Discussion of: "Power and Resilience: An Economic Approach to National Security Policy" by Olivier Kooi (UChicago)

César Sosa-Padilla

Notre Dame, NBER

Summary

- This paper highlights the **national security externality**, focusing on resilience to conflict as key to enhancing bargaining power.
- It shows how investment subsidies, reshoring, and strategic trade policies can be used to strengthen resilience.
- A quantitative model is used to assess economic strategies in conflict scenarios, like the U.S.-China-Taiwan situation.
- Expanding global trade increases the need for policies that boost domestic resilience and limit adversaries' resilience.

National Security Externality

Resilience $\equiv V^{S,C}(\bar{k}_0^S, \bar{k}_1^S) - V^{S,P}(\bar{k}_0^S, \bar{k}_1^S)$

Planner's optimality condition:

$$\frac{\partial V^{S,P}(\bar{k}_0^S, \bar{k}_1^S)}{\partial \bar{k}_g^S} + \theta_A \left(\frac{\partial V^{S,C}(\bar{k}_0^S, \bar{k}_1^S)}{\partial \bar{k}_g^S} - \frac{\partial V^{S,P}(\bar{k}_0^S, \bar{k}_1^S)}{\partial \bar{k}_g^S} \right) = \mu^S$$

Decentralized optimality condition (w/o intervention):

$$\frac{\partial V^{S,P}(\bar{k}_0^S, \bar{k}_1^S)}{\partial \bar{k}_g^S} = \mu^S$$

Therefore, can figure out the optimal subsidy:

$$s_g^S = \theta_A \left(\frac{r_g^{S,C}}{r_g^{S,P}} - 1 \right)$$

Optimal Policy Interventions

- Investment subsidies should be directed to capital goods that appreciate in value during conflict
- Clear tradeoff
  - reallocating capital to $\uparrow V^C$ causes $\downarrow V^P \implies$ Resilience $\uparrow$
  - but you pay for it bc in eqm you have peace, with lower welfare.
- Trade policies can be leveraged to improve domestic resilience and reduce that of adversaries.
  - This is shown in the full model (w/ trade)
- Policy interventions are validated through quantitative exercises, such as reshoring production in key sectors.

Friendshoring by subsidizing FDI?

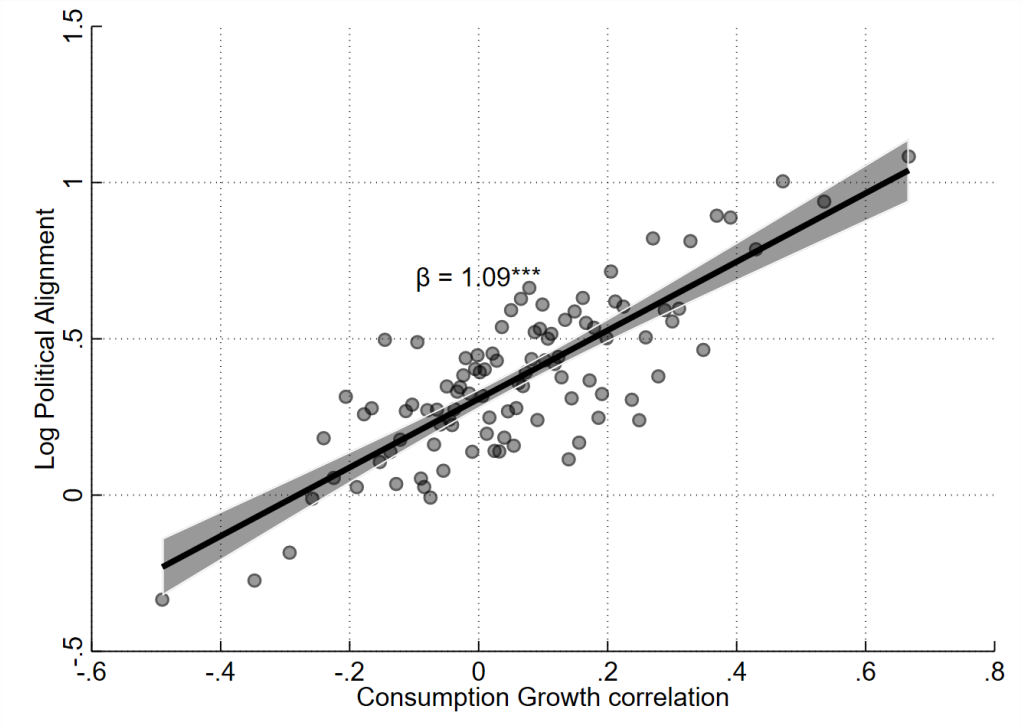
- Result in the paper: use trade policy to induce allies to increase capital in sectors that will be critical during a conflict
- Sounds like going against the 'targeting principle'
- What about subsidizing those investments directly? (Maybe via FDI)
- Random reference:
  - Thought of this because of an Azzimonti-Quadrini (RESTUD) paper on bailouts
  - Country $\mathcal{A}$ finds it optimal to bail out country $\mathcal{B}$, just to avoid a default that would damage country $\mathcal{A}$'s banks

