

Debt was the price of liberty

BY RICHARD GRECO

American power sprang out of debt. Now with the need to cut military spending, it is imperative that the structure of the US and her allies' defense industries be reexamined in order to maintain their competitive edge.

In his first report on the Public Credit in 1790, Secretary of the Treasury Alexander Hamilton wrote, "The United States debt, foreign and domestic, was the price of liberty. The faith of America has been repeatedly pledged for it... To promote the increasing respectability of the American name; to answer the calls of justice; to add to security against foreign attack; these are the great and invaluable ends to be secured by a proper... public credit."

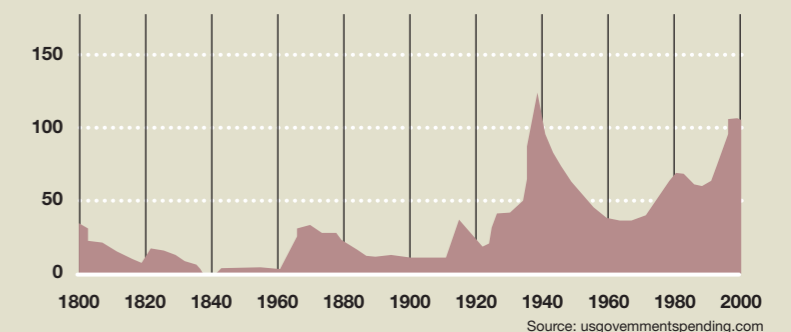
In the 221 years since 1790, America has repeatedly needed to spend more resources than she has had to achieve the invaluable ends described by Hamilton. Every war that America has fought resulted in sharp increases in borrowing. At the height of the Revolutionary War, the Civil War, and World War I the federal debt was 40% of GDP; at the peak of World War II it was 120%; the 1991 Gulf War, 70%; and ten years into the present War on Terrorism, 105%. Debt was – and still is – the price of liberty. In every past instance of war, once the conflict was over and optimum economic activity resumed, the debt was repaid.

But on August 5, 2011 the US's AAA rating was downgraded for the first time ever, hurting the faith in America and the respectability of the American name, and raising fears that the federal debt could not be repaid unless drastic steps were taken to cut federal spending. Of course over time we must fund spending within our means; otherwise annual budget deficits will, mathematically, drive the national debt unsustainably higher. But relative to GDP, the US has actually run higher budget deficits than now and for longer periods of time, even when the federal debt was higher.

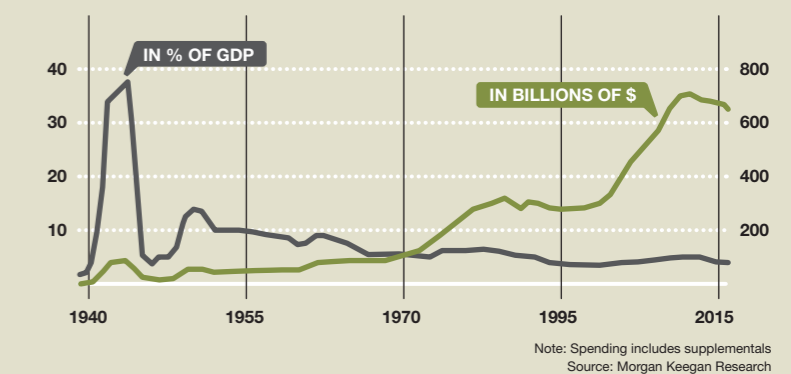
In light of the downgrade and the increased politicization of Congress ahead of the 2012 Presidential elections, the US will make choices today that will have strategic consequences tomorrow. One strong temptation will be to reduce future spending for national defense. The defense budget is an easy target – it is big (\$700 billion); it has been growing since September 11, 2001; and it is intensely political because it is linked directly to jobs.

But the temptation to cut defense spending is misplaced. It is also dangerous. Relative to GDP the defense budget is historically low at 4.7% and has trended steadily lower since the 1950s, when it was 14% of GDP. It is even lower than the 6.5% peak at the height of the

