatist regions, and Missile Defense will continue to pose difficulties for the relationship and underscore the challenges of finding ways to engage with Russia. Even as it seeks to negotiate a robust post-START agreement, Moscow consistently stresses that the accession to NATO of Georgia and Ukraine would put existing arms control regimes and negotiations at risk and could prompt Russian military countermeasures as well as increased pressure against Tbilisi and Kyiv. Russia's strong engagement with countries like Iran and Syria, including advanced weapons sales, also has implications for US nonproliferation interests.

Eurasia/Caucasus/Central Asia

Six months after the fighting between Russia and Georgia over Abkhazia and South Ossetia last August, the separatist regions remain potential flashpoints. Moscow's expanded military presence in and political-economic ties to these regions, along with continuing violence increase the risk of provocation, overreaction, or miscalculation leading to a resumption of fighting. Although the political situation in Georgia has stabilized, President Saakashvili faces

increasing criticism from the domestic opposition, and his reaction to that will either enhance or set back Georgia's democratic development.

The continued difficulty of bridging fundamental differences between Azerbaijan and Armenia over Nagorno-Karabakh will also keep tensions high in the Caucasus. Azerbaijan fears isolation in the wake of Kosovo's independence, Russia's recognition of South Ossetia and Abkhazia, and signs of improved Armenian-Turkish relations. Armenia is concerned about Baku's military buildup and does not want to become dependent on Russia. Both countries face the dual challenges of overcoming inertia in democratic reforms and battling endemic corruption in the face of an economic downturn.

An increasingly assertive Russia and the fallout from the global financial crisis will combine to amplify the challenges facing Ukraine as it heads for a presidential election in Winter 2009-2010. Ukraine has moved toward democracy and Western integration despite numerous political tests since independence. Progress will be difficult because of weak political institutions, ongoing conflicts with Russia over gas pricing and contracts and the new exigencies of the global financial crisis, which has dramatically revealed the underlying weaknesses of the Ukrainian economy and potentially Ukraine's stability.

In Belarus, the Lukashenko regime appears willing to cooperate with Russian efforts to counter US missile defense plans with Prague and Warsaw. However, Russia's continuing efforts to control key Belarusian economic sectors could prompt Minsk to improve ties with the West to balance Moscow. Lukashenko maintains an authoritarian grip on power and could return to repressive measures if public discontent over the worsening economy turns to protest.

The five Central Asian states—Kazakhstan, Uzbekistan, Kyrgyzstan, Tajikistan, and Turkmenistan—with their highly-personalized politics, weak institutions, and growing inequalities are ill-equipped to deal with the challenges posed by Islamic violent extremism, poor economic development, and problems associated with energy water and food distribution. Energy helped make Kazakhstan a regional economic force, but any sustained decline in oil prices would affect revenues, could lead to societal discontent, and will derail the momentum for domestic reforms. Tajikistan and Kyrgyzstan have heavily depended on migrant worker remittances from both Russia and Kazakhstan for a significant portion of their gross domestic product—up to 45 percent in the case of Tajikistan—and will be severely affected by the financial crisis. Tajikistan, in particular, faces increased threats to internal stability from the loss of these critical revenue streams. Ultimately, these challenges to regional stability could threaten the security of critical US and NATO lines of communication to Afghanistan through Central Asia.

The Balkans

Events in the Balkans will again pose the greatest threat of instability in Europe in 2009, despite positive developments in the last year that included Kosovo's peaceful declaration of independence from Serbia, the election of pro-EU leaders in Serbia, and offers of NATO membership to Croatia and Albania. The principal challenges to stability will come from the unresolved political status of the Serb minority in Kosovo, particularly in northern Kosovo, and Bosnia-Herzegovina's (BiH) continuing uneasy inter-ethnic condominium.

More than 50 nations, including 22 of 27 EU members, have recognized the new state of **Kosovo**. In the coming years Pristina will depend on the international community for economic and development assistance and to ensure Kosovo's territorial integrity. Belgrade openly supports parallel Kosovo Serb institutions. It has used political and legal means to challenge and undermine Pristina's sovereignty and to limit the mandate of the EU's Rule of Law mission (EULEX) in Kosovo, which is meant to help Kosovo authorities build multi-ethnic police, judiciary, and customs systems. This has reinforced the de facto separation of Kosovo into an Albanian-majority south and a Serb-majority north and frustrated the Kosovo Albanians. Kosovo Force's (KFOR) presence will help deter widespread violence, however. **Serbia's** leaders espouse a European future, and President Tadic desires quick progress toward EU membership, but they are unwilling to abandon Belgrade's stake in Kosovo to achieve that end. Belgrade still looks for Moscow's diplomatic support on this issue and recently concluded a significant energy deal with Moscow, including sale of a majority stake in its state oil refinery.

Bosnia's future as a multi-ethnic state remains in doubt, although neither widespread violence nor a formal split is imminent. Ethnic agendas still dominate the political process, and wrangling among the three main ethnic groups over the past 18 months has stalled the process of building a central government capable of taking the country into NATO and the EU. Threats of secession by Bosnian Serb leaders and calls by some Bosniak leaders to eliminate the Bosnian Serb entity have increased inter-ethnic tensions to perhaps the highest level in years.

Testing Times for Latin America

Latin American economies, following five consecutive years of solid performance, are feeling the repercussions from the global financial crisis. We expect the region's growth rate will fall substantially this year to about 1 percent from 4 percent for 2008. Exports from the region have averaged 20 percent growth for five years, but falling commodity prices and slowdowns in major industrial markets have sharply reduced export growth in the fourth quarter of 2008 and into 2009. Foreign direct investment flows through mid-year 2008 were on pace to reach the record level of $110 billion in 2007, but are likely to have diminished in late 2008 and probably will continue to do so in 2009. Finally, after 10 years of worker remittances growing at an average annual rate of better than 15 percent, remittances grew just 7 percent in 2007 and grew only 1 to 2 percent in 2008.

