# Chapter 1

# The Global Financial Crisis and International Security: Impacts on the Defense Budgets of Major Countries

The global financial crisis that has unfolded since 2008 caused the economies of many countries to stall and plunged the world economy into minus growth. However, the global economy has shown signs of recovery since the second half of 2009 thanks to aggressive fiscal and monetary policies by the governments of most countries. Amid this situation, in contrast to the gradual recovery being seen in the advanced economies, emerging economies such as China and India continue to achieve higher growth rates. These emerging economies now constitute the principal driving force behind the global economy's growth. The current crisis cannot be adequately dealt with by the advanced economies alone, or by utilizing the existing international financial system. It is essential to encourage cooperation by the emerging nations, whose economic power is growing apace. It is clear, nevertheless, that the interests of the industrialized nations and those of the emerging nations come into conflict on several fronts. This ongoing power shift from industrialized to emerging nations has led to calls to change the way in which global economy is managed. The Group of Twenty (G-20) is now assuming greater importance as an international framework for tackling global economic and financial issues.

Since the start of the global financial crisis, the US government has been following the double-track policy of restoring fiscal discipline over the medium-to-long term, and supporting the economy's recovery via increased public spending over the short term. In line with this, the United States has implemented a variety of measures aimed at addressing structural problems and restoring fiscal discipline. In this context, a wide-ranging debate on the military budget has taken place within and outside Congress regarding medium-term budget planning and the budget for military capability development. Given the current severe fiscal conditions, the US government is struggling to devise new initiatives in budget allocation, focused on the rebalancing of US military capabilities, as well as more efficient equipment acquisition with the focus on affordability.

The economies of the leading European countries—the United Kingdom, France, and Germany—had been sluggish even before the onset of the financial crisis, but the crisis caused a still further slowdown in the real economy. Europe has been plagued by the sovereign risk, and there is rising apprehension that the central banks of some countries may be unable to continue operating normally. These fears have had an adverse impact on the financial markets, leading to stock price falls and the devaluation of the euro. All parties concerned have been strongly impressed by the urgent need for the restoration of their own fiscal discipline. Amid this situation, the governments of the United Kingdom, France, and Germany are being strongly urged to reform their public finances. The need for efforts to cut back on defense spending and utilize funds more efficiently has turned out to be recognized as one of the major aspects of such fiscal consolidation. At the same time, more attention is now being paid to possibilities of further collaboration and common use of military equipment among the member states of NATO and the EU.

Turning to China, which has maintained fiscal discipline amid sustained economic growth, the government responded to the global financial crisis by implementing an aggressive fiscal policy incorporating a four trillion yuan economic stimulus package. Thanks to this, the country realized a quick economic recovery, in vivid contrast to the performance of the advanced economies. Up until this point, the growth of the Chinese economy had been led mainly by exports and foreign investment, and developments over the past three years have sparked a high level of inflation, and have aggravated various economic disparities within the country. The emergence of these problems has provoked calls for a change in the country's economic growth model. In these circumstances, the Chinese government has announced that the growth of China's defense budget, which was over 15 percent in fiscal 2009 in line with the expansion of overall government expenditure, decreased to 7.5 percent in fiscal 2010 in line with the government's across-the-board restraints on budget appropriations.

## 1. Searching for International Cooperation—Response by Advanced and Emerging Economies

### (1) The Background to the Financial Crisis and the Rise of the Emerging Market Economies—Worldwide Low Interest Rates and the Global Imbalance

The year 2000 saw the bursting of the dot-com bubble that had begun around 1995. This was followed the next year by panic on the US financial markets in the wake of the 9/11 attacks. In response, the US Federal Reserve System adopted a phased monetary relaxation policy to inject adequate liquidity into the nation's capital markets, and interest rates fell below 2 percent. They remained at this low level until 2004, when the US housing bubble began, eventually leading to the subprime mortgage crisis. The provision of ample liquidity to the markets caused borrowing costs to drop in international financial markets, while investors shifted their focus to the emerging market economies in a flight from the low interest rates of the advanced economies. In the emerging market economies, investment in export-oriented industries grew as a result of borrowing from overseas at low interest rates, as well as increased investment from overseas. This stimulated consumption within the emerging market economies, creating a virtuous circle that sucked in yet more investment and led to rapid economic growth. In this way, both the advanced and emerging market economies saw economic expansion on the back of notably low interest rates from the start of the century.

The growth of the emerging market economies sparked expectations of rising demand for natural resources, and capital inflows were seen into commodity futures trading, such as oil futures, sharply pushing up resource prices. As a result, foreign currency reserves began to accumulate not only in the Asian emerging markets, which had long maintained healthy surpluses in their current account balances, but also in resources-exporting countries such as the oil-producing countries of the Middle East. The combination of these factors caused an inflow of funds into risk-free assets such as United States Treasury securities (US Treasury bills), as well as into high-return investment operations by US and European trust banks, investment banks, and brokerages. Global imbalances began to be noticeable, due to the persistent US current account deficit in the Asia-Pacific region and the nation's surplus in its capital account balance.

In 2004, the Federal Reserve—convinced that the US economy was back on track—reversed its easy credit policy, but international capital flows increased further, and banks and brokerages took advantage of sophisticated financial engineering techniques to carry out aggressive risk taking. As a consequence, trading volume and value expanded on US stock and bond markets, thereby prolonging the country's economic boom.

This boom, however, was brought to an end by the subprime mortgage crisis, leading to the bankruptcy of Lehman Brothers in September 2008. This, in turn, triggered a series of developments that spread alarm in financial markets across the world in what is now referred to as the Global Financial Crisis. Economic growth stalled in many countries, and in 2009 global economic growth recorded its first minus figure (-0.6 percent) since the end of World War II. At the same time, governments cooperated in aggressively implementing fiscal and monetary policies that succeeded in reversing the downward spiral of the world economy in the latter half of 2009. Despite the continued risk of a downturn, the world economy is believed to have recovered in 2010, posting growth of 5.0 percent. The pace of this recovery, however, has been very different for the industrialized nations and the emerging markets. Recovery has been moderate in the advanced economies but strong in the emerging market economies, which now constitute the major engine of world economic growth. The Asian emerging market economies such as China and India have posted especially high growth rates, at 7.0 percent in 2009 and 9.3 percent in 2010, demonstrating that they have fully shrugged off the effects of the financial crisis. At the time of writing in 2010, the twelve emerging market economies that are members of the Group of Twenty (G20) account for 41 percent of the gross world product, and their rate of contribution to global economic growth now exceeds that of the industrialized nations. In response to calls for changes in the existing international regime as a result of this ongoing economic power shift, the G20 summit was set up as a forum where leaders from the world's twenty major economies (nineteen countries plus the European Union) could meet to discuss problems facing the global economy. The first G20 summit was held in Washington in November 2008.

As a result of the global financial crisis, the world's economy faces a number of newly arisen issues that need to be addressed, as well as the structural issues that it inherited from the pre-crisis period. Firstly, among the new issues are the questions of how to revive the ailing "real economies" (as opposed to the financial economy) of the industrialized countries and how to get the global economy back on a stable growth track. The key to this lies in how far the emerging market economies are able to supplement the role that the United States has played up to now, of stimulating increased internal demand and consuming goods exported by many other countries. The structural issues that plague the world economy include global imbalances and the continued low level of interest rates. Although signs of an improvement are visible in the United States' deficit in its current account and surplus in its capital account, the underlying structural problems remain unchanged. Regarding the US current account balance, policy collaboration between the United States and the emerging market economies is expected to lead to an improvement through stimulation of domestic demand in the emerging markets. Regarding the capital account surplus, cooperation in the field of financial policy is required between the advanced and emerging market economies, but as this issue is closely intertwined with the various countries' differing currency and foreign exchange policies, as well as their financial regulations, it may be difficult to reach agreement on the measures needed. Looking at the flow of funds into and out of international financial markets, we see that, following the start of the financial crisis, there has been no significant slowdown in the flow of funds back into the United States, particularly from countries in the Asia-Pacific region. Moreover, US investments into economies in all regions of the world already showed signs of recovery in the latter half of 2009. In fact, the inflow of US investments into Asia-Pacific emerging market economies exceeds the pre-crisis level. This is in sharp contrast to investments in European emerging market economies, which have been slow to recover their former levels.

The United States, which is the leading advanced economy in the Asia-Pacific region, and China, the region's leading emerging market economy, have taken different stances on these issues. For example, the United States regards its persistent trade deficit with China as a problem requiring a solution, and has urged China to flexibly revalue its currency. For its part, China has criticized the United States for keeping interest rates low and implementing additional credit relaxation measures, thereby causing excessive liquidity in international financial markets and raising the specter of asset inflation in the emerging market economies. The G20 summits are now being looked to as an international discussion framework that could help resolve such differences of opinion.

### (2) The US Subprime Mortgage Crisis—Steps to Restore US Economic Presence and Realize Economic Recovery

By the time house prices in the United States began to fall in 2007, the roots of the subprime mortgage crisis had already been pointed out by many observers as a serious structural problem. Although US securities markets remained healthy subsequent to the housing price decline, liquidity fears in early 2008 caused a sudden increase in market unease. First came the news of impending collapse at Bear Stearns, a major US investment bank and securities trading and brokerage company, and at the government-sponsored enterprises Fannie Mae (Federal National Mortgage Association/FNMA) and Freddie Mac (Federal Home Loan Mortgage Corporation/FHLMC). Bear Stearns was subsequently bailed out by the federal authorities and sold to JPMorgan Chase in May 2008, while Fannie Mae and Freddie Mac were placed into conservatorship by the federal authorities in September. This series of events raised strong doubts in the financial markets regarding the balance sheets of the nation's financial institutions. Then, on September 15, upon the news of the breakdown of capital investment negotiations between Korea Development Bank and Lehman Brothers (a major investment banks and financial services firm), the stock price of Lehman Brothers collapsed. When the Federal Reserve Board announced that it would not extend any emergency credit to Lehman Brothers, the company was unable to raise funds and was forced to file for Chapter 11 bankruptcy protection.

The fallout from Lehman Brothers' collapse was felt across the whole world. Stock prices plunged in every country, and many financial institutions were reported to be in trouble. On October 3 in the United States, the Emergency Economic Stabilization Act was signed into law, under which the Troubled Asset Relief Program (TARP) was created to employ public funds in buying up bad mortgages. European countries also injected public money into ailing financial institutions, while according to the International Monetary Fund's (IMF) Global Financial Stability Report, injections of public funds to bail out the financial sector came to $675 billion in Europe and $250 billion in the United States.

By November, the focus of attention in the United States had shifted from the liquidity crisis to bolstering the real economy through the injection of public funds into private-sector corporations. However, the government failed to enlist public support for a bailout of the auto industry after the heads of the auto firms were criticized for their use of corporate jets to attend Congressional hearings, leading to a widely held perception that the executives were not taking their responsibilities seriously. The government's attempt to bail out the auto industry was thus effectively derailed, and in March 2009 Chrysler filed for bankruptcy, followed by General Motors in June.

In this way, the financial crisis that began in the United States spread across the whole world and had a serious impact on the world's real economies. The economic policies adopted by the US government subsequent to the emergence of the crisis—particularly Washington's attempt to restore its economic presence—had a major impact with respect to the two points described below.

