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## THE STRATEGIC CONSEQUENCES OF THE GLOBAL FINANCIAL AND ECONOMIC CRISIS

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# The Strategic Consequences of the Global Financial and Economic Crisis

Working Paper No. 31  
of the  
European Security Forum

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# Chairman's summing-up

Michael Emerson<sup>1</sup>

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This 31<sup>st</sup> session of the European Security Forum on the strategic consequences of the global economic and financial crisis took place on 20 February 2009, at a time when the crisis seemed still to be deepening. The graphs of industrial production and global trade looked as if the world economy had fallen off a cliff, without showing any signs of hitting bottom. The losses of output and trade had not yet reached 1930s proportions, but they were already way beyond any post-World War II experience in terms of gravity. No member of the panel claimed to know what was going to happen next: no-one volunteered to forecast the timing of a rebound, or to predict a sharp rebound versus a decade long (Japanese style) stagnation.

Brad Setser of the Council for Foreign Relations, New York, underlined the gravity of the current crisis, with annualized data for the fourth quarter of 2008 pointing to huge output losses for industrial production and trade, most of all in Asian economies heavily dependent on exports. As the crisis passed on from the localised US sub-prime affair of 2007 into the global crisis of 2008, new financial vulnerabilities have emerged, especially at the level of Chinese financing of US deficits, now running at the unsustainable pace of about \$400 billion a quarter. Chinese official investors are now giving priority to the comparative security of US Treasury paper, after painful experiments at investment in riskier assets. This has boosted the dollar exchange rate, but leaves the US strategically exposed to funding by non-democratic states (Gulf as well as China). Setser called this a dangerous game. The ideal scenario is for the US-Chinese current account imbalance to get onto a glide path towards reducing deficit and reliance on Chinese funding, but there was no sign of this happening.

For his part Lanxin Xiang of the Graduate Institute, Geneva and Fudan University, Shanghai, advocated a massive shift in Chinese economic policy, away from excessive export dependency and into social welfare and education programmes, which he called Chinese Keynesianism. If this was accompanied by dissaving by the government (i.e. deficit spending) it could indeed cut the current account surplus and get away from the huge and wasteful investment in US Treasury assets. However, there was no assurance that this was going to happen on a scale sufficient to set the US-China imbalance on a correction course.

Fyodor Lukyanov, editor of *Russia in Global Affairs*, characterised the Russian situation now as having shifted from the past decade of 'automatic growth' to a new period of 'automatic decline'. With the rise of oil and other commodity prices the Russian economy could not but grow, and now there was nothing that could prevent a very painful period. However, he portrayed Russian society as being adaptable in the sense of being able to endure hard times. So far the authorities had been reasonably successful in keeping to a stable path tactically, e.g. with a smooth and controlled depreciation of the ruble. However he speculated that the present tandem leadership would be under strain, with a possible shift of power to the Kremlin. Russia's foreign policy priorities would become more constrained, with less priority for initiatives in distant places (e.g. Latin America), but new opportunities in the former Soviet space, as these countries were coming to Moscow for economic aid, which no-one else seemed willing to supply.

Richard Youngs, of FRIDE and CEPS, saw the crisis accentuating the trend in EU foreign policy, which he characterised as pulling back from the serious promotion of a liberal democratic order. This had the effect of sacrificing the EU's comparative advantage as a global actor. The pressures for protectionism were evident, but not yet amounting to a qualitative change. He saw the emerging multi-polar world in increasingly Hobbesian terms, but raised questions nonetheless over how non-democratic regimes would fare in the adequacy of their responses to the crisis. An EU official

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<sup>1</sup> Senior Research Fellow, CEPS.

remarked that ‘maybe’ Youngs was right in detecting a retreat from liberal cosmopolitanism, but noted that Europe’s political values were very deeply rooted.

The deteriorating situation in Eastern Europe was described by a Commission economist. This was not just the shock impact of the global financial crisis. The transition indicators of the EBRD had been stagnant now for several years, and notably so for Ukraine. “Back to basics” was his message, i.e. an inevitable need to revert to hard adjustment policies. The emergence of Russia as supplier of financial aid to several CIS countries including Ukraine meant that there was a new case for the coordination of EU policies in the region with those of Russia, as well as with the IMF, for which there is already experience to build on. This remark met with the agreement of the Russian diplomat, remarking that there is the need now for frank discussions over our goals for the region, and over what to do together, rather than acting in a competitive mode. The chair remarked that this would be quite a revolutionary prospect, but one to be greatly welcomed.

In discussion over the possible political impact of the crisis on the world, Youngs’ supposition was that it would be bad news for fragile democracies, and would push authoritarian regimes into more repressive measures. This argument was met with sceptical comments from Lukyanov and Xiang. For Lukyanov Russia’s failed democracy would continue to navigate between semi-authoritarianism and semi-democracy. For Xiang China had its own system, with its own logic. Whether or not Western democracy was better placed to face up to the crisis, he was not sure.

A number of more specific themes were touched upon. A discussant on the social consequences contrasted the situation at least in Europe with that of the 1930s. Today’s advanced social security regimes and large public sectors ensured that powerful automatic stabilisers would be activated. Nonetheless large differences in labour market flexibility between European countries would see mean difficult adjustments in the most rigid of regimes, versus more organic adjustments to follow naturally in the more flexible regimes.

The structure of the presentations and debates came to take on a certain shape: one of different combinations of pairs among the four actors under consideration: the US-Chinese pair locked in a uniquely important but dangerous financial interdependence; the EU-Russia pair due perhaps to become more cooperative together with shared concerns for their common neighbourhood; and the EU-US democrats compared to the Chinese-Russian (semi-) autocrats now engaged in testing which regimes will prove best able to handle the crisis.

# How will the financial crisis affect EU foreign policy?<sup>1</sup>

Richard Youngs<sup>2</sup>

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Attention is beginning to turn to the broader political impact of the financial crisis. The question arises of whether the crisis will affect the EU's broader foreign policies – and if so, how.

On this a degree of consensus is evident in commentators' preliminary musings. Many voices are already suggesting that the crisis is likely to mark a turning point in international relations of the same magnitude as those produced by the fall of the Berlin Wall and the attacks of 9/11. Many predict a weakening of support for economic liberalism beyond the immediate banking crisis. And many also foresee the crisis triggering a fundamental shift in the global balance of power and even infecting the liberal political values that ostensibly lie at the heart of European foreign policies. In short, the fear is taking hold that the financial crisis will undermine the principal tenets of Western-sponsored global liberalism and encourage a retrenchment in US and European diplomacy.

With the situation still in flux, worst-case scenarios remain a distinct possibility. But it is more convincing for the present to caution against such apocalyptic reasoning.

In this regard, two arguments are advanced here. First, the financial crisis is unlikely to represent a watershed moment for EU foreign policy. It is more likely simply to reinforce a number of trends already in train. Second, it would be wrong for the EU to respond to the crisis by withdrawing into itself and abandoning the cause of liberalism – in either its economic or political dimensions. To suggest that the crisis reflects an excess of political and economic liberalism is misleading and likely to result in damaging policy responses. The EU has been shifting away from liberal trade and foreign policies for a number of years. The crisis in part reflects such a trend, while also threatening to further tempt European governments away from cosmopolitan internationalism. This might seem an apparently paradoxical conclusion to draw at present, but one that would better safeguard long-term European interests.

## The fate of liberalism

Some commentators have argued that the crisis risks undermining the whole appeal of free market capitalism. The EU's international leverage is based in large measure on the 'normative appeal' of its own internal market. Surely, many suggest, that influence stands to diminish now as the crisis exposes the fallacies of 'unfettered capitalism'.

Yet it is important here to take a critical view of the hyperbole that has flooded press comment. The financial crisis is clearly a cataclysmic event. On some indicators it has surpassed the gravity of the 1929 crash and has exposed the worst excesses of capitalism that have been allowed to flourish in recent years. It represents a serious case of market failure, asymmetrical regulation of different parts of the financial system and lax supervision having failed to forestall banks becoming massively over-leveraged.

Prior to the crisis economic policies were based on the West providing capital to emerging economies and supporting a liberal trading regime as a means of importing goods back into European markets. The whole geopolitical balance of this bargain has now shifted. The West is now set to export less

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<sup>1</sup> An earlier, shorter version of this paper appeared as a FRIDE Policy Brief, November 2008, [www.fride.org](http://www.fride.org)

<sup>2</sup> FRIDE, Madrid.

capital, while China's unparalleled liquidity will enhance its power. It is argued that the 'liberal equation' has been undermined.<sup>3</sup>

But it is doubtful that recent events entail the kind of general crisis of liberal markets as suggested in particular by some French, German and Spanish ministers. Contrary to much media comment, the problem is not the wholesale spread of 'unfettered markets'. Government accounts for more than twice the share of GDP than it did in 1929. European states all operate a mixed economy and will continue to do so.

What has been striking is the lack of full European integration and transnational supervision in the financial sector. It is this that has produced responses geared towards protecting national markets rather than an overarching European plan – notwithstanding the loose coordination that has gradually taken shape at an inter-governmental level.

Extracting the foreign policy implications from this understanding of the crisis requires a finer-grained understanding of recent trends in EU external policies. The very real risk is that a crisis rooted in the malgovernance of the financial sector will encourage European states to adopt a less liberal stance on external economic policies across the board – and that a wounded Europe will retreat into a new protectionism.

To point out that the EU will now find it harder to sell a model based on the free market and governance standards outside its own borders misses a crucial fact: in recent years the EU has been circumspect in promoting such liberalism through its external trade anyway.

The EU has already done more than its fair share to sink the Doha Round. It has ended its own moratorium on bilateral trade deals to pursue talks with important Asian economies to the detriment of its supposed commitment to the multilateral trading system. The EU is seen around the world as the worst culprit of intensified 'standards protectionism'. For several years now the rhetoric of most EU ministers and commissioners has constantly stressed what there is to fear from globalisation more than the benefits that flow from it.

While the EU has been criticised for imposing reciprocal market-opening on African states through new Economic Partnership Agreements (EPAs), it is also the case that member states have wrested control over EPA talks from the Commission's trade directorate in order to inject a 'development mandate' and somewhat dilute liberalisation requirements placed on Cotonou partners. Indeed, most European donors still pursue a very statist model to development and post-conflict reconstruction. The EU has, of course, also baulked at extending EU membership. And its determination to spread standards of trade- and investment-related good governance has weakened.

Curiously, continental European politicians have been far more vociferous in declaring that the financial crisis represents 'a defeat for the market' and liberal economics than has the Chinese Communist Party!

It is too early to determine whether there will be a full-scale retreat into protectionism. But the early signs do not look good. Since the outbreak of the crisis European ministers have ritually promised that there will be no slide towards protectionism. The more ardently they state this, the more they contemplate just such measures.