Democracy in much of Latin American has established impressive roots over the past decade or so. In countries that comprise the bulk of the region's GDP and population—like Brazil, Chile, Colombia, Mexico, and Peru—pro-market policies have yielded important economic dividends that help fortify democratic gains. Brazil is becoming a leading regional power and, along with others like Argentina and Chile, is trying to promote greater South American integration

Developments in the last year, however, underscore the challenge that populist, often-autocratic regimes still pose in the region. Venezuela attracts substantial, if declining, regional popular support, but its influence is likely to diminish as its economic problems mount. Cuba, though an economic basket case, can still influence the Latin American left because of its so-called "anti-imperialist" stance. Others like Bolivia, and to a lesser extent Argentina and

Ecuador, have embraced populist policies and are likely to also lag behind. Some, such as Haiti, have become even poorer and still less governable. Basic law-and-order issues, to include rising violent crime and powerful drug trafficking organizations also confront key hemispheric nations, as do uneven governance and institution-building efforts and performance in confronting chronic corruption. To maintain our political and economic influence in the region, the United States will be called upon to help the region's governments address their growing security problems and to deliver greater market access. Our use of bilateral trade agreements, and foreign aid through the Millennium Challenge Account to less developed countries, helps cement sound economic policies and more effective governance.

As in Africa (see below), China has increased its outreach to Latin America in recent years, primarily in pursuit of access to markets and resources to fuel its economic development and growth. This is boosting Chinese economic and diplomatic influence in the region, and generating questions about Beijing's long-term intention in the developing world—potentially as an alternative development model. Beijing's military engagement in the region—while secondary to its economic and political engagement efforts—also facilitates access to strategic natural resources. People's Liberation Army outreach activities in Latin America have included high-level strategic dialogue, personnel exchanges, and sales of weapons and equipment. Nonetheless, Beijing has made few arms sales to the region, outside of Venezuela, nor developed significant military-to-military ties with any countries. For its part, Tehran has made some progress over the last few years in improving commercial ties and establishing embassies and cultural centers in Latin America, with an aim to reducing Iran's international isolation. Hizballah has long maintained a presence in the tri-border region between Argentina, Brazil and Paraguay, a notorious region for narcotics and arms trafficking.

Mexico

Mexico's sound fiscal and monetary policies will probably provide some insulation from the current global economic volatility. With 80 percent of its exports destined for US consumers and low international oil prices, however, Mexico would take a strong hit from a prolonged US recession. Mexico's Finance Secretariat cut growth estimates for 2008 to 1.5 percent, and Finance Minister Carstens has openly acknowledged growth might contract by a percentage point this year. Mexico last experienced a fall in GDP in 2001. Unemployment late last year was almost 4.5 percent, up a point from 2007 and underemployment is even higher. Employment in the construction sector dropped more than 4 percent in the same time period, according to Mexico's National Statistics Institute.

The sharp economic downturn as yet shows no sign of hurting Mexico's debt posture or spurring northward migration. Mexico's National Statistics Institute late last year indicated that Mexican emigration had dropped 42 percent since 2006, probably due to the decreased demand for labor in the United States. That trend probably will lead to declines in remittances, the second largest source of foreign currency after oil exports, and increase pressure on the government to create jobs.

Mexico remains the most important conduit for illicit drugs reaching the United States. As much as 90 percent of that cocaine known to be directed toward the United States, and some Colombian heroin, eventually transits Mexico before entering the United States. Despite recent

successful efforts to counter precursor chemical diversion and drug trafficking, Mexico is the chief foreign supplier of methamphetamine and marijuana to the US market and produces most of the heroin consumed west of the Mississippi River. The corruptive influence and increasing violence of Mexican drug cartels, which are among the most powerful organized crime groups in the world, impede Mexico City's ability to govern parts of its territory and build effective democratic institutions.

Nearly 5,500 people—mostly cartel operatives and to a lesser degree local police—were murdered in 2008 in cartel-related violence, far exceeding the record of about 2,700 drug-related murders in 2007. Also, the cartels have shown their willingness and capacity to strike Mexican Government officials, its leadership, and the military. Nevertheless, sustained government pressure has disrupted established transnational cocaine supply chains, interfered with day-to-day cartel operations, and has started to fragment Mexico's powerful drug cartels. We assess that significantly more cocaine is diverting to Central America before moving into Mexico, a shift that, in our judgment, mitigates some risks drug traffickers faced in Mexico but that also complicates trafficking operations.

As trafficking networks have come under increasing strain from President Calderon's counternarcotics efforts, elements of Mexico's most powerful cartels have become more aggressive. The assassination of the national police commissioner last May, the grenade attack in a crowded plaza in Michoacan State last September and the execution of Brigadier General marco Enrique Tello Quinonez this month indicate cartel elements are increasingly willing to kill high-level Mexican officials, retaliate against soldiers, and tolerate more collateral damage among civilians not directly involved in the drug trade.

Calderon has demonstrated his determination to address the problem of narcotics-related corruption at all levels of the government by launching Operation Cleanup. Most notably, this has led to the arrest of a former Deputy Attorney General and the head of Interpol in Mexico. In addition, Calderon won approval in November of the 2009 federal budget, which increased outlays in real terms to the Public Security Secretariat and the Attorney General's Office by 69 percent and 29 percent, respectively.

Colombia

President Uribe is committed to an all-out effort to defeat the Revolutionary Armed Forces of Colombia by the time his term ends in 2010. His public statements indicate he is determined to use Colombia's security forces to maintain the systematic military pressure that has kept the FARC on the run, caused the FARC to lose territory, and degraded FARC command and control. Among the major successes in 2008 were the deaths of key FARC leaders, including members of the ruling Secretariat, a continued high number of FARC desertions, and the 2 July rescue of 15 hostages, including three US citizens.

Despite these reverses, the FARC leadership has shown no signs it seeks to end hostilities or participate in serious peace talks. The group has a record of resilience, and its chances for surviving as a viable insurgent force over the next several years will be aided by a still-cohesive leadership structure, substantial drug revenues, and cross-border sanctuaries in Venezuela and Ecuador.

Although the FARC is unlikely to make a sustained comeback, it will still be able to conduct small-scale guerrilla and terrorist attacks nationwide. Official and nonofficial US citizens remain at risk.

The government's successes have contributed to a dramatic drop in crime, terrorist acts, massacres, and kidnappings. Bogota has made progress on providing better protection for labor unionists and instituting policies to educate the security services on human rights standards. Bogota needs to follow through, however, with its proposals to strengthen the judiciary and prosecute the murders of union members and human rights workers.