The first point relates to the US government's pursuit of a balanced fiscal policy. Declining revenues, as well as expenditures to stabilize the financial system, had caused a deterioration in the US government's fiscal situation, pushing up the debt-to-GDP ratio. To address this issue, over the medium to long term the government is seeking to restore fiscal discipline to maintain confidence in the dollar and US Treasury bills. In the short term, the government aims to use public spending to underpin economic growth, create jobs, and restore the nation's vigor through investments for the future. These policies are all aimed at recovering the United States' leading role within the global economy and restoring the United States to its position within the community of nations.

The second point is the emergence of a movement to create a new international regime capable of addressing the world's economic and financial problems. Up to now, the normal international response to financial crises was characterized by lending to encourage growth. For instance, in response to the Latin American debt crisis of the 1980s and the 1997 Asian financial crisis, the IMF took steps to increase liquidity in the markets and encourage the governments concerned to undertake structural adjustment programs, while the World Bank Group and other multilateral development banks (MDBs) made loans to cushion the shock of the structural adjustments. These measures are known as the Bretton Woods system, and the set of economic policies that lie behind this is called the Washington Consensus. The advanced economies, notably the United States, played the leading role in the creation of both of these. However, following the outbreak of the global financial crisis precipitated by the collapse of Lehman Brothers, it was widely felt that such crises could not adequately be dealt with using existing systems and policies. This was because: (1) most of the advanced economies that cooperate with the IMF and other international institutions to provide financial support lack the necessary underlying fiscal solidity, and (2) the problems underlying the crisis emerged in the US and European financial markets—the very markets that should complement the IMF-World Bank system but were rendered vulnerable by the heavy private-sector risk taking that takes place in them. In response to this situation, international discussions were held on the need for summit-level meetings at which economic and financial issues on a global scale could be dealt with effectively, and on October 18, 2008, the United States, France, and the EU issued a post-summit statement in which they announced that the first G20 summit would be held in the following November in Washington, D.C. In addition to the advanced economies, which hold fundamentally similar views to the United States on economic and financial issues, a number of emerging nations—whose economic systems and views on such issues are very different—were also invited to the summit. As a result, the leaders of the attending nations were able to hold multilateral discussions on economic and financial issues. The holding of the G20 summits reflects the belief of the US administration that increased emphasis must be placed on international cooperation in addressing these issues.

### (3) The European Sovereign Debt Problem—EU Financial Institutions Face a Burden-sharing Dilemma

Following the enactment of the Emergency Economic Stabilization Act by the US Congress in October 2008, the leading European countries such as the United Kingdom, France, and Germany successively announced plans to inject public money to bolster the capital of financial institutions, with the aim of stabilizing their financial systems. The respective amounts of these capital injections were reported as £37 billion for the UK, €40 billion for France, and €80 billion for Germany. Meanwhile, certain European countries such as Iceland and Hungary, whose financial markets had posted growth out of all proportion to the scale of their economies, found it difficult to bail out troubled financial institutions on their own. At the same time, European leaders began discussing ways in which the EU as an integrated unit could handle the instability of the financial systems in some countries, which threatened to spill over national borders, leading to systemic risk for the region as a whole. In the end, the European Central Bank (ECB) and the EU member countries handled the problem on a case-by-case basis.

Subsequently, thanks to the injection of liquidity into the markets by European governments, as well as their use of public money to recapitalize financial institutions, the international financial markets were gradually regaining stability, when the crisis erupted again with the emergence of a new scandal in October 2009. Upon the inauguration of the new Greek administration of George Papandreou on October 6, the government revealed that the country's budget deficit was actually more than 12.5 percent of GDP, almost four times the 3.7 percent announced under the previous administration. This situation had come about because the Greek government, faced with the requirement to apply strict fiscal discipline to meet the economic convergence criteria for adoption of the common European currency under the European Economic and Monetary Union (EMU), had adopted certain practices proposed by the global investment bank and securities firm Goldman Sachs (converted into a bank holding company in September 2008) in order to hide the actual level of its borrowing, enabling the government to spend beyond its means. This was followed in the same month (November) by the Dubai Debt Shock, in which a number of French, German, and other European banks were found to be dangerously overextended. This caused a loss of confidence on the money markets not only in the dollar but also the euro. Simultaneously, the decline in the lending capacity of certain European banks caused the market to take a close look at the economic fundamentals of the so-called "European emerging economies" in Central, Eastern, and Southern Europe, whose shortcomings had up to then basically been passed over by analysts. It was then realized that sovereign bonds issued by governments and government-linked financial institutions in these regions carried an unacceptably high level of risk.

The mechanism whereby excess liquidity caused the financial crisis was basically the same in Europe as in America. From 2002 the major EU countries had been maintaining low interest rate policies in response to those implemented by the United States. As a result, euro-denominated borrowing costs had been declining. For this reason, European banks had invested aggressively in Central and Eastern European economies, which were conveniently close to Western Europe but where wage costs were low. In addition, as in the United States, funds had been flowing back from oil-producing countries, creating even higher levels of liquidity. Moreover, excessive fund inflows were seen not only in Central and Eastern Europe, but also in "emerging economies" such as Ireland and Spain, which were experiencing a boom in construction of housing and commercial buildings. The consequence of all this was that the global financial crisis that erupted in the United States brought these booms to an end, and the crisis spread across the whole of Europe.

Unlike the situation in the United States, however, in Europe, the fact that the target of any bailout would be another country made it difficult to implement a swift solution to the problem. Since the start of 2010 the credit ratings of government bonds issued by Spain, Portugal, Greece, Hungary, and other nations have been downgraded. In response to the spread of the sovereign debt crisis across the entire European Union, the ECB overcame its initial reluctance to act, moving to buy the debt of those countries in danger of default and adopting a policy of making credit available to each country. However, it proved difficult to gain public approval in EU countries for the provision of financial support to other nations—whether bilaterally or via the ECB—when their own economy was also in serious trouble. The populations of EU nations did not see why they should have to shoulder the burden involved in the fiscal reconstruction of another country, just because it was a fellow member of the EU. Meanwhile, financial institutions in France, Germany and other major EU countries had extended large amounts of loans to the countries at risk of default, and they faced the dilemma that an attempt to rescue one country from the risk of default would cause impairment of their balance sheets and could have an adverse impact on the financial system of their home nation. In any event, the countries that were recipients of loans from the ECB or the IMF were faced with demands for harsh structural adjustments, including reductions in public employees' salaries and pensions, and cuts in social security spending. The general perception is that it would be difficult for the emerging economies of Europe to serve as the driving force of a rapid economic recovery. Moreover, all European countries had long suffered from structural problems such as rising social security expenses, and amid an economic slowdown caused by the sovereign risk issue, the governments of these countries are under pressure to carry out fiscal reconstruction. This may impact their defense budgets and military postures.

### (4) G20 summits—Seeking a Framework for Cooperation between Advanced and Emerging Economies

In November 2008, US President George W. Bush proposed the holding of a meeting of the heads of state of twenty leading economies (nineteen countries and the EU) as well as finance ministers and central bank governors, to discuss ways of tackling the financial crisis and economic downturn sweeping the globe in the wake of the bankruptcy of Lehman Brothers. As a result, the first G20 summit was held in Washington.

The unique features of the G20 summits that set them apart from the G8 summits are the participation of the emerging market economies, whose political and economic presence has been growing stronger from year to year, and the inclusion of international financial institutions like the IMF and the World Bank as official invitees (although not permanent members).

At the first G20 summit, many of the leaders present called for economic stimulus measures to counteract the global business downturn. In a document entitled "Declaration of the Summit on Financial Markets and the World Economy," they called for a unified response to the crisis by the international community, and stressed their rejection of protectionism. At the second G20 summit, held in London in April 2009, the participants agreed on the need for fiscal and monetary measures to stimulate demand and boost employment, and on closer monitoring and stricter regulation of financial authorities, as well as on the need to strengthen international financial institutions. They also reached agreement to bolster the financial foundations of the IMF and to establish the Financial Stability Board (FSB), among other measures to reinforce the capabilities of international financial institutions.

The third G20 summit was held in Pittsburgh in September 2009 amid signs of a global economic recovery, and the fourth summit in Toronto in June 2010. At Pittsburgh, in view of the fact that recovery was still underway, the members agreed that it was still too early to draw up exit strategies, and that they must maintain their stimulus policies until such time as the economy had fully recovered. They also asserted that the creation of jobs was the principal goal of their economic recovery efforts, and that they were squarely resisting the pressure to implement fiscal reconstruction. They called on those advanced economies that were preparing to withdraw their stimulus measures to wait until a sustainable economic recovery was assured. At the fourth G20 summit in Toronto, amid a situation in which many governments were preparing to implement a policy turnaround in response to the changing world economic climate, the leaders recognized the growing danger of mounting public debt to the public finances of many countries. While admitting the need for swift action to restore fiscal responsibility and realize sustainable public finances, the summit members called on those advanced nations whose economic recovery was still fragile to implement flexible measures to achieve fiscal sustainability, tailored to national circumstances so as not to impede economic recovery.

At the same time, the summit agreed to implement reforms to strengthen the voting power of emerging market countries in the IMF and increase the quota share of these countries in the IMF and the World Bank, so as to strengthen their roles and influence within these organizations. At the same time, the summit members voiced their determination to utilize a framework for the realization of strong, sustainable, and balanced growth. This was the international framework established by the Pittsburgh summit (following a proposal by the United States), intended to rectify global economic imbalances through policy coordination among the G20 member nations. The framework would supplement the efforts of the advanced economies, which have not yet recovered from the business downturn, and would enable efforts to rebalance global demand to help ensure global growth continues on a sustainable path.

At the Pittsburgh summit it was agreed to make the summit a regular event, and the members expressed their hopes for the success of the summit as the premier international forum for discussion of economic issues. Subsequently, however, confirmation was obtained of a global economic recovery, and attention shifted from emergency measures to treat immediate symptoms to post-crisis efforts to reconcile various basic and structural interests. It was at this stage that conflict between the opinions of G20 members came to the fore. In fact, prior to the holding of the fifth G20 summit in Seoul in November 2010, there were media reports of disagreement between G20 members regarding current account imbalances, the renminbi exchange rate issue, and the easy money policies being pursued by advanced economies. Specifically, the United States had for some time been calling—at G20 meetings of finance ministers and central bank governors—for greater flexibility in the pegging of the renminbi against the dollar, as well as for the introduction of numerical targets for current account balances. On November 3, just prior to the scheduled start of the Seoul summit, the United States attempted to include these issues on the agenda for debate. Ma Delun, vice-president of the People's Bank of China, criticized the Federal Reserve's decision to print more money, saying it could cause an asset bubble in the emerging market economies. German Federal Minister of Finance Wolfgang Schaeuble stated that there was already sufficient liquidity in the market, and the decision to pump more into the market was incomprehensible. Federal Reserve Chairman Ben Bernanke responded by insisting that the currencies of certain trade surplus countries was undervalued. Clearly, the stage was set for difficult talks at the Seoul summit.

In the end, the US proposal to set numerical targets for the rectification of current account imbalances was not included in the items agreed on at the Seoul summit. Although the discussion of details was postponed to future summits, the Seoul summit did reach agreement on the need to make preparations for: (1) specific measures by trade surplus and trade deficit nations; and (2) the strengthening of the Mutual Assessment Process; and (3) guidelines for evaluating external imbalances. The United States succeeded in including these items on the agenda for discussion. Regarding currency exchange policies, on the other hand, the G20 leaders did not reach a specific agreement, but affirmed their commitment to take the following actions: (1) shifting to market-determined exchange rate systems; (2) introducing greater flexibility in exchange rates; (3) avoiding competitive devaluation of currencies; and (4) monitoring against excess volatility and disorderly movements in exchange rates.

