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The Great Regression?

Financial Crisis in an Age of Global Interdependence

Kristian Kurki (ed.), Toby Archer, Vadim Kononenko, Matti Nojonen and Raimo Väyrynen

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Executive summary

The financial crisis and the ensuing global economic downturn have been the focal point of news coverage and policy analysis for over a year now, and speculation has been rife about how things will pan out. At one extreme are those who shrug the situation off as a significant yet transient dent in economic development, with marginal repercussions on the global system. At the other end are those touting the crisis as the first step in an epoch-making transition in the global power balance, where rapidly expanding economies like China, Brazil and India will make gains on the hitherto dominant developed nations, shifting the distribution of power in the world. Whatever the eventual outcome, there is no denying that the crisis's impact on international relations will be significant.

This report provides a comprehensive overview of the dynamics of the global financial crisis and the challenges it poses for governance across the board. This is followed by detailed accounts of the way in which key international and institutional relations have been strained by the crisis with potential ramifications for the global distribution of power, focusing on relations within the European Union, Russia's relationship with the West, and China's relationship with the United States. Rather than addressing the speculative debate about recovery models and economic outlooks, the report focuses on how political-economic relations between countries, the fabric of globalization, have been tested by the steep economic downturn. It seeks to assess whether the numerous potentially destabilizing factors of the financial crisis have indeed nudged international relations onto a substantially different path than previously assumed.

The financial crisis began to gain its full momentum in 2008 as the extent to which major financial institutions had acquired sub-standard assets was disclosed. The failure of banks and government intervention has challenged conventional notions of the market's ability to regulate itself, while the age-old debate over the necessity of government intervention and regulation has illustrated regional differences in approaches to dealing with the financial crisis. Efforts to reverse the financial downturn have largely been conducted on a national basis. In an age of global interdependence, however, national economic policy has economic ramifications for other countries. Furthermore, the impact of the financial crisis has been much greater

in some countries than in others; China only witnessed a blip in its rapid growth while Russia is in the throes of a deep recession.

In its attempts to overcome financial depression, the EU has found itself held hostage to its member states, at times struggling to achieve agreement between member-state policy and union-wide policy. Nevertheless, the European Central Bank's move to lower interest rates amidst the crisis paved the way for counter-recession measures across Europe. The Union, and the Eurozone in particular, albeit not a single political entity, still retains its appeal as a single market that has the power to shield the weaker economies in Europe.

Meanwhile, Russia's relationship with the West remains complex and is based on constellations that predate the crisis. Russia, defiant against Western political institutions and determined to claim its interest in affairs close to its borders, has been more severely hit by the crisis than many other countries, yet reform either in domestic or foreign politics is not a viable option due to Russia's rigid government structure that revolves around the prevalence of a select elite. The government's fiscal balance remains bearable, but currency reserves are diminishing and corporate debt rates are high.

The economic relationship between China and the United States constitutes a deep mutual interdependence. In spite of the two parties' political rivalry, they rely on each other to complement their economic cycles: China purchases US treasury bonds to provide the US with currency, with which US consumers purchase Chinese goods to keep the Chinese export industry afloat. China benefits from the situation by utilizing its financial upper hand as political leverage against the debt-ridden US, but China's success depends on America's fortunes. Both countries recognize this relationship as being politically as well as economically unsustainable in the long run, and China in particular is already moving to reduce its dependence on the US.

The unbalanced effect of the financial crisis in different countries has indeed affected the relative political influence between nations on a bilateral and a regionally limited basis. What the impact will be on global institutions, however, remains to be seen, as the promise of improved and more "inclusive" global governance is little more than lip service at this stage. The developed countries accustomed to being at the forefront (and most severely hit by the crisis) are understandably unenthusiastic about any reform that would compromise their international political influence, and the financial power therefore remains highly concentrated and politically potent.

1. An overview of the global financial crisis

Raimo Väyrynen

1.1 The crisis spreads from the United States

The present financial and economic crisis has passed through successive stages in which it has both expanded and deepened. The crisis has been so pervasive and complex that practically no one was able to foresee the ways in which it would unfold in different parts of the world and in different sectors of the economy. Therefore, neither state nor non-state actors were able to apply effective preventive measures to stop the expansion and deepening of the crisis in its early stages. Given the lack of effective early foresight and prevention, it is nothing short of a miracle that relevant national and international institutions have been able to tackle the fallout as well as they have done in reality.

In the early phases of the crisis, very few realized the scale and depth of the problems to come. George Soros stated at an annual "benchmark lunch" in October 2007 that only two out of seven owners of the biggest private equity funds in New York were seriously concerned about the future. Prior to that, in July 2007, Ben Bernanke of the Federal Reserve Bank (the Fed) had stated that the subprime crisis, stemming from bad mortgages, might cost the banks US$100 billion (in spring 2009 the estimate stood at US$945 billion, while the estimate for the total cost of the crisis for all financial institutions topped US$4,000 billion).

Until early 2008, a commonly held assumption was that the crisis could be confined to the real estate and housing loans business in the United States. In other words, the financial crisis would not spill over into the "real economy" in any serious way. Another common assumption was that the financial crisis had been created in the United States and its negative effects would be largely restricted to the American economy. The rest of the world, then, would be "decoupled" from America's problems. As a result, the debate focused on the failings of the American brand of capitalism compared to the Asian and European models. Lax financial and deregulatory policies

by the Bush Administration were regarded as a major shortcoming, and the crisis was widely seen as a befitting epilogue to the failed presidency of George W. Bush.

Both of these assumptions have turned out to be misleading. In March 2008, Financial Times writers would still claim that "a financial crisis spreads slowly into the real economy… the global economy is in the middle of a phoney war". Now, a year and a half later, we all wish their prognosis had been correct. Instead, the global economy is in a full-blown crisis as the economic growth rate for 2009 will be negative for the first time since World War II, experiencing a 1.3 per cent drop according to the IMF. Export income in the leading industrialized countries has been shrinking by at least 30 per cent, and in several cases by even more. The present crisis has affected all economic sectors and all corners of the world, albeit to varying degrees. It is no exaggeration to speak of a financial pandemic that has metamorphosed into a more serious economic disease. Yet, recent signs of recovery indicate that the patient, although still in a serious condition, is nonetheless stable.

The financial crisis started to unfold in the United States in March 2008 when the investment bank Bear Stearns was sold to JPMorgan Chase for a nominal sum and when the US government, in early September 2008, took over Freddie Mac and Fannie Mae, two huge and partly publicly owned mortgage companies. The biggest shock, however, came on September 20, 2008 when Lehman Brothers collapsed after the US federal government refused to bail it out. On the other hand, the government considered that the insurance giant American International Group (AIG) was too critical for the financial system and bailed it out to the tune of US$85 billion.

As a result of the turmoil in the US economy, the federal government has become a reluctant owner of banks and corporations, especially in the car industry. Nationalization has been defended as a policy to protect individual shareholders and prop up the entire market system, while being criticized as a waste of taxpayers' money and for producing what has been dubbed a "moral hazard". The use of federal funds and the expansion of governmental regulation and bailouts has opened up deep political rifts in the United States; for the liberals they are "necessary evils" to correct the aberrations of freewheeling capitalism, while conservatives see them as evidence of "creeping socialism". The ideological battle is now spreading to other sectors of society as well, especially health care.