GROSS US FEDERAL DEBT FROM FY 1972 TO FY 2015



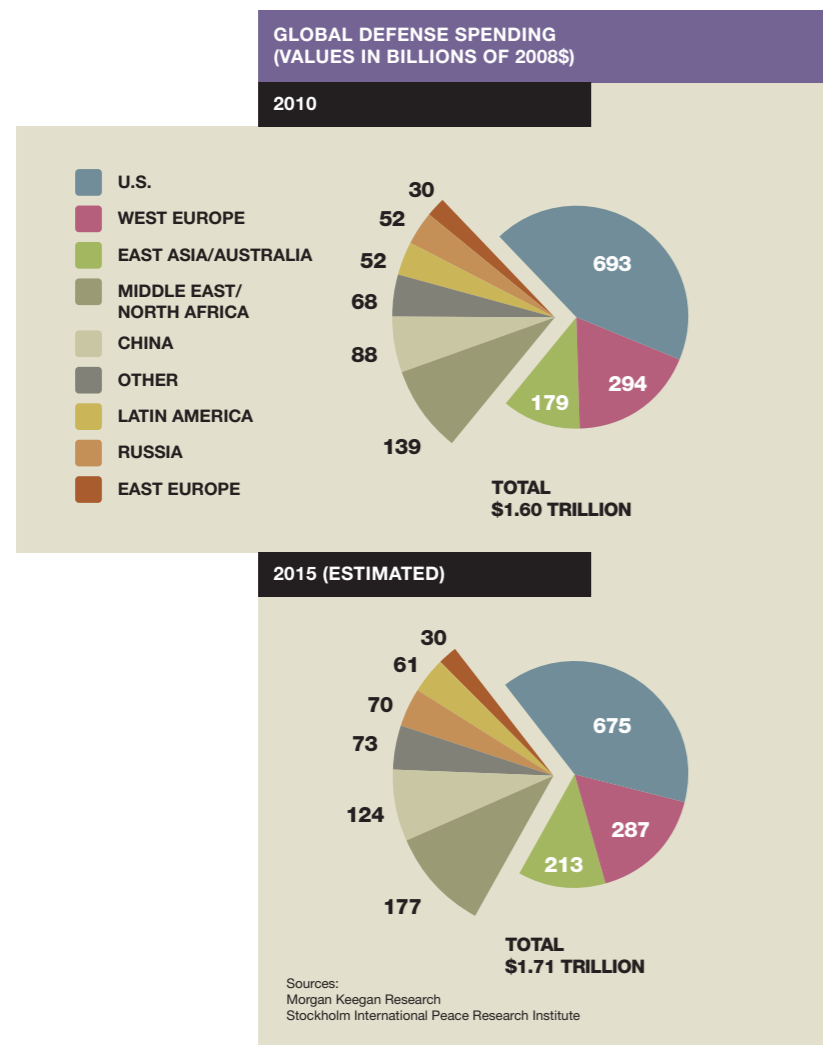
US DEFENSE SPENDING (1940-2015E)



Cold War. By comparison, federal spending on healthcare is 7.3% of GDP and accelerating higher. Former Secretary of Defense Bob Gates said, "The truth... is when it comes to the deficit, the Department of Defense is not the problem... If you took a 10% cut in defense, which would be catastrophic in terms of capabilities, that would be \$50 billion on a \$1.6 trillion deficit." The former Secretary – a Republican – was



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ty goals is not our own defense spending but that of our allies and partners who can help give us global reach and leverage but who are facing budgetary imbalances more acute than our own. While the US spends 4.7% of GDP on defense, the average European NATO nation spends only 1.7%. And of the world's top 25 debtor nations, there are 19 US allies. Our allies and partners must contribute their share to global security, even if it means cutting long-established social welfare and labor benefits programs.

This seems unlikely, however. The prestigious Stockholm International Peace Research Institute has estimated that while net global spending on defense will increase by \$110 billion from 2010 to 2015, spending by the US and her European allies will decline by \$25 billion. By comparison the Institute predicts China will increase spending on defense by \$36 billion, the countries of the Middle East by \$38 billion, and Russia by \$18 billion.

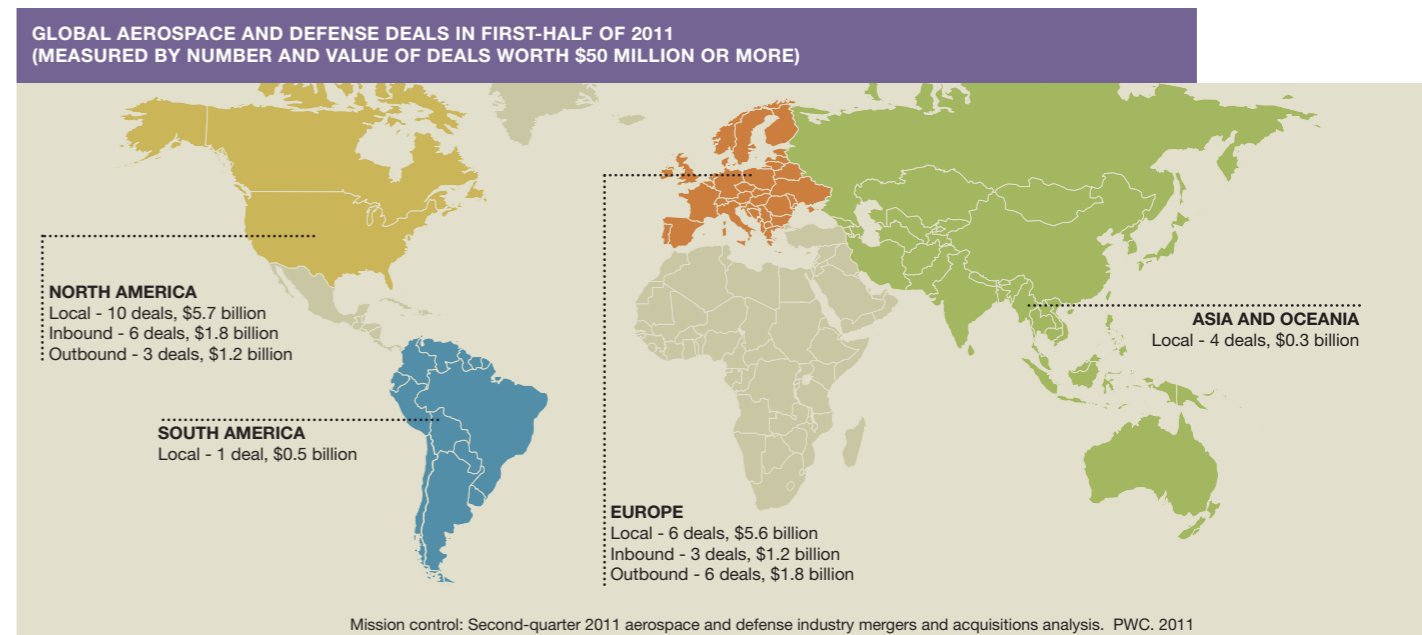
These numbers paint a picture of defense spending growth shifting from West to East. Besides obvious geostrategic implications that are worrisome for the West, some not-so-obvious consequences may also be worrisome (or not) depending on how we deal with them. In particular, the defense industry will undergo important changes. Companies in the West will be forced to consolidate as they compete for fewer dollars while facing intense financial market pressures to keep earnings growth. Consolidation may reduce not only competition in the industry but also the innovation, flexibility, and adaptability that usually come with competition. As a result, American and other Western defense companies will seek to use their large cash balances to acquire innovation and revenue abroad through increased cross-border M&A transactions, especially where technologies may be more advanced, including in emerging and developing countries. Current policies and regulation, mainly developed during the Cold War, will have to be adjusted to facilitate these transactions and then to make certain the accompanying advanced technology stays among family and friends.