Some observers believe that multilateral talks such as the G20 summits are, by their very nature, unsuitable to the building of a consensus capable of solving issues that entail conflicts of interest. On the other hand, it is clear that in an economic environment marked by growing globalization and increasing interdependence, it is more efficient and effective to deploy policies in a coordinated way, rather than for each country to approach problems on an individual basis. The G20 members represent roughly 65 percent of the world's population and account for about 85 percent of world GDP. In view of the major influence that these countries have on the global economy, even after the emergency response to the global financial crisis had come to an end, great hopes were pinned on the G20 summits as a practical forum where international cooperation could be realized.

## 2. Restoring Fiscal Soundness in the United States and Debates Concerning the US Defense Budget

### (1) Efforts to Tackle the Mounting US Budget Deficit and Restore Fiscal Soundness

The restoration of fiscal soundness was an important pre-election campaign promise for the new Obama administration. The US government's fiscal health had been worsening as a result of declining tax revenues, as well as expenditure to restore stability to the country's financial system. As a result, the debt-to-GDP ratio rose, and in the economic field the presence of the United States, which had provided important international public goods, was becoming weaker. For this reason, calls were growing for the formulation of government budgets that would incorporate two fundamental fiscal principles—the restoration of fiscal discipline over the medium-to-long term, and the use of public expenditure to support economic recovery over the short term.

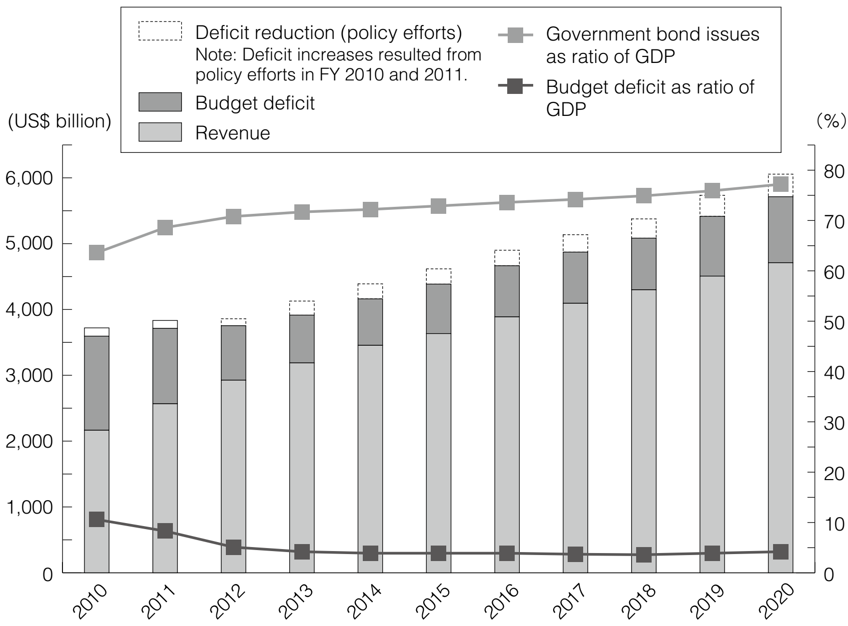
President Obama assumed office amid a continued serious impact on the real economy from the fallout of the Lehman Brothers bankruptcy, and in his Budget Message for fiscal 2010 (the US fiscal year is from October to September of the following year), delivered on February 26, 2009, President Obama revealed that the government's budget deficit for fiscal 2009 was estimated at a record high of $1,752 billion, or 12.3 percent of the nation's GDP (the final figure was approximately 1,410 billion, or 9.9 percent of GDP). However, this situation was the result of a decline in tax revenues due to the business downturn, combined with one-time expenditures involving economic stimulus packages and rescue packages to stabilize the financial system, which could be described as the negative legacy of the previous administration. Then, against the backdrop of the American Recovery and Reinvestment Act enacted in February 2009, it was forecast that the federal budget deficit would be kept below $1 trillion in fiscal 2010 thanks to a recovery by the economy from its temporary downturn, aided by swift action to rescue the financial system and stimulate the economy, and the drafting of a budget focused on investment to realize strategic long-term growth. Unfortunately, that proved to be an overoptimistic scenario, as was clearly revealed in the budget for fiscal 2011.

In his budget message for fiscal 2011, announced on February 1, 2010, President Obama estimated that the federal budget deficit for fiscal 2010 would come to about $1,550 billion, representing a further deterioration from the record-high deficit of fiscal 2009 (the final figure for the fiscal 2010 deficit came to $1,300 billion, at 8.9 percent of GDP, the second-highest in history). Although the US economy was indisputably in the process of recovering from its worst period in 2008, the pace of recovery was slow and tax revenues were sluggish. This revenue shortfall was one of the factors behind the increase in the budget deficit in fiscal 2010. Compared with the steady recovery being staged by the financial markets, the real economy remained very weak, with unemployment at 10 percent as of the end of 2009 (9.8 percent at the end of 2010). For this reason, the fiscal 2011 budget request contained increased appropriations in line with the American Recovery and Reinvestment Act, including a total of $170 billion in budget requests for the creation of jobs. The budget contained total expenditure requests of $3,720 billion. Regarding the federal budget deficit for fiscal 2011, the Office of Management and Budget (OMB), which oversees the federal budget, projected a deficit of $1,267 billion (down 18.6 percent from the previous year), while the Congressional Budget Office projected a deficit of $1,341 billion. Thus, the US government continued to record large budget deficits (which had previously been thought to be purely a temporary phenomenon). Many observers began to express fears that the government's financial reconstruction plan was lagging behind.

The US government continued to set medium-term fiscal reconstruction targets for up to ten years ahead (fiscal 2020). These targets envisioned an aggregate reduction of $2.1 trillion in the federal budget deficit by fiscal 2020 by comparison with the baseline (the forecast budget deficit figure assuming no reform efforts were undertaken). It is assumed that annual government revenue will grow as a result both of natural increases and strengthened tax collection, and that government expenditures will be reduced (greater efficiency in mandatory spending, restraint in discretionary spending), and that stricter controls will be placed on future budgets (introduction of budget ceilings).

Regarding cuts in discretionary spending, recent proposals include holding

**Figure 1.1. Prospects for the reconstruction of US public finances**




*Source*: Compiled from *The Budget for Fiscal Year 2011.*

down spending to the present levels for the next three years and implementing a total reduction of $310 billion over ten years. However, spending on national defense and security are excluded from the scope of these proposed cuts. Overseas Contingency Operations (OCO) account for a particularly large proportion of these proposed reductions in spending, at $728 billion, but it should be noted that this figure is calculated by comparison with the baseline. That is to say, by comparison with predicted spending under a situation where the United States does not withdraw from Afghanistan before 2020. This does not refer to reductions in the general expense budget of the US Department of Defense.

Mandatory spending accounts for a very large percentage of total US government expenditure, and this includes healthcare costs, which are set to increase as a result of the health care reform enacted in 2010. However, it is estimated that total reductions in expenditure on health care, including Medicare (a public social insurance program providing health insurance coverage to people aged 65 and older) and the taxation of high-premium health insurance plans, could amount to around $150 billion. The current health care reform efforts are seen both as a necessary step to achieving fiscal stability, and as way of improving the provision of social security. During discussions in Congress of the two health care reform bills passed in 2010, the Democratic Party candidate was defeated in a Senate special election (by-election) in Massachusetts, making it more difficult for President Obama to force legislation through the Senate. The President succeeded in forcing through the bills against the opposition of the Republican Party, but this issue became a point of contention during the mid-term elections in November 2010. Other proposals for reducing the federal budget deficit include the setting of budget ceilings, such as the "pay-as-you-go" initiative introduced in February 2010, which was aimed at restricting new budget appropriations that did not include an alternative revenue source.

### (2) Security Risks in Deficit Reduction—Constraints on Policy Flexibility

The Obama administration has continued to insist that an early restoration of fiscal discipline is achievable through a combination of economic recovery and effective legislation, but the Congressional Budget Office and other official agencies have pointed out the risk involved in additional government spending to prop up the economy, as well as the over-optimistic nature of the 3.0 percent economic growth forecast on which the administration's plans are based. Moreover, with respect to spending on military operations, which accounts for a large proportion of the administration's planned cuts in discretionary spending, the administration assumes the completion of withdrawal of US forces from Afghanistan by 2014, and many critics question whether this is achievable. Furthermore, looking at economic and fiscal prospects over the medium and long terms, once the budget deficit begins to shrink, a major demographic change will soon overtake the United States, with the retirement of the Baby Boomer generation. This will put upward pressure on mandatory spending such as pensions and Medicare. The OMB predicts expansion of the federal budget deficit from around fiscal 2018 onward, with the deficit once again topping $1 trillion in fiscal 2020.

In these circumstances, bipartisan efforts are required in order to devise and push through strong measures to reform the US government's finances. On January 20, 2010, the National Commission on Fiscal Responsibility and Reform was established as a bipartisan Presidential advisory body. On December 3, just after the mid-term elections, the commission voted on its final plan, which proposed reducing the debt-to-GDP ratio to 2.3 percent by 2015 and achieving an accumulated reduction in the deficit of around $4 trillion (including the national defense budget) by 2020 (comparison with the baseline). It received a majority approval (eleven votes for, seven against), but this fell short of the fourteen votes required to submit the proposal to Congress, and it is thought unlikely that this plan will become law any time soon. It is unclear how much success the administration will have in drawing up a specific set of measures to restore fiscal discipline in the remaining two years of Barack Obama's current presidential term.

The revenue shortfall in the US budget can be financed through the issuance of sovereign bonds such as US Treasury securities, but the world's capital markets currently regard such sovereign bonds as carrying unacceptably high levels of credit risk. Since before the bankruptcy of Lehman Brothers, market participants both inside and outside the United States have been well aware of the structural problem of the so-called twin deficits—the federal budget deficit and the current account deficit. However, prior to the financial crisis, the United States financial markets were the most competitive in the world, and the dollar was the world reserve currency. There was thus little reason to fear any sovereign risk with regard to the financing of the federal budget deficit, and debate focused on whether or not the excessive budget deficit was exacerbating the domestic supply-demand gap and distorting the market. In fact, many observers believed that the deficit, by causing huge amounts of US dollars to flow back into the international money markets via investments in US Treasury securities and so on, was necessary to help promote the spread of financial liberalization and economic globalization in the post-Cold War world. Following the financial crisis, however, the massive amounts of bond issuances conducted to stabilize the financial system pushed up the US public debt to 53.0 percent of GDP in fiscal 2009, and according to a forecast by the OMB, on a baseline comparison the debt-to-GDP ratio would reach 77.2 percent by 2020 as a result of cumulative growth in interest payments and the persistence of the federal budget deficit. The IMF has pointed out that this is a worrying level of public debt even for an advanced economy. Within the United States, too, there have been increasing calls for the rectification of the government debt level, in view of the danger that it may lead to a sharp rise in interest rates.

