The Financial Front in the War on Terror

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I am grateful to Martin Feldstein for inviting me to speak at this session and for his efforts to bring better economic analysis into our discussions of national security. I would like to use the opportunity to review developments in international finance since the September 11, 2001 terrorist attacks—a period when U.S. national security policy began to focus more seriously than ever before on the war against terrorism. The financial front of the war on terror is a very fruitful area for economic research. Not only are the research problems fascinating, they require interesting economic methods to solve, and they are enormously relevant.

My discussion today is based on my recent book *Global Financial Warriors: The Untold Story of International Finance in the Post 9-11 World*, which is a first person account of policy making from the perspective of my position as head of the international affairs division at the U.S. Treasury from 2001 to 2005.

International Financial Cooperation Post 9-11

Why focus on the post-9/11 era? The obvious reason is that many international finance developments during this period have been directly related to the war on terror, including creating an international coalition to combat terrorist financing, fundraising for reconstruction in Afghanistan, currency reform in Iraq, and the creation of new initiatives to encourage economic freedom around the world, especially in the Middle East.

Another reason is that many other financial developments during this period can be traced to the war on terror and, I believe that 9/11 will eventually be seen as a watershed for international finance. Driven by both a cooperative spirit and a necessity to prevent crises in the early post 9/11 days, the international financial community implemented reforms and changed policies in ways that were only talked about—and some not even talked about—before 9/11. Moreover, these policies have been, to a considerable degree, successful: Many serious crises that could have happened did not happen, and, I believe that we are in better shape now to confront international financial problems than we were before 9/11.

Previous Financial Fronts

All wars have an international finance dimension. The international finance front in World War II, for example, included the lend lease negotiations with the British and the Russians, the diplomatic effort to use economic warfare to stop trade through neutral countries to Nazi Germany, the creation of the Bretton Woods financial institutions, and the currency reforms in Germany after the war. These episodes have become classic topics in international finance and they are the subject of many histories including Robert Skidelsky's recent *Fighting for Freedom,* which documents the role of John Maynard Keynes.

But we are still very close to the war on terror; indeed it is still going on. This close proximity can cloud our appreciation of what is happening compared with other eras. To better appreciate the post 9/11 period, recall briefly the time after the December 7, 1941 Pearl Harbor attacks, when the wartime international finance issues were not yet considered classics. As Dean Acheson reported in his memoir, *Present at the Creation*, the financial front did not appear to go at all smoothly in the months and years following the December 7, 1941 attack on Pearl Harbor. As Assistant Secretary of State for economic affairs he observed "bureaucratic warfare" and a "breathless and bewildered" foreign economic policy apparatus. He candidly describes President Roosevelt's decision to run lend-lease through the White House as a "prescription for confusion," the diplomatic effort on economic warfare as "administrative bungling," the early post war planning as "singularly sterile," and President Truman's decision to end lend lease prematurely in 1945 as his "greatest mistake" And it wasn't until a full two years after the war that George Marshall's gave his history making speech on post war reconstruction at Harvard's 1947 graduation.

The International Economic Situation in 2001

What was the international economic situation like at the time of the 9/11 terrorist attacks? It was not a good time for the world economy. Stock markets around the world had recently declined sharply and the U.S. economy was in the middle of a recession with negative fallout on the world economy. Confidence was further shaken by the corporate scandals. Financial crises in emerging markets were continuing, especially in Argentina and Turkey. Risks of contagion—so apparent after the Russian financial crisis of 1998—were still on everyone's mind. It was only a short time earlier that the Federal Reserve had been so concerned about the impacts of the global financial crises on the U.S. economy that it sharply cut the Federal funds rate to prevent a freeze-up in financial markets.

The International Coalition to Combat Terrorist Financing

The 9/11 attacks brought forth many changes. A spirit of cooperation suddenly permeated everyday life in the days and weeks following the terrorist attacks. Though little noticed at the time, this spirit of cooperation was widespread on the international finance front in the fall of 2001. In large part because of this spirit of international cooperation and good will, the U.S. government was able to put together quickly an international coalition— including the French, the Germans and the Russians—to freeze terrorist assets around the world. The aim was twofold:

to thwart the financing of more terrorist acts and to gain information about possible terrorist threats by "following the money" so that they could be stopped.

At the time I said this coalition was the finest example of international cooperation in the international finance field since the founding of the Bretton Woods institutions, and I still have that view. We argued that it was not enough to simply freeze terrorist assets in one country; the terrorists would simply move their money to another country. Because of security threats, we decided to cancel the IMF and World Bank meetings that September. Nevertheless, the G7 finance ministers came together for a special session in the United States Treasury in October 2001 where an action plan to freeze assets was issued, and followed up diligently during 2002 and 2003.