The trend is towards 'protection lite'. The EU has not adopted out and out trade restrictions but a series of actions that militate against international interdependence. The EU reacted vigorously against the 'Buy America' campaign launched under the new Obama presidency, but several similar 'buy national' campaigns have been supported in Europe too. State aid rules have been relaxed. Financial bail-outs have gone hand in hand with governments encouraging banks to retreat into national markets. Some accuse the UK of letting the pound fall as a protectionist measure. France has offered

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<sup>3</sup> Roger Altman, "The Great Crash 2008: A Geopolitical Setback for the West", *Foreign Affairs*, Jan-Feb 2009.

soft loans to companies on condition they use local suppliers. Gordon Brown lectures the world on the dangers of protectionism; but for one commentator the prime minister's own inward-looking policies render him 'hypocrite-in-chief'.<sup>4</sup> In the US Democrat free traders have refused to criticise the Buy America initiative in part because they insist that European procurement rules are still far more restrictive. Middle Eastern, Russian and African interlocutors have all ironically suggested to diplomats that the European spree of bank nationalisations mirrors the statist route for which the EU has for so long admonished developing countries.

Member states such as Germany, France and Italy have introduced restrictions on Sovereign Wealth Funds. A new German law restricts access of foreign buyers, in particular big Chinese and Middle Eastern SWFs. President Sarkozy has moved ahead with creating a French fund explicitly to fend off such foreign 'predators'. The so-called Santiago principles agreed in October 2008 to open up east-to-west investment are now in doubt. EU populations now perceive open trade very much as a risk more than an opportunity. The rise of the Linke (leftist) party under Oscar Lafontaine in German polls is seen to be the result of its highly protectionist platform.

Some have welcomed the prospect of a humbled Europe, in the midst of nationalising swathes of its own financial sector no longer being able to impose IMF-style structural adjustment on developing countries. But this caricatures the nature of EU external economic policies in recent years. EU policies still require greater finesse to ensure that developing states are helped into global markets in a way that does not undermine local wealth generation. But even before the crisis struck, the challenge was to turn Europe away from inward-looking market protection and self-interested mercantilism much more than it was to rein in any free-trade, structural-adjustment fervour. This challenge is likely to be magnified after the autumn of 2008.

Contrary to the very thing it is supposed to excel at, the EU has failed to use a liberal concept of economic order as the basis for a strategy to support security objectives. In terms of the much-lauded (but confused) concept of EU 'normative power' one wonders how much there was to salvage from the wreckage of the 2008 financial crisis anyway.

While the crisis entailed a major failure of market mechanisms, it should at its core be understood as a crisis of bad governance rather than one of market-capitalism per se. In this sense, whatever the shortcomings exposed in the US and European economies, governance problems remain much more serious outside the West. If the crisis does spread to Asian and other markets this is likely to become painfully apparent.

The crisis may then help propel forward a broader and more assertive international focus on governance standards and regulations. The end result of the crisis may be to intensify pressure for international, and maybe even supranational, good governance regulations. This is precisely the EU's supposed niche in international relations. It is where the EU can assist in both tempering the excesses of US deregulation and improving multilateral rules and governance. The crucial thing will be to ensure that such regulations work to facilitate, rather than restrict, global trade and investment.

## Power shifts

A second widespread prediction is that the financial crisis will hammer the final nail into the coffin of the 'unipolar moment'. For analysts who have long seen the liberal world order underpinned by US hegemony, this is seen as a harbinger of global instability. The journey from unipolarity to 'balanced multipolarity' will certainly be difficult to navigate without events leading the world into far less benign forms of 'competitive multipolarity.' And certainly not a voyage best undertaken in the current storm of panic and confusion.

However, that the crisis will unleash such a fundamental shift in relative power is by no means certain. Few commentators have resisted the temptation to draw parallels with 1929 and its subsequent global

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<sup>4</sup> Martin Wolf, "Why Davos man is waiting for Obama to save him", *Financial Times*, 4 February 2009, p. 11.

after-shocks. But for the current financial crisis to end up triggering serious international conflict the whole framework of collective security put in place since the 1940s would have to unravel. The cushioning effect of international institutions and cosmopolitan civic organisations simply did not exist to the same extent in the 1930s as today.

It is by no means certain that European economies will emerge stronger from the crisis than the United States. The latter retains its higher productivity and innovation base. Speculation that the time is once more ripe for the EU to challenge US leadership looks premature. As always, any decline in US relative power is anyway a mix of both boon and bane for Europe: a relative gain vis-a-vis Washington can be off-set by accompanying US introversion in promoting a broad set of global liberal values.

Conversely, it is not clear that the emerging powers will escape unscathed. Russia has been harder hit than any EU economy. Indeed it is ironic that the crisis has exposed underlying weaknesses in Russia's economy and system of governance just as the EU was fretting over how to respond to the changed European security panorama ushered in by the August 2008 Georgia conflict. Once again, this has reinforced the fact that the balance between Russian assertiveness and Russian fragility is a fine one. Still, dealing with the post-Georgia scenario may remain a greater diplomatic challenge than anything thrown up by the financial crisis. In this sense the EU's measures – a 500 million euro aid package to Georgia and a relatively weak monitoring mission – are no more than short term palliatives. In a situation where the EU's model of 'transformation through integration' has so far failed, policy-makers are bereft of long-term solutions. The positive outcome would be that the financial crisis tempers Russian adventurism while also making clearer to EU governments that engagement with Moscow cannot be based only on traditional forms of geopolitical balancing devoid of any consideration of internal Russian problems.

In general, while many have predicted a relative rise in power of resource-rich states, one of the casualties of the crisis has been the international oil price – at the time of writing this has halved since the crisis erupted. The Iranian economy is being hit hard, for example. It is true that several powers may feel emboldened in their dealings with what they perceive to be a weakened West; but they themselves may be left feeling chastened too.

It seems likely that China will emerge a more powerful actor as a result of the crisis, by virtue of its financial assets and the fact that it was not responsible for the crisis. With the West hoping that China can re-inject liquidity back into the global economy, Beijing will likely demand a greater say in international financial institutions in return. But it also the case that Asia itself teeters on the brink. Regulatory structures were strengthened after this region's 1997 financial crisis but experts have pointed to a decline in basic governance standards in several key Asian economies. As of this writing, the crisis seems to be arriving at China's shores. This has added grist to the mill of those arguing that the sustainability of the 'China model' has begun to look increasingly questionable in recent years.

There were already compelling reasons of enlightened self-interest for Europe to cede its over-representation in international bodies before the crisis struck: if it does not emerging powers are increasingly likely to bypass such institutions. The new prominence of the G20 reflects a trend long in gestation.

Some analysts have begun to go even further and suggest that a shift in international power will undermine not just economic liberalism but a broader set of liberal *political* values. The Economist Intelligence Unit has drawn attention to the prospects of the financial crisis undermining democracy and democracy promotion in many places of the world. In terms of Europe's 'soft power' most commentators had already been making stark comments about the declining appeal of 'Western' democratic and human rights ideals. But the key will be how democracies deal with the crisis. If they succeed better than non-democratic states then pluralism's appeal could actually rise. If they demonstrate that – in the spirit of Amartya Sen – openness and robust democratic debate can help mitigate crises better than autocratic guidance it is not inevitable that the crisis will be entirely negative for democratisation.



## Resource diversion

A final concern is that scarce resources will be shifted away from international priorities.

The most obvious fear is that spending on development assistance could be an early casualty. Some EU member states are already intimating at cuts in the less high profile areas of aid priorities. Funding to help meet renewable energy targets already seems to be at risk. And money for inclusive migration policies could diminish, hand in hand with a rise in populist nationalism.

But there are some reasons to hope this will not be the case across the board. Budgets for overseas development assistance (ODA) are a small percentage of the amounts of funding that European governments have found for their respective bail-out packages. Cutting back development aid would make little dent in newly-increased public debt levels, but would inflict a heavy political price on governments already under intense public scrutiny for having ‘bailed out the fat-cats’. The huge amounts of money that governments have spent on rescuing banks may even make them more vulnerable to public admonishment for any cuts in development aid. Most ODA is locked into multi-annual budgets and oriented increasingly towards meeting the Millennium Development Goals in relation to which EU governments have made so many promises.

It has often been noted that rich countries may look to increase ODA when their own economies are under stress. Internal crisis heightens the concern to temper instability in and migration from the developing world. The link between development and security has been placed at the centre of EU foreign policy; European policy-makers would lose considerable credibility were they to retract from such a logic precisely when its more effective implementation is required – precisely when, that is, such a forward-looking and holistic commitment to development presents itself as one necessary part of systemic stabilisation rather than, as realists would have it, a mere ‘feel-good luxury’.

Defence spending would seem to be far more at risk. It is indeed reasonable to expect defence budgets to come under more intense pressure. Cutbacks are already on the cards in the UK. Defence budgets have conspicuously not been ring-fenced from cuts in the same way as health and social spending. From a liberal, Europeanist perspective this may be no bad thing. The new juncture may provide the much-needed prompt for EU member states to cut duplication and attain better value for money from their defence budgets. Most member states maintain huge numbers of soldiers in uniform that cannot be deployed and are completely useless for ‘fragile state’ type interventions. Now would be a good time to cut back waste and forge a more common and economical European defence architecture, better prepared to assist in peace support operations.

## Recuperation?

None of this is to minimise the seriousness of the crisis or to ignore the fact that events could still take an even more catastrophic turn. But it is to invite consideration of a paradox: that the ultimate lessons for EU foreign policies could be the opposite of what it would currently seem most sensible to argue. It should be remembered that despite the crisis and need in specific parts of the financial sector for state intervention and better market regulation, overall European economies still require more market competition and international interdependence not less.

The temptation to pull in the wrong direction will be strong. But the crisis may also provide a wake-up call. A wake-up call that Europe’s already-existing drift away from global (economic and political) liberalism is part of the problem not part of the solution. If development budgets do suffer this will certainly undermine Europe’s soft power, but here public pressure can help keep member states to their commitments. And while the crisis might tempt at least some member states into resisting any further EU enlargement even more fiercely, it could also raise the costs of ‘non-enlargement’ as European governments desperately seek out new market openings to recover growth.

The crisis may even provide a positive service if it convinces the EU that simply declaring ad nauseam that Europe has a wonderfully successful and progressive model of ‘normative power’ no longer suffices when events increasingly reveal exactly the opposite to be true – and increasingly require real effort and conviction to ensure that liberal foreign policies regain some reality.

# Strategic implications of the financial crisis

Brad Setser<sup>1</sup>

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**Z**hou Enlai's famous response to a question about the impact of the French revolution – “It is too soon to tell” – is overused for a reason. It certainly applies to any attempt to assess the strategic impact of the financial crisis.

The crisis has already been through two very distinct phases. The collapse in prices for complex ‘structures’ in August 2007 (‘the subprime crisis’) was followed by a fall in private demand for US assets, a depreciation of the dollar, a surge in the price of oil, a surge in China’s reserves and an increase in the United States’ reliance on non-democratic governments for financing to support its still-large trade deficit. The US economy slowed, the world economy did not. The relative position of the US fell. The collapse of Lehman brothers – ‘the Lehman crisis’, though that seems too narrow to describe the ‘great unwind’ of financial leverage that followed – unleashed another phase of the crisis. It led to a huge surge in demand for US Treasuries from central banks and private banks alike, a rise in the dollar, a sharp fall in the price of oil and a reduction in US demand for the financial assets of the rest of the world. The US government shifted from borrowing from other central banks (through the sale of Treasury bonds) to lending to other central banks, as the Fed’s swap lines supplied scarce dollars to other central banks. The US economy fell into a recession, if not something rather worse. But European output is falling at a comparable pace. The fall in output now underway in Asia looks to be steeper than the fall that accompanied Asia’s own crisis.