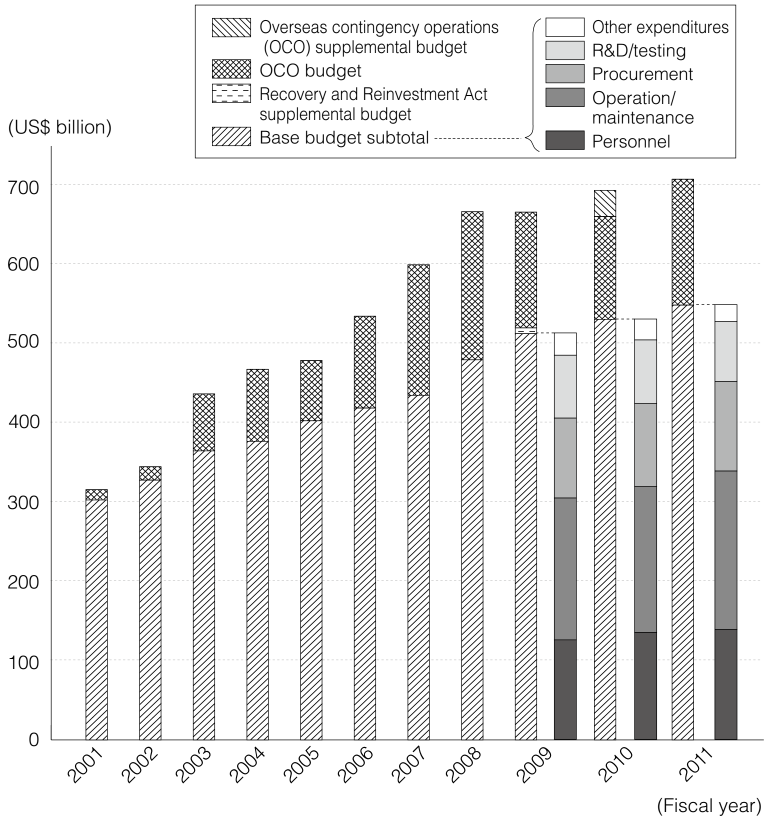
The United States' fiscal problems are undoubtedly different from the sovereign risk issues in Europe. They are seen strictly as credit risk problems that could, at worst, affect the country's debt management conditions and the dollar's exchange rate. However, because the emerging market economies have been making their presence increasingly felt on the global economic stage and China's trade policy in recent years has shown the influence of protectionist attitudes and geopolitical considerations, top military and government officials in the United States are warning that the mounting federal budget deficit constitutes a serious risk in the sphere of national security. If the United States is slow to restore fiscal health, the country will be faced with the structural problem of a continued expansion in mandatory spending without any fiscal latitude, and this would put strong pressure on discretionary spending, including the military budget. It is feared that such a situation would seriously impair the US government's policy flexibility. In the current United States budget proposal, national defense and security budget appropriations are excluded from the requirement to freeze spending at current levels, but there is no guarantee that cuts in these appropriations will remain taboo. In fact, a number of influential commentators have begun calling for a reexamination of the military budget of the United States, with a view to the reallocation of resources and possible overall cuts. For example, Secretary of Defense Robert Gates has stated that there is a need to restrain the growth of military spending in real terms. He called for a reduction in military spending of $100 billion over the five years to fiscal 2015, through more efficient budget appropriations, cuts in indirect expenses, and the transfer of budget funds to essential areas. The proposal by the National Commission on Fiscal Responsibility and Reform includes a plan to reduce the US military budget by a cumulative total of $100 billion over the next five years. This would be achieved by reallocating to the military budget reductions in expenses made through improved efficiency, enabling a reduction of $28 billion in the federal budget deficit, as well as by freezing salary levels and reducing the acquisition budget by 15 percent.

### (3) Medium-term Direction of the US Overseas Operations Budget—Reduced OCO Spending and Increase in International Aid Budget

The Obama administration aims to reduce expenses on military operations through a "responsible withdrawal" from Iraq and Afghanistan, and to rebuild the US military without imposing a further burden on the national economy. The administration also plans to strengthen the US commitment to international society by doubling the aid budget. US military operations in Iraq and Afghanistan have led to increased expenses pertaining to the so-called War on Terror, now referred to by the administration as the Overseas Contingency Operations (OCO). Although these expenses had decreased in fiscal 2009 after steadily rising up through fiscal 2008, the subsequent dispatch of additional troops to Afghanistan pushed OCO costs to $163 billion in fiscal 2010, up 8.6 percent over the previous year.

In a speech delivered at the US Military Academy at West Point on December 1, 2009, President Obama revealed a new strategy for dealing with the situation in Afghanistan. Under this plan, US troop levels in Afghanistan would be increased by roughly 30,000 by the end of 2010. The President also expressed apprehension regarding the enormous cost of military operations in Iraq and Afghanistan, and announced that the pullout of combat troops from Iraq would be completed in January 2010. He also outlined his exit strategy for Afghanistan. The withdrawal of US forces from Afghanistan would commence in July 2011, prior to which responsibility for internal security would be handed over to US-trained native Afghan troops. These withdrawal plans were not, of course, motivated primarily by a desire to achieve fiscal discipline, but the President stated that "we must

**Figure 1.2. US defense budget trends**




*Source*: Compiled from Office of Under Secretary of Defense, *Overview—FY2011 Defense Budget.*

rebuild our strength here at home." As this statement indicates, the cost of the prolonged overseas military campaigns has exhausted the US economy by expanding the nation's fiscal burden. According to a report by the Congressional Research Service, the cumulative total of costs to the United States arising from the conflicts in Iraq and Afghanistan between fiscal 2001 and fiscal 2010 was approximately $940 billion.

President Obama stated that, over the past ten years, the United States had failed to find an appropriate balance between national security and the economy. In the wake of the global financial crisis, the United States can no longer afford to ignore the costs of military operations or their impact on the economy. The US administration is now committed to reducing the future burden of military expenditure, and following the planned withdrawal of US troops from Afghanistan in 2014, the United States can look forward to a major reduction in OCO expenditure. Within the total reduction of $2.1 trillion in the federal budget deficit for fiscal 2011–2020 (reduction compared with forecasts predicated on the baseline) planned under the government's medium-term fiscal reconstruction plan, cuts in military expenditure will contribute as much as $728 billion. The extent to which the planned troop withdrawals go smoothly and military operation costs are reduced on schedule will have a significant impact on the entire fiscal reconstruction process.

For these reasons, in parallel with the planned withdrawal of combat forces, the United States has also drawn up plans to strengthen its operational capabilities in Afghanistan. In the budget appropriation requests for fiscal 2011 priority has been accorded to providing support for front-line units, and Secretary of Defense Robert Gates has stated that: "We need to provide our troops in the field the resources they need and fund other priorities." Because of this stated policy, almost all the budget proposals were approved, and budget spending levels were in line with the previous year.

As an exit strategy aimed at preventing a deterioration in security risks following the withdrawal of combat forces, the United States is providing support for Afghan security forces through the NATO Training Mission-Afghanistan. Simultaneously, to prevent a decline in the ability of the Afghan central government to control the region, as well as a weakening of local communities, the United States is reinforcing its long-term support programs in the country. The appropriation requests made by the Department of State for the fiscal 2011 budget include both expenses for these programs and for strengthening support for front-line countries such as Iraq and Pakistan in the struggle against terrorism. Specifically, the State Department has requested total budget appropriations of $10.7 billion ($5 billion for Afghanistan, $3.2 billion for Pakistan, and $2.5 billion for Iraq), including the creation of a $1.2 billion fund to finance Pakistan's counterinsurgency capabilities and a $100 million multipurpose crisis response fund (which is a reappropriation of existing Department of Defense budget appropriations). The State Department is also aiming to double its external aid budget (including aid for non-front-line countries). Fiscal 2011 budget appropriation requests by the State Department and affiliated government agencies total $56.8 billion, for an increase of $1.60 billion, or 1.0 percent, over the previous year.

While the United States is in this way increasing its international aid budget and implementing the prioritized allocation of spending to parts of the world tagged as important in the struggle against terrorism, Congress is asking hard questions about efficiency or the lack of it in the implementation of aid budget spending, as well as the legitimacy of the foreign governments concerned, and there have been calls within Congress for the imposition of restrictions on this spending. There is also the problem that the long-term provision of financial support to these countries and the reinforcement of the United States' commitment in these regions will impose burdens not only on the United States, but also on the international community of nations as a whole. As discussed in the following section of this report, the global financial crisis is exerting an impact on donor countries in the EU, and there is concern that this factor could restrict US activities in the future from the standpoints of personnel and funding.

### (4) Prioritization in the US Military Budget—Disputes between the Government and Congress over Rebalancing of Military Capabilities

In its fiscal 2011 budget request, the Department of Defense (DOD) places priority on taking care of military personnel, rebalancing the force, reforming the DOD's acquisition practices, and providing support for troops in the field. In the United States' budget for fiscal 2011, the DOD has asked for a total appropriation of $733.3 billion (up 3.4 percent in nominal terms and 1.8 percent in real terms over the previous year) for military spending. This breaks down into $548.9 billion for the DOD base budget (up 3.4 percent in nominal terms and 1.8 percent in real terms over the previous year); $159.3 billion for OCO funding (up 11.6 percent in nominal terms and 10.0 percent in real terms over the previous year), notably the operations in Iraq and Afghanistan, which will be continuing in fiscal 2011; and a total of $25.1 billion for security-related agencies other than the DOD itself, such as the US Department of Energy ($17.8 billion appropriation request), which has responsibility for the safety in the handling of nuclear materials, including the US nuclear weapons program and the construction of nuclear reactors for the Navy. The DOD also requested additional expenditure of $33.6 billion in military operations expenses (including $655 million in humanitarian aid to Haiti) in a fiscal 2010 supplemental spending bill.

Comparing this with the defense budget for fiscal 2009, under the previous administration of President George W. Bush, we see that the DOD base budget includes increased spending on several items—personnel expenses, operational and maintenance costs, and acquisition costs—while reductions were made in the budget for defense-related construction and R&D. With regard to the fiscal 2011 budget request for personnel expenses, Secretary of Defense Robert Gates has reaffirmed the department's commitment to take care of the all-volunteer force, which, he stated, represents the United States' greatest strategic asset. To this end, the DOD intends to increase the number of troops, raise their pay (up 1.9 percent over the previous year in nominal terms and 0.3 percent in real terms), increase various allowances, and expand health insurance programs and programs for wounded troops. These items, applicable to military servicemen and servicewomen as well as civilian employees of the DOD and aimed at, in the DOD's words, "taking care of people," have been incorporated into the fiscal 2011 budget request.

Within the budget category of research and development, drastic cuts have been made in programs for which no pressing need is seen, and those where progress management is being maintained but no achievements are apparent. Hitherto, development programs, particularly cutting-edge projects, had suffered from endemic schedule and budget overruns, leading to higher equipment costs. The DOD has taken a strict stance on this situation, streamlining the budget to focus resources on the wars actually being fought now, and simultaneously rebalancing the United States' military capabilities.