1.2 The long tentacles of the financial system

The financial panic in the United States quickly spread to Europe. Most Europeans were under the impression that their economies were more resistant to the threat of downturn than that of their counterpart on the other side of the Atlantic. To some extent, Europeans were deluding themselves, however. Financial crises are usually preceded by two major developments: credit expansion and a rapid increase in asset prices. In reality, due to low interest rates, the increase in leverage was also rapid in Europe, thanks to the euro as a new force of growth. Although trends varied significantly from one EU country to another, many of its members, such as Ireland and Spain, experienced a serious asset bubble. Thus, European countries displayed the same critical symptoms as the United States, and in some respects their economies were even more prone to implosion.

The global financial system had become much more internationalized and interconnected than most people realized, including financial experts. Mortgage lending was no longer a transaction performed by a single bank in the national setting. After a loan had been granted to a household by a bank, it sold the credit on to an investment bank which sliced it into components, combined them with other assets in its ownership and sold the product to yet another financial actor. To increase profits, banks created new financial instruments, such as collateralized debt obligations (CDOs), thus promoting the securitization of the system. Mortgages became a major source of CDOs under the widely held but mistaken assumption that there would be no significant drop in house prices. It was also argued that the new forms of securitization would help to diversify assets and would thus reduce risks inherent in any investment decision.

These instruments were often of such a complex and opaque nature that it was nigh on impossible to assess their real value. It has been claimed that a single CDO might easily contain money from several hundred different sources from a dozen countries. For this reason, rating agencies became increasingly central in assessing the credibility and creditworthiness of the banks and their CDOs and other similar instruments that they issued. The financial edifice was thus built on sand and fuelled by the desire for quick profits that the perverse incentives of the system condoned and even encouraged. The expansion of credit was further fuelled by the availability of easy

money and low interest rates, which had become a trademark of Alan Greenspan's central bank policy. The trust placed in Greenspan during his 17-year tenure as Chairman of the Fed indicates, however, that the financial system needed an anchor that would stabilize the risky operations of individual investors. In the United States in particular, Greenspan became the last-resort provider of systemic trust.

Trust is a vital element in the volatile and speculative financial markets. If it collapses, there is little left to be done. It has been said that the provision of credit by banks to other banks is the foundation of commerce. If the trust between partners dries up, the result is defective institutional trust which leads first to a liquidity crisis and, ultimately, to a solvency crisis. In effect, the current crisis has escalated in the industrial West from a liquidity to a solvency crisis, especially in the domestic construction industry and in the main export industries.

A trust deficit was also experienced by European banks that had purchased collateral from American banks, deriving in part from similar motives to earn quick profits, and in part from ignorance of the true value of the assets acquired. The first to suffer were British banks, including Northern Rock and the Royal Bank of Scotland. The risks also materialized in Germany, Belgium, and the Netherlands where the government had to bail out individual banks. Intensive financial internationalization of small economies overleveraged their resources and the default of their banks jeopardized the economy of the whole country. This problem was manifested most visibly in Iceland where the international commitments made by the banks were twelve times bigger than the country's GDP. In Switzerland, commitments were eight times bigger and, while its economy has not descended into a major crisis, the banking giant UBS has had to write down US$13.4 billion of mortgage-linked losses.

A dynamic of a somewhat different sort developed among banks in Austria, Italy, and Sweden, which lent extensively in euros to households in the new member states of the EU, including Hungary and the Baltic countries. For instance, Raiffeisen, a major Austrian bank, increased its balance sheet twelvefold between 2000 and 2008, mostly by lending to customers in Eastern Central Europe. By early 2009, it had accumulated a loan portfolio of US$280 billion, amounting to roughly 70 per cent of Austria's total economic output. No doubt Austrians became seriously concerned about being hit by

a major compensatory crisis. So far this has not fully materialized, however.

When the crisis started ravaging the economies of the new EU member states and their currencies depreciated, the debt burden of their households increased and they were in many cases unable to meet their mortgage payments. An even more serious consequence was the bursting of the real estate bubble, which devastated the construction industry and its workers. Reckless international ventures by banks increased the risk that their home countries would have to bail them out despite the fact that the domestic economy in other respects remains in reasonable shape. Notwithstanding the dire predictions concerning the negative impact of Swebank's lending to the Baltic countries, the domestic consequences in Sweden appear to remain limited partly due to anticipatory preventive measures by the government.

When the trust evaporated, banks stopped lending to each other for fear that the respective partner might be the next one to go under and the lender would have to bear the brunt. The flow of money between banks ceased and, as a result, they were unable to provide loans for companies and other customers. A major characteristic of the current crisis is the failure of the systemic trust both within and between national economies. The present financial system is so dependent on the smooth circulation of money that if it slows down, the whole economy can go into meltdown.

In sum, the starting point of the crisis, the US subprime problem, was merely symptomatic of the fact that the global financial system is extremely interdependent and fragile, and its functioning is, in turn, a condition for the proper working of the "real" economy. For this reason, it is unfair to argue that the whole crisis could have been avoided if the poorer American families had not had access to easy money which they were not able to pay back to the banks.

1.3 Global economic imbalances at fault

The international and interconnected nature of the global financial system is reflected in the fact that many of the security transactions were carried out by foreign subsidiaries over which the headquarters often had only limited control. For instance, in 2008 Citigroup had

2,435 and Deutsche Bank 1,954 foreign subsidiaries, while Raiffeisen had 3,200 branches in Eastern Central Europe. Subsidiaries are instruments of "regulatory arbitrage" in which banks seek overseas locales where the political and legal environment is most permissive. The demise of Lehman Brothers was largely due to the operations of its Amsterdam-based subsidiary, Lehman Brothers Treasury, which churned out US$35 billion worth of dubious CDOs (accounting for a quarter of the total bond debt of the parent company).

An even more fundamental reason for the present crisis has been the emergence of deep global imbalances accumulating in the global economy over the years. These imbalances have been visible both in the commodity and capital flows between the major economies. The twin deficits in the United States – in the fiscal balance and the current account – created a huge demand for foreign capital, primarily from Asia but also from other sources. The relative safety of the US market and the leading role of the dollar attracted such funds and contributed to the emergence of a "bubble" economy, which would have burst even sooner if capital had not been excessive and so easily available.

In this sense, the United States was the main culprit in fostering the imbalances, but equally one can argue that the surplus economies, especially China, helped sustain the imbalances. These imbalances have also plagued China's relations with the EU member states, and the restoration of a better balance in the world economy will be key in the return to sustainable growth. However, this would require difficult domestic decisions; reduced consumption and a higher savings rate in the United States plus increased domestic consumption and more safety nets in China.