Bogota's counterdrug successes—including capture and extradition of the leaders of the North Valley Cartel, the last remaining large-scale drug cartel (besides the FARC), the targeting of mid-level leaders, a strong security force presence in key drug transit and coca growing zones, and its US-backed coca eradication program—have hampered FARC drug trafficking operations. Bogota's strides in tackling corruption also have led to high-profile trafficker takedowns. Bogota arrested or killed important traffickers such as the Mejia Munera brothers, known as "los Mellizos," in 2008 after the officials protecting them were removed from office. Colombian interdiction efforts resulted in an increase in seizures in 2008. Still, Colombia remains the world's leading producer of cocaine and a key supplier of heroin to the US market. The US Government's 2007 imagery-based survey indicates 167,000 hectares in Colombia were planted with coca, as compared to 157,200 in 2006, a statistically insignificant increase. Although the total area under cultivation remained nearly constant, aerial eradication reduced yield per hectare by killing some plants inside of areas counted as fully under cultivation and causing some farmers to lose harvests before they could rehabilitate the field. This resulted in a reduction in potential cocaine production from 550 metric tons in 2006 to 535 in 2007. Area under cultivation in 2007 was slightly less than in 2001, the year when Plan Colombia support began to take hold, but potential production is about one quarter less, due to the effects of aerial eradication on yield. We are still compiling and assessing the data from 2008.

Venezuela

President Hugo Chavez is focusing on shoring up public support at home after his opponents won five key states and the capital in November gubernatorial and mayoral elections. Chavez also must deal with growing public concern about violent crime and worsening economic conditions. Nevertheless, Chavez remains Venezuela's most popular politician, according to a reputable local polling company, and controls the country's key institutions. To consolidate his socialist "revolution," Chavez has ordered a referendum for February aimed at allowing indefinite reelection for all elected officials. His push probably reflects concern over dwindling oil profits undercutting his ability to maintain popular domestic programs.

Chavez probably will struggle to maintain economic growth in the coming years as oil prices fall from their record highs. He has been unable to control high inflation and his statist economic policies have reduced drastically private-sector growth. Chavez also has failed to make sufficient investments in infrastructure, especially in the vital oil sector, necessary for sustained growth.

- Venezuela's crude oil output of about 2.3 million b/d and its exports to the United States are slowly declining; prospects for a significant turnaround are limited unless Caracas changes its current oil policies.

- If the price of West Texas Intermediate oil stays below $50 per barrel for most of 2009, Chavez probably will be forced to make major cuts in domestic and foreign spending or to devalue the Venezuelan currency and draw down government hard currency reserves to avoid a major economic crisis.

Chavez is likely to face new constraints in 2009 as he attempts to expand his influence in Latin America. His willingness to spend oil revenue on foreign aid and his unstinting populist message have paid some dividends, but repeated spats with foreign leaders have tarnished his image and falling oil prices could further undermine his ability to buy friends. Chavez's approval rating has been decreasing regionally, according to the 2008 Latinbarometer, a highly regarded regional survey. Chavez has provided significant financial and political support to Evo Morales in Bolivia and Daniel Ortega in Nicaragua.

Public disclosure of Chavez's close ties with the Revolutionary Armed Forces of Colombia (FARC), which were reflected in documents from the hard drives captured after the death of a FARC Secretariat member in March, have forced Chavez, at least rhetorically, to improve relations with Bogota. We assess Chavez is likely to maintain his decade-long ties to the FARC by providing them safehaven because of his ideological affinity to the group and his interest in influencing Colombian politics.

- The United States in September designated two senior Venezuelan Government officials and one former official under the Foreign Narcotics Kingpin Designation Act for materially assisting the narcotics trafficking activities of the FARC.

Chavez's efforts to expand his reach beyond Latin America continue to give priority to Iran, Russia, and China. The personal relationship between Iran's President Ahmadi-Nejad and Chavez drives strengthening bilateral economic and military ties, although the two countries are still struggling to overcome bureaucratic and linguistic obstacles to implementing accords. Venezuela also is serving as a bridge to help Iran build relations with other Latin American countries. Chavez has given special attention in recent months to deepening political, economic, and military ties to Russia. In late 2008, he announced his plans to build a nuclear power plant in Venezuela with Russian assistance.

Despite Caracas's stated interest in purchasing more Russian, Chinese, and Spanish armaments, worsening economic conditions probably will force Chavez to slow such acquisitions. His $5.3 billion in military purchases since 2005 have attracted notice within the region, although Venezuela's overall military capabilities remain plagued by logistic, maintenance and transportation shortfalls. Notable purchases from Russia include 24 Su-30MK2 fighters, helicopters, and assault rifles.

Chavez's growing ties to Iran, coupled with Venezuela's lax financial laws and border controls, and widespread corruption have created a permissive environment for Hizballah to exploit. In June 2008, two Venezuelan-based individuals, one a Venezuelan diplomat, were

designated by the US Treasury Department as supporters of terrorism for reportedly providing logistical and financial support to Hizballah members.

Venezuela is second only to Colombia as the most important cocaine departure country in South America, and it is the leading departure country of air smuggling to world markets. Venezuela's share of the cocaine departing South America has tripled from 5 percent in 2004 to 15 percent through the third quarter of 2008. counternarcotics cooperation has sunk to an all-time low in the wake of the expulsion of the US Ambassador by Chavez and his refusal to grant visas to new DEA officials to work in Venezuela.

Cuba

President Raul Castro's record since formally taking power in February 2008 indicates his primary objective in the coming year will be to make Cuba's dysfunctional socialist economy more efficient. His task has been made more difficult, however, by the extensive damage to the country's already weak agricultural sector and infrastructure by three major and successive hurricanes last year. The global economic downturn will further slow growth, diminishing the regime's options for addressing public dissatisfaction with living conditions.

Havana's competent and immediate response to the hurricanes underscores the effectiveness of regime controls and indicates that it remains capable of preventing a spontaneous mass migration. Nevertheless, we judge that at a minimum the annual flow of Cuban migrants to the United States will stay at the same high levels of about 35,000 legal and illegal migrants annually that have prevailed over the past several years.