In the January/February 2009 edition of *Foreign Affairs*, Secretary Gates had already advocated a "balanced strategy" with regard to the military's capabilities and organization culture. That is to say, there was a need to balance the requirement to maintain the United States' existing conventional and strategic technological edge over other military forces, against the need for counterinsurgency capabilities, financial support and training for allied military forces, as well as the need to focus more resources on ensuring the ability to engage in ongoing conflicts such as Iraq and Afghanistan. The fiscal 2010 budget request had included the termination of certain development programs, such as missile defense and the Future Combat Systems modernization program, and the proposals also called for steps to raise the efficiency of the defense industry through reform of the acquisition system, as well as a review of contracts with support service contractors. At the same time, during debates over the fiscal 2010 National Defense Authorization Act and the Department of Defense Appropriations Act, there was an attempt to roll back these cuts in development programs, with a particular focus on the acquisition of the Lockheed Martin/Boeing F-22 Raptor fighter aircraft, whose production involved plants all over the United States. The initial plan had called for the production of F-22s to be terminated after 183 aircraft, but proposals were made by both houses of Congress to produce additional aircraft (four more under the House of Representatives' proposal and seven more under the Senate proposal). In response to these moves, in a speech made in July 2009 Secretary Gates expressed his suspicions that a group of officials who dominated opinion in the military and the DOD were seeking to extend the acquisition of the sort of equipment needed to fight conventional wars between nation states, despite the fact that the more pressing need nowadays was the ability to successfully deal with unconventional conflicts. Subsequently, certain Congress members whose local constituencies included defense contractors, and defense industry lobbyists pressed for the original plan to be maintained, claiming that the termination of F-22 production would cause unemployment and damage the economy. However, in response to the Obama administration's firm insistence on scrapping all F-22-related programs, the budget was finally passed by Congress without any F-22-related appropriations. Among the reasons given for terminating acquisition of these aircraft were: both the initial price and maintenance costs of the F-22 were too high, especially in view of the serious state of the federal finances; adequate US air superiority could be achieved with the already planned number of aircraft; development was proceeding smoothly on the F-35, whose planned price would be lower than the F-22; and, the F-22 would not be likely to make a significant contribution to the currently ongoing conflicts. In short, Secretary Gates was determined to realize the rebalancing of US forces, and as the F-22 constituted a symbol of the traditional Cold War approach to military equipment acquisition which he was committed to ending, it had to be terminated.


**The F-22 Raptor, whose procurement plan was capped at 183 airframes** (US Air Force photo by Tech. Sgt. Ben Bloker)

In the Quadrennial Defense Review released in February 2010, the term "rebalancing" was employed extensively, in the context of a rethinking of plans for investment in the military capabilities and weapons systems that will be required in the future. Then, in its Overview on the fiscal 2011 budget request, the DOD called for "rebalancing the force," i.e., rebalancing US military capabilities to enable the country to fight unconventional wars and prevail in future conflicts. The DOD stated that rebalancing should have priority second only to the strengthening of the all-volunteer force. However, the government and Congress continued to haggle over the huge sums requested in the budget for development programs, and these arguments continued in the Congressional debate over the defense budget appropriations for fiscal 2011. On May 19, 2010, the House Armed Services Committee passed the National Defense Authorization Act for Fiscal Year 2011 (originally bill H.R.5136), authorizing the expenditure and management of $725.9 billion on the DOD and related programs conducted by other government agencies. This represented a reduction of $27 million from the President's budget request. Although the bill was passed, Secretary Gates warned at a Congressional hearing that he would recommend the President veto any legislation that sustains the unnecessary continuation of rolling budget programs. The act contained a $485 million appropriation for one such program, the continued development from fiscal 2010 of the F136 alternate engine for the Joint Strike Fighter program. At the Senate, meanwhile, debate became heated on a different issue, with the result that the defense budget was ultimately passed in December through the upper house's approval of the House of Representatives' National Defense Authorization Act for Fiscal Year 2011 (H.R.6253, as a bill it was originally H.R.5136, and later co-sponsored by Representative Ike Skelton as H.R. 6523 and renamed). Changes made from the original bill did not include specific measures regarding an appropriation for continuing the F136 development program.

### (5) The Implications of Rebalancing and Acquisition Affordability

In line with the policy of the current administration, since early fiscal 2010 the Department of Defense has been expanding military budget appropriation requests to strengthen US forces' operational capabilities in unconventional warfare, including counterinsurgency operations (COIN), heliborne (air assault) operations, special operations, and unmanned aerial vehicles (UAVs). Meanwhile, in June 2010 Secretary of Defense Robert Gates, testifying at a meeting of the

Senate Appropriations Subcommittee on Defense (under the US Senate Committee on Appropriations) held to discuss the DOD's budget requests for fiscal 2011, listed among the programs for which budget requests had not been made and that should be terminated, the next generation CG(X) cruiser, the Navy's EPX intelligence aircraft, and the third-generation infrared surveillance program (3rdGIR). Among programs that were performing poorly and ought to be terminated, he listed the net-enabled and controlled command and control program, and the Defense Integrated Military Human Resources System (DIMHRS). Secretary Gates also called for the completion of the C-17 airlifter program (for which attempts had recently been made to resurrect budgeting) and closure of the production line, and the ending of the extended development program on an alternate engine for the F-35 joint strike fighter.

However, it should not be thought that Secretary Gates' call for the rebalancing of the US forces implies making cuts in the budget appropriations for conventional next-generation military equipment in order to focus on improving counterinsurgency capabilities and unconventional warfare capabilities. The concept of rebalancing naturally also includes preparations for fighting future conventional wars.

For example, the proposal in the fiscal 2011 budget bill to terminate funding for the Navy's CG(X) cruiser program was based on the perception that, given that an integrated Air and Missile Defense Radar (AMDR) system was still under development, the effort to design ship's hulls based on a radical new concept carried a high risk. Instead, it would be more logical for the Navy to continue purchasing *Arleigh Burke*-class destroyers (DDG-51 Flight IIA), and subsequently to equip Flight III destroyers with the AMDR system. This decision makes it clear that the DOD does not intend to stop investing in next-generation equipment for use in conventional conflicts. Moreover, there is the possibility that US Navy's forthcoming Force Structure Assessment may call for an overhaul of the current long-term ship construction plan for fiscal 2011–2040, which aims at achieving and maintaining a fleet strength of 313 vessels. With this possibility on the horizon, it can be argued that the DOD has judged it wiser to draw up a new Future Years Defense Program that, based on a more realistic shipbuilding plan, will maintain the fleet at its present strength.

There have been cases in which budgeted appropriations for a development program had been terminated but later revived after new value was imparted to the project through the discovery of a new concept that could be incorporated or a new role that could be filled. One such case is the US Air Force's development of its next-generation long-range strike force, including long-range bombers. In such cases, the decision to approve funding is often influenced by the perceived need to maintain the strength of the nation's defense industry base and its technology resources, but as future conflicts may necessitate an expansion of military capabilities and equipment, depending on changes in the security environment and technological developments, the DOD usually decides to continue or even expand development programs for the time being so as to ensure that it can deal with all conceivable developments. In other words, the criticism by the Secretary of Defense is not so much aimed at new development programs themselves as at the ingrained attitude—the unique cultural attributes, so to speak—of many leaders in the US military and the defense industry. It is an attitude in which military leaders seek to develop and procure the equipment needed to fight future wars without concern for current unconventional wars and the nation's lack of fiscal elbow room. They pay insufficient attention to orders of priority, cost overruns, or delays, and demand operational capability well in excess of that needed to meet present threats.

Reform of acquisition practices is one of the top-priority tasks of the Obama administration, and was touched on in an administrative policy speech delivered by the President in February 2009. Then, in March 2009 the Defense Acquisition Reform Panel was established as a subcommittee of the House Armed Services Committee, and in May the Weapon Systems Acquisition Reform Act of 2009 was enacted to increase the transparency of the acquisition process and reduce costs. The act also created a new Pentagon office—the Office of Cost Assessment and Program Evaluation—with responsibility for cost programs, development testing and evaluation, and systems engineering, and regular reporting to Congress was made mandatory. In March 2010 the House Armed Services Committee Panel on Defense Acquisition Reform submitted to the House its panel findings and recommendations. With respect to the handling of defense contracts, the panel recommended: (1) a reduction in the reliance on outsourcing of defense work, and an increase in the number of staff responsible for overseeing contract execution; (2) creation of a workplace environment that has greater competition and incentives; and (3) utilization of the financial information of acquisition. Later legislation reflected the recommendations in this report, incorporating provisions for reducing the proportion of defense work outsourced, and directly hiring 13,000 additional personnel to oversee outsourcing contracts.

In June 2010 Secretary Gates testified at the Appropriations Subcommittee on Defense of the US Senate Committee on Appropriations, where he stated that, in view of the difficult economic situation in the United States, the government's fiscal situation was becoming increasingly serious, and that the DOD would have to make efforts to reduce costs. At the same time, with regard to OCO expenditure, he asserted that this would continue to grow for several years. This called, he said, for the simultaneous pursuit of several goals—winning the current wars, rebuilding the nation's military forces, and preparing for future contingencies—all while taking due account of the need to restore the nation's fiscal health amid an ailing economy. Secretary Gates called for using the funds that would be freed up by the continued pursuit of the acquisition reform process to invest in providing the needed care for military personnel, as well as for investment in rebalancing the force and preparing for the future. In September 2009 Secretary Gates and Dr. Ashton B. Carter, Under Secretary of Defense for Acquisition, Technology and Logistics, jointly released a memorandum entitled Guidance for Greater Efficiency and Productivity in Defense Spending, which contained twenty-three specific changes to the way in which the DOD contracts for goods and services. According to this memorandum, the DOD plans to reduce the national defense budget by a total of $101.9 billion ($84.9 billion for the armed services and $17 billion for the DOD and related agencies) over the five years from fiscal 2012 to fiscal 2016 (October 2011 to September 2016). This will be achieved through greater efficiency in acquisition, with an emphasis on affordability. While defense industry spokesmen have complained that expenses stemming from the DOD's bureaucratic red tape and auditing procedures are pushing up contractors' costs, Under Secretary Carter appealed for understanding on the part of the defense industry, insisting that the Guidance memorandum was intended to facilitate cooperation between DOD's accounting divisions and the contractors.

## 3. Fiscal Problems and Defense Budgets in Europe

### (1) Deteriorating Economic and Business Conditions in Europe and Responses by the Principal Countries

In November 2008, two months after the bankruptcy of Lehman Brothers, the

European Commission unveiled its European Economic Recovery Plan, which was approved in December at a meeting of the European Council (regular meetings of the heads of state in the EU). Under this plan, EU member nations would undertake discretionary government spending amounting to a total of €200 billion to stimulate their economies. In fact, however, stimulus spending by the EU nations exceeded the planned amount by a wide margin.

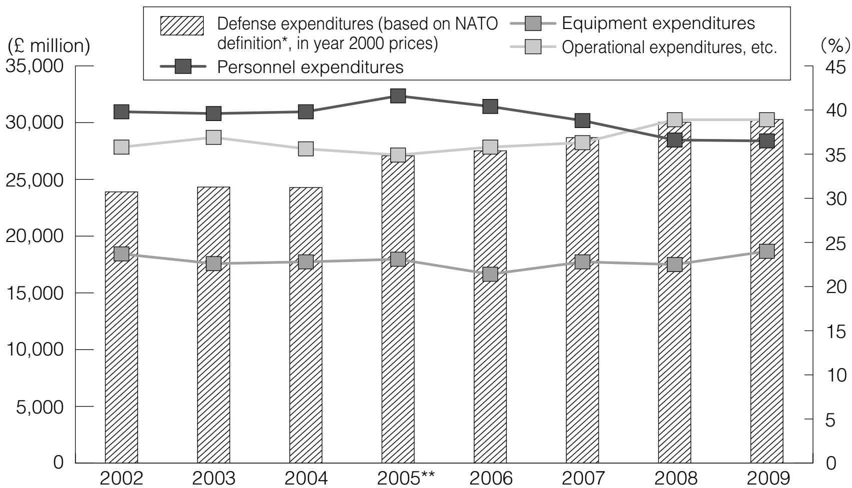
The real economic growth rate of the member states of the European Economic and Monetary Union (EMU; also known as the euro area or eurozone) for the first quarter of 2009 was minus 9.8 percent, but certain countries, including France and Germany, recovered positive growth in the latter half of 2009, thanks to the vigorous implementation of fiscal and monetary measures. However, some of the EU nations such as Italy and Spain, which were already burdened by heavy public debt and were unable to implement large-scale stimulus packages, enjoyed only limited recovery, and sharp disparities in economic growth emerged between the various European advanced economies.