There is no denying that the global financial system has failed dismally. The experience has also shown that governments are badly needed to ensure the functioning of the system. On one level, governmental actions to cope with the crisis have, indeed, been a success story. They were initiated early on in the game and policy-makers acted decisively, which was crucial in preventing complete chaos in the market. In October 2008, all major central banks were able to agree, virtually overnight, on a coordinated reduction of 0.5 per cent in interest rates. The stock market's recovery since spring 2009 – which may yet turn out to be only temporary – would hardly have been possible without the actions undertaken by key governments both on their own and in cooperation with each other.

The instruments employed by governments are essentially of two kinds: the re-regulation and recapitalization of the banks, and rescue packages for the entire economy. The scale of the problem is indicated by the fact that, by spring 2009, governments had provided US$8,900 billion to finance banks by lending them money, purchasing their assets, and giving guarantees. Yet, this figure is estimated to be only one-third of their total financing needs. This means that the road to recovery will inevitably be slow and tortuous.

Debates on the kinds of regulatory reforms required are only beginning. They reflect the standard political divide; business is worried about too much regulation, while most politicians demand an overhaul of the entire system of financial regulation. Business leaders tend to argue that what is needed is "better regulation", not "more regulation". It is not surprising that the London mayor is lobbying in Brussels against tighter financial regulation and the efforts to curb the size of the financial sector to a healthier level. Yet, it is clear that there will be rather pervasive regulatory reforms both at the national and regional level (the EU has already agreed on the contours of the reform in the regulatory institutions, relying on the so-called de Larosière report). In the United States, the position and resources of the Securities and Exchange Commission (SEC) will be strengthened. Major regulatory reforms are unlikely to occur at a global level, however, even though they appear on the G20 agenda. Efforts to restrict the operations of tax havens and make them more transparent have been reasonably successful.

At the policy level, national decisions on rescue packages have meant the abandonment of extreme market liberalism – which has often been more visible in words than in deeds – and the return to a sort of Keynesianism. The size of the national rescue package has varied greatly between countries. According to the IMF, the total fiscal costs of rescue efforts have amounted to 13 per cent of GDP in the US and 9 per cent in the UK, while in Continental Europe the shares have hovered around 5 per cent. In addition to the US and the UK, China and Japan have been the most ardent advocates of large fiscal inputs for the economy to stop the decline in economic growth and employment. It is often difficult to estimate the exact size of the packages because they may contain programmes that were decided on before the crisis erupted and often include a mixture of short-term and long-term projects.

In any case, the EU countries have been less keen to favour large rescue packages and have considered the regulatory reforms, such as the elimination of tax havens and the control of hedge funds, to be more important. One reason for limiting the size of stimulus programmes is – as European governments have emphasized – that they are using public money extensively to fund "automatic stabilizers", such as unemployment benefits and social services. They grow with the deterioration of the economy and infuse new money into the system, thus maintaining the consumption capacity of the people. If these contributions are taken into account, the share of European rescue packages often exceeds the 5 per cent mark.

In preparing for the G20 summit in London in early April 2009, there were rather deep divisions between the United States and the EU countries on whether rescue policies or regulatory reforms should take priority in the management of the crisis and the coming recovery. In the end, these disputes were buried in a compromise. In Europe, the British government has long been reluctant to increase financial regulation as it has feared the adverse repercussions for the City, which expanded during the past financial boom. Germany and France, in turn, have been more willing to embark on major regulatory reform.

It is often suggested that the present crisis will lead to the expanding role of the state. This is true to the extent that rescue funds can only come from the public purse and regulatory legislation can be passed only by national parliaments and intergovernmental bodies. Many banks and companies may have no choice but to accept governmental support if they want to survive in the market. Taxpayers are the ultimate guarantor of capitalism if its excesses lead to a major crisis.

The situation is, however, more complex than that because governments are also in a bind. Sovereign wealth funds, owned and managed by governmental institutions, have been similarly hit by the present slump, especially in the Persian Gulf. Moreover, states can steer public money to ailing businesses only to a restricted extent and for a limited period of time. The increase in fiscal deficits and debt burdens is becoming an ever-greater problem. The IMF has estimated that by 2014 the total gross debt burden of the ten richest G20 countries will increase to 114 per cent of their GDP, compared to 78 per cent in 2007. The growth of public debt is inevitable in the present circumstances, but it cannot continue indefinitely.

Steep increases in fiscal deficits and national debt burdens mean that once recovery is underway, governments must initiate savings to restore the fiscal health of the nation unless they are ready to propose an increase in taxes (both measures are often required). Inflation is, of course, yet another solution, but unless economic orthodoxy changes drastically as a consequence of the crisis, it is an unlikely remedy, though it may become a threat if governments replenish the deficits by printing money. Also, major increases in direct taxes are unlikely and the emphasis will probably be on indirect taxes that would increase the regressive nature of taxation.

As a result, the role of the state will become stronger over the short term, but it is very much an open issue as to whether this will be a secular trend or merely a temporary change imposed by the circumstances. Concern over the growing role of the state, especially in conservative circles, is visible in the debates on the need for an exit strategy from the public rescue policies; namely how to halt the increases in fiscal deficits and debt burdens as quickly as possible. My hunch is that in today's world there are so many forces opposing the expansion of the state's role that this trend will hardly augur a long-term process.

The crisis is also complicating relations between politics and business. In several countries – such as Iceland, Ireland, and the Baltic states – banks and companies are at the mercy of the government, which is also suffering badly itself. In other countries, such as Finland, banks are using every means at their disposal to avoid an increased dependence on the government, which their relatively healthy balance sheets have made possible. Bank failures and mergers have resulted in a concentration of financial power, which has increased their bargaining power vis-à-vis the government. For instance, in the United States two-thirds of the assets of all commercial banks are owned by the five biggest banks (JPMorgan, Chase, Citigroup, Bank of America, and Wells Fargo).

In larger countries, the relationship is more complex as the conditions of individual sectors, banks, and corporations vary considerably. In the United States, in October 2008, the Bush Administration forcefully convinced nine leading commercial banks to accept US$125 billion in TARP (Troubled Asset Relief Program) funds in the name of preventing the entire financial system from collapsing. As the "stress tests" conducted for several US banks in the spring of 2009 showed, some of them truly needed these relief funds.

On the other hand, some of the banks were very reluctant to accept TARP funds as they wanted to avoid the interference of the government in their business activities and populist Congressional criticism of their past mistakes. The effort by the banks to disengage from governmental control is seen in the fact that in June 2009 five out of the original nine banks paid back US$68 billion bailout funds in an effort to be "free" of political directives. Goldman Sachs did so in order to start paying fat bonuses to its top directors as a result of the record US$3 billion net income in the first half of 2009, the most profitable six-month period in the company's history. In 2008, total earnings at Goldman Sachs were US$2.3 billion, while it paid out US$4.8 billion in bonuses (78 executives getting more than US$5 million each). In 2009, the money has been earned from risky trading and investment decisions in a climate in which competitors have been reluctant to take such risks. The early bird may indeed catch the worm in the financial business, which also suggests that its traditional methods have not disappeared and will probably return in new forms when the crisis subsides.