The crisis has dimmed the lustre of the US economic and financial model – no doubt a key part of the US soft power. The US financial system, until recently considered a model of sophistication, gave rise to a crisis that infected the world. The world’s willingness to adopt aspects of the US economic model has unquestionably declined. The United States itself is shying away from the stylised version of the US model. In other ways, though, the crisis has improved the relative position of the US: dramatic shifts in the global flow of funds and the fall in the price of oil – have worked to the advantage of the US, largely at the expense of the oil exporters. The United States’ external deficit is shrinking even as the world’s demand for dollars, at least temporarily, has increased. It now relies far less on non-democratic governments for financing than it did 12 months ago. However, the crisis is sure to evolve. Its long-term strategic consequences will hinge on which country proves most able to pull itself out of the current, severe, global downturn, and whether it does so by drawing on its own resources or borrowing (demand as well as funds) from the rest of the world.

This paper reviews the impact of the financial crisis on the strategic position of the US, Russia (and the Gulf), China and Europe. It is based on a key assumption: financial power tends to accrue to creditors not debtors and that thus relying on other countries’ governments for financing is a strategic vulnerability. Other prisms for analysing the strategic impact of the crisis would undoubtedly lead to different conclusions. The goal of this paper is to spur discussion of the strategic impact of the crisis, not to offer a comprehensive assessment.

## The United States

The US entered the current crisis with two enormous financial vulnerabilities: a leveraged financial system that had little resilience against shocks and a larger external deficit than could be financed in the private market.

The first vulnerability led directly to the current crisis. Poorly regulated banks, lightly regulated broker-dealers and the unregulated components of the shadow financial system all made an enormous, leveraged bet that the rise in US home prices would be sustained and large macroeconomic imbalances

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<sup>1</sup> Council for Foreign Relations, New York.

were consistent with low levels of macroeconomic and financial volatility. When home prices started to fall, the combination of leverage and financial complexity proved lethal to most major financial institutions. Some institutions initially raised capital from private investors and – to a lesser degree – from the sovereign funds of non-democratic countries.<sup>2</sup> Over the course of 2008, though, it became clear that financial losses were growing not shrinking – and more and more financial institutions failed.

An overleveraged financial system that lacked resilience in the face of shocks proved to be a larger risk to US taxpayers than to the strategic position of the US. The financial system will ultimately be recapitalised by the public purse, not by the wealth funds of non-democratic governments. The losses in the European and American financial system are now estimated to exceed the assets managed by the world's sovereign funds.<sup>3</sup>

The second vulnerability posed larger long-term strategic risks. The gap between the United States' need for external financing and private demand for US assets (private inflows, net of US purchases of foreign assets) was met largely by the purchase of US bonds by emerging market central banks. The sources of financing for the rise in the United States' external deficit that accompanied the recovery from the 2000-01 recession consequently differed from the sources of financing for past rises in the US external deficit. In the early 80s, high US interest rates pulled in funds from Japan and Europe. In the latter half of the 1990s, the United States' rising stock market pulled in funds from the world – including, after 1998, funds that previously had been flowing to an emerging Asia. For most of the 2000s, though, returns on US financial assets lagged returns on non-American financial assets. Not surprisingly, (net) foreign demand for US financial assets from private investors was restrained.<sup>4</sup> However, the enormous increase in the foreign exchange reserves held by the central banks of the world's emerging economies – China in particular – provided the net inflow needed to support the US deficit. Asian economies that import oil were adding record sums to their reserves – largely because they sought to resist Asian market pressure for their currencies to appreciate against the dollar – at the same time that high oil prices were generating record growth in the reserves of the oil-exporting economies.

This relationship had aspects of mutual dependence. Asian countries rely on the US to supply demand for their products as much as the US relies on Asian central banks for financing on terms that were not available in the market. The oil-exporters rely on the United States for demand for their crude oil –

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<sup>2</sup> Nearly all the investment in US and European financial institutions came from the Gulf, China and Singapore. But for every rule there is an exception: the Korean Investment Corporation (KIC) invested \$2 billion in Merrill Lynch (now part of Bank of America). Korea now regrets that investment: not only did it take large losses, but it also turned out to have a larger need for liquid financial assets than it anticipated when it set up the KIC.

<sup>3</sup> A related issue is whether relying on the sovereign funds of non-democratic countries to provide the capital for a large share of the financial system poses strategic risks. Hillary Clinton's comment about China "It is hard to enforce your trade law against your banker" presumably applies to the folks who own your bank too. Democratic change in autocratic states with large investments in the US could potentially jeopardise US financial stability; it isn't clear, for example, if a democratic Saudi Arabia would be willing to continue to hold most of its reserves in dollars. The current head of the national economic Council, Lawrence Summers, has highlighted another risk, namely that investments in regulated banks by foreign governments would necessarily turn a banking crisis into a foreign policy crisis. The decision to shut down an insolvent bank and wipe out its equity – including the equity of a sovereign fund – could easily be perceived abroad as the confiscation of its investment.

<sup>4</sup> For a time, the expansion of the shadow financial system – which operated offshore – masked the absence of private demand for US financial assets. The shadow financial system led to a huge increase in gross flows, as vehicles legally domiciled in London (and European banks) issued short-term dollar debt to US money market funds to finance the purchase of longer-dated US asset backed securities. This led to matched inflows and outflows, leading gross flows to increase. However, such matched flows couldn't meet the financing need associated with the US current account deficit, which required a net build-up of foreign claims on the US. The shadow financial system took the credit risk associated with lending to risky US borrowers, but not the currency risks associated with lending to the US.

and in some cases protection – as much as the US relies on the oil-exporters for financing. Any sudden interruption in the relationship would have damaged the economies of both the borrower and the lender. But the persistence of large deficits financed by the build-up of reserves implied growing underlying risks – and a large build-up of US treasury and agency bonds in the hands of foreign central banks.

The cheap financing from central bank reserves classically has been viewed as a ‘good thing’ – and as a source of national power. The ability to borrow allows countries to spread costs – including the costs of wars – over time. As long as other countries could not reduce their dollar reserves without risking their own financial stability, it was hard for any country to translate its dollar holdings into leverage over US policy. The asymmetries in this relationship though were changing. Key countries – notably China – built up dollar reserves well in excess of what they needed to guarantee their own financial stability. The US increasingly risked finding itself in a position where it needed central banks around the world to add to their reserves more than the central banks actually needed more reserves.

Of course, no country with a large current account surplus that is adding to its reserves rapidly could stop doing so without risking its own exports. As a result, the US increasingly relied on the desire of other countries to support their own exports – not the intrinsic appeal of US financial assets – to offset its low savings rate. The current head of the national economic council, Lawrence Summers, referred to this relationship as the “balance of financial terror” back in 2004. Summers’ analogy to the balance of nuclear terror implicitly raises the question of whether the United States reliance on other countries government for financing posed a strategic threat. Even if other countries could not cut the United States off without risking their own economies, awareness of its need for financing could constrain the United States’ policy choices.

The strategic impact of other countries’ surplus reserves could express itself in other ways as well. The availability of alternative sources of large quantities of dollar financing could reduce the United States’ ability to use other countries’ need for dollars in a crisis as a strategic tool. Countries with large quantities of reserves have more strategic freedom of action; they are less likely to be deterred from taking geostrategic risks by the possibility that their actions could precipitate a financial crisis.

The United States’ strategic and financial vulnerability increased after the price of securities constructed from subprime mortgages collapsed in August 2007. The dollar had been moving down against the euro over the course of 2006, as initial downturn in residential investment pulled down US growth. After a brief rally as European institutions scrambled to find dollars to repay their dollar debt, the dollar’s fall accelerated in autumn 2007. Moreover, the dollar’s fall against the euro was simply the most visible manifestation of a broader decline in foreign willingness to hold US financial assets – and a rise in US demand for foreign financial assets. The US economy – but not the world economy – slowed, and private capital moved from the stagnant US to the fast growing parts of the world. Asian reserve growth soared, as central banks in all emerging Asian economies – not just China – added huge sums to their reserves to keep the dollar from falling against their currencies. At the same time, high oil prices pushed up the growth in the foreign exchange reserves of many oil exporters – and allowed others to transfer large sums to their sovereign funds. Emerging markets that kept their currencies pegged to the dollar encouraged this flow, as private investors started to bet that a host of fast growing economies would eventually allow their currencies to rise. Countries that pegged to the dollar were importing loose monetary policy from the US at a point in time when their economies were generally doing well. The predictable result: an uptick in inflation in the emerging world.

During this period, the US external deficit fell as a share of US GDP, but not in nominal terms. And the US increasingly relied on central banks to make up for a shortfall of private demand for US assets. Many observers argued that financial power was shifting from West to East, as the US relied ever-

more-heavily on emerging market governments for financing. Niall Ferguson wrote in the *Financial Times*:<sup>5</sup>

We are indeed living through a global shift in the balance of power very similar to that which occurred in the 1870s. This is the story of how an over-extended empire sought to cope with an external debt crisis by selling off revenue streams to foreign investors. The empire that suffered these setbacks in the 1870s was the Ottoman Empire. Today it is the US. .... The US debt crisis has taken a different form, to be sure. External liabilities have been run up by a combination of government and household dissaving. It is not the public sector that is defaulting but subprime mortgage borrowers. As in the 1870s, though, the upshot of this debt crisis is the sale of assets and revenue streams to foreign creditors. This time, however, creditors are buying bank shares not canal shares. And the resulting shift of power is from west to east.

In other words, as in the 1870s the balance of financial power is shifting. Then, the move was from the ancient oriental empires (not only the Ottoman but also the Persian and Chinese) to Western Europe. Today the shift is from the US - and other western financial centres - to the autocracies of the Middle East and East Asia.

.... It remains to be seen how quickly today's financial shift will be followed by a comparable geopolitical shift in favour of the new export and energy empires of the east. Suffice to say that the historical analogy does not bode well for America's quasi-imperial network of bases and allies across the Middle East and Asia. Debtor empires sooner or later have to do more than just sell shares to satisfy their creditors.

The intensification of the financial crisis that followed Lehman's default brought this unstable equilibrium to an end. It did not end though with a fall in demand for US financial assets from emerging market central banks and a dollar crisis. Rather it ended with a huge contraction in US demand for foreign financial assets – and a rise in demand for safe dollar assets from borrowers abroad who had large dollar liabilities. As the entire global economy slowed, private money was withdrawn in mass from the emerging world. Bets against the dollar were unwound. Foreign demand for US financial assets didn't really rise – no one wanted toxic US assets. Private capital flows started to contract – but they contracted in a way that increased (net) demand for dollars. Americans sold foreign assets and called their loans to Europe's banks faster than private investors abroad sold their US assets. This shift, combined with the fall in oil prices that brought the United States' external deficit down, dramatically reduced the United States reliance on foreign governments for financing.