As of May 2009, the amount of emergency economic stimulus spending by all the EU countries had reached €600 billion. As a result, it was predicted that the fiscal deficit of all the EU members would grow sharply in 2009 and thereafter, and that the balance of general public debt in the euro area would exceed 70 percent of GDP. These figures would exceed the allowable limits under the EU's Stability and Growth Pact of 3.0 percent for the ratio of fiscal deficit to GDP and 60 percent for the government debt-to-GDP ratio. The EU governments consequently began examining ways of restoring sound public finances. At a meeting of the European Council in December 2009, the leaders agreed that implementation of an exit strategy from the stimulus policies would be premature, as economic recovery was still in a fragile state. They therefore decided to commence measures toward reestablishing fiscal discipline in 2011. However, this decision was overtaken by events, with the sovereign debt crisis threatening to affect the whole of Europe from early 2010, forcing the EU states to draw up concrete fiscal rehabilitation measures as a matter of urgency.

The deterioration of public finances that has resulted from the financial crisis and consequent business downturn has had an impact on defense budgets in countries worldwide, notably the advanced economies, but especially in Europe. Public finances in Europe were in a serious situation even before the financial crisis and economic downturn, due to rising social security costs. In these circumstances, the European governments have been searching for an appropriate policy mix that would allow them to maintain their defense expenditures at a certain level and realize the required military capabilities. To enable governments to make the most effective use of their limited budget resources, in addition to cutting the number of troops to restrain the growth of personnel costs, there have been moves within NATO and the EU to promote the use of international equipment standardization and joint development. EU countries have, in fact, been making attempts to collaborate in military equipment acquisition through the European Defence Agency. Through this kind of multilateral cooperation, the European countries are searching for a way to address the host of problems they face in creating the military forces needed to cope with the new security environment.

However, the worsening of their economies and public finances following the start of the financial crisis and economic downturn has made making such collaboration more difficult in certain respects. In 2010 the United Kingdom, France, and Germany successively announced plans for sharp cuts in defense expenditures as part of their efforts to restore sound public finances. In the

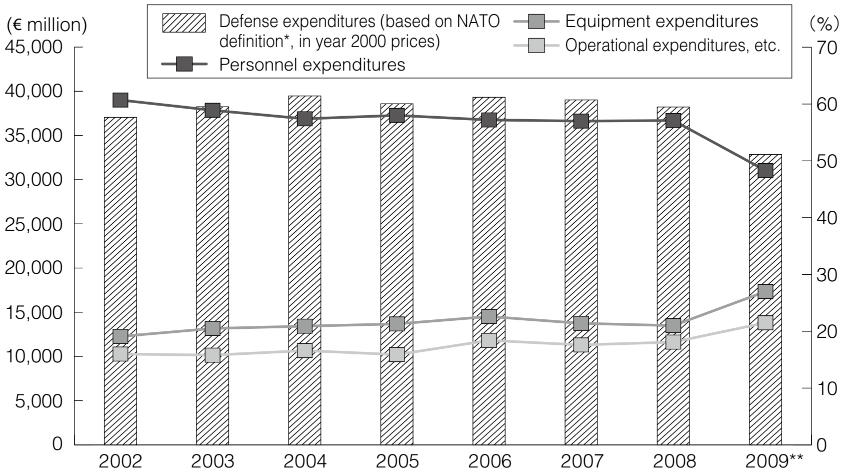
**Figure 1.3. Defense expenditures of the United Kingdom**




*Includes nonmilitary units that are deployable and have military support functions. Personnel expenditures include pensions. Equipment expenditures include R&D costs of key equipment.
**Figures from 2005 onward include pensions.

*Source*: Compiled from NATO, *Financial and Economic Data Relating to NATO Defence* (various years).

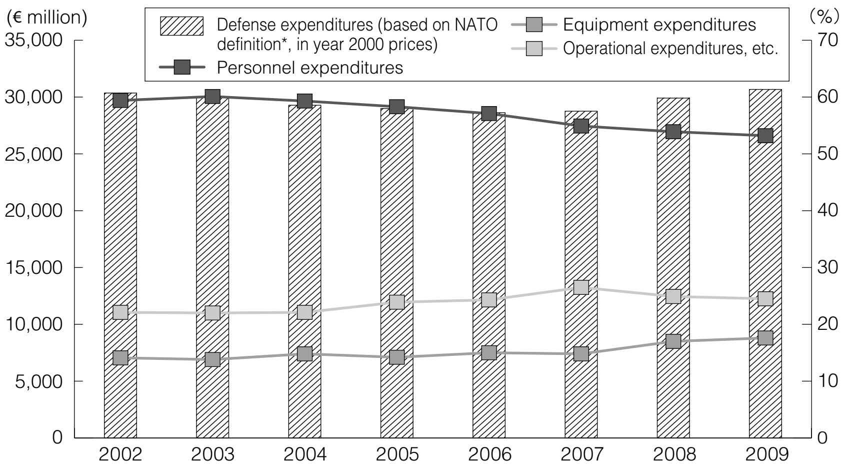
**Figure 1.4. Defense expenditures of France**




*Includes nonmilitary units that are deployable and have military support functions. Personnel expenditures include pensions. Equipment expenditures include R&D costs of key equipment.
**Figures from 2009 onward exclude Gendarmerie expenditures.

*Source*: Compiled from NATO, *Financial and Economic Data Relating to NATO Defence* (various years).

**Figure 1.5. Defense expenditures of Germany**




*Includes nonmilitary units that are deployable and have military support functions. Personnel expenditures include pensions. Equipment expenditures include R&D costs of key equipment.

*Source*: Compiled from NATO, *Financial and Economic Data Relating to NATO Defence* (various years).

subsequent sections of this report, we examine the defense expenditure situation in these three countries and their likely impact on military capability development in these nations.

### (2) Efforts to Restore Sound Public Finances and Defense Policies—The United Kingdom

In April 2009 the Economic and Financial Affairs Council of the EU (ECOFIN) made recommendations to the United Kingdom to end the excessive deficit situation. A British general election was scheduled in May 2010, and one of the major points of contention in the election campaign was the restoration of fiscal discipline. The Conservative Party, which had high hopes of regaining power in the election, criticized the Labour Party for running up the public debt through growth in expenditure. In the event, the Conservatives won the election and formed a coalition government with the Liberal Democrats under party leader David Cameron. The new administration announced a policy of emergency reductions in government expenditures, unveiled an emergency budget in June, and proceeded to revise the nation's public expenditure plans. In October, the government published a Spending Review incorporating a detailed program of reductions in public spending from 2011 to 2015.

The two main deficit-reduction goals put forward by the coalition government, for achievement by fiscal 2015, are: (1) to achieve a balance between fiscal revenue and expenditure; and (2) to turn around the upward trend of the general public debt-to-GDP ratio. Specifically, in the June emergency budget document the government announced its plans to: (1) reduce expenditures by £83 billion by 2014 through fiscal reconstruction policies including a reform of the nation's medical treatment system, a reform of the social security system and a freeze on public sector pay rises, and a freeze on child benefit; and (2) achieve a cumulative reduction in the fiscal deficit of £113 billion by 2014 and £128 billion by 2015 through an increase in revenues of £29 billion by raising the rate of value added tax (VAT). These phased deficit-reduction plans were revised in the Spending Review announced in October 2010, with the cumulative deficit reduction target for 2014 being revised downward to £81 billion. The final target, however, was left unchanged. In parallel with this, all government ministries were required to prioritize their spending, and to draw up structural reform plans and detailed operational plans.

In June 2010 the Ministry of Defence (MoD) began drawing up the Strategic Defence and Security Review (SDSR), the first since 1998. The SDSR, which presents specific policies for realizing the national security and defense priorities set out in the National Security Strategy (NSS) that is drawn up simultaneously by the Cabinet, was released ahead of the Spending Review in October.

At the time of the release of the SDSR, Prime Minister David Cameron personally explained the review to Parliament. He asserted that the reductions in defense spending up to 2014 were not motivated by the need to reduce the fiscal deficit, emphasized that the defense spending cuts, at 8 percent, were much smaller than those (between 20 and 25 percent) imposed on other ministries, and insisted that the government regarded national security as very important. Liam Fox, Secretary of State for Defence, explained to Parliament that the government's defense equipment acquisition debt, accumulated under the previous Labour government, amounted to £38 billion, which was larger than the annual defense budget. He stated that the government intended first to deal with this debt, and then to tackle the needed reorganization of the UK armed forces to meet future threats.

In the SDSR, the government called for a reorganization of the UK armed forces with priority on two issues: (1) ensuring the ability of UK forces to carry out the country's mission in Afghanistan; and (2) creating a balanced defense capability by 2020. It also called for a reduction in the number of armed forces personnel over the next five years, and a reform of equipment acquisition plans. Specifically, by 2015, the number of armed forces personnel would be reduced by a total of 17,000—7,000 for the army, 5,000 for the navy, and 5,000 for the air force—while the civilian defense staff would be cut by 25,000. However, units of the army, marines, and air force brigades operating on the front line would not be subject to cuts as long as the Afghan operations continued. The principal changes called for in equipment acquisition ranged widely and incorporated detailed technological adjustments. The changes included extending the period for the phasing out of Trident SLBMs and postponing the decommissioning of *Vanguard*-class nuclear submarines, reducing the nuclear warhead stockpile, making changes to the construction designs for new aircraft carriers and reviewing plans for the decommissioning of existing aircraft carriers, and reducing the numbers of newly-procured main battle tanks and field guns for the army and cruisers and destroyers for the navy. On November 2, 2010, the United Kingdom and France signed the UK-France Summit 2010 Declaration on Defence and Security Cooperation, in which they pledged to jointly procure and operate defense equipment, share technology in the construction of new aircraft carriers, and develop a Combined Joint Expeditionary Force.

These moves by the UK government to reduce defense expenditure have come under fire from various quarters. It has been claimed that the cuts would prevent the UK from adequately meeting its security needs, that they would harm relations with the United States by forcing the United States to shoulder a greater burden, and that they might discourage efforts by NATO members to improve their defense capabilities. Amid this debate, Prime Minister David Cameron originally leaned toward making major cuts in defense spending, but was dissuaded from this course of action by Defence Secretary Liam Fox, who agreed with the United States, which was urging limited spending cuts. Fox engaged in a fierce debate with Cameron and with Chancellor of the Exchequer George Osborne, who was seeking defense cuts of 10-20 percent in line with those at other ministries, and finally succeeded in limiting the defense spending reductions to eight percent.

The spending reduction measures proposed in the SDSR will not have any direct effect on the UK forces' mission in Afghanistan, and, in contrast to the reductions in defense spending, overseas aid will be increased by 37 percent. Prime Minister Cameron, who paid a visit to Afghanistan on December 7, 2010, officially announced the start of troop withdrawals in 2011, but at the same time pledged a long-term commitment to providing financial assistance to Afghanistan for reconstruction.

In relation to the SDSR, moves also got underway to reassess the UK government's policy toward the defense industry, which had hitherto lacked clarity of purpose. This reassessment resulted in a Green Paper entitled Equipment, Support, and Technology for UK Defence and Security: A Consultation Paper, released by the Ministry of Defence in December 2010. In this Green Paper the MoD proposed to acquire military equipment in the open market wherever possible, so as to strengthen the competitiveness of the UK defense industry, and to promote collaboration with other NATO members. Based on this document, the UK's White Paper on industry and technology policy in the defense and security domains, which will serve as an important guideline for the government's conduct of acquisition activities, is scheduled to be released in the first half of 2011.

