<u>Washington Agenda Increasingly Shaped by Forces Beyond Our Borders</u>

Economic markets, and policy makers in Washington, were doused with cold water on Tuesday when stock exchange indices around the world plunged sharply. In practice, the precipitous decline of equity markets may well prove to be no more damaging than a plunge into cold water—it is a bit of a shock, but serves to make you more alert and less drowsy, and does no harm so long as you emerge quickly. Even a 416 point drop in the Dow Jones Industrial Average is, in itself, little cause for long term concern in a market which had climbed over 2,000 points since mid-summer. In fact, many analysts viewed the correction as a healthy development in a frothy market.

In retrospect, what is likely to be most significant about this week's stock market decline is not its magnitude, but its origins. U.S. equity markets dropped in the immediate aftermath of an even more dramatic decline of 9% in the Shanghai stock market, which in turn responded to an announcement from the Chinese government that it would seek to curb speculative investing and pierce asset price bubbles. Chinese stocks and other asset classes had been bid up significantly by countless new investors, many of them Chinese citizens, who were seeking to get rich quick. Anecdotes abounded about day trading grandmothers in Beijing, and young people who eschewed work to make their fortunes sitting in cramped apartments in front of their computers. (Sound familiar?)

Capital markets were further roiled by Japan's decision to raise its benchmark lending rate from a neglible 0.25% to 0.5%, a modest increment but nonetheless enough to disrupt the yen "carry trade", in which maket participants borrowed yen, converted those yen into other currencies, largely dollars, and invested in those converted currencies.

The bottom line, literally, is that the U.S. is increasingly intertwined with the rest of the world. A sharp drop in Chinese stocks triggered a decline on Wall Street that, on paper, wiped out several hundred billion dollars of value in U.S. companies. A *Wall Street Journal* article yesterday further underscored that dynamic when it noted the convergence of pricing trends among asset classes. It has long been axiomatic among investors that, to limit risk, it is advisable to diversify among asset classes. Among stocks, that largely meant to allocate a significant portion of portfolios to international equities, which tended to do well when U.S. stocks lagged, thus limiting downside risk. Yet, increasingly, equity markets across the globe are moving in sync, thus frustrating investors seeking to manage volatility.

The increasing interdependence of the world economy greatly complicates the task of policy makers in Washington, who must consider factors far beyond our shores in making their decisions.

The U.S. remains, unquestionably, the world's sole superpower, but only in military might. Economically, the Euro zone is slightly bigger. Japan's GDP, even after nearly two decades of sluggish—and, at times, negative—growth, is roughly a third that of the U.S.

Most significantly, China and India continue to surge. Though its GDP is notoriously difficult to measure, by most accounts China is now the world's fourth largest economy—perhaps a quarter the size of the U.S.—and holds foreign currency reserves of slightly over $1 *trillion*, of which an estimated 60% are U.S. government obligations. It is by no means certain that disparities in economic growth rates between the U.S. and China will persist, both because of the law of large numbers—it is more difficult to achieve high percentage increases off of an expanding base—and because the Chinese government is reluctant to implement structural reforms needed to sustain rapid growth because decentralizing economic power necessarily decentralizes political authority. However, if the disparities in GDP growth continue, China will have the world's biggest economy in a few decades.

The toothpaste is out of the tube. The world economy has evolved to the point that the U.S. has very limited power to affect international commerce. That is just as well. As an old adage goes, Washington does two things very well: nothing and overreact. The notion that Washington would responsibly manage international commerce, even if it had the power to do so, fails to acknowledge that truism. Each day, the world economy requires an almost infinite number of transactions and decisions that no single authority could make, let alone make correctly. As former Congressman Sam Gibbons (D-FL), an ardent free trader who preceded current Ways and Means Chairman Charles Rangel (D-NY) as the senior Democrat on the Ways and Means Committee, repeatedly observed, no one is smart enough to manage trade—better to leave decisions as much as possible in the hands of the billions of market participants.

To his credit, Chairman Rangel, who presides over the House Committee with principal jurisdiction over trade, shares the free trade instincts of his predecessor. Yet, on the whole, Congress is far more skeptical of free trade than a decade ago, when a Democratic president vigorously pushed to open international markets. Now, a clear majority of the Democratic caucus, and an increasing number of Republicans, are expected to oppose extending "fast track" authority later this year, which would authorize the President to approve trade agreements subject only to an up-or-down vote on ratification by the Congress, as opposed to what could be an interminable, and often fatal, process where Congress could amend the pact, which then would need to be presented again to the other party.

National politics also shapes the debate on trade and economic policy, as it does—and should—on any issue. Notwithstanding the enormous amount of prognosticating that will go on over the next two years, the electoral math for the 2008 presidential race is pretty simple. Whoever wins Ohio probably will be elected president. And whoever wins Ohio, Pennsylvania, Michigan, and Missouri certainly will be elected president. Manufacturing job losses have been severe in each of those states (though, thanks to increased productivity, manufacturing *output* is largely up). Understandably, a disproportionate number of their residents are deeply wary of international trade. President Bush certainly was mindful of that sentiment when, over the objections of most economists but at the urging of his political strategists, he imposed tariffs on imported steel in his first term. Expect other candidates to attack free trade on the stump in those states, just as they will sing the praises of increased use of ethanol, another initiative of uncertain economic merit, when campaigning in the Iowa caucuses.

As important as trade policy and international economic matters are, policy makers in Washington must deal with another, more urgent, aspect of how a changing world increasingly affects the U.S.—security, Iraq, and the Global War on Terror. Isolationism in security matters, like its economic counterpart, protectionism, denies the realities of a changing world.

The late Senator George Aiken (R-VT) famously counseled the U.S. to deal with the Vietnam War by declaring victory and getting out. If that ever made sense, it no longer does. The world's problems are now our own, and no matter how geographically remote—few places are more distant and isolated than Afghanistan—we are not spared its consequences.

Yet, as in trade, the U.S. lacks the means to unilaterally determine outcomes in matters of international security. Military force is an effective, and sometimes necessary, tool in defeating armies of countries led by genocidal dictators. However, it is very difficult to adapt military power to fight enemies that are not constituted into formal armies, such as the terrorists we now face. And military force is of still less use in addressing other crucial security concerns, such as resolving centuries-old ethnic feuds, be it Shia-Sunni in Iraq, Moslem-Hindu in Kashmir, or Arab-African in Darfur.

Because the world beyond our borders has a much more immediate impact upon us, U.S. policy makers need to understand that world better. Protectionism is a compassionate response to the problems of many decent people who work hard to provide a decent life for their families. Yet it is based on a flawed understanding of international commerce. Similarly, assuming that all people aspire, above all else, to freedom, peace, and prosperity is a noble sentiment and characteristically American—it is affirmed by the observation that Americans, who themselves came from every corner of the globe, share those aspirations. However, it fails to acknowledge the unhappy reality that, in certain parts of the world, a violent minority prefer, for reasons decent people have trouble understanding, murder and chaos to peace and stability.

The central challenge for America's leaders in the coming years is to understand that the U.S. has increasingly limited powers to affect world affairs, but to nonetheless use those powers as effectively as possible. Toward that end, they would be well served to bear in mind another observation by former Congressman Gibbons, who parachuted into Normandy on D-Day as part of the 101st Airborne: "A world bound together by the ties of trade is a world strongly inclined toward economic growth and peace."