It is difficult to predict how the crisis will pan out. One may surmise, though, that we are not witnessing the end of capitalism, nor even the financial system anchored in Wall Street and the City of London. The recovery from the crisis may be slow, but it will happen if the economic and financial growth models can be renewed by learning the necessary lessons and redirecting policies. This is most likely to happen again in the United States, where the system is more flexible and innovative than in the BRIC countries. It is relevant to observe that this time Japan seems to be following the US stimulus model closely, obviously trying by quick actions to avoid a repetition of the long deflation period it suffered in the 1990s.

Internationally, the IMF has recently published an estimate suggesting that so far only half of the bad loans issued by banks have been disclosed. Another wave of the banking crisis has not yet been ruled out. For instance, many banks in Russia are in very poor shape.

1.4 Multilateral governance

In addition to domestic consequences, the financial crisis is having multiple international implications as well. Supported by the Obama Administration in the United States, efforts to manage the crisis have given rise to a new brand of multilateralism which is also more inclusive, as witnessed by the G20 summits, and more international consultations on Afghanistan and Iran than before. It appears that the G20, which was launched in the late 1990s as meetings of finance ministers, has started to replace the old G7/8 as the major informal forum of economic policy consultations. In fact, the Pittsburgh G20 summit made the decision to replace the outmoded body of the old industrial countries with the new G20. One main merit of the G20 is the inclusion of the rising economic powers, such as China, India, and Brazil, as fully-fledged participants. It has to be borne in mind, however, that the G20 does not have any official structure, secretariat, and executive functions.

The summits held in London in April and in Pittsburgh in September 2009 suggest that the composition of the G20 is too large and uneven to permit the making of effective decisions among all the participants, who number closer to thirty in reality. Therefore, bilateral and minilateral consultations are needed, as seen in London where China and the United States took the driving seat. These manifestations have given rise to speculation that the world economy will be managed by the G2 in the future, through which Beijing and Washington, as major surplus and deficit economies, manage their mutual relations and give guidance to the entire world economy. This bilateral constellation has rightly been dubbed a "mirage" and the proposition is premature, but Japan and the European Union should take it seriously nonetheless. Another possibility is the institutionalization, in the G20 framework, of a G4 group that would comprise the United States, the European Union, Japan, and China. Such a club would be particularly relevant in managing the exchange rates between the major national and regional currencies that appear to be facing a fair amount of turbulence as a result of the global economic imbalances and the efforts to mitigate them.

Increasing reliance on multilateral institutions is also reflected in the decision by the G20 summit in London to triple the assets of the IMF to US$750 billion. The strengthening of its role requires,

however, that the old industrial countries are ready to redistribute a share of their voting power within the governing bodies in favour of countries like China and India. As the Pittsburgh summit indicated, the restructuring of the IMF is no mean feat, but goes right to the heart of international politics. The main dispute has been between the United States and the major EU countries. Washington does not want to give up its de facto veto in IMF decision-making, while France and the United Kingdom are fearful of losing their seats on the IMF board of directors if their number is cut back to increase the relative influence of the rising economies.

IMF funds have been used to rescue the countries that are in the deepest difficulties – such as Iceland, Latvia, and Ukraine – though governments try to avoid the helping hand because of the strict conditions imposed by the Fund on their economic policies. Like it or not, the IMF will probably play a bigger role in managing distressed economies in the future, but it will hardly be able to wield enough power to monitor the global economic imbalances and exchange rates.

One of the systemic effects of the current financial crisis is the redistribution of economic and political power in the world. This is no new development, but has continued for the past two decades. However, the crisis will accelerate the process of the redistribution of power. The Chinese economy is predicted to grow by 8 per cent in 2009, and the Indian economy by 6 per cent. Meanwhile, Western economies are declining by roughly 4 to 5 per cent. The decline will be smaller in the United States than in the European Union and especially Russia, which is expected to suffer an 8 per cent decline in its economy. In these circumstances, an economic power shift at least is inevitable. Its political consequences are far from clear, however, as economic resources cannot be converted directly into political outcomes unless other powers consider them to have benign effects on the stability of the entire international system.

In this context, many seem to think that the greater integration of China and India into the world system, meaning their increased recognition as major players, would make international institutions more representative and thus more effective. In a similar manner, the ability of the Asian economies – even smaller, export-dependent ones – to bounce back would be good news for the rest of the world as well. The continuing growth of key Asian economies would help,

through "reverse coupling", to pull others out of the present slump, too. In other parts of the world, the US economy may recover more quickly than those of the European countries, whose relative position will thus deteriorate. The ultimate victims of the crisis are, however, the poorest countries of the world and their people. The total write-downs of the banks are thus far estimated to equal 37 years of official development assistance. The number of abject poor in the world will increase this year by 60 million, which jeopardizes the Millennium Development Goal to halve world poverty by 2015. Indeed, one of the elements in the policy debates on the financial crisis has been its devastating effects on the poor of the world. The President of the World Bank, Robert Zoellick, has demanded a strong focus on the plight of those peoples on the social peripheries. The foreign minister of France, Bernard Kouchner, is one among many to suggest a tax on financial transactions, the good old Tobin Tax, to help the world's poor.

Everyone recognizes that the future is uncertain. The incipient recovery may continue or not. The current consensus, also reflected in the communiqué of the G20 summit in Pittsburgh, is that the economic stimulus should not be discontinued now despite mounting public debt in most countries. The fear is that if the pumping of money into the economy is stopped too abruptly, the result might be a W-shaped economic curve, indicating we may face a new dip in economic growth. This is the view held particularly by the Anglo-Saxon countries and Japan, while some EU countries, especially Germany, continue to stress the importance of further financial regulation to facilitate a market-based recovery.

2. Parallel but opposite? Contradictory impacts of the financial crisis on the European Union

Toby Archer

2.1 Introduction

The European Union, taken as one entity, now represents the biggest economy in the world. However, it is not a single political unit. The EU remains a unique hybrid, considerably more than the other regional organizations spread around the world, but still much less than a federal state like the United States. In certain areas of political and economic policy-making, the Union is more important than the national political systems, and member states cannot individually block legislation that will affect them. This is what makes the EU unique, in that the member states are 'pooling' their sovereignty in these areas. But in other policy areas the member states still have sovereign rights, meaning that each state sets its own policy, or at least can veto any proposed EU-wide policy.

The single market was a founding idea and has been central to the creation of the Union. It is in matters relating to this, as opposed to security, foreign policy and justice and social issues, where the EU generally has competence over the member states. Centrally these competences are connected to the 'four freedoms' of the single market: the freedom of movement within the EU of goods, services, people and capital. The European Commission is the executive authority in these matters. The introduction in 1999 of the Euro currency, controlled by the European Central Bank (ECB), increased still further the community-level responsibility for economic and financial matters.

The importance of community-level competence in so much of Europe's economic and financial life made the European Commission a central actor in the unfolding financial crisis through 2008, but it was by no means the sole one. Much regulation of the financial

sector remains in the hands of national governments in the individual member states, and this bifurcation of responsibility has been central to the difficulties that have followed. The hybrid nature of split responsibilities between the national and community levels makes the EU a process as much as an institution. The balance between the national capitals and the Brussels institutions is changeable and often changing.