Indeed, the basic pattern of the past six years fully reversed itself in the second half of 2008. A shortfall in private demand for US financial assets gave way to a shortage of dollars in Europe and many emerging markets as private actors that had borrowed dollars scrambled to find dollars to repay their debts. The US – and international financial institutions where the US continues to have a lot of influence – helped meet that demand. The Fed, not China's State Administration of Foreign Exchange, acted as the world's dollar lender of last resort. In the third quarter, the US government provided more financing to the rest of the world – through the Fed's large dollar loans to European central banks that needed access to dollars to help their own banks – than it received. That pattern continued in the fourth quarter.

This isn't an argument that the crisis has been good to the United States. It clearly hasn't. The fiscal cost of the financial bail-out – and the fiscal cost of a necessary Keynesian stimulus to counter a stunning contraction in private demand – will add to the United States' stock of public debt. The burden of that debt is a limit on the United States long-run ability to project power abroad.

At the same time, a continuation of the trends that existed prior to the crisis would not have worked to the United States' advantage. During the course of this decade, the coffers of a set of countries that in

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<sup>5</sup> *Financial Times*, “An Ottoman warning for America, by Niall Ferguson, 2 January 2008 (<http://www.ft.com/cms/s/0/a3679558-b8d4-11dc-893b-0000779fd2ac.html>).

general didn't fully share US strategic goals were growing – and the US increasingly came to rely on the governments of countries that were neither democracies nor US allies for financing. The intensification of the crisis in autumn 2008 reduced the funds available to the governments of these countries – oil fell, and 'speculative' outflows reduced China's reserve growth. It also reduced the United States' trade deficit – and therefore the United States' need for financing from abroad. In this respect, it reduced – at least temporarily – a key US strategic vulnerability.

### **The oil-exporters: Russia and the Gulf**

In 2008, Russia needed \$70 oil – and comparably priced natural gas – to cover its imports. Oil averaged close to \$100, though obviously it was much higher in the middle of the year and much lower in the fourth quarter. When oil was high Russia – like many other oil exporters – received substantial capital inflows. Until the middle of 2008, Russia's private firms and banks were building up external dollar and euro debt almost as rapidly as Russia's government was building up its external reserves.

This changed last autumn. Oil fell sharply. Capital started flowing out of Russia even faster than it flowed in during the boom. The change in Russia's financial and strategic position over the past 12 months has consequently been extreme. The first phase of the financial crisis was marked by a huge rise in oil prices that worked to Russia's advantage. The second stage of the financial crisis, by contrast, has been marked by a large fall in oil prices and a collapse of private capital flows to emerging economies. Russia's reserves fell from close to \$600 billion to under \$400 billion in record time.

The crisis has had three effects:

- The government of Russia's oil and gas revenues no longer generate the funds needed to cover the government's spending commitments; it is consequently currently drawing on the fiscal stabilisation fund to cover a large fiscal deficit.
- Russian banks and firms – whether private, state-owned or owned by friends of the state – cannot refinance their maturing external debts, let alone finance rapid growth with new credit. Russia consequently has relied on its foreign exchange reserves and the foreign exchange that was slotted for its incipient sovereign wealth fund to cover the external debts of Russian banks and companies. This has kept Russian companies in Russian hands rather than handing them over to (generally) Western bank creditors, but it also has contributed to a rapid depletion of Russia's reserves.
- Russians themselves have gone from betting on the ruble to betting against the ruble. Dollars under the mattress that turned into rubles in the banks at the peak of the boom are once again returning to the mattress. The ruble has already fallen significantly against Russia's euro-dollar basket – and it remains under pressure.

A year ago, Russia looked to be a financial rock – with enormous and growing reserves and a large external surplus. It had plenty of funds to spread around, and growing external confidence. Then Prime Minister Medvedev was talking of the ruble's eventual emergence as a global reserve currency at Russia's own version of Davos.<sup>6</sup> Russia's strategic interests in Georgia likely meant it would have intervened no matter what its financial position. At the same time, Russia's \$600 billion in assets seemed to guarantee that Russia didn't have to worry too much about the impact of its foreign policy choices on its currency or its finances.

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<sup>6</sup> “We think the ruble could potentially aspire – as a freely convertible currency – to the role of a reserve currency to service transactions in those countries which are part of the ruble zone, which use the ruble for payments. We have yet to take a number of steps, in particular, to transfer trade in energy supplies into rubles, but in general I think this is an absolutely achievable task, it is interesting for Russia and for the CIS governments, but, in my view, it is also of interest to the entire outer world, because it can create a system based on using several reserve currencies.” (<http://www.reuters.com/article/topNews/idUSL2450096420080625>).

Today, Russia will need to accept large (and painful) policy shifts to reduce the drain on its reserves. Shedding \$100 billion of reserves a quarter simply isn't sustainable. Without policy change, Russia risks putting itself back in a position where it relies on external financial support. It is hard to believe that in October Iceland was exploring whether Russia might supply it with emergency financing on better terms than the IMF. Russia is still willing to deploy its reserves to support major strategic priorities – drawing Ukraine back into its fold, for example. But it has to make choices now that it could avoid when its financial resources seemed virtually unlimited. Some Russian oligarchs aren't going to be bailed out, for example.

The oil-exporting economies in the Gulf are in a similar – though less dire – position.

The Gulf countries are in aggregate net lenders to the world. When oil was high, the governments of all the large oil exporters were building up large central bank reserves or adding large sums to their sovereign funds. However, the aggregate data was driven by the funds the Gulf's governments invested abroad. At the same time as the Gulf's governments were building up large foreign assets, many private banks and firms were borrowing large sums from abroad. Many Gulf banks in particular came to rely on external deposits to finance very rapid loan growth. The UAE's debt to international banks that report data to the BIS rose from a little over \$30 billion in 2005 to \$110 billion in the middle of 2008. That total leaves out a host of intra-regional debts. It also overstates the distinction between 'public' external assets and 'private' external debts, as many 'private borrowers' are closely connected to the 'palace'.

The global economic crisis has made it impossible for many borrowers in the Gulf to refinance their external debts even as the fall in global stock markets have cut into the value of the foreign investment portfolio of many Gulf sovereign funds. Sovereign funds consequently feel squeezed on both sides. They are being called on to finance domestic bail-outs just when the value of their external portfolio hit a nadir.

Moreover, the average oil price the Gulf States need to cover their import bill – and their budgets – rose during the boom. Most Gulf States now need roughly \$50 billion oil to pay for their imports. The region's public investment boom – and the ongoing expansion of government budgets – can only be sustained if the region dips into its existing external assets to meet a host of domestic needs. The viability of many of the region's more ambitious internal development projects – and a fair amount of Dubai real estate – is in question.

The Gulf countries' financial position isn't as dire as Russia's financial position: the Gulf countries 'break-even' oil price is lower and their (combined) external assets are larger. Saudi Arabia was more conservative than many of the smaller Gulf countries and is consequently in better shape. But the region is also no longer flush. The Gulf's losses from the fall in global equity markets probably offset the roughly \$300 billion windfall the Gulf received from \$100 a barrel oil in 2008. And in 2009, the Gulf will almost certainly run current account deficits for the first time in a long time.

### **China: the wounded financial giant**

A crisis marked by a shortage of dollar liquidity would seemingly work to the advantage of the government of the country with by far the world's largest dollar reserves. China reports \$1.95 trillion in reserves – and its true reserves, counting the dollars stashed in the state banks and the cash held at the China investment Corporation – top \$2.3 trillion. About \$1 trillion of that has been invested in US treasuries and another \$600 billion or so in the debt of Fannie, Freddie and the other US government sponsored 'agencies'. Counting its modest equity investments and corporate bonds, China's total US portfolio likely exceeds \$1.7 trillion.

The foreign assets now controlled by China's State council are, put simply, staggering. A few examples. Before the disruption of the fourth quarter of 2008, China's reserves were growing at a \$600 to \$700 billion annual clip – faster than the reserves and sovereign funds of all the oil-exporters combined. China's non-dollar reserve portfolio would top the total reserves of all countries but Japan. China could repay its \$400b in external debt and have close to \$2 trillion left over. The combination of

China's large current account surplus and minimal external debt give it great potential freedom to use its reserves creatively. China is one of only a handful of countries that could lend out \$100 billion (or more) of its reserves without worrying that it might find itself short of reserves.

However, China hasn't been willing to use its reserves to extend its influence during the crisis. It has rebuffed most bilateral pleas for help. China did provide backstop financing for Korea through a network of swaps among Asia's central banks – in part because the weakness of Korea's won was a threat to China's exports and in part because it could do so through a cooperative regional framework alongside Japan. But it wasn't willing to offer Pakistan financing to prevent Pakistan from going to the IMF. Nor has China been keen to use its resources to help private firms that are short of capital and liquidity. After getting burned on its investment in Morgan Stanley, China's sovereign fund has repeatedly turned down requests from Western banks. And China, unlike Japan, hasn't been willing to provide the IMF with additional supplementary resources.

This reluctance may reflect a desire on the part of China's leadership not to disrupt the existing international system so long as the system – in China's eyes – continues to evolve in ways that work to its long-term advantage. It could also reflect a reluctance on the part of China to assume the mantle of global financial leadership, whether on its own or through the world's existing institutions for international financial cooperation. But it also likely reflects the political fallout from the financial losses China took on its initial investments in risky assets – along with China's concerns about the safety of its large holdings of the debt of Fannie Mae and Freddie Mac.

Put simply, China dipped into risky assets at the top of the market and then retreated from risk at the same time as the private financial system. Its quest to protect its portfolio from losses limited its ability to project financial power during the crisis.

The overwhelming majority of China's portfolio has been invested in safe government bonds (at least so long as the US doesn't walk away from Fannie and Freddie). As a result, China's portfolio has, in aggregate, performed far better than almost any other large investment portfolio. Only Japan – with a portfolio composed almost exclusively of Treasuries – has done better, as the crisis dramatically increased the market value of a portfolio of safe, liquid government bonds. However, Chinese politics has been dominated by the losses China took on the small share of its portfolio that was invested in risky assets in an effort to boost returns. In 2006 China began exploring new ways of managing its reserves to obtain higher returns. The state banks were allowed to borrow about \$100 billion of China's reserves in 2006 to invest abroad. And in 2007, China both created a new sovereign fund and allowed its long-time reserve manager (SAFE) to experiment with equities and other assets that carried a risk of losses. In aggregate, though, that meant that China was buying risky assets at the peak of the boom. China compounded that error with a string of specific bad bets: Chinese state banks took losses on their holdings of securities backed by subprime loans, the CIC took losses on its investment in the US private equity firm Blackstone and the US investment bank Morgan Stanley and a state investment company (CITIC) would have taken large losses from an investment in Bear Stearns if China's regulators had approved the proposed deal. The CIC even has taken losses on its safe investments: it had \$5 billion invested in the 'Reserve Primary Fund', an American money market fund that 'broke the buck' after investing in Lehman paper.

China responded to these losses – and concerns about the financial health of the Agencies – by shifting its portfolio toward the safest, most liquid bonds around: short-term Treasury bills. It likely bought close to \$200 billion of bills in the fourth quarter alone. By running to the most liquid Treasuries during a liquidity crisis, China protected itself from taking credit losses (it obviously remains exposed to large moves in the dollar). But its quest for safety also limited its ability to act as an emergency source of liquidity, and thus its political influence. The Federal Reserve – which sold its Treasuries to take on the risky assets that the markets were selling – emerged as the key actor stabilising a host of US and global markets. The Fed ended up lending \$600 billion to European central banks that needed dollars to help their own banks and stabilising the Agency market by indicating it would buy what China was selling.