Relationship with fragmentation

- Another way of reducing adversaries' resilience is to manipulate (lower) the return on their assets
- Imagine $\mathcal{S}$ (some western country) is a net borrower from $\mathcal{A}$ (China). A (partial) default of $\mathcal{S}$ will hurt $\mathcal{A}$ and lower its resilience.
- However, ex-ante, $\mathcal{A}$ will offer lower prices for $\mathcal{S}$ bonds. This will induce $\mathcal{S}$ to borrow more from allies/friends $\rightarrow$ **fragmentation in capital flows**
- We are thinking of these dynamics in a new paper: Bianchi, Horn, Grosso, and Sosa-Padilla (2025)

Relationship with fragmentation & risk-sharing

- Politically aligned countries have more synchronized business cycles



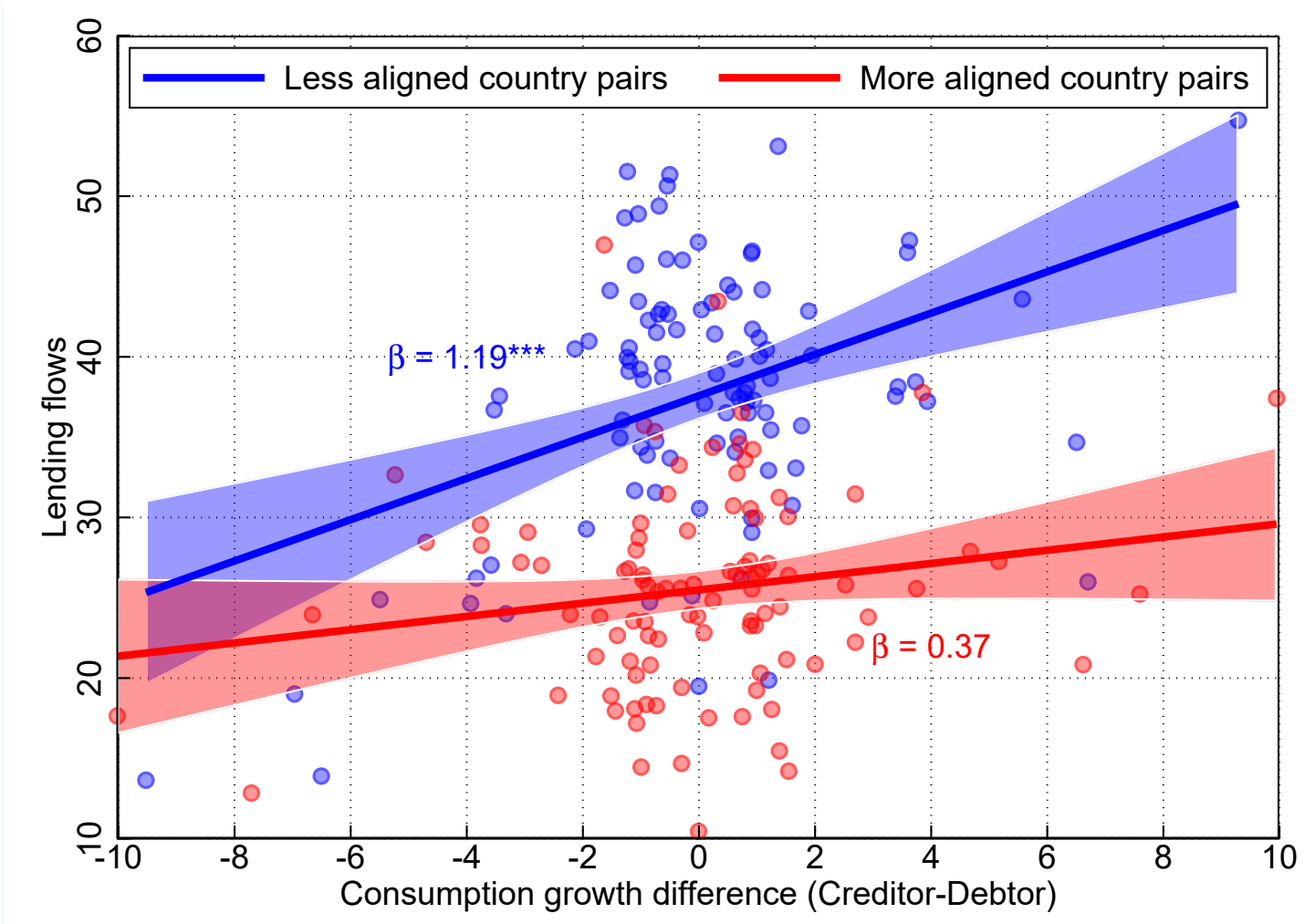
- So, fragmenting along geopolitical lines is **bad** for risk-sharing
- This lowers resilience $\rightarrow$ another dimension to consider when designing the optimal interventions

Last slide

Main conclusion: "... national security concerns are simple to incorporate into the standard economic framework. By doing this one obtains a framework that can be applied to a wide range of national security questions."

- Exciting paper and agenda
- Clear presentation of the core idea
- Maybe the paper has too many applications ... but it's hard to let go of interesting ideas!

Extra slide – Geopolitical Fragmentation and Risk-Sharing



Correlation btw consumption growth difference and lending flows at the country-pair level. The data are plotted separately for two groups: in blue country-pairs in the bottom half of political alignment and in red the top half. Data points are grouped in 100 bins for each group. We show a line of best fit and a 95% confidence interval.