It is because of this dynamic relationship between the member states and the common EU institutions – most importantly, the European Commission – that the financial crisis is exerting both centrifugal and centripetal forces on the Union. The increasing integration of national economies across the EU, particularly amongst those countries that are part of the Eurozone, means that there is a sense that there needs to be common responses to the problems that the financial crisis has produced. This is the centripetal urge: to further integrate the economies of the EU in response to the international problems.

At the same time, whilst national economies are closely integrated through the common market, a singular European economy does not exist. This means that common regulation is not welcomed by all sectors of all European economies. Most notable has been the resistance from the financial sector of the City of London, and the influence these institutions have on the UK government, in resisting suggestions of a bigger role for the EU or the European Central Bank (ECB) in regulating financial markets in Europe. Contrarily, this regulation has found a champion in the German government, who felt that their manufacturing and export-led economic model had been vindicated by the crisis, which was a result of 'Anglo-Saxon' financial capitalism. This tendency may not push European economies further apart, but it does mean support for the status quo where the EU remains a hybrid somewhere between an international organization and a federal super-state, and limits the power of the actions that the EU can take. This is not a situation that has arisen only in connection to the financial crisis.

A similar dynamic had been seen with the attempt over the last decade to implement the Lisbon Strategy for jobs and growth. When the strategy was agreed upon in 2000, it was not politically possible to make the economic and structural changes obligatory for the member states through a new treaty. Because most of the areas that needed

reform were national competences, the strategy relied upon 'OCM': open methods of coordination, which included jointly agreed national plans and peer reviews to try and implement the strategy, but there was no legal imperative for the members to follow through. With little more than moral pressure on the member states, when Lisbon Strategy reforms went against immediate national political priorities, it was the reforms that tended to be set aside. Similar results can be observed in trying to produce a joint response to the current crisis.

Finally, the governments of the member states remain ultimately accountable to their own national electorates. This means that some national leaders have taken, or at least proposed, economic protectionist measures to benefit their national economies, but at the expense of fellow EU members, when they believe that this is what their electorates demand. If protectionist measures resulting from the financial crisis and the ensuing recession actually go against the common market, they are indeed pulling the constituent states of the EU further apart.

2.2 Protectionism and economic nationalism

The financial crisis and the recession which followed have caused a sharp downturn in GDP growth rates across the EU. This has led to an increase in economic nationalism in many member states, where governments aware of upcoming elections have adopted various protectionist postures to assuage the anger of domestic electorates. This reveals political limits to the logic of economic integration and the single market in Europe; a market which, by many accounts, has been the major success of the European institutions in the post-war era. This section investigates to what extent claims to defend national economies within the EU are rhetoric aimed at domestic electorates, and to what extent they constitute real policy changes with economic implications.

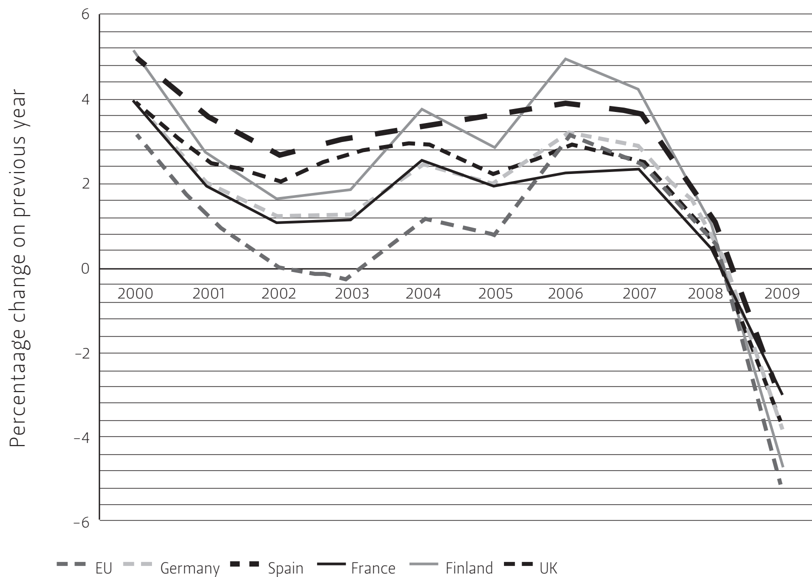

Figure 2.1. GDP volume growth rates for the EU as a whole and for individual member countries. Source: Eurostat (2009)

Being in the EU minimizes opportunities for member states to take protectionist measures against each other because respecting the common market is a basic precept of membership. This has meant that within the EU, the Commission has questioned national policies that might contravene common market rules. A prominent case in point has been the French proposal of support via 'soft loans' to French car makers dependent on the protection of jobs in France and the repatriation of jobs from factories that had been located elsewhere in the EU. President Sarkozy said in February 2009: "We want a French industry, we want a French automobile industry, we want to keep production capacity on French territory". The French proposal resulted in angry comments from the government of the Czech Republic, where a Peugeot-Citroën plant is located. Immediately, the European Commission requested clarification on the structure of the proposed package and sternly reminded the French that it was illegal to protect national industries at the expense of common market rules. This resulted in sufficient assurances from the French

government for European Competition Commissioner Neelie Kroes to announce that the Commission was satisfied that the French proposal was legal. Nevertheless in late March 2009, when Renault announced it was moving production of one model from Slovenia to France, and a French Minister described this as ”repatriation of production”, Commissioner Kroes stepped in once again saying that if, against the assurance already given, the French loans included clauses on jobs being in France, then this would constitute ”illegal aid”. The Commission's speed in reacting was lauded by the Slovenian prime minister. In fact, the Slovenian factory was at full production and could not meet further demand for the models that it produced, so a French plant also began producing those models to meet the excess demand; Sarkozy admitted that ”this is not taking work away from our Slovenian friends”. This is nevertheless what The Economist calls ”virtual protectionism”, arguing that it actually has serious negative effects in that electorates now think that their national governments can defend jobs against other European countries, which will only cause more cynicism and anger against both the EU and their respective governments when this proves not to be the case.

Actual policies have been implemented, however, which served to set Union members against each other. At the end of September 2008, at the height of the banking crisis, the Irish government began guaranteeing bank deposits up to a higher rate than the EU-mandated basic amount. Meant to allay fears over Irish banks, it resulted in a flow of new money into Ireland. This created considerable irritation amongst other EU states as pressure built on them to follow suit. Many member states, starting with Greece, soon followed the Irish lead out of the need to protect national banking sectors, not because of any joint EU decision. Help for domestic banking sectors has often come with conditions that the banks favour domestic lending. The bankruptcy of GM in the United States yet again threatens to push EU member states to put their domestic manufacturing industries before the common EU economy.