The crisis has had a second impact on China: it has contributed to a sharp downturn in domestic economic activity and thus prompted China's policy-makers to focus on putting in place policies to limit the domestic downturn. China's downturn isn't totally a product of the global slump. China's property sector started to cool in the summer of 2008 – before the 'Lehman' crisis. The net result though is that one of the domestic engines of China's growth has stalled even as a sharp contraction in US and European demand has cut into the external demand for China's exports. China's exports were up 20% (y/y) in September. They were down 3% in December. And China's imports were down 20% (y/y). The latest data suggests that China's economy stalled in the fourth quarter of 2008. While that is better than the outright decline most other large economies experienced, it represents an enormous deceleration from the fast growth China enjoyed until recently.

China's leadership consequently seems to have defined its international objectives in a defensive way: it wants to avoid international commitments that might limit China's domestic freedom of action. For example, it has vetoed any international discussion of its exchange rate regime. It hasn't pushed to join other international groupings out of concern that membership would create pressure for China to give global concerns more weight in its economic decision-making. China's latent international financial power consequently hasn't been tapped.

## Europe

Setting Britain – which has all of the United States financial weaknesses and few of its strengths – aside, the impact of the crisis on Europe has been ambiguous.

The first phase of the crisis was marked by the euro's strength and relatively strong European growth. Indeed, European growth has exceeded US growth – after adjusting for US population growth – for most of this decade. It far exceeded US growth in 2007 and 2008. During this period the EU was the engine of global demand growth, with the EU's growing current deficit increasingly offsetting the emerging world's current account surplus. Housing and consumption bubbles in many countries on Europe's southern (Spain, Portugal), eastern (From the Baltics down to Bulgaria) and western (Ireland, UK) periphery fuelled its growth. European banks played a key role channelling funds from high savings countries at Europe's core – and the inflows associated with global demand for euro reserves – to the fast-growing countries on the periphery. Strong growth in Asia's exports to Europe sustained Asian export growth even as the United States non-oil deficit contracted. Conversely, the strong euro was creating serious difficulties for key European industries (aircraft most obviously). Much of the financing for the EU's aggregate current account deficit and Europe's global investment came from the emerging world's growing holdings of euro reserves.

In many ways, Europe was stepping into the role of the United States had previously played in the global economic system. The combination of euro strength and dollar weakness was creating incentives that were shifting the world's macroeconomic imbalances from the US to Europe, as Europe's deficit increasingly offset the surplus in Asia and the oil-exporting economies.

The second stage of the crisis, by contrast, has been marked by the spread of the financial crisis to Europe, with the losses European banks incurred on their US book triggering a broad contraction in all lending. Banks in countries with domestic real estate booms – notably the UK, Ireland and Spain – are facing additional domestic losses. Their losses at home in turn have led eurozone (and Swedish) banks to scale back their lending to Eastern Europe.

In effect, Europe – taken as a whole – is currently facing four interlinked financial crises. First, a host of European banks that previously had borrowed in dollars in the wholesale market to finance bets on risky US bonds have lost access to dollar financing. This liquidity shortage was addressed by the Fed's swap lines with the ECB, the Bank of England, the Swiss National Bank, Sweden's Riksbank and others. This allowed Europe's central banks to function as dollar lenders of last resort for the institutions they supervise. Second, a number of European banks have taken large losses at home and abroad. They, like their American counterparts, are effectively insolvent and in need of large scale equity injections. Third, the banks in Europe's core have dramatically scaled back lending to banks and firms in Europe's periphery, creating enormous pressure on a host of countries in Europe's East.

Fourth, the economic slump, the cost of the financial bailout and a repricing of risk across a host of markets has increased the borrowing costs of some of Europe's weaker governments. New York and North Carolina aren't being asked to pick up the cost of bailing out 'their' financial institutions; European countries with large banks sometimes are.

The resulting crisis is testing Europe's collective institutions for crisis management. The ability of Europe's nations and institutions to rise to this challenge will likely determine whether the crisis strengthens or weakens Europe's strategic position. This is most obvious with the crisis on Europe's eastern periphery.

In many ways, 'Europe' created a successful model for integrating the poorer countries in the East into Europe's industrial and political core. The perceived protection offered by membership in the European Union created a portion of the world where capital was flowing in the direction most expected: the wealthier parts of Europe were financing high levels of investment in poor countries, with rapid growth in the periphery in turn creating strong demand for the exports of many countries in Europe's core. The contrast with the Pacific – where poor Asian savers financed wealthy American consumers – is obvious.

However, this model clearly got taken a bit too far. Many countries in Eastern Europe were running current account deficits of over 10% of their GDP. Many households and firms in the East were borrowing in euros, effectively betting that their local currencies wouldn't depreciate against the euro. The result: many countries in Eastern Europe were vulnerable to an interruption in financial flows. The scale of the financing needs in many Eastern European countries though are so large that they cannot easily be met even with IMF's loans of the size provided to Mexico in 95. Hungary's IMF programme was supplemented with additional financing from the European Central Bank. Iceland's programme was augmented by additional financing from the Nordic countries and the UK.

The current crisis is consequently testing Europe's collective institutions for financial crisis management – particularly if the IMF is counted as part of 'Europe's' institutional infrastructure. Remember, European countries are heavily over-represented on the IMF's board – and with most IMF lending to European countries, it is quickly morphing into the European monetary fund. A successful response would augment Europe's strategic position; Europe would have demonstrated its capacity to manage a crisis in its own backyard – and laid the foundation for a European financial order that is less dysfunctional than the current global financial system. Capital could continue to flow downhill, to Europe's periphery and in the process facilitate the expansion of Europe's zone of democratic prosperity. Capital would just flow into the countries on Europe's periphery at a more subdued pace.

## Conclusions

The United States' most serious financial crisis since the Depression has led, surprisingly, to a rally in the dollar. The crisis coincided with an enormous reversal in global capital flows. All the trends of the past several years – whether large private capital flows to the emerging world that financed stunning growth in the emerging world's reserves or huge two ways through London as the shadow financial system expanded – have gone into reverse. The United States unique ability to create dollars – and its ongoing ability to borrow in its own currency – reasserted itself as a key strategic asset. A host of countries had to turn to the US, Europe and the IMF for financing, reviving a traditional avenue for American influence. Falling oil prices dramatically reduced the United States reliance on non-democratic governments for financing. The direct strategic consequences of oil's fall from \$140 a barrel to \$40 a barrel likely exceed the direct strategic impact of the financial crisis. In the second half of 2008, the United States government even became a net lender to the rest of the world (through the Fed's swap lines). The net effect was an improvement in America's international financial position – at least if that position is defined by the US need for financing from potential geostrategic rivals – even as the global appeal of the American model of capitalism fell.

Over time, the countries – and regions – that are most able to pull themselves out of the current slump will emerge in a stronger position than those countries that cannot. But even here the analysis is ambiguous: key countries are – appropriately – relying on government spending and tax cuts to

stimulate their economies. That – plus the cost of various bank bailouts – will add dramatically to the stock of public debt that will eventually need to be offset by higher taxes or reduced spending. The governments of countries that entered into the crisis with a stronger initial fiscal position will consequently emerge from the crisis in a stronger financial position. They may also end up in a stronger strategic position if the financial world shifts from worrying about the risk that a bank will fail to the risk that a government will fail to pay its debt. The core balance then, as always, is between taking on more debt to spur a recovery and the long-term costs of additional debt.

# Russia and world recession

Fyodor Lukyanov<sup>1</sup>

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The former Prime Minister of Belgium, Guy Verhofstadt wrote that:

2008 may well go down in history as a pivotal year: like 1989, when the Berlin Wall fell and the Iron Curtain was torn down; 1944-1945, when World War II ended, the United Nations was founded and the Bretton Woods Agreements signed, and when two new superpowers embarked on a fanatical race for supremacy; or 1919, 1815 or 1648 – the years, respectively, of the Treaty of Versailles, the Congress of Vienna and the Peace of Westphalia. All momentous events that marked the end of an era and at the same time heralded a new epoch in human history.<sup>2</sup>

There is no country left in the world that has not been affected by the general economic recession. All countries suffer from the same root cause of this disease (that is, an imbalance in the global economy, which stems from ‘blowing bubbles’). But the specific diagnoses, the way in which the disease runs its course, and the treatment methods are different everywhere. Economies pegged to natural resources (Russia, Kazakhstan, Iran, Arab countries, and Venezuela) are suffering from the crisis in one way; export-oriented countries (China and other Asian states) in another way; and advanced industrial countries in yet another.

The nature of the changes and a new global alignment of forces will depend on how much the leading world actors have been affected by economic problems and, therefore, on the extent to which they will retain the ability to implement their international agenda. Most likely, everyone will have to be more economical, rethink their ambitions, and set priorities more clearly: what is imperative; what is desirable; and what is not necessary at all. This concerns every international player, but in the case of Russia the contrast between the ambitions declared just a few months ago and the real opportunities available today is especially striking.

## New position of Russia

The crisis has drastically changed the trend in Russia’s political and economic development.

Almost throughout Vladimir Putin’s rule (from August 1999 when he was appointed prime minister to the autumn of 2008), the country was in a state of **automatic growth**. In other words, whatever the authorities did, the economic situation kept improving. At first, this phenomenon was due to the effect of a sharp devaluation of the ruble in 1998, and then it stemmed from the growth of oil prices, which since 2003 turned into a real hydrocarbon boom. Measures to centralise economic management gave the government additional opportunities to consolidate its own positions.

The beginning of the global recession has put Russia in a situation of **automatic decline**: whatever the government does, the situation continues to deteriorate. All the talk in recent years about the Russian economy reducing its dependence on the raw materials sector has proved to be illusory. The dependence of the Russian economy on the external market environment has turned out to be all but absolute, and this applies both to the state in general and to the largest Russian corporations. The lack of an investment resource and the need for drastic cuts in spending at all levels have become obvious.

The political model established in Russia since last spring has no parallel in history. The ruling tandem, intended to symbolise continuity and innovation at the same time, was planned for an entirely different economic situation. In the conditions of stability, it did not really matter that the powers and

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<sup>2</sup> Guy Verhofstadt, “The Financial Crisis: Three Ways Out for Europe” ([http://www.bertelsmann-stiftung.de/bst/de/media/xcms\\_bst\\_dms\\_26640\\_26641\\_2.pdf](http://www.bertelsmann-stiftung.de/bst/de/media/xcms_bst_dms_26640_26641_2.pdf)).

responsibilities between the president and the government were blurred, as the two offices were one ruling conglomerate with a vague division of duties. However, the crisis dictates greater certainty, at least when it comes to responsibility.