The CEO of Northrup Grumman recently said, "The very policies that were intended to keep... technology secure for us, actually encouraged others who could not buy it from us to develop their own. America lost valuable export opportunities, and we are no safer as a result." Not only are we not safer as a result, but without technology sharing we may become less safe as defense spending growth begins to slow. Modern warfare technologies like unmanned aerial vehicles, sensors, and other defense electronics are not only more profitable for the companies that manufacture them, but more importantly, they tend to give greater military advantage than the actual platforms that deliver them. With shorter and shorter technology life cycles of develop-

ment, deployment, and obsolescence, more new dollars will have to be invested annually just to keep the technology advantage current. Fewer incremental dollars in the West and more in the East may result in a shift in technology advantage unless our allies and partners are able to cooperate industrially.

not an alarmist; he was a realist. So is his successor, Leon Pnaetta – a Democrat – who has said that proposed cuts to defense would "terribly weaken" national security. Cutting defense spending is also inconsistent with the 2010 National Security Strategy of the United States, which clearly commits America financially to preserving and promoting global security. "Going forward, there should be no doubt: the United States of America will continue to underwrite global security through our commitment to allies, partners, and institutions; our focus on defeating al-Qaeda and its affiliates in Afghanistan, Pakistan, and around the globe; and our determination to deter aggression and prevent the proliferation of the world's most dangerous weapons." This serious commitment requires serious investment. But the document is also clear that the US cannot do it alone. If liberty is for all, so should be its price.

The real challenge in meeting our national securi-



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The cross-border transactions that will accompany reduced defense spending (and they have already started) will inevitably create real issues for current constructs and mechanisms of export control, anti-corruption, accounting, military cooperation, and diplomacy. These issues will have to be dealt with faster and more efficiently than bureaucracies are currently accustomed to. The principal question for the US and her Western allies is whether or not they will cooperate in creating the regulatory conditions necessary to share technologies that mutually enhance their national securities while simultaneously strengthening their underlying political and strategic relationships. Since technology is now strongly linked with military advantage and can make a difference in military outcomes, it is a matter of national security. New constructs will be difficult to develop and implement, but they are becoming urgently necessary.

The 2010 Quadrennial Defense Review says, "Today's export control system is a relic of the Cold War and must be adapted to address current threats. The current system impedes cooperation, technology sharing, and interoperability with allies and partners... hindering US industrial competitiveness and cooperation with allies... The global economy has changed, with many countries now possessing advanced research, development, and manufacturing capabilities. Moreover,

many advanced technologies are no longer predominantly developed for military applications with eventual transition to commercial uses, but follow the exact opposite course... The US Export system itself poses a potential national security risk... [and] these deficiencies can be solved only through fundamental reform." A new, post-Cold War framework is necessary. As Northrup Grumman's CEO put it, one simple approach would be to build higher walls around fewer things.

If defense budgets in the West are cut as predicted, reform of export controls and technology sharing will have to be addressed in order for America and her allies to keep their military advantage. Managing smaller defense budgets and the inevitable cross-border transactions that will follow so that defense companies remain competitive will have to be done in a way that allied and partner relationships are solidified for the long term. True strategic relationships need to be developed not only politically and diplomatically but also industrially, through trade, export, and technology sharing policies, as well as mechanisms that concretely support and enhance the relationships. If further debt is deemed to be too high a price for liberty and defense spending declines as expected, this is the only way the US and her Western allies will be able to maintain the technology and military advantages they currently have to confront very real threats to their fundamental interests.

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