Earlier in 2009, the German government indicated that it would support GM's German subsidiary, Opel, in an attempt to find a buyer that would save German jobs, whilst the Swedish government took steps to protect Saab, also owned by GM. GM's European operations extend beyond Germany, which led to the German government facing criticism that it is only focusing on saving German jobs. The UK

business secretary, Peter Mandelson, warned that Britain would lodge a complaint with the EU if the German bailout led to British job losses at Vauxhall, part of the GM group. Likewise, the Belgian government also complained, fearing for an Opel plant in Antwerp. All of these examples demonstrate how, when electoral politics necessitates it, the governments of EU members act out of national interest first, even if this goes against EU interests – although the financial crisis did not emerge as a central theme during Germany's elections in October.

Nevertheless, despite these individual and specific cases of EU member states adopting protectionist postures or measures, they do remain limited. Indeed the World Trade Organization reported that although these limited forms of economic nationalism are increasing globally, "there is no indication of an imminent descent into high intensity protectionism". The WTO believes this is because, unlike the 1930s, there are extensive networks of international trade rules in place and governments around the world do not want to repeat the mistakes of the Great Depression. This is particularly the case within the European Union, with the common market legislation staunchly defended by the Commission. Also noticeable is that in the EU members states most heavily impacted by the financial crisis, such as some of the smaller Eastern European states, where loose lending from the banks of some of the older EU member states led to the formation of huge property bubbles, the EU is not being blamed by an angry population. Indeed, reports from Latvia in the aftermath of the rioting that broke out in Riga in January 2009 suggest Europe was in part seen as the solution to a failed domestic political class, not the problem. In Lithuania, Dalia Grybauskaite, previously a well-respected EU budget commissioner, easily won the presidential elections in May 2009 due in part to her EU reputation. Even Iceland, not an EU member, is now applying to join the Union after the implosion of its economy as a result of the banking crisis. The populations of EU member states (and of states outside of the EU) seem willing to a great extent to accept the limitations on economic sovereignty that membership brings, in the knowledge that membership also brings stability. There is less protectionism in this recession partly because of structures created to limit it, but also because there is less demand for it from electorates.

2.3 The push for a new EU-led regulatory system for international financial markets

Germany, being the biggest player in the European economy, has played a central role in the European response to the crisis. Arguably, that role has been in limiting some EU-wide actions to counter the effects of the crisis with spending, but also to push for better regulation of financial markets. Through much of 2008, Germany regarded itself as less affected by the financial crisis; the crisis seemed to be a financial sector one, with much smaller impacts on the 'real economy' of manufacturing and exports. Nor were German banks exposed to bad loans made in Central and Eastern Europe to anything like the extent that Austrian, Swedish and Italian banks were. This led to German resistance to early plans for a European-wide stimulus package and the issuing of Euro-bonds. The German government felt, justifiably perhaps, that German taxpayers should not be bailing out the bad decisions and financial profligacy exemplified elsewhere in the EU. Instead, their priority was regulation at the European level. German attitudes changed in 2009 as the financial crisis increasingly impacted on the wider economy, causing a recession, and German banks revealed their exposure to subprime loans in the United States, but the German position was central to setting the context for the actions that the EU could and could not take as the crisis unfolded.

Additionally, the EU has for some years attempted to justify itself by arguing that only a multinational organization of its size could have any impact on shaping globalization to the benefit of Europeans. In response to the financial crisis, the EU is attempting to put this rhetoric into practice by finding new ways to regulate international financial institutions but, to date, the proposed measures remain limited and focus more on intergovernmentalism than the community level.

In the autumn of 2008, as banks around the world teetered on the brink of bankruptcy, national governments scrambled to prop up banking systems. The European Commission appointed a group of 'wise men' under the chairmanship of the former head of the International Monetary Fund (IMF), Jacques de Larosière, to explain the financial crisis and make recommendations to the EU on steps to take to avoid similar disasters in the future. The de Larosière report, published in February 2009, suggests a number of new mechanisms

to try and manage financial risk-taking better across Europe, but the report is clearly sensitive to the differing national positions of the member states. EU Internal Market Commissioner Charlie McCreevy was quoted as saying that the new regulations would have to be ”evolutionary” as opposed to ”revolutionary”, as even ”minute steps in this area are fraught with difficulty”.

The central recommendations of the de Larosière report were adopted by the Commission proposals, published in May. The proposal recommends the creation of a new European Systemic Risk Council (ESRC) and European System of Financial Supervisors (ESFS). The ESFS will actually comprise three new European supervisory authorities: a European Banking Authority, a European Insurance and Occupational Pensions Authority and a European Securities Authority. But central to this is that all of these bodies will be made up of representatives of the national regulatory bodies and central banks of the member states. The Commission proposed that the ESRC be permanently chaired by the representative of the European Central Bank (ECB), but this was immediately greeted with alternative suggestions from the UK, including the proposal that the chair should rotate to increase the influence of non-Eurozone member states on the council. Britain’s position is unique because of the importance of the City of London for the country’s economy, but other member states, including Germany, are also said to be reticent about the proposal to let the ECB play such a central role. The UK has also garnered support from Ireland and some of the eastern European states, as well as central bankers within other EU member states, who would lose power if a more centralized European approach were implemented.

The central limitation on pan-European regulation is that banks, even if operating globally, remain based in particular countries. The ESRC may tell a European bank what risks it can or cannot take, but if that bank runs into financial difficulties, as was the case across Europe in 2008, any bailout will be the responsibility of national regulators and governments. The inability to find a way of ’burden sharing’ for future bank rescues across the EU explains why the proposed ESRC and ESFS will be committees of national representatives meeting under the aegis of the Commission and the ECB, and not just a single EU executive agency with the power to set the rules and enforce them on its own. Steps that would give more power to the EU centrally over financial regulation would require a change to the treaties. In the context of the problems over ratifying the Lisbon Treaty that already

exist, it seems highly unlikely that there would be much appetite for yet more negotiations over further changes. But critics claim the structures of regulation as currently proposed serve national and not European interests.

The sense in some quarters that the EU must 'do something' on financial regulation, whilst resistance to that idea grows in other quarters, reflects the unique hybrid nature of the EU. Not a state, but more than just a collection of states, a conflictual relationship forms between national and European-level authorities. The result will, if past precedent is followed, be an uncomfortable compromise, with the member states accepting that there is an advantage to their cooperating at the EU level, whilst the Commission accepts that it does not have sufficient legitimacy to gain more than limited control.

2.4 The Euro

The financial crisis and subsequent recession have been a major test for the Euro currency, still only ten years old. The financial power and stability of the 16 members of the Eurozone differs significantly, but there is a strong argument that particularly the smaller economies amongst the members have weathered the storm of this crisis far better for having the Euro than not having it. Greece and Ireland have been particularly singled out as the weakest amongst the Euro members, and there were fears that they could default on their sovereign debts until Germany promised that it would step in to support other Eurozone members in danger of defaulting.