Objective conditions are arising for the emergence of differences between the participants in the ruling tandem, although the existence of prerequisites does not necessarily mean that they will develop into a full-blown conflict. Ties between the president and the prime minister are so close that it would take the accumulation of very serious discord to bring about a rift in the present model. It must be borne in mind that Vladimir Putin personally was (and largely remains) the only source of legitimacy of President Medvedev. Without him, Dmitry Medvedev could not even dream of the position he now occupies. The awareness of this, coupled with a high degree of personal loyalty developed over many years of working together, will prevent the president from initiating a conflict.

At the same time, the agenda of efforts to solve the economic problem is objectively more associated with the public image of Dmitry Medvedev than that of Vladimir Putin. Putin is a 'man of war', whom the public associates, above all, with the notion of security – national and personal. The population trusts Putin in these matters. Medvedev has from the very beginning positioned himself as a statesman who cares about quality of life, that is, with a more 'human' dimension. It is precisely the latter that concerns society today, and this factor enables the president to assert himself more often and more and more convincingly.

It is very difficult to assess the real potential of social discontent. According to the Levada Center, the most influential independent sociological agency, the Social Sentiment Index (ISN) decreased by 17% in December 2008 from September, or by 21% from the record high level of the ISN in March 2008. These rates are comparable to the peak of decline in social sentiments in September 1998, immediately after the financial collapse and the announcement of default.<sup>3</sup> Interestingly, 69% of the population believes that the crisis had been brewing for a long time.<sup>4</sup> This contradicts the official position that the successful development of Russia has fallen victim to external factors, above all the crisis in the US.

Nevertheless, there have been no serious manifestations of social discontent in the country so far. The only instance that attracted international attention took place in Vladivostok on 14 December 2008, when police violently broke up a protest against the government's plans to raise tariffs on imported used cars. It must be borne in mind, however, that that region is the most criminalised part of the country and that the business of importing used cars from Japan is controlled by organised criminal gangs, which had a role in organising the protests. However, the events sparked such a widespread negative social reaction that police preferred not to intervene in subsequent protests in Vladivostok.

The experience of the 1990s has demonstrated that Russian society has a high level of adaptability. Citizens focus their efforts, first of all, on adapting to ongoing negative processes, rather than on trying to change them by influencing the government.

At the same time one important aspect should be noted. Previous periods of Russian development were based on a kind of social contract: stability and improved living standards for the population in exchange for increased political rights for citizens. This principle can no longer be regarded as effective.

Meanwhile, the actions taken by the authorities reveal their growing concern about the situation, evident in the tone of official statements and personnel decisions. For example, President Medvedev began a purge of governors in February, after he previously lashed out at regional authorities for their inability to cope with the crisis. The way the authorities have been devaluing the ruble shows the extent to which the authorities are concerned about public reaction to the developments in the country: the first stage of the devaluation extended from November to February. The majority of economists

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<sup>3</sup> <http://www.levada.ru/indexisn.html>

<sup>4</sup> <http://www.levada.ru/press/2009021301.html>

insist that the ruble should have been devalued at once, which would have been more effective and saved considerable hard currency resources for the Central Bank. However, President Medvedev defended the stage-by-stage tactic in a recent interview:

In my view what is most important is that the weakening of the ruble was gradual, which was totally unlike the barbaric way that this was done in 1998 when people's wallets, in fact everyone's wallets, suddenly slimmed down by 300%, and this wave swept over everyone and it was very unpleasant. In this case, the drop in value that has occurred, something of the order of 30-35%, was handled with great care. And virtually all the participants in our economic dealings, our citizens and our businesses, were able to choose for themselves a sensible strategy for dealing with their savings in rubles... Some economists did recommend a rapid devaluation. According to certain economic models this presumably makes sense, but it could have a devastating effect on millions of our people and our companies.<sup>5</sup>

This humane approach, which really let the population, banks and businesses convert their savings into foreign currencies, cost the Central Bank of Russia dearly. The bank's international reserves have decreased by 209,672 billion dollars, or by 35.1%, from 1 August 2008, when these reserves stood at 596,566 billion dollars. This does not mean that the reserves will continue to be spent at the same rate – the authorities will obviously be much more cautious with spending. The current balance of payment has now been brought back to normal, and if oil prices stop falling, the ruble rate will be maintained at approximately the present level.

Russia managed to avoid major problems in the banking sector, nothing like the big bankruptcies in the US and EU member states took place in Russian banks. But the real economy has been greatly affected; Russia's GDP decline in January 2009 compared to January 2008 was 8.1%.

Economist Sergei Alexashenko writes that:

by the end of last year, the sum of accumulated and unfunded anti-crisis promises amounted to about 7 trillion rubles (200 billion dollars, or three-quarters of the 2009 federal budget), which exceeded the size of the Reserve Fund by 50%. If we add to this the reduction of federal budget revenues from the planned figures, which is estimated at 3.5-4 trillion rubles this year, it becomes clear that the government has lost control over the growth of its spending promises, while the implementation of all these plans will put the country on the brink of a macroeconomic collapse.<sup>6</sup>

Experts agree, however, that cuts in spending, including cuts to social programmes, are inevitable, although the authorities are studiously avoiding using the term 'budget sequestration'.

Much will depend on the scale of support that the government will give to large state-owned and private enterprises that have found themselves on the brink of bankruptcy. Alexashenko warns that

if the government wants to retain control over the macroeconomic situation, it will have to limit the 'size of the pie' to be divided; that is, it will have to declare the maximum amount of expenses that it is ready to fund within the framework of anti-crisis efforts.<sup>7</sup>

Limiting the size of the pie may increase tensions within the elite, as groups of discontented will inevitably emerge. Since many large corporations will have to pay large debts to foreign creditors, the government will have to decide what industries and what owners should be saved and what industries could be ceded to repay the debts. Discussions about the protection of 'strategic industries', which have been continuing in the last few years, are now acquiring a new content.

On the whole, the impact of the crisis on the situation in Russia can be summarised as follows:

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<sup>5</sup> [http://www.kremlin.ru/eng/speeches/2009/02/15/1110\\_type82916\\_212924.shtml](http://www.kremlin.ru/eng/speeches/2009/02/15/1110_type82916_212924.shtml)

<sup>6</sup> <http://www.vremya.ru/2009/21/4/222632.html>

<sup>7</sup> Ibid.

- The crisis has revealed the ineffectiveness of the existing economic model based, as before, almost entirely on raw materials and dependent on the world market environment and external sources of finance (foreign investment and corporate borrowings);
- Two structural problems of the Russian economy – corruption and monopolisation – are growing from acute to fatal in the crisis conditions;
- There emerge prerequisites for contradictions within the ruling elite due to the vague distribution of powers and responsibilities, to the emergence of interest groups deprived of their share of governmental support for businesses, and to the imbalance in economic and security agendas in favour of economic issues;
- There is a need for structural reforms, privatisation and the opening of the economy to attract domestic and foreign financial resources. Although there is a ‘mobilisation’ element in Russian discussions (calls for isolationism, self-reliance, and for fencing the country off from the global processes), it remains marginal and, on the whole, has no influence on political or economic decision-making;
- The potential for social discontent is not obvious yet – despite the deepening decline, the situation remains under control, and the authorities may launch ‘managed liberalisation’ in order to let off steam and reduce tensions. The government still has substantial financial resources that can alleviate the most acute problems.

### Changes in the world situation

The economic crisis has affected the overall alignment of forces in the world arena. Yet rather than change the political reality drastically it has revealed processes that have been in latent development for a long time.

The United States is past the peak of its global influence, and this did not happen last autumn. It became clear after the Iraqi campaign that the US lacked the strength for hegemony or, most likely, that hegemony in principle is impossible in the modern world.

The relative decline of the United States (in absolute terms it will remain an actor beyond compare for a few more decades) will be accompanied by changes in tactics. Barack Obama declared that he would assign the key role to multilateral cooperation and international institutions back at the early stage of his election campaign.<sup>8</sup> The crisis and the need to economise resources make the problem of ‘burden-sharing’ especially important.

In practice, this means that the US will seek to build up ‘soft power’ (in Obama’s style) and opportunities for indirect influence, and will take a more flexible position on alliances. Washington will certainly try to strengthen its ties with Europe as its traditional and closest partner. Simultaneously, however, it will set its eyes on Asia, rightly believing that the ‘old world’ is losing its central position in the global system. The US may also place more emphasis on Africa and Latin America – partly because of Obama’s African roots, and partly because the role of these continents will keep growing, at least for demographic and resource reasons.

Trans-Atlantic unity rests on the solid foundation of extensive economic ties, mutual investment, cultural and historical community, and traditional allied relations, which became particularly strong in the Cold War years.

At the same time, the focus of Washington’s economic attention is gradually moving towards Asia, as has just been confirmed by the crisis, which has once again demonstrated how much the US and China depend on each other. As regards the ‘strategic horizons’ of the two shores of the Atlantic, they are

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<sup>8</sup> Barack Obama, “Renewing American Leadership”, *Foreign Affairs*, July/August 2007 (<http://www.foreignaffairs.org/20070701faessay86401/barack-obama/renewing-american-leadership.html>).

diverging somewhat. America has not given up its global leadership ambitions and expects real support for its efforts from Europe. The old world is not ready to participate in Washington's geopolitical projects around the globe. This unreadiness was evident in previous years, and the crisis will most likely only consolidate this approach.

A possible loss in status of the privileged partner of the US would put Europe in an unusual position. On the one hand, the leading European nations have long wanted to move out from the US umbrella and play an independent role in world politics. On the other hand, Europeans have long been out of the habit of playing such a role; not a single EU country can play it on its own, whereas the EU as a whole is unable to work out a common policy due to its heterogeneity, even though this organisation has great potential. In addition, the US has enough levers to neutralise any attempts by the EU to get out of control, if ever they are made.

By appealing to shared values and historical commonality with Europe, the United States is trying to involve the 'old world' in its efforts to strengthen its global positions, but there is a conceptual contradiction here. In remote regions (Central Eurasia, and South and East Asia), Europe is not ready to sacrifice its interests for the sake of its Atlantic ally. But as regards adjacent territories (the Middle East, North Africa, and part of the post-Soviet space), which the European Union includes in the sphere of its immediate interests, the EU and the US often turn out to be soft competitors there.

Many analysts say that the crisis may result in regionalisation and the consolidation of individual centers of gravity, around which zones of economic growth will be formed. Guy Verhofstadt writes about the emergence of political and economic entities

potentially made up of many states and peoples, united by common structures and modern institutions, often nourished by diverse traditions and values and rooted in old and new civilizations... What matters is the political stability and economic growth that they can create at a regional level, not for one or other of them to rule the whole world. In a nutshell, this is not about nostalgia for a return to the European empires of old but rather the birth of new types of political organizations, established by open and free societies, competing with each other at a global level, building bridges rather than walls, but each retaining its regional roots and customs.<sup>9</sup>

Most likely, it will be impossible to avoid a surge of protectionism while overcoming the crisis,<sup>10</sup> and markets will try to protect themselves. Therefore, the desire of each market for expansion is only natural. The most illustrative examples of this are the European Union and East and Southeast Asia, where China acts as the centre. Moscow, too, is now attracting visitors from neighbouring countries – it has turned out that there is no-one to ask for help except the former metropolitan country. Even 'rebellious' Kiev has asked for loans.