### (3) Efforts to Restore Sound Public Finances and Defense Policies—France

France's Six-Year Military Planning Law, which was adopted in 2008, sets total French defense spending (excluding pensions) for the period fiscal 2009 to fiscal 2014 at €185 billion (calculated at 2008 prices), of which €102 billion is earmarked for the purchase of equipment. This gives average annual equipment expenditure of about €17 billion. In fiscal 2009, however, spending on military equipment posted a record high of €19 billion, partly because certain equipment items were at that point moving from the development stage to the production and purchasing stages, and also due to the appropriation of an additional €1.3 billion investment in national defense as part of the government's economic stimulus package.

In April 2009, the French government, under current Prime Minister François Fillon, which had already received the ECOFIN's recommendations to end the excessive deficit situation, was tackling a reform of the nation's pension system aimed at reducing expenditures and featuring a plan to raise the age at which pensions are payable. This pension plan faced strong opposition from labor unions and other pressure groups, but was finally enacted into law in October 2010. The government simultaneously announced its budget bill for fiscal 2011 and its fiscal program for 2011–2014, under which it aimed to bring down the debt-to-GDP ratio to within the 3 percent level stipulated by the EU's Stability and Growth Pact by 2013. Principal means to achieving this goal included reducing the number of public employees and curtailing health insurance expenditure, but the plan also included cuts in defense spending from €32.2 billion in fiscal 2010 to €31.2 billion in fiscal 2011, and a further reduction in equipment acquisition spending of €3.6 billion by 2013. Under this plan, spending on military equipment in fiscal 2011 would be cut to €16 billion, and plans for programs such as capability development of the Mirage 2000D aircraft and acquisition of Multi-Role Tanker Transports (MRTTs) would be postponed.

However, Defence Minister Hervé Morin, who drew up and announced this plan, insisted that it would have only a limited impact on overall military equipment acquisition. As reasons for this view, he cited expectations that the Ministry of Defence would realize some €2.6 billion in gains by 2013 on the selloff of real estate holdings in Paris and unused radio frequency bands. These gains would be employed to offset the equipment spending cuts, enabling the reductions in real terms to be held down to only €1.3 billion or so over three years.

Consequently, although the delivery dates of certain large-ticket equipment items would be delayed, there would be no major change in plans for the acquisition of important items, including: the Dassault Rafale fighter aircraft, which were assigned priority by the government; the multi-mission frigate development and production program (Frégates Européennes Multi-Missions /FREMM) being jointly pursued by the French and Italian governments; the Airbus A400M military transport aircraft, being developed and produced on a multi-national basis; the FÉLIN (*Fantassin à Équipement et Liaisons Intégrés* [Integrated Equipment and Communications Infantryman]), an advanced infantry combat system; and *Suffren*-class nuclear attack submarines.

In addition, to compensate for the delay in delivery of certain major equipment items, the French government is examining possibilities for a limited period for the joint acquisition and operation with the United Kingdom (which is also under pressure to reduce its defense equipment expenditure) of certain items such as the A400M transport planes, and an agreement to this effect was signed between the two countries at the Anglo-French summit meeting on November 2, 2010.

The process of deciding on cuts in military equipment spending in line with the need to achieve fiscal reconstruction has gone comparatively smoothly in France. In addition to the Defence Ministry's expectations of recording gains on the sale of assets, this can be attributed in large part to the French government's arms export strategies as well as its good relations with the defense industry. France is said to be pursuing an active arms export policy in support of its national interests, and is believed to be employing arms exports as a means of diversifying the risks involved in the development and production of new military equipment. France ranks third in the world in terms of the value of arms exports after the United States and Russia ($21.034 billion in the period 2006–2009), and its arms exports to developing countries have grown sharply in recent years. For this reason, even if France temporarily reduces its spending on defense equipment acquisition, the French defense industry will be able to maintain a strong production and technology base thanks to the export of military equipment. It is believed to be for these reasons that the cuts in military equipment spending met little opposition from either defense industry or the French Parliament.

### (4) Efforts to Restore Sound Public Finances and Defense Policies—Germany

In response to the ECOFIN's December 2009 recommendations to end the excessive deficit situation, in February 2010 the administration of Chancellor Angela Merkel unveiled a program for reducing the government's budget deficit by 0.5 percent per annum with the goal of bringing the debt-to-GDP ratio down to within 3 percent by 2013. This came just at the time when fears were growing that Germany could be severely impacted by the Greek sovereign debt crisis, and the Bundestag (German parliament) requested the Federal Ministry of Defence—which had originally planned to commence cutting the defense budget from fiscal 2011—to make major cuts in the defense budget from fiscal 2010. Then, at a meeting of the Budget Committee in March, the proposal was made to reduce the defense budget for fiscal 2010 by €450 million to €31.1 billion. Of this reduction, expenditure for equipment development and acquisition accounted for €250 million. It was feared that these cuts would have an impact on defense and equipment acquisition plans across the whole of Europe. This is because the A400M and multi-national development and production project and the acquisition of NH90 helicopters were included in items targeted for spending cuts, and because Germany had already sent an additional 850 troops to Afghanistan in response to the United States' announcement of its new strategy. In the fiscal 2011 budget bill, a sum of €31.5 billion (an increase of €400 million) was earmarked for defense spending, but this is expected to be held down to around €25.9 billion in actuality, in light of the necessity to limit expenditures as well as the government's pension payment obligations and other constraints.

In response to the recommendation by the Bundestag that a streamlining of the Bundeswehr should be examined in light of the serious fiscal situation, Chancellor Merkel set up a structural commission to look into the matter. The commission produced a report on the optimization of the Bundeswehr structures, encompassing the three armed services (army, navy, and air force) and the Joint Support Service, and released the report in April. The report recommended that the army retain an operational capability strength of six brigades, that six new battalions be formed, that one new airborne brigade be formed—consisting of one airborne brigade to handle special operations such as the rescue of German nationals, as well as helicopter units and light infantry units—in addition to two new commands to direct and control these brigade-strength forces. For the navy, although the report did not, for the time being, recommend any new ship construction not included in the current acquisition plans, it asserted that the current naval strength no longer allowed the maintenance of current levels of engagement in peace-keeping and peace enforcement operations. In the case of the air force, the report pointed out that, in relation to the reorganization of the Bundeswehr, that it would be too risky to rely solely on the lessons learned from operations in the Balkan Peninsula and Afghanistan, and because of this, future combat aircraft would have to be of the multirole type, such as the Eurofighter Typhoon.

In July 2010 the government approved a four-year plan for the restoration of sound public finances. This plan contains reductions in social security expenditures such as long-term unemployment benefits, as well as a reduction of over 10,000 in public sector jobs. In addition to these measures to hold down spending, the plan also takes steps to increase government revenues. The fiscal improvement targets under the plan include a reduction in the fiscal deficit of €81.6 billion over the 2011–2014 period, bringing the debt-to-GDP ratio down to around 1.5 percent. In addition, the general government debt is to be cut to around 40 percent of the current level by 2015. In line with this plan, the Federal Ministry of Defense submitted a list entitled "the prioritization of materiel investments" to then Defence Minister Karl-Theodor zu Guttenberg. This prioritization list enumerates the items that could be targeted for reduction or termination for the purpose of effecting a structural downsizing of the Bundeswehr and the reduction of expenditures. Principal proposals included making increased use of UAVs and cutting the acquisition of new combat aircraft, as well as other reductions in acquisition to match the planned cuts in troop numbers.

As a result of the above-described plans for reductions in defense expenditure and proposals by the Ministry of Defence for cutbacks in military equipment acquisition, it is reported that the Bundeswehr's total manpower will be reduced from the current 250,000 personnel to 175,000. In addition, in August 2010 Defence Minister zu Guttenberg put forward a proposal for the ending of the conscription system. Under this proposal, conscription would be terminated from the second half of 2011 and the number of Bundeswehr personnel reduced from the current 252,000 to approximately 165,000 consisting of 7,500 volunteers and 157,500 professional military personnel, but the regulations under the Basic Law for the Federal Republic of Germany (the German constitution) regarding military conscription would remain in force. However, the issue of the termination of conscription was debated very carefully because of divided opinion over the differing standpoints of the government and the Bundeswehr, as well as the relationship between Bundeswehr volunteers and alternative forms of public service. In December 2010, the government announced a plan for the reorganization of the Bundeswehr based on the recommendations received from the structural commission in October and a report from the Chiefs of Staff. Under this plan, the number of Bundeswehr personnel is to be reduced to a maximum of 185,000, slightly less than in the original proposal, and conscription is to be ended in July 2011, although the military service requirement in the Basic Law will be unchanged. In parallel with the ending of conscription, a new volunteer military system is to be introduced.

The new system differs from the combined volunteer and conscript system employed hitherto, in which conscripted military personnel became able to serve overseas if they opted to extend their enlistment, and also differs from systems where civilians voluntarily enlist as professional soldiers who can be deployed abroad. Under the new system, voluntary service is planned to last twelve to twenty-three months, and the first six months will be a probationary period in which recruits can choose to leave the service at any time. This setup is designed to provide civic duty-minded citizens with the opportunity to freely experience military service and make informed career choices based on an understanding of the Bundeswehr's mission. If the Bundeswehr reorganization plan passes the German parliament, the Bundeswehr will, by January 2013, combine 170,000 professional soldiers and 15,000 new volunteer conscripts into an 185,000-strong force designed for efficient operation, including in anticipated deployment overseas.

As we have seen, the German government has decided on a program of sharp cuts in defense expenditure to facilitate its policy of restoring health to the country's public finances against the backdrop of the financial and economic crisis. Currently, the main emphasis of these efforts is on the cost of acquisition of military equipment, but these moves are believed to be part of a plan to reduce the scale of Germany's armed forces in the future. At the same time, if these moves to cut the military budget and reduce the scale of the Bundeswehr are not to exert an adverse effect on international efforts to ensure security, Germany will have to maintain or even strengthen its capacity to deploy troops outside the West European theater. This issue will need to be watched closely.

## 4. China's Expansionary Monetary Policy and Trends in its Defense Budget

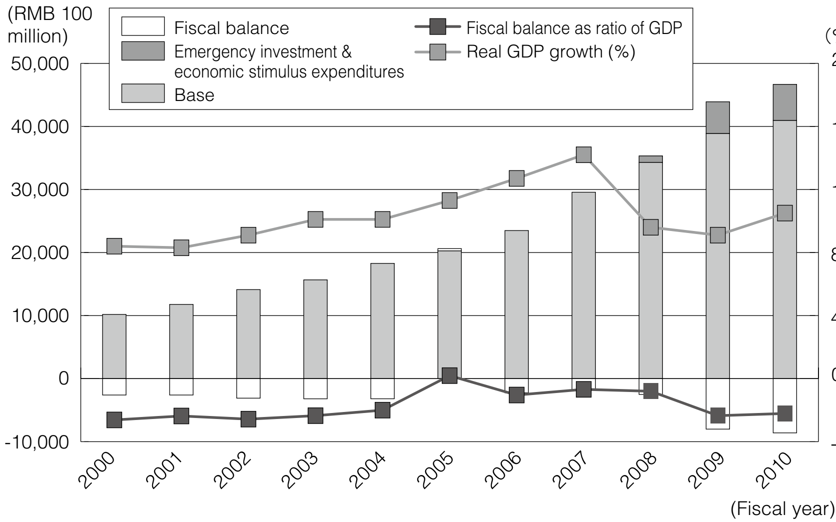
### (1) China's Expansionary Monetary Policy in Response to the Global Financial Crisis

In 2007 it appeared at one point that China was planning to switch from its expansionary fiscal policy to a contractionary one, but with the eruption of the global financial crisis in 2008 the Chinese domestic economy entered a downturn, and the authorities responded by once again adopting aggressive fiscal measures.