Some analysts have suggested that countries are weaker now for not having the independence to devalue their own currencies, but the costs of leaving the Eurozone would be so high that few economists feel that the benefits of leaving could possibly outweigh the costs. The stability of the Euro through this difficult period is also attracting possible new members. A number of the newer, Eastern EU members had previously pegged their currencies to the Euro and maintain their ambitions to join fully – even if the current crisis has delayed plans, as in the case of Latvia after it needed IMF support in December 2008 to remain solvent. Iceland has also announced that it wishes to join the EU as a step towards joining the Euro, and the crisis has prompted the Danish government to seek membership.

2.5 Conclusion

As is so often the case with the European Union, it is hard to detect what the financial crisis might mean for the future of the EU because of the inherent tension between state sovereignty and the advantages of community-level action. The EU has had an important role, but has not become the central player in responding to the crisis; different economic positions amongst different member states caused major tensions even for those members inside the Eurozone, let alone those outside of it. When major banks teetered on the verge of bankruptcy, and runs on banks began, it was national governments and central banks and not the EU that had to respond. But the EU has always moved forward via incrementalism and compromise. If the ESRC and ESFS mechanisms are seen as helpful in stabilizing the excesses of banking and financial institutions, they may become the basis for more regulation being conducted at the European level as opposed to the national level in the future. But any major changes would require a new treaty, and the continuing travails of the Lisbon Treaty, preceded by the failure of the Constitutional treaty, suggest that there will be little enthusiasm to begin a new round of renegotiation even if Lisbon does come into force.

The EU remains hostage to the domestic political situation within its member states. In this way the financial crisis might push forward European integration in an unexpected direction. The economies of Ireland and Iceland have both been rocked by the global crisis, and whilst the Irish economy has suffered greatly, it has not suffered to the extent that Iceland has, where the crisis not only crippled the country economically but also led to the fall of the government. This was not the result of more far-sighted policy-making on the part of the Irish government and regulators than that of the Icelanders, but simply because Ireland is part of the Eurozone whilst Iceland is not. The Irish rejected the Lisbon Treaty in a referendum in June 2008, but the second referendum in October 2009 ended in a clear victory for the Treaty's supporters. This change of heart has been identified as stemming from the fact that Euro-membership helped save the Irish economy from bigger difficulties in the past than it is facing at present. Now that the Irish have voted 'yes', the Lisbon Treaty will finally come into force, ushering in the next steps in European integration.

Likewise, other countries have decided that being within the Eurozone will help them weather future financial storms better than remaining outside. The history of the EU has shown that it is these types of functional steps, not necessarily viewed as particularly politically symbolic, that have paved the way to further European integration.

3. Russia: Shattered hopes, unexpected outcomes, uncertain future

Vadim Kononenko

3.1 Introduction

For Russia, the global economic downturn became an unexpected "requiem for a dream" of the never-ending financial growth and staggering profits from energy exports. Not long before the crisis, the majority of the political class in Russia were convinced that the global economic climate would be stable and favourable for Russia's economy for years to come. In fact, these optimistic assumptions, codified in various policy plans and programmes stretching into 2020, became an important part of the context for the transfer of presidential power from Vladimir Putin to Dmitry Medvedev in the spring of 2008. The stable economy was seen as an assurance that the political transition would be smooth, generally leaving the contours of Russia's politics unchanged.

Not only did the penetration of the global crisis into Russia's economy shatter these expectations, it also brought about distinct changes in Russia's economic and corporate landscape. As stated in the Russia Economic Report released by the World Bank in June 2009, the decline in global demand, the fall in commodity prices, and the tightening of credit have accelerated Russia's economic slowdown since 2008. The price of crude oil is far below its 2008 level of nearly 100 dollars per barrel, and industrial production has contracted at a rate of some 15 per cent (year-on-year) during 2009. All in all, Russia's real GDP is likely to contract by about 7.9 per cent this year, while unemployment could rise to 13 and poverty to 17.4 per cent by the end of the year. According to World Bank forecasts, Russia's economy could return to modest growth in 2010, but the external environment will remain fraught with difficulties, which will slow down the economic recovery.

Apart from the obvious economic implications, the global downturn may have effects on Russia's political and social systems. The crisis has hit the elite sector of Russia's highly fragmented society, including the high-ranking bureaucracy, the oligarchs and the upper middle class, who benefited most from the recent decade of economic growth. Although this is a relatively small faction of the population, the cohort of well-paid professionals and executives working in Russia's major corporations has constituted the power base of the present regime.

Given these profound social and economic impacts of the crisis on Russia, one might assume that the Kremlin would be prompted to readjust its internal policies towards political liberalization, and possibly towards launching a series of structural reforms to modernize Russia's economy and make it more competitive in the face of the global economic meltdown. In a similar vein, one could expect a certain readjustment of Russia's foreign policy course towards more cooperation with the West on a number of issues, such as energy relations and pan-European security.

However, Russia's response to the challenges of the crisis is in stark contrast to these assumptions. The thrust of the Kremlin's anti-crisis measures has been to preserve political and social stability in order to maintain control and preserve the political status quo, as opposed to reforming the country's deficient economy and social structures. Second, despite the strains of the crisis, Russia's diplomacy has remained resurgent towards its neighbours in the CIS and the West.

This chapter seeks to address the question of why the effects of the global financial meltdown on Russia did not lead to rethinking or any radical readjustment of policies, as was the case in other countries discussed in this report, such as the US – or, for that matter, the Soviet Union after the oil crisis of the 1970s and the subsequent period of reforms during Gorbachev's perestroika. It shows that the personified nature of Russian governance is an inherent obstacle to political reform that might mitigate the consequences of the financial crisis. In this regard, Russia's reactions and responses to the crisis are an example of how the global crisis might have truly local and regime-specific outcomes for an individual country.

3.2 Challenges for the Medvedev-Putin system of rule

The crisis, which descended on Russia as an unexpected external challenge, has revealed the limitations of the current political system in effectively tackling such sudden shocks to the economy and society at large. As a result, the Kremlin's approach to the crisis has remained reactive and been geared towards maintaining the political order that was formed prior to the global recession.

According to media reports throughout most of the autumn of 2008, both president and prime minister chose to downplay the significance of the crisis, or dismiss its direct effect on Russia altogether by saying its economic effects would be confined to the US and Europe. This apparent reluctance to discuss the crisis with the right degree of seriousness indicated that the leadership had underestimated the significance of the global financial crisis for Russia. It also prompted the question of whether Moscow actually had a strategy with which to tackle the crisis at all.

In the meantime, the Kremlin has opted for institutional and constitutional modifications in order to strengthen the regime in the face of the economic crisis. The president's proposal to extend the presidential term from four to six years, and the terms of the State Duma (the lower house of parliament) from four years to five, reflects the underlying concern of the leadership with maintaining power. Medvedev also made proposals which would amount to increasing the role of the ruling party, United Russia, and centralizing the country further by decreasing the number of subjects of the federation.

In September 2009, President Medvedev published an article in his blog a few days before his birthday acknowledging the challenge that the crisis posed for the country. The article, entitled "Forward Russia!", critically exposes many of Russia's central problems, including the corrupt and inefficient bureaucracy, the oligarchy, and the lack of civil society. Interestingly enough, Medvedev's article was surprisingly non-committal when it came to the head of government: the president neither praised Prime Minister Putin for any particular success in tackling the crisis, nor expressed any specific discontent even though the general tone of the article was critical.