The latter case is indicative. It would seem that the European Union and the US must support Ukraine, because the geopolitical alignment of forces in the entire post-Soviet space depends on Ukraine's future. The crisis limits the ability of even large powers to provide financial aid. The International Monetary Fund's reserve is not great (250 billion dollars), yet it can still be used. The IMF has always served as an instrument for strengthening American leadership, because it conditioned its assistance on compliance with recommendations of the Washington Consensus.

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<sup>9</sup> Guy Verhofstadt, "The Financial Crisis: Three Ways Out for Europe" ([http://www.bertelsmann-stiftung.de/bst/de/media/xcms\\_bst\\_dms\\_26640\\_26641\\_2.pdf](http://www.bertelsmann-stiftung.de/bst/de/media/xcms_bst_dms_26640_26641_2.pdf)).

<sup>10</sup> The Buy American provision in a US economic stimulus bill, passed by the US House of Representatives on 13 February 2009, says: "None of the funds appropriated or otherwise made available by this Act may be used for a project for the construction, alteration, maintenance, or repair of a public building or public work unless all of the iron, steel, and manufactured goods used in the project are produced in the United States", <http://uk.reuters.com/article/economyNews/idUKTRE51C4RG20090213>. To read about the French government's measures to support national carmakers see: [http://www.bloomberg.com/apps/news?pid=20601100&sid=aMyHAf8uV\\_n8&refer=germany](http://www.bloomberg.com/apps/news?pid=20601100&sid=aMyHAf8uV_n8&refer=germany)



But first, the founders of the Consensus themselves are now the main violators of these recommendations. Second, the economic and political position of Ukraine inspires no hope that Kiev will fulfil the terms set for it. One can now hear calls for flexibility in relation to principles: “Conditionality remains necessary over the long term, but with this crisis still unfolding, the IMF is rightly moving toward temporarily suspending it.”<sup>11</sup> However, this would make the structure on which the US-centric world was based – namely, a combination of ideological integrity, an attractive political image, and the ability to project military and economic strength – lose its rigidity and stability, especially now that lively discussions are being held in the world (albeit not backed by reality) about alternative development models.

Of all great powers, the United States is the only one that in the coming decades will not be content with the status of a regional centre with its own sphere of influence. Europe, China, India, Russia, Brazil, Iran, South Africa, Japan and some other countries would be quite satisfied with such a status, (which does not mean that all the above-mentioned countries will be able to play such a role.) American hegemony is no longer possible. But the position of the only global force among many multi-sized regional forces may prove to be winning, although it would require sophisticated tactics. At the very least, this is a new situation.

### **Russia – temptations and reality**

Russia is a natural centre of gravity for post-Soviet countries, because most of them are experiencing a severe economic decline and cannot count on support from other countries. Kyrgyzstan, Armenia, Belarus and Ukraine have already asked Moscow for help, in one way or another, and they are likely to be followed by other neighbouring countries. All spending planned by Russia, including the allocation of 7.5 billion dollars to the Anti-Crisis Fund of the Eurasian Economic Community (EurAsEC), has already exceeded 11 billion dollars. This sum does not look critical yet, compared to the remaining total reserves; however, the dynamics of both internal and external spending will limit the temptation to strengthen the country’s geopolitical positions.

Changes in the global economic situation will certainly affect the substance of Russia’s foreign policy. Moscow will have to match its desires and expectations with its reduced capabilities and to build a system of clear-cut priorities. In particular, it will have to decide what geopolitical projects must be implemented, what projects are of minor importance, and what projects can be given up. Obviously, Europe and Eurasia will remain Russia’s priority areas of interest in any situation, and the desire to play a leading role in international affairs will not disappear, even if the resources shrink, because this is in line with the aforementioned general tendency towards regionalisation.

On the other hand, it is unlikely that last year’s ideas of consolidating Russian presence in the western hemisphere by establishing close ties with Venezuela, Cuba and Bolivia, will retain their priority.

On the whole, the impact of the crisis on Russia’s foreign policy may have a dual nature. The need for investment in economic development will cause Russia to be more open in its relations with industrialised countries. At the same time, the aggravation of general competition, amidst growing protectionism and declining global governability, will increase the isolationist/anti-globalist sentiments that are already visible in Russian politics.

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<sup>11</sup> Roger C. Altman, “The Great Crash, 2008: A Geopolitical Setback for the West”, *Foreign Affairs*, January/February 2009 (<http://www.foreignaffairs.org/20090101faessay88101/roger-c-altman/the-great-crash-2008.html>).

# The lessons for China

Lanxin Xiang<sup>1</sup>

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## China caught by surprise

The financial crisis has caught the Chinese leadership by surprise. There are three reasons for the lack of psychological and policy preparation: first, over the years, the Chinese economy has become heavily reliant upon the export sector and an economic recession caused by the financial sector was not thought possible as long as consumer spending showed no sign of slowing down. The Washington Consensus created a bubble, but behind the bubble was real estate mortgage and subprime derivatives. China has little knowledge, let alone practice of this type of seemingly advanced financial market innovations in the United States. Hence, it was the backwardness of China's banking system, and its failure to understand financial innovations, that saved China from falling deeply into the current crisis.

Second, China has little knowledge and working experience in general of the Anglo-American monetary system, which has dominated the international financial scene since 1945. China was not part of the Bretton Woods system (for Taiwan had represented China in international organisations, including all UN institutions and the Security Council seat till 1971) until it collapsed in the 1970s. China hardly participated in any international financial cooperation and policy activities. After the Nixon Shock in 1972 when a floating exchange rate became a reality, the Chinese monetary system was not affected at all as long as the RMB was not convertible and trade volume was exceedingly small.

Third, the current Chinese exchange rate regime was created during the 1997 financial crisis when its currency started pegging to the US dollar, but now the RMB is no longer immune from turbulences of the international financial system not only because of China's holding of the largest dollar debt, but also because its heavy investment after the 'Going-Out Strategy' was launched at the beginning of the new century, especially in Latin America and Africa.

## The lessons from the 1997 financial crisis do not apply

First, exchange rate pegging no longer works in coping with a sinking banking system in the West. China played a critical and responsible role during the 1997 financial crisis in East Asia, by holding its currency exchange rates steady to avoid competitive devaluations in the badly hit region. Since then, China thought that another financial crisis might come China's way, but would not impact directly on China as it did during 1997. But such a judgement has proved wrong and the magic policy of exchange rate pegging has now become a liability rather than asset, since the fair trade issue is framed precisely in terms of currency manipulation, even though such a manipulation was not initially intended during the 1997 crisis.

Second is the danger of the 'new weapons of mass destruction'. The G2 structure, or US-China condominium, publicised by Niall Ferguson as "Chimerica" does not necessarily serve China's national interest well. In the past three years, the China-US Strategic Economic Dialogue (SED) has become important for the world's two most powerful countries, the United States and the People's Republic of China, to discuss mutually related topics and try to avoid many misunderstandings. The SED was initiated in 2006 by President George W. Bush and President Hu Jintao. The format is such that top officials in charge of the economies of both countries would meet twice a year at locations alternating between China and the US. It has been described by a former US Treasury official as "sort of like the G2". The Obama Administration decided to end such a dialogue, but at the same time elevates G2 to the level of summit meetings.

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What the true objective is on the part of Washington remains to be seen, but one thing is certain: the US needs China's help to overcome the domestic economic downturn. More specifically, the US definitely wants to reduce trade deficits and at the same time secure financial resources when expanding domestic spending through its huge stimulus plans. Since double deficits (trade and fiscal) have been a rather common practice in US history since the 1970s, the only way of pursuing this twin objective is to manipulate the international monetary system by printing money and attracting foreign buyers to increase or at least not decrease dollar holdings. This is what might be called 'indirect imperial tax' as compared with the direct tax levied by the Roman legions in ancient history. The friction between China and the US is therefore inevitable, as the US clearly aims to export 'toxic assets' to China through whatever means available and as Thomas Friedman said, by using toxic assets as the new weapon of mutually assured destruction, China will have no escape.

### **The export-led model and the need for fundamental review**

Great trade dependency has now become China's Achilles heel. China is the third largest economy in the world, China's foreign trade dependency, defined as a country's export-GDP ratio and share in total world exports, has increased considerably over the last two decades. In 1978, China's exports constituted a mere 5% of its GDP; by 1998 that figure topped 20%. The country in 2006 registered an unwholesome trade-to-GDP ratio of 69%. In many cases the economies of large countries tend to have lower degrees of trade dependency because of large domestic production and consumption. But China's trade dependency is already higher than that of the United States, Japan, India and Brazil, and a greater degree of trade dependency would result in an exodus of resources because of worsening trade terms. China now claims to be the world's largest workshop. What needs to be understood is that China produces primarily for the international market rather than the domestic market. Export overproduction cannot be easily absorbed by the internal market.

In fact, China's greatest weakness in economic development is its foreign dependency. Under the so-called East Asian development model, foreign funds and foreign economic relations are based on the economic theory of 'comparative advantage'. According to this theory, a developing nation must export goods it can produce cheaper than other nations and import goods where it is at a disadvantage. Only in this way can it maximise the efficiency of the international division of labour and use it to the benefit of its own economic development. Because of its large economic and population scales, China's growth momentum and excessive dependence on international markets is unparalleled in the economic history of the world. Singapore, South Korea, Taiwan and Hong Kong have small-scale economies, so it is relatively easy for them to catch up with the world's advanced standard of living. Some large economies, such as that of the US, also evolved from secondary developed nations into leading trading nations. But the US has a relatively stable domestic market with a relatively constant market demand. On the other hand, given the low wages of China's labourers, the purchasing power has remained low and consumption demand has not been able to meet the manufacturing supply.

For two reasons, the comparative advantage model cannot be successful in China. On the one hand, China's single-minded pursuit of comparative advantage leads to over-production in some industries and, as a result, the goods it produces become too cheap. On the other hand, China does not have a mature domestic market to create the demand to sustain its economy. China's goods must therefore be sold in overseas markets. China's imports and exports represent such an immense share of world trade that its prices distort the world market. It should be noted that China has concentrated its import and export trade to a few countries and regions, namely the US, Japan, and the EU. These three account for around 50% of its total trade volume. So, any goods that China injects into these three markets will create pressure on local producers.

As the communist leaders begin to consider downgrading manufacturing growth and export-led development strategy, the traditional measures based on GDP growth will become less emphasised. A Keynesian recipe will perhaps work better for China, given the fact that China badly needs to create a serious social welfare and health care system and revamp its entire education system. On the other hand, the long suppressed domestic consumer spending could be greatly stimulated if social welfare,

health care and education savings in most households could be released and directed towards housing and other consumer spending.

### **China and the reform of the current international financial system**

The first priority for China before any meaningful reform is attempted should be a break away from dollar hegemony.

China must cooperate with those who are willing to initiate serious reform of the international financial system. The Bretton Woods institutions are outdated. But there is no consensus as to what the international community could do next to reform the system.

In breaking away from dollar hegemony, China has to regain real sovereignty in its central banking, because in a world order of sovereign nation states, the supranational nature of central banking has been used as an all-controlling device for the world's rich nations to neutralise the sovereign rights of financially weak nations. Even in a democratic world order, central banking is inoperative within national borders, as it can be used by a nation's rich population as a device to deprive the working poor of their economic rights. Central banking, including the state-run system in China, has so far supported dollar hegemony, and operates, more often than not, internationally against the economic interests of sovereign nation states and domestically against the economic rights of the working poor by discrediting enlightened economic nationalism.