The coalition grew rapidly from the original 7 to ultimately 172 countries and jurisdictions. We set up a "war room" in the Treasury with about a dozen financial experts to keep track of what each country was doing and to exercise financial diplomacy as required. Over $100 million of the assets of terrorists and their financiers were soon frozen in financial institutions all over the world. Much of this money could have gone to finance additional acts of terror, but was no longer available to finance those acts. And just as important, information provided through the financial system helped thwart additional attacks. Many financial intelligence experts and diplomats in the United States and other countries participated in this effort and continue to participate.

Financial Reconstruction in Afghanistan

Nearly simultaneously with the terrorist asset freezing in the fall of 2001, another flank of the financial front was being formed: a plan for fundraising and reconstruction in Afghanistan. Closely paralleling political and security developments in Afghanistan—and coordinated operationally through the NSC—the U.S. government assembled another international coalition starting with the European Union, Saudi Arabia, and Japan, and then expanding beyond. The international institutions—the World Bank and the Asian Development Bank—were asked to participate and did so expeditiously at the international community's urging. Following closely the military developments in Afghanistan we scheduled an international meeting in November in Washington; by January at a meeting in Tokyo, the international community had pledged $5 billion.

During the next few years the international finance coalition focused more on "action raising"—getting results—as distinct from "fund raising." The U.S. Treasury sent a budget expert to Kabul to put together the first post-Taliban Afghan government budget on a laptop computer. Treasury staff traveled several times to the very remotest areas of Afghanistan to get the people's reactions to the reconstruction effort, to meet with warlords and find innovative ways for our military to help with revenue collections at the borders. This focus on results was one of the reasons that the reconstruction effort in Afghanistan went more rapidly and more visibly than many previous reconstructions, though there is still much to improve on. This emphasis on visible actions was a factor in the support for the Karsai government and its political success in the elections.

Emerging Market Crises

As all this was happening in the fall of 2001, the threat of 1990s style global emerging market crises was looming. Indeed, earlier crises seemed to be continuing in Argentina and Turkey, and potentially in Brazil. Argentina's debt problem continued to mount and the new IMF program agreed to in December 2000 was not leading to better fiscal policies. There was considerable debate in the summer of 2001 about whether Argentina should be given any more support from the IMF.

After 9/11 hit, we were thankful that the United States government and the rest of the G7 had supported giving Argentina an infusion of funds just one month before 9/11. That was part of a strategy to reduce the shock of an inevitable debt restructuring and to prevent contagion. To have had a Russian style default with global contagion at the same time as 9/11 would have been a complete disaster, and one of the most remarkable achievements was that there was almost no contagion when IMF augmentation of loans, as expected, did finally stop in December 2001 and Argentina defaulted. This was in marked contrast to the contagion following the surprise Russian default in 1998. Economists will debate the reasons for the difference for many years, but as I argued at the time, the purposeful policy of gradually, rather than suddenly, removing additional support was a major factor. When the default did come to Argentina, the United States worked closely in 2002 to limit the impact on its neighbor Uruguay with one of the most surgical and effective rescue plans that I have ever seen. The international support from other countries and the international financial institutions was essential to this strategy of containment.

Reform of the International Financial Institutions

The start of the global war on terror made it clear that a more lasting strategy was needed to deal with global crises in the cases of countries reaching unsustainable debt levels. In the fall of 2001, the U.S. Treasury staff therefore developed a comprehensive reform proposal. It called for the inclusion of "collective action clauses" in the debt issued by emerging market countries; once such clauses were issued they would make it possible for countries to come together with their creditors and restructure their debt if that became necessary. With that reform it would be possible to place clearer limits on exceptional loans from the IMF: this would help deal with the inevitable *time inconsistency* issue where promises to adhere to limits in the future would be hard to enforce later.

For all of 2002 the United States and the entire G7 pursued that financial reform agenda, largely through an intense diplomatic effort with the emerging market countries, investors, lawyers, and bankers. In the end, by the end of 2003 such clauses were the rule rather than the exception. Many people had predicted that this reform was unworkable and that, as in the past, the private sector and the emerging markets would refuse to implement it. But in the end the naysayers were wrong and Mexico and other emerging market countries—largely in the spirit of cooperation so common following 9/11—went ahead with the reform. In parallel, the IMF board voted in new clearer limits on exceptional access to IMF loans. So far, these limits have held excluding the obvious need to unwind from the previously large exposures.