Raul almost certainly will continue to proceed cautiously on any reforms to the economy in order to maintain elite consensus and avoid raising public expectations beyond what he is able or willing to deliver. We have seen no indication in the modest changes he has implemented that he intends to abandon core Communist economic principles, such as state ownership of production. On the political front, all indications are that Raul will continue to deny elements of civil society and pro-democracy dissidents the exercise of free expression.

Venezuela's preferential terms for oil sales and payments for Cuban medical personnel and other technical specialists will remain Cuba's economic lifeline, despite Cuba's efforts to attract other sources of foreign investment from countries such as China and Russia. President Chavez probably will prioritize aid to Havana over other foreign policy commitments.

We assess Raul will continue his efforts to bolster Havana's international legitimacy by projecting a more moderate political image. Nevertheless, Cuba almost certainly will remain heavily involved behind-the-scenes in counseling and supporting authoritarian populist governments in Latin America and otherwise seeking to undermine US influence across the region.

Bolivia

After nearly a year of sporadic unrest and rising tensions, President Evo Morales and opposition legislators last October reached a compromise to allow a referendum in late January on a draft constitution that encapsulates much of Morales' social and economic reform agenda.

The compromise eased tensions following a string of violent protests last fall, but some leaders in eastern departments rejected the compromise. Nevertheless, the referendum passed by a comfortable margin. The draft constitution leaves many contentious issues vague, which several government and opposition leaders have acknowledged probably will lead to further disputes over implementation in the run-up to new presidential elections in December 2009.

Although the risk of violence against US citizens has been reduced for the time being, Morales consistently has accused official US organizations—the US Embassy, DEA, and USAID—of conspiring against him. Morales in September expelled the US Ambassador and in November expelled DEA personnel. Morales in January publicly threatened to close Congress and pass bills implementing the new Constitution by decree if legislators refused to cooperate.

Chavez promised to protect Morales's government and provided La Paz important financial assistance. Since 2006, Venezuela has provided Bolivia more than $95 million in direct financial aid.

Africa: Falling Further Behind

Africa has made substantial economic and political progress over the past decade. However, the durability of the region's recent positive growth trend, particularly among countries dependent on commodity exports and foreign capital inflows, will be tested by the drop in commodity prices and recessions in the United States and Europe. Even before the financial crisis hit, the 6 percent GDP growth rate—although impressive—was insufficient to bring about necessary structural changes in the continent's economy. Africa's economic growth is led by a small number of oil-producing countries, but even those countries without oil resources have experienced GDP growth rates far above their historical rates. Agriculture, the foundation of most African economies, is far from achieving self-sufficiency, but technical solutions and infrastructure enhancement have demonstrated their ability to boost production in Mali, Malawi and Zambia. Further transformations remain uncertain in light of the EU's continuing ban on genetically modified foodstuffs.

In addition to fallout from the global financial crisis, Africa faces other economic, societal and security challenges. Sub-Saharan Africa is confronting a shortage of skilled medical personnel, deteriorating health systems, and inadequate budgets to deal with diseases like HIV/AIDS, malaria, and tuberculosis. Transnational crime, especially the transshipment of illegal drugs to Europe, and corruption are growing in various parts of Africa, weighing down the continent's economic growth, reducing government efficiency, and undermining the security services of African states.

China's presence has grown substantially over the past decade. Total bilateral trade between China and the continent has increased from less than $4 billion in 1995 to $100 billion in 2008, but the EU and US still remain far larger economic partners for the region. China's objectives are to secure access to African markets and natural resources, isolate Taiwan, and enhance its international stature, all of which it has made progress on. Nevertheless, China's role has generated local resentment as Chinese firms are seen as undercutting African competitors in

securing commercial contracts and falling short of standard local labor practices. Moreover, there is little discernible evidence of Chinese investments being used to incorporate Africa into the industrial "global value production chains" that are becoming the hallmark of integrative trade and FDI flows, especially in manufacturing in other regions of the world.

The most serious problem confronting Africa is the continuation of a number of serious and seemingly intractable conflicts in three of Africa's largest and most important states: the Democratic Republic of the Congo, Nigeria, and Sudan. The conflicts in the Congo and Sudan have spilled across their borders and have at times taken on a regional dimension. In the Horn of Africa, the ongoing conflict in Somalia and the collapse of the country's economy have given rise to a piracy epidemic in the Gulf of Aden and have created a terrorist safehaven in southern Somalia.

Although African governments' political commitment to peacekeeping has increased significantly over the last ten years, the capacities of the African Union, regional organization, and individual African states to conduct peacekeeping operations have been stretched to the limit. Major troop contributing countries are becoming more wary and less capable of deploying peacekeepers to potentially dangerous operations whose mandates and missions are unclear.

The Democratic Republic of the Congo

In the Democratic Republic of the Congo, President Joseph Kabila has been unable to consolidate his control over the turbulent Eastern border region. In that area, rebel groups, undisciplined soldiers, and ethnic militia have operated inside and outside of the DRC largely with impunity for many years and have been responsible for numerous acts of violence and human rights abuses. The trouble has persisted, even with the help of the largest UN peacekeeping operation in the world. Recently, however, Kabila has agreed to conduct joint military operations with nearby countries in an effort to root out some of these groups. As a result, Rwanda and Uganda have each sent forces into different parts of the border region, Rwanda into the North and South Kivu Provinces and Uganda into the extreme northeastern region. In the Kivus, Kinshasa and Kigali are both concerned about the remnant of the 1994 Hutu-led Force for the Democratic Liberation of Rwanda (FDLR). While not a military threat to the Tutsi-led government in Kigali at this time, the force is a threat to local Congolese communities. With Kinshasa's approval, Rwanda sent several thousand soldiers into the area to defeat, demobilize, or repatriate the FDLR. In return for Kinshasa's cooperation, Kigali appears to have dropped its support for a Congolese Tutsi rebel leader, General Laurent Nkunda. The Rwandans have arrested Nkunda and have him in custody. Moreover, his forces have divided, some joining up with Congolese government troops. In the northeast, the Ugandan-led military operation (with both Congolese and Sudanese support) has so far been unsuccessful. Its objective is to eliminate the threat posed by the Ugandan rebel group known as the Lord's Resistance Army (LRA), led by Joseph Kony. Congolese forces, in the near term, probably will not be able to reassert sufficient control over territory occupied by the LRA and other rebels groups or to stop sporadic outbreaks of violence.