To preserve dollar hegemony, exporting economies that accumulate large dollar reserves through trade surpluses are forced by the US to revalue their currencies upward, not to redress the trade imbalance, (which is the result of dysfunctional terms of trade rather than inoperative exchange rates), but to reduce the value, in foreign local currency terms, of US debt assumed at previously stronger dollar exchange rates.

China is therefore stuck in a double dysfunctionality. The fall in exports is expected to accelerate as any quick or sharp recovery in the US economy is not on the horizon. But a falling exchange rate causes more domestic inflation from imports denominated in dollars; and rising domestic inflation adds pressure to a falling exchange rate in a downward spiral, preventing the yuan from rising against the dollar from market forces. That is the dysfunctionality of the yuan-dollar exchange rate regime in relation to the inflation rate differentials between the two economies, when the exchange rate is set by trade imbalance denominated in dollars. This problem is caused by the flawed attempt to use exchange rates to compensate for dysfunctional terms of trade, which has been mostly caused by wage disparity.

### **Conclusion: Back to Keynes?**

In conclusion, China must reduce its foreign trade dependency ratio and drastically expand the domestic trade market. It must also reduce dollar debt holdings and encourage the euro to become a leading international, alternative reserve currency. Keynes had three beliefs that are still valid for China. First, he argued vehemently against over reliance on foreign trade, since no-one can predict market behaviour in the 'long run', no government can guarantee full employment. Second, he preferred a fixed international exchange rate system. If this cannot be realised, international cooperation is absolutely necessary to avoid currency wars. Third, accumulating foreign exchange reserve is not for hoarding but for spending and investment.

The current Chinese policy of defending an 8% growth rate in 2009 is based on a flawed concept, as if China could spend itself out of its international dependency. There is no 'scientific' foundation for this growth rate. The only justification is China's domestic political economy, as 8% is considered the bottom-line for preventing mass unemployment, which will destabilise its internal system. By publicly announcing this target, China will become even more vulnerable since international competitors could thus make policies aimed at either blackmailing China to make trade or monetary concessions, or simply undermining China's chance of success.

For the purpose of collaborating with the EU to overcome the current financial crisis, China has a vital stake in the EU's success in passing the Lisbon Treaty and starting a serious CSFP. Despite current setbacks between China and its erstwhile best friend in Europe, France, the relations with other major EU players are dramatically improving. The new Sino-UK relationship is a good start, which is described by both London and Beijing as the 'best', especially in view of the UK's position of officially recognising China's sovereignty over Tibet. The recent publication of the British document: "The Framework of Engagement with China" marked a new beginning. This is after all the first British document regarding its strategies towards a particular country in modern times. Whether or not other countries in the EU could seize the same opportunity to elevate bilateral relations, remains to be seen.

# The social consequences of the economic crisis

Jørgen Mortensen<sup>1</sup>

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## Drivers of globalisation will weaken

This working paper draws on an earlier study on the drivers of globalisation,<sup>2</sup> and considers how the current crisis may affect these trends. The discussion will follow the structure of Figure 1, below. Although the degree of weakening of the drivers of globalisation will only become clear as the depression unfolds, several of these drivers are set to slow down or be reversed.

- Trade liberalisation is already taking several blows as a result of the emergence of certain measures to save 'domestic' financial institutions protect the automobile industry and certain sub-contracting branches.
- EU enlargement and the process of integration would seem unlikely to slow down much but should certainly not be expected to accelerate except in one important area: the possible creation of an EU financial watchdog or an extension of the competences of the ECB with respect to financial surveillance and regulation.
- The costs and techniques of transportation may not be directly influenced by the financial crisis but in the short and medium term appear likely to be substantially reduced as a result of the lowering of demand and the present low oil prices. A number of cargo ships are already being laid up and more seem likely to follow. This will of course have severe knock-on effects on the shipyards.
- The liberalisation of capital movements and financial markets will no doubt slow down or be reversed as a result of the ongoing nationalisation of banks and other financial institutions, more intense scrutiny of many transactions and the enforcement of regulatory surveillance.
- The role of ICT and the internet as drivers of globalisation should not, it seems, be expected to weaken. In fact, a more active supervision of financial institutions and transactions would probably be facilitated by the internet. However, the internet and the expansion of mobile phones and the increasing scope for financial transactions via the latter will also promote the globalisation of terrorism and the drug trade.
- Migration policy and frontier control may on the whole become more restrictive both in the short and the medium term. However, as the incentives to migrate from poor to rich countries would seem likely to strengthen, the main effect of the depression will be a rise in illegal migration.
- The role and weight of multinationals in the world economy may not change significantly. However, an important question is whether the financial crisis and its economic consequences will bring about changes in international economic and financial governance. There would at present seem to be a certain movement in favour of assigning additional responsibility in the field of financial surveillance to the IMF and, within the EU, to the ECB. The nationalisation of parts of the financial services in several OECD countries will also result in a deeper involvement of governments in the running of key financial institutions and the financial crisis will per se result in changes in the perceptions and handling of financial risks.

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<sup>2</sup> I. Begg, J. Draxler and J. Mortensen (2008), *Study of the Social Impact of Globalisation in the European Union*, SIMGLOBE Special Report, CEPS, Brussels, April.

## The process of globalisation may slow down

The direction and size of trade flows and maritime and inland transport have already weakened significantly and we cannot exclude more permanent repercussions for the structure, direction and level of trade flows and their associated transport services. Furthermore, there are good reasons to expect the financial crisis to have severe consequences for capital movements. In general the whole process of globalisation is therefore likely to slow down and possibly even be temporarily reversed.

- The direction, structure and size of trade flows have already been significantly influenced by the depression, but whether these changes are just temporary or of a more lasting nature remains to be seen. The principal factors having determined trade flows over the recent decades would seem likely to remain in force, with, however, the possibility that the liberalisation of trade may slow down or even be reversed at least for some 'sensitive' products, such as automobiles or steel. It may also become more difficult to continue the liberalisation of world trade.
- The outsourcing and insourcing of production, which has been part and parcel of globalisation during the last couple of decades is likely to slow down in response to new perceptions of risk and uncertainty.
- Whether migration will slow down as a result of the crisis remains to be seen. On one hand there are signs that a number of the most developed countries are taking steps to tighten rules or to adopt more selective policies for admitting economic migrants. Furthermore, at least in the short run there seems to be a tendency for migrant workers in Ireland and the UK to return to their home countries. On the other hand the crisis and the depression are now extending more broadly to the developing countries and the fundamental incentives to migration would seem unlikely to weaken, rather the contrary.
- The structure of trade in services could change as a result of a considerable slowdown in the size and pattern of capital movements but also as a result of a possible slowdown in maritime transport and aviation, etc.
- A huge increase in capital movements has been one of the dominant features of globalisation since 1990 and there are good reasons to suppose that the size and flows of capital will be profoundly influenced by the financial crisis and associated depression. Net inflows of private capital, according to The Economist's special feature on Globalisation (Feb. 7<sup>th</sup>), have fallen to a fraction of the 2007 level. The perception of risks and uncertainties has been durably changed and the scope for the play of financial innovation severely reduced. Already investors and sovereign wealth funds have expressed increasing preference for government bonds and other instruments considered 'safe' but also an increasing tendency for spreads in favour of 'prudent' governments' bonds to increase.
- While there is little doubt that the financial crisis and the decline in financial and non-financial activity will lead to a narrowing of the tax base in a number of countries, this would not necessarily lead to a more permanent change in the location of activity, with, of course, the exception of a general lowering of the tax base in the branches most directly involved in the financial crisis and the slowdown of activity, such as, notably, financial services and building and construction. Consequently, countries that have depended strongly on these branches may see a more permanent narrowing of their tax base.

## Social consequences

The social consequences of the financial crisis and depression will not be uniformly and linearly dependent on the decline in activity. They will to a large extent depend on the basic features of the system of social protection and the capacity of the economy to avoid poverty traps and hysteresis.

- As the depression is largely caused by the sudden and dramatic drying up of the flow of credit, regions and branches that have benefitted most markedly from the enormous rise in credit and the decline in household saving in some countries will be the first to suffer. Whether this can be

expected to lead to an increase or, on the contrary, to a lowering of regional disparities can hardly be determined without an in-depth study of the regional patterns of growth in the different countries.

- The rise in income disparities since 1990 has probably only to a minor extent been caused by the explosion of financial services and credit and more to such fundamental factors as the increasing importance of knowledge and investment in education and human capital as the key determinants of life cycle income. Similarly, the failure of EU member states and other countries to reduce poverty rates cannot be assumed to have been caused by the expansion of credit and may therefore not be much influenced (in relative terms) by the depression. This, however, is a subject that merits deeper analysis.
- On the other hand there is no doubt that the rise in employment in a number of countries such as, the US, Spain, Ireland and the UK during the last couple of decades owes a lot to the boost in easy credit and therefore has been on an unsustainable path. The depression will therefore most likely lead not only to an increase in unemployment but also be followed by structural changes in employment.
- The failure of many countries to make progress with respect to social inclusion, and this despite declared objectives and policies, would not seem to have been caused mainly by the process of globalisation. However, in countries with a high degree of segmentation and fragmentation of the labour market (for example France and Italy) the ongoing decline in activity and the resulting rise in unemployment may lead to a new process of hysteresis (permanent exclusion from employment of the 'outsiders') and thus a significant weakening of the process of inclusion. Countries with a higher degree of mobility and flexibility in the labour market will also suffer a rise in unemployment but can be expected to recover more rapidly and without severe long-term consequences for the process of inclusion.

### **Social policy recommendations**

The policy recommendations presented in the study on the social consequences of globalisation remain valid and in some countries the depression should in fact lead to a more rapid implementation of policies to promote flexibility and adaptability.

- In a number of countries the labour market position of low-skilled groups is likely to be significantly aggravated by the depression and the need for a strengthening of education and training is even more pressing than before the emergence of the financial crisis.
- Whereas the depression is leading to increasing public resistance to immigration and, in some countries, to a return of migrants to their home country, the need for measures to foster the integration of (accepted) immigrants would not in any way be reduced by the depression. The decline in activity and increase in unemployment, including unemployment among immigrants, will, if not met by policies to foster integration, result in new social tensions and the additional fragmentation of labour markets between insiders and outsiders.
- More generally, the need for enhancing labour market adaptability and flexibility will be even more urgent than before. The association of the financial crisis and depression will not only lead to a rise in unemployment but the recovery, once it is underway, will most probably involve structural changes and the relocation of activities and employment. Consequently governments would be well-advised to initiate new policies promoting adaptability.
- The likely acceleration of structural changes (including the strengthening of climate change mitigation and environmental protection) will require the additional adaptability of individuals so there is an added need to reshape social protection and enhance the empowerment and human capital endowment of individuals.
- Consequently the need to find new ways of managing social and individual risk is in no way reduced but actually becoming more urgent by the day.



Figure 1. Schematic overview of the process of globalisation