Another international institution in need of reform in this post 9/11 world was the World Bank. Here the approach of the United States was to focus on converting aid to grants, rather than loans, and to insist on measurable results. This was an institutional reform in that it affected the basic workings of the World Bank and the other multilateral development banks. It was a reform that had been talked about in the past, but it had not been implemented. There had been too much international disagreement.

However, after a year-long international negotiation a new grants window was established in the fall of 2002. The rationale for the reform was that grants would lead to better poverty reduction results. Again the war on terror was lurking beneath the surface of these arguments because of the general recognition that poverty and low levels of development in countries created hotbeds of terrorism. And because of the success of this reform, observed in joint U.S. Treasury-World Bank assessment trips to Africa during 2004, it was expanded in 2005. Equally important, the G8 agreed to write off the rest of the World Bank debt to the poorest counties in 2005, thereby converting past, as well as future, loans to grants. Disagreements between the G7 countries that might have prevented such a major reform in the past were overcome. Again I would say the fight to stop terrorism by increasing economic growth and reducing poverty was a factor underlying the agreement.

While not establishing new international financial institutions, as was done in World War II, the international community had successfully implemented reforms-post 9/11terror that had begun to fundamentally change the international financial institutions.

Iraq Currency Reform

Within a year of 9/11, in the fall of 2002, U.S. financial officials began working, along with their allies, on contingency planning for financial reconstruction in Iraq if there turned out to be a war in Iraq. In the end this plan would entail the creation of a whole new currency, with the currency exchange taking place 6 months after the fall of Saddam's regime; in contrast the currency reform took three years in post World War II Germany.

The first stage of the currency plan commenced on March 20, 2003 the first full day of Operation Iraqi Freedom, as the military operation was moving into full swing. As planned, the President issued an executive order that day calling for U.S. banks to send Saddam's previously frozen dollar deposits—worth about 2 billion dollars—to the Federal Reserve Bank in New York. The objective was to use those dollars to pay the Iraqi workers and thereby provide financial stability and prevent a financial collapse after the government fell.

The first stage of the plan worked very well. The money had been shipped in small denominations (mostly 5 or 10 dollar bills, rather than 100 dollar bills) by truck convoy from the New York Fed's warehouse down the New Jersey Turnpike to Andrews Air Force Base in Maryland where it was loaded onto military jumbo jets, flown to Iraq, and then paid to Iraqi workers in Baghdad and other Iraqi cities—a complex financial and logistical undertaking. And a financial collapse was avoided.

The second stage of the plan—approved by the President on May 9, 2003—was a financial and logistical feat many times larger and more complex than the first stage. It required the printing of a brand new currency—in record time, in seven different locations around the world, and in enough volume to fill twenty-seven 747 planeloads—which would then be shipped to 250 exchange points all over Iraq in a risky security environment.

Iraq's Debt Reduction

The final agreement to reduce Iraq's debt took place during the weekend before Thanksgiving of 2004. The agreement was to cancel 80 percent, or ultimately $100 billion, of the debt that Saddam Hussain had run up to support his cruel dictatorship. The amount of reduction was much larger than the experts had predicted.

The plans for the debt deal had been developed throughout 2003. Treasury debt experts went through old debt files in the rubble of looted and trashed buildings in Baghdad. Mathematical finance experts made the computer calculations under every conceivable scenario. Macroeconomists at the IMF determined how much debt reduction would be needed for sustainability of the Iraq economy. A distinguished Presidential envoy—James Baker—had been to major capitals of Europe and Asia. The leaders of the G8 agreed set a deadline that the negotiations had to finish by December 2004.

The final negotiations took place at different locations all over the world. The U.S. Treasury Secretary was in Berlin negotiating with the Finance Minister of Germany. The Finance Minister of Iraq was in Paris negotiating with the President of the Paris Club, the international forum for debt deals. And the President of the United States was in Santiago, negotiating the last piece of the puzzle over lunch with the President of Russia.

Conclusion

In conclusion, I hope this brief summary conveys the magnitude of the policy changes that have occurred in the international finance arena in recent years, and that they are indeed comparable in significance to the international fronts in previous periods, such as World War II. What is the explanation for the apparently smooth policy operation?

One reason is that the spirit of cooperation in the international finance area was at least as high as in earlier periods. The squabbles between the British and the Americans on international finance issues during World War II have been well documented. And of course, the Germans, the Italians, and Japanese are now allies with America. And at least on the international finance front, the disagreements between the French and the Americans have not been severe enough to impede progress on important reforms.

In my own experience in the international finance area, effective management of the pubic policy implementation process—setting clear goals, emphasizing results, setting up teams of experts—has also been essential.