Nigeria

Nigeria's oil-rich Delta region, which supplies 10 percent of US oil imports and accounts for America's largest investment in Sub-Saharan Africa, has been engulfed in civil strife for

nearly two decades. Widespread violence, criminality, and corruption have continued to disrupt Nigeria's oil and gas production, costing the country millions of dollars in lost revenue. Inadequate governance and a total lack of accountability has put billions of dollars in the pockets of corrupt leaders rather than in much needed development and infrastructure projects. Opportunistic militants, many of whom are beholden to local political leaders who have armed them in the run-up to Nigeria's last three national elections, have attacked oil facilities, kidnapped Nigerian and foreign oil workers, and left much of the Delta lawless and economically ravaged. As result of the violence and criminal activity, Nigerian oil production declined about 10 percent in 2008. Unstable political conditions and the fall in the price of crude oil probably will slow or deter additional foreign investment in the Delta, contributing to further production drop-offs in the future. A turnaround in the current security environment is unlikely soon.

Sudan

As Sudan approaches two major landmarks in the implementation of the 2005 Comprehensive Peace Agreement (CPA), the country remains plagued by violence in Darfur, and the ruling National Congress Party's (NCP) confidence in President Omar Hassan al-Bashir may be waning. The NCP and Sudanese People's Liberation Movement (SPLM) are likely to postpone national elections required to be held under the CPA by July 2009. Election delays are unlikely to trigger a violent collapse of the CPA because both parties have strong incentives to maintain the status quo until at least 2011 when the South will vote on a referendum for independence. However, the parties will have to address critical benchmarks for wealth-sharing and border demarcation contained in the CPA.

- The Darfur conflict has become increasingly complicated over the course of the past five years and is unlikely to be resolved in the near future. While bureaucratic and logistic constraints in New York and Sudan continue to delay full deployment of a 26,000-person UN peacekeeping force, the UN mediator's attempt to hold inclusive peace talks remains stymied by rebel disunity and ongoing fighting, which, to date, has displaced more than 3 million people. Chadian-backed rebels based in Darfur have advanced on the Sudanese capital in the past year, risking an escalated proxy war between Khartoum and N'Djamena.

- A pending request by the International Criminal Court's (ICC) chief prosecutor for a warrant to arrest Sudanese President Omar Hassan al-Bashir on charges of war crimes, crimes against humanity, and genocide has heightened Khartoum's distrust of Western intentions, while inducing Sudanese officials to appear cooperative with international peacemaking attempts in the short term. The ICC charges against Bashir may undermine his support in the NCP and among Sudan's military leadership.

Somalia

Somalia has not had a stable, central government for 17 years and continues to be mired in conflict. An UN-brokered agreement between the Somali Transitional Federal Government (TFG) and key opposition leaders in mid-2008 is unlikely to bring peace to Somalia in the near term. In January 2009 Ethiopia withdrew the troops it deployed in late 2006 to protect the TFG and oust the Council of Islamic Courts (CIC). Resurgent Islamic extremists are now fighting to fill the void and expand their hold on territory throughout the country. A newly elected

pragmatic Islamist president may enhance the credibility of the TFG, but he will face multiple challenges maintaining the new ruling coalition, including the continued dominance of clan politics. The removal of Ethiopian troops, whose presence has alienated most Somalis, is likely to reduce popular support for the extremist group, al-Shabaab al Islamiyah. However, the TFG lacks a viable security service to defend its leaders and a modest African Union peacekeeping force has limited reach in Mogadishu. Violent power struggles between Islamist militias and emerging local resistance groups could displace thousands of additional Somalis, exacerbating already dire humanitarian conditions.

Lawlessness in Somalia already has prompted a surge in piracy in the Gulf of Aden. The number of successful pirate attacks has increased almost fourfold since 2007 after the pirates received several multi-million dollar ransom payments in early 2008. Local authorities' unwillingness or inability to stem piracy also has fueled the proliferation of hijackings. The growing number and sophistication of Somali pirate attacks threaten to restrict the options for countering them, and they could take root in Somali society if left unchecked.

Zimbabwe

Zimbabwe continues to deteriorate under the brutal and corrupt rule of President Robert Mugabe. Over half the population is food insecure and public health facilities and schools have been almost completely shut down. With over 60,000 infected, the recent cholera epidemic is dramatic evidence of how far living conditions have plummeted in this once-prosperous and relatively well-developed country. Zimbabwe's sharp decline has generated problems throughout southern Africa as millions of refugees have fled to South Africa, Botswana, and Mozambique and as the region's well-publicized economic and security concerns have frightened foreign investors away. To date, Mugabe retains the support of his senior military officers and has shown little commitment to the power-sharing deal signed with the opposition Movement for Democratic Change (MDC). Mugabe also has managed to hold on to the backing of South Africa, a key regional player. Pretoria, which recently brokered a coalition agreement between Mugabe and the opposition Movement for Democratic Change, remains unwilling, despite growing criticism at home and abroad, to apply stronger pressure on Mugabe to step aside or to undertake fundamental political and economic reforms. Mugabe and his ruling elite are likely to remain in power until he loses the support of the security forces, South Africa steps up its pressure, or social and economic conditions in Zimbabwe become substantially worse. With both political parties signing on to the recent power-sharing agreement, it will be up to South Africa, the Southern African Development Community, and the African Union to carefully watch Mugabe's actions and ensure that power is in fact shared and the MDC is allowed to lead.

Drug Trafficking in West Africa

Drug trafficking has become a major problem in West Africa, and the emergence of Guinea-Bissau as Africa's first narco-state highlights the scope of the problem and what may be in store for other states in the region. Away from the scrutiny of local and international law enforcement, drug traffickers, often departing from Venezuela by air and sea, have transported large quantities of drugs, predominantly cocaine, from Latin America to European markets through the porous borders of more that a half dozen West African countries. Traffickers have successfully co-opted government and law enforcement officials in these countries, further undermining weak and economically impoverished governments who lack adequate law

enforcement and judicial capacity. ECOWAS sponsored a conference in Cape Verde in late 2008 to address this issue and the governments of Great Britain and France have conducted limited law enforcement and counternarcotics training in the region, but drug trafficking in West Africa probably will continue to expand in volume and scope in the absence of a concerted international effort to stop it.