In November 2008 at an executive meeting of the State Council, Premier Wen Jiabao announced a package of ten measures to stimulate domestic demand and support economic growth. These measures included the promotion of projects to provide low-income housing, the building of infrastructure for rural communities, and other infrastructure construction projects including railways, roads, and airports, as well as strengthened environmental measures and the rebuilding of areas devastated by earthquakes. In December 2008, at a meeting of the Central Economic Work Conference, Premier Wen specified as areas for priority investment: (1) the Three Rural Issues (agriculture, rural communities, and peasants); (2) the construction of low-income housing in both urban areas and farming villages; (3) raising the country's capabilities in the fields of energy and freight transportation; (4) energy conservation and environmental measures, innovation, and the upgrading of the industrial structure; and (5) the provision of a better education and medical care infrastructure. The Premier also said that an investment of RMB 4 trillion (equivalent to 13 percent of China's GDP) was required by the end of 2010 to enable these measures to be carried out. Of this RMB 4 trillion, RMB 1.18 trillion would come from the central government, and the remainder from the local governments. The Chinese government immediately implemented an economic stimulus package worth RMB 104 billion within 2008.

China's fiscal 2009 budget, which was approved at the second session of the Eleventh National People's Congress of China (NPC) in March 2009, adopted an expansionary fiscal policy. Expenditure was raised by 22.1 percent over the previous year in response to an estimated decline in the growth of the government's revenues—due to an economic slowdown—from 19 percent in fiscal 2008 to 8 percent in fiscal 2009. The central government's budget, which accounts for 60 percent of the total national budget, was implemented almost entirely in line with

**Figure 1.6. Fiscal situation of China's central government**




*Source*: Chinese Ministry of Finance, *Budget Report to the National People's Congress* (various years); Chinese National Bureau of Statistics, *China Statistical Yearbook 2009*; IMF, *World Economic Outlook 2010*.

the initial plan. To underpin the economy, the central government invested RMB 1,235.9 billion under its public works budget, including an additional outlay of RMB 503.8 billion in economic stimulus measures. At the same time, the combined fiscal deficit for the central and local governments was estimated at approximately RMB 1 trillion, and the central government's fiscal deficit reached an all-time high of RMB 800.5 billion. For this reason, the government took the decision to draw RMB 50.5 billion from the central budget stabilization fund, which had been built up for some time, to reduce the fiscal deficit by RMB 750 billion in order to bring the debt-to-GDP ratio down below 3 percent, which is regarded as the rough standard for fiscal health. The remainder of the deficit would be covered by the issuance of government bonds, and the central government approved the issue of bonds by local governments.

The Chinese economy was showing signs of recovery, but the economic base remained fragile. In recognition of this, the fiscal 2010 budget, which was approved at the third session of the Eleventh NPC in March 2010, incorporated further aggressive economic stimulus measures, including an investment by the central government of RMB 992.7 billion in public works. Meanwhile, on the basis of a forecast growth of only 8 percent in revenue, national expenditures—for the central and local governments combined—were increased by 11.4 percent over the previous year in order to bring down the ratio of the fiscal deficit to GDP to a more appropriate 2.8 percent. The growth of the central government's expenditures was held down to 6.3 percent. The combined fiscal deficit for the central and local governments came to RMB 1.05 trillion, setting a record high.

### (2) Defense Budget Trends

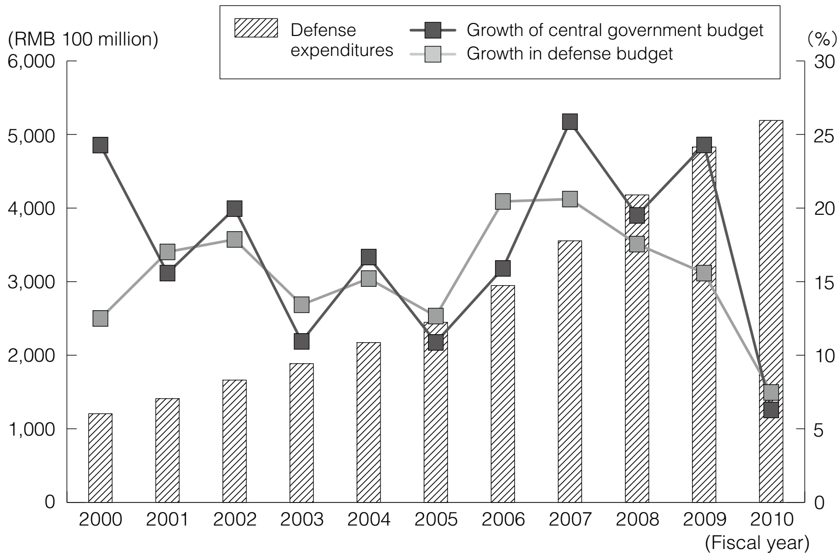
In contrast to other countries, which are having to constrain their budget expenditures strictly, China's defense budget has been recording year-on-year growth of over 15 percent, at 17.7 percent for fiscal 2008 and 15.6 percent for fiscal 2009. In the central government's budget for fiscal 2010, however, the growth in defense spending was held down to only 7.5 percent. This is thought to be because the growth in expenditures for the entire budget was a mere eight percent. In fact, the growth of China's defense spending has up to now stayed almost completely in lockstep with the growth of the central government's budget as a whole, and defense spending has accounted for a roughly constant 11–12 percent of the total budget.

In March 2010 NPC spokesman Li Zhaoxing announced that the national defense budget for fiscal 2010 would be RMB 532,100 million. In an explanation given to the NPC, the Ministry of Finance stated that expenditure in the fiscal 2009 budget was appropriated to improving the livelihoods of military personnel and promoting the spread of information technology, the acquisition of military equipment and construction of logistics support facilities, and on responding to emergency situations and natural disasters, and that the fiscal 2010 defense budget would be focused mainly on modernizing the armed forces. The *PLA Daily* carried an article by a specialist who opined that defense spending would have to be reviewed in light of the domestic economic situation. The article also stated that the curbs placed on the defense budget for 2010 indicate that China's defense development has entered a more healthy and stable stage.

In June 2010 Premier Wen Jiabao held a press conference for foreign media with the goal of displaying the transparency of China's defense spending. He stated that China's defense spending was below the international average, being less than 1.5 percent of GDP. Premier Wen asserted that China's defense spending process was fully transparent, as evidenced by the fact that spending on troops was the single biggest item. In July, in response to reports from the Japanese media that China's actual defense spending would be up by 50 percent over the Chinese government's officially announced figure, the Ministry of Defense stated that the government was concealing nothing with regard to defense spending, and branded the reports as completely unfounded. The ministry insisted that defense spending levels continued to be determined rationally and appropriately in conformity with China's economic growth rates and in the light of the country's need to bolster its defense capability.

Overseas media observers and analysts have attributed the decline in China's defense spending below 10 percent in fiscal 2010 to a variety of causes, including the impact of the economic downturn. For example, *Military and Security Developments Involving the People's Republic of China 2010*, a report issued in August by the US Department of Defense, states that the pace of growth of China's defense spending continues to outpace the country's GDP growth, albeit only slightly, and opines that too little attention has been given to the effect of increased defense spending on China's economy. The report also dismisses the

**Figure 1.7. China's defense budgets**




*Source*: Chinese Ministry of Finance, *Budget Report to the National People's Congress* (various years); Chinese National Bureau of Statistics, *China Statistical Yearbook 2009*.

likelihood that the Chinese leadership's priority on developing the nation's military has been or will be significantly affected by the economic downturn, and explains the recent curbs on defense spending as a cyclical phenomenon coinciding with the final year of the country's five-year plan.

In a report written by Tai Ming Cheung, an associate research scientist at the University of California San Diego, he quotes PLA academic, Major-General Luo Yuan of the Academy of Military Sciences (the PLA's premier strategic think tank) as saying, "this year's 7.5 percent increase signaled that China's defense development has entered a more mature, healthy, and stable stage." Cheung points out that year 2011 will be the first year of the Twelfth Five-year Program, and that past precedents suggest that the level of defense budget increases in the first year of a five-year program provides a rule of thumb of the level of increases for the following four years. Therefore, he says, it will be interesting to see the level of year 2011's defense budget growth.

### (3) Prospects and Issues for China's Economy—The Specter of Inflation and Efforts to Change the Economy's Reliance on Investments and Exports

After bottoming out in the first quarter of fiscal 2009, the Chinese economy is believed to have achieved growth of 9.2 percent for fiscal 2009 as a whole and 10.3 percent for fiscal 2010. This rapid recovery from the economic downturn stands in sharp contrast to the performance of the advanced economies. The reasons for this success are believed to be: (1) the central government has up to now maintained fiscal discipline, and the gross general government debt stood at around 17 percent of GDP as of 2008, which is the fruit of the above-described active fiscal measures undertaken in response to the financial crisis; (2) the government followed a vigorous monetary relaxation policy following the outbreak of the global financial crisis, lowering interest rates by stages over a short period from September 2008 and maintaining them at that low level; and (3) the balance sheets of the main pillars of the domestic economy—mainly general business enterprises and financial institutions—were not seriously damaged, and capital investment levels remained robust.

It was in March 2010 at the third session of the Eleventh NPC, held while China was in this way enjoying a smooth economic recovery, that Premier Wen Jiabao reported that China had endured its most difficult year since the start of the century. Wen praised the country's response to the international financial crisis and its swift economic recovery, and forecast that China would realize stable and relatively fast growth thanks to the government's maintenance of active fiscal policies and its appropriate level of monetary relaxation. Premier Wen also pointed to a number of basic policies that should be followed in the drafting of future measures: (1) stronger macroeconomic control and the maintenance of stable and relatively fast economic growth; (2) a reform of the economic development pattern, and the adjustment and optimization of the country's economic structure; and (3) unified development of urban areas and rural communities, including reinforcement of the nation's agricultural and village base. Premier Wen also stressed the importance of seeking not solely faster economic growth, but also efficiency and an improvement in the quality of life. These policies can be seen as a recognition of the danger posed to the future stable and continued growth of the Chinese economy of the short-term market risks that have come to the fore during the recovery process, in addition to structural issues that had been pointed out earlier.

The market risks involved consist of the overheating of the real estate market from the latter half of 2009, the fact that a large proportion of loans made to finance infrastructure projects in the provinces have turned into bad debt, and the impact on the markets of the specter of inflation. In the face of these risks, the central government has implemented a tight monetary policy, raising short-term interest rates and the reserve deposit rate, and tightening credit controls through supervision of the banks. Meanwhile, the structural issues include problems with corporate governance, and sharp disparities in income levels between social classes as well as between urban and rural communities. To realize continued economic growth, the Chinese government needs to achieve a balanced growth pattern by boosting domestic market demand and eliminating the worst disparities, and it must change the structure of the economy, whose growth up to now has been driven primarily by exports and investments. If such efforts to stimulate domestic demand help to lower China's trade surplus with the United States, this would alleviate much of the external pressure China faces to raise the exchange rate of the renminbi and improve China's economic relations with other countries. This is a major challenge for China, which, as a member of the Group of Twenty, seeks to play a significant role complementing that of the advanced economies.