The Growing Cyber and Organized Crime Threat

Threats to the US Information Technology Infrastructure

The US information infrastructure, including telecommunications and computer networks and systems, and the data that reside on them, is critical to virtually every aspect of modern life. Threats to our information technology infrastructure are an important focus of the Intelligence Community. As government, private sector, and personal activities continue to move to networked operations, as our digital systems add ever more capabilities, as wireless systems become even more ubiquitous, and as the design, manufacture, and service of information technology have moved overseas, the threat will continue to grow.

This information and communications revolution also is enabling an unprecedented ability to spread ideas and influence large numbers of people. Nation-states and non-state groups are taking an increasing interest in the role of mass media in shaping international opinions. Terrorists will continue to be motivated to conduct spectacular attacks in part by the desire to achieve maximum media exposure for their cause. Increasing global connectivity is enabling radical groups to recruit and train new members, proliferate extremist ideologies, manage their finances, manipulate public opinion, and coordinate attacks. In the recent conflict in Gaza, for example, the media played an important role for both sides in shaping public perceptions of the conflict. We can expect future adversaries to similarly employ mass media in an attempt to constrain US courses of actions in a future crisis or conflict.

Further, the growing connectivity between information systems, the Internet, and other infrastructures creates opportunities for attackers to disrupt telecommunications, electrical power, energy pipelines, refineries, financial networks, and other critical infrastructures. Over the past several years we have seen cyber attacks against critical infrastructures abroad, and many of our own infrastructures are as vulnerable as their foreign counterparts.

- A successful cyber attack against a major financial service provider could severely impact the national economy, while cyber attacks against physical infrastructure computer systems such as those that control power grids or oil refineries have the potential to disrupt services for hours to weeks.

Network defense technologies are widely available to mitigate threats but have not been uniformly adopted due to associated costs, perceived need, operational requirements, and regulatory constraints. This slow rate of adoption has allowed cyber attackers to keep up with many defensive advances. Meanwhile, advances in digital communications technology, such as the growth in wireless connectivity and the acceleration of network convergence with a variety data increasingly digitized and transmitted over the Internet, are creating new vulnerabilities in our networks and new avenues for cyber attacks.

Malicious activity on the Internet also is rapidly increasing: spam—unsolicited email that can contain malicious software—now accounts for 81 percent of all email according to Message Labs (Symantec); the Georgia Tech Information Security Center projects a ten-fold increase in malicious software targeting data in the coming year; and botnets—networks of hijacked computers used to deliver spam or launch distributed denial of service attacks—are expected to compose 15 percent of all online computers in 2009. Ferris Research estimates that the total cost of spam and all of the types of fraud that take advantage of spam's impact is $42 billion in the United States and $140 billion worldwide in last year, while McAfee estimates that global companies may have lost over $1 trillion worth of intellectual property to data theft in 2008.

State and Non-State Threats. A growing array of state and non-state adversaries are increasingly targeting—for exploitation and potentially disruption or destruction—our information infrastructure, including the Internet, telecommunications networks, computer systems, and embedded processors and controllers in critical industries. Over the past year, cyber exploitation activity has grown more sophisticated, more targeted, and more serious. The Intelligence Community expects these trends to continue in the coming year.

We assess that a number of nations, including Russia and China, have the technical capabilities to target and disrupt elements of the US information infrastructure and for intelligence collection. Nation states and criminals target our government and private sector information networks to gain competitive advantage in the commercial sector. Terrorist groups, including al-Qa'ida, HAMAS, and Hizballah, have expressed the desire to use cyber means to target the United States. Criminal elements continue to show growing sophistication in technical capability and targeting and today operate a pervasive, mature on-line service economy in illicit cyber capabilities and services available to anyone willing to pay. Each of these actors has different levels of skill and different intentions; therefore, we must develop flexible capabilities to counter each. We must take proactive measures to detect and prevent intrusions from whatever source, as they happen, and before they can do significant damage.

We expect disruptive cyber activities to be the norm in future political or military conflicts. The Distributed Denial of Service (DDoS) attacks and Web defacements that targeted Georgia in 2008 and Estonia in 2007 disrupted government, media, and banking Web sites. DDoS attacks and Web defacements targeted Georgian government Web sites, including that of Georgian President Saakishvili, intermittently disrupting online access to the official Georgian perspective of the conflict and some Georgian Government functions but did not affect military action. Such attacks have been a common outlet for hackers during political disputes over the past decade, including Israel's military conflicts with Hizballah and HAMAS in 2006 and 2008, the aftermath of the terrorist attacks in Mumbai last year, the publication of cartoons caricaturing the Prophet Mohammed in 2005, and the Chinese downing of a US Navy aircraft in 2001.

The Comprehensive National Cybersecurity Initiative. In January 2008, the Comprehensive National Cybersecurity Initiative (CNCI) was adopted as national policy as part of National Security Presidential Directive 54/Homeland Security Presidential Directive 23 (NSPD-54/HSPD-23). With bipartisan support, Congress appropriated the vast majority of the CNCI funding request in the Consolidated Security, Disaster Assistance, and Continuing Appropriations Act of 2009.

The CNCI addresses current cybersecurity threats, anticipates future threats and technologies, and develops a framework for creating in partnership with the private sector an environment that no longer favors cyber intruders over defenders. The CNCI includes defensive, offensive, education, research and development, and counterintelligence elements, while remaining sensitive throughout to the requirements of protecting the privacy rights and civil liberties of US citizens. The CNCI is now making considerable progress in building a better understanding of the cyber threat, developing concrete solutions, and approving detailed courses of action. The Adminstration is now reviewing CNCI, to ensure it is consistent with its own cybersecurity policy.

To be sure, significant work remains in order to protect, defend, and respond to the cyber threat in a manner that markedly improves our nation's overall security. Yet there is reason to be hopeful. We are witnessing an unprecedented unity of effort across a broad coalition of government agencies, members of Congress, and leaders of industry. To succeed, however, the CNCI must remain a long-term national priority. With sustained momentum and continued national resolve we can and will build an enduring security framework capable of protecting our vital national security, economic, and public health interests.

We cannot afford to discover successful cyber intrusions after-the-fact, accept disastrous losses, and then seek merely to contain them. It requires a broad alliance of departments, agencies, and industry leaders to focus on countering the threat, mitigating vulnerabilities, and enhancing resiliency in order to preserve our national security, national economy, and public welfare.

Growing Transnational Organized Crime Threat

Most organized criminal activities increasingly involve either networks of interconnected criminal groups sharing expertise, skills, and resources in joint criminal ventures that transcend national boundaries or powerful, well-organized crime groups seeking to legitimize their image by investing in the global marketplace. Organized criminals and groups will increasingly pose a threat to US national security interests by enhancing the capabilities of terrorists and hostile governments.

Some organized crime networks, groups, and individuals also have invested in energy and mineral markets in an effort to diversify and legitimize their business activities. Criminals' coercive tactics, underhanded business practices, opaque motives, and self-serving loyalties can undermine the normal workings and integrity of these global markets. The most powerful, high-profile Eurasian criminal groups often form strategic alliances with senior political leaders and business tycoons and can operate from a relative safehaven status with little to fear of international arrest and prosecution. The leaders of many of these groups go to great lengths to portray themselves as legitimate businessmen and use front companies that give them more market access and leverage. They also employ some of the world's best accountants, lawyers, bankers, and lobbyists to deflect and frustrate the efforts of authorities.

The change in the structure and types of activities conducted by transnational criminal groups is making it increasingly difficult to identify and attack them. In particular, the

increasing prevalence of loosely knit networks, the use of cyberspace and global financial systems, and political corruption have made it easier for them to hide their involvement, to thwart law enforcement efforts, and to create images of legitimacy.

Environmental Security

Climate change, energy, global health, and environmental security are often intertwined, and while not traditionally viewed as "threats" to US national security, they will affect Americans in major ways. The Intelligence Community has increased its focus on these three critical issues as a result of unprecedented developments in the last year.

Access to relatively secure and clean energy sources and management of chronic food and water shortages will assume increasing importance for a growing number of countries. Adding well over a billion people to the world's population by 2025 will itself put pressure on these vital resources. An increasing percentage of the world's population will be moving from rural areas to urban and developed ones to seek greater personal security and economic opportunity. Many, particularly in Asia, will be joining the middle class and will be seeking to emulate Western lifestyles, which involves greater per capita consumption of all these resources.

The already stressed resource sector will be further complicated and, in most cases, exacerbated by climate change, whose physical effects will worsen throughout this period. Continued escalation of energy demand will hasten the impacts of climate change. On the other hand, forcibly cutting back on fossil fuel use before substitutes are widely available could threaten continued economic development, particularly for countries like China, whose industries have not yet achieved high levels of energy efficiency.

Food and water also are intertwined with climate change, energy, and demography. Rising energy prices increase the cost for consumers and the environment of industrial-scale agriculture and application of petrochemical fertilizers. A switch from use of arable land for food to fuel crops provides a limited solution and could exacerbate both the energy and food situations. Climatically, rainfall anomalies and constricted seasonal flows of snow and glacial melts are aggravating water scarcities, harming agriculture in many parts of the globe. Energy and climate dynamics also combine to amplify a number of other ills such as health problems, agricultural losses to pests, and storm damage. The greatest danger may arise from the convergence and interaction of many stresses simultaneously. Such a complex and unprecedented syndrome of problems could cause outright state failure, or weaken important pivotal states counted on to act as anchors of regional stability.

Six to nine months ago we were worried about the implications of increasing high oil prices: the situation has reversed sharply with oil prices falling to close to a third of their July 2008 peak of $147 per barrel in response to the sudden drop in world oil demand growth and slower economic growth resulting from the global financial crisis. Although we believe the longer-term trend is toward high oil prices, the current lower oil prices reduce pressures on the global economy. Emerging economies previously concerned about busting their budgets on fuel and food subsidies are breathing a sigh of relief now that prices have fallen substantially over the last six months. Most forecasters expect global oil demand and oil prices to remain depressed

through 2009 as the financial turmoil continues to unwind. The decline in price may, however, lead to delayed or cancelled investments in the upstream oil and gas sectors, creating the conditions for another spike in oil prices once global oil demand recovers. We also are concerned that lower oil prices may weaken momentum toward energy efficiency and the development of alternative sources of energy that are important for both energy and environmental security. The fall in energy prices also has had the side benefit of undercutting the economic positions of some of the more troublesome producers.

Assessing the Impact of Climate Change

According to the United Nations Intergovernmental Panel on Climate Change (IPCC), a failure to act to reduce green house gas emissions risks severe damage to the planet by the end of this century and even greater risk in coming centuries. In a fossil fuel-intensive scenario that IPCC examined (A1FI), global average temperatures increase by almost four degrees centigrade. In such a scenario, water stored in glaciers and snow cover would decline significantly, reducing water availability in regions supplied by melt water from major mountain ranges, where more than one-sixth of the world population currently lives. Sea-level rise could be up to 59 centimeters by the end of the century and would cause substantial flooding. Individuals in densely populated and low-lying areas, especially the mega deltas of Asian and Africa, where adaptive capacity is relatively low, and which already face other challenges such as tropical storms or local coastal subsidence, are especially at risk. At a four-degree rise, according to the IPCC, up to 30 percent of plant and animal species would be at risk of extinction, global productivity in cereals would decline, intensity of tropical cyclones would increase, and extreme drought areas would rise from 1 percent land area to 30 percent.

The Intelligence Community recently completed a National Intelligence Assessment on the national security impacts of global climate change to 2030. The IC judges global climate change will have important and extensive implications for US national security interests over the next 20 years. Although the United States itself could be less affected and is better equipped than most nations to deal with climate change and may even see a benefit in the near term owing to increases in agriculture productivity, infrastructure repair and replacement will be costly. We judge the most significant impact for the United States will be indirect and result from climate-driven effects on many other countries and their potential to seriously affect US national security interests. We assess climate change alone is unlikely to trigger state failure in any state out to 2030, but the impacts will worsen existing problems such as poverty, social tensions, environmental degradation, ineffectual leadership, and weak political institutions. Climate change could threaten domestic stability in some states, potentially contributing to intra- or, less likely, interstate conflict, particularly over access to increasingly scarce water resources. We judge economic migrants will perceive additional reasons to migrate because of harsh climates, both within nations and from disadvantaged to richer countries.

From a national security perspective, climate change affects lives (for example, through food and water shortages, increased health problems including the spread of disease, and increased potential for conflict), property (for example through ground subsidence, flooding, coastal erosion, and extreme weather events), and other security interests. The United States depends on a smooth-functioning international system ensuring the flow of trade and market

access to critical raw materials such as oil and gas, and security for its allies and partners. Climate change could affect all of these—domestic stability in a number of key states, the opening of new sea lanes and access to raw materials, and the global economy more broadly—with significant geopolitical consequences.

In addition, anticipated impacts to the Homeland—including warming temperatures, changes in precipitation patterns, and possible increases in the severity of storms in the Gulf, increased demand for energy resources, disruptions in US and Arctic infrastructure, and increases in immigration from resource-scarce regions of the world—are expected to be costly. Government, business, and public efforts to develop mitigation and adaptation strategies to deal with climate change—from policies to reduce greenhouse gasses to plans to reduce exposure to climate change or capitalize on potential impacts—may affect US national security interests even more than the physical impacts of climate change itself.

Multilateral policymaking on climate change is likely to be highly visible and a growing priority among traditional security affairs in the coming decades. We observe the United States is seen by the world as occupying a potentially pivotal leadership role between Europe, which is committed to long-term and dramatic reduction in carbon emissions, and a heterogeneous group of developing states wary of committing to greenhouse gas emissions reductions, which they believe would slow their economic growth. As effects of climate change begin to mount, the United States will come under increasing pressure to join the international community in setting meaningful long-term goals for emissions reductions, to reduce its own emissions, and to help others mitigate and adapt to climate change through technological progress and financial assistance.

Global Health

Considerable empirical and theoretical studies have demonstrated the links between the health of a population and economic growth and development. Highly publicized virulent infectious diseases—including HIV/AIDS, a potential influenza pandemic, and "mystery" illnesses such as the 2003 outbreak of severe acute respiratory syndrome (SARS)—remain the most *direct* health-related threats to the United States. The most pressing *transnational* health challenge for the United States is still the potential for emergence of a severe pandemic, with the primary candidate being a highly lethal influenza virus. The World Bank estimates that if the next pandemic virus is similar to the one that caused the 1918 pandemic, it could kill 71 million people worldwide and cause a major global recession with global costs exceeding $3 trillion. Other estimates, applying the 2.5 percent fatality rate from the 1918 pandemic to today's population, reach 180 million deaths worldwide. Current threats include H5N1 influenza, a virus that, while primarily a poultry disease, continues to evolve and expand its geographic range.

Infectious diseases are not the only health indicators with strategic significance. Chronic, non-communicable diseases; neglected tropical diseases; maternal and child mortality; malnutrition; sanitation and access to clean water; and availability of basic health-care also affect the US national interest through their impacts on the economies, governments, and militaries of key countries and regions.

- Terrorists and warlords have gained local and international stature and even power by providing health services governments could not. Widespread ill health in the youth cohort

may reduce a country's pool of healthy and capable military recruits, a phenomenon that is currently playing out in Russia and North Korea.

Looking at specific states, the inability of the central government of **Afghanistan** to provide health-care and other services has helped to undermine its credibility while boosting support for a resurgent and increasingly sophisticated Taliban. Wide incidence of traumatic births, malnutrition, and disease put children there at high risk of impaired development, undermining their prospects of attending school, engaging more productively in critical labor such as agricultural production, and participating in other economic activity. In **Iraq,** a degraded health sector, shortages of medical personnel, and infections stemming from deficient sanitary conditions and lack of clean drinking water have undermined the credibility of the central government.

Russia has the overall worst health indicators of any industrialized country. Poor health of Russian children and young people combined with falling birthrates threatens Russian military readiness with a projected halving of eligible military recruits between 2005 and 2018. **China's** high incidence of chronic disease stemming in great part from heavy tobacco use threatens to slow economic growth by incapacitating workers and incurring heavy health-care costs. The health effects of environmental degradation are an increasing source of discontent in China.

Venezuela and Cuba have been particularly adept at parlaying provision of charitable medical services to nationals of other countries into support in international forums such as the United Nations. Hizballah's provision of health and social services in Lebanon over the past 20 years has helped to legitimize the organization as a political force in that country, while HAMAS's delivery of similar services was a factor in its legislative electoral success in the Palestinian territories.

Turning to US Homeland health security issues, existing international resources and regulations will be inadequate to control transnational disease spread at least through the next decade. Movement of people, animals, and products through mass transportation, smuggling, and commerce will continue to homogenize the already global environment. Incidents involving chemical or bacterial contamination of imported food or trade goods, whether accidental or intentional, are likely to increase as China and other developing countries struggle to implement effective monitoring systems. A similar challenge involves ensuring the safety of imported therapeutic drugs and precursor products, as contaminated and counterfeit pharmaceuticals continue to be a worldwide public health threat.

Conclusion

The international security environment is complex. No dominant adversary faces the United States that threatens our existence with military force, but the global financial crises has exacerbated what was already a growing set of political and economic uncertainties. We are nevertheless in a strong position to shape a world reflecting universal aspirations and values that have motivated Americans since 1776: human rights; the rule of law; liberal market economics and social justice. Whether we can succeed will depend on actions we take here at home—restoring strong economic growth and maintaining our scientific and technological edge and defending ourselves at reasonable cost in dollars without violating our civil liberties. It will also depend on our actions abroad, not only in how we deal with regions, regimes and crises, but also

in developing new multilateral systems, formal or informal, for effective international cooperation in trade and finance, in neutralizing extremist groups using terrorism, in controlling the proliferation of WMD, developing codes of conduct for cyberspace and space, and in mitigating and slowing global climate change.

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