The relationship between Russia's two leaders remains pivotal to an understanding of Russia's transition through the crisis. Having entered the post-2008 era in close mutual alliance, President

Medvedev and Prime Minister Putin seldom reveal how their partnership works in practice: what are the policy ideas, where do they come from, and how are they implemented (and if not, why not)? Certainly one will never know for sure, but at least for the time being, the impression is that Medvedev and Putin are looking in the same direction, but mainly to avoid facing each other. Effectively, it limits the possibility for policy change, since such a change in Russia's system needs to be directed from the very top. Moreover, thus far at least, while Russia's societal repercussions from the crisis have been considered alarming, they have not been considered alarming enough to pressure the leadership into executing any real reform.

3.3 Economic nationalism and populism on the rise

Although substantial political change remains unlikely, the worsening economic conditions have led to a call for protectionism and a boosting of the role of the state in Russia's economy. The prospect of "re-nationalization" – a term the Russian authorities avoid using, even though one senior cabinet member was reported to have uttered it – reflects the controversy surrounding the actual success of Russia's key industries during 2000–2008.

The financial crisis exposed the fragility of Russia's corporate system as most of the country's strategically important industries, such as energy, metals, and finance, were found to be heavily indebted to foreign financial institutions. This has prompted the Kremlin to bail some of the oligarchs out by using previously accumulated state reserve funds. Not only did this increase budgetary pressure on the state's public spending, but it also tarnished Russia's reputation as a competitive economy with global ambitions.

The state evidently has the resources to implement rescue measures for the sectors of the economy most severely hit by the crisis: banks, energy companies and the big investment holding companies. To date, more than US$182 billion has been allocated to support the ailing banking sector. However, it is worth pointing out that these funds are also affected by the crisis as their actual value depends on the fluctuations of crude oil prices, the inflation rate and other factors. More importantly, it is unclear how the rescue measures will be implemented and what will happen after the bailed- out companies

are placed under state control. If the state is to intervene, it will have to service the external debts of the companies and, more importantly, improve their overall management and strategy. This is a formidable task given the level of corruption and the lack of transparency and efficiency in Russia's state institutions.

In addition to economic protectionism, another element in Russia's response to the crisis is political populism. A case in point are the unexpected trips by Prime Minister Putin to Moscow's supermarkets in June 2009, to oversee that retail prices in shops are not too high compared to wholesale prices. Another example is the closure of the biggest market in Moscow, the Cherkizovsky Rynok. The shutdown left several thousand workers – many of them migrants from countries such as China, Vietnam and the former Soviet republics – without work and, in some cases, homeless. The pretext for the closure of the market was to curb corruption and smuggling. However, the decision was criticized by migrant organizations as too rash an action, taken without weighing the potentially catastrophic consequences of putting thousands of desperate people out of work in the middle of a severe recession. In a similar vein, the Russian prosecutor's office went as far as to send a request to the Ministry for Labour to make sure that the quotas for labour immigrants had been cut as previously planned.

Despite the lack of a public debate regarding the government's policies, the positions of key policy-makers seem to differ when it comes to the success of populist measures and the prospects for Russia's economic recovery. Russian Finance Minister Alexei Kudrin stated on several occasions that the oil price is not likely to rise to levels seen before the crisis. In his opinion, in 2010–2015 the price of oil will float around the 50-dollar mark per barrel.

The president of the Russian Union of Metal and Steel Suppliers, Alexander Romanov, said that the automotive industry, manufacturing, and the construction sector, for example, remain in a very unstable condition because of the difficulty in obtaining credit. The head of the Russian Union of Industrialists and Entrepreneurs, Alexander Shokhin, says that 90 per cent of Russian banks may find themselves on the verge of bankruptcy during the second wave of the crisis, which might descend in autumn 2009. The banks will be facing the problem of unpaid loans, while the state will not be able to help that many of them out by bailing them out. According to some estimates, the internal and external debt of Russian companies stood

at around US$500 billion in early 2009. Most of these loans are due during 2009–2010. At the same time, according to Anatoly Chubais, head of the State Corporation of Nanotechnologies and former CEO of the Russian Unified Energy System, the second wave of the crisis will depend on external factors, in particular the situation in the economies of China and the US.

3.4 Foreign policy: a continuing resurgence?

Russia's response to the crisis has a foreign-policy dimension. As far as foreign policy is concerned, Russia has demonstrated a mix of isolationist tendencies on the one hand and attempts to launch new ambitious proposals concerning global energy and security on the other. Its response to the crisis domestically is deeply intertwined with the country's foreign policy. The crisis poses a serious external challenge to the internal stability of the ruling class, whose interests Russia's foreign policy is meant to protect. Protectionism and populism at home are reflected in controversies concerning Russia's diplomacy, such as the decision to put the WTO accession talks on hold while opting to promote a system of common rules for energy trade. As such, Russia's foreign policy remains dualistic towards the crisis. On the one hand, the crisis limits the country's self-assertiveness, which was gained during the years of prosperity. On the other hand, the crisis is perceived as an opportunity to expand Russia's influence while other major players are constrained by the recession.

Russia's foreign policy aims to serve the interests of the ruling class, which predominantly sees the West in terms of geopolitical competition. At the same time, the Kremlin's strategy for such competition is not very consistent.

The most prominent example of this is Russia's refusal to continue the negotiations with the WTO, opting instead for joint WTO membership along with Belarus and Kazakhstan. Russian officials say this "new cycle" of negotiations would take another ten years, which shows that Russia is in no hurry to adopt WTO norms. At the same time, Moscow is showing little interest in opening its borders to its closest neighbours or political allies such as Belarus.

Russia perceives the current global recession as a sign that the political and ideological predominance of the West is on the wane. Despite the fact that the country itself has been severely affected by the economic meltdown, Russia's leaders see it as the right moment to launch new ambitious policy proposals on pan-European security and energy architectures in which the institutions of the West are not regarded as the centrepiece. While the Kremlin might be right in assuming that, stricken by the crisis, Europe is now open to new ideas, Russia's proposals fail to translate into real alternatives. It is also unclear whether Russia itself is prepared to play by the rules that it so actively promotes.

According to Russia's proposal, outlined in a concept paper recently made available by the Kremlin, the new energy treaty should include most of the energy sources, including fossil and nuclear fuel, and the entire process ranging from extraction to supply and energy transit. Russia would like to get other countries involved in the energy transit and commit itself to making the process transparent and uninterrupted. The new treaty is seen as an attempt to restore Russia's (read: Gazprom's) reputation as a reliable energy supplier, as it was tarnished after the latest gas war with Ukraine.

Moscow's proposal for a new energy charter can also be interpreted as an attempt to revise the energy arrangements in Europe, such as the European Energy Charter of 1991. The Kremlin has been critical about the EEC, which Russia signed but did not ratify on account of its being incompatible with Russia's national interests. Should it be accepted by other states, the new agreement would replace the current EEC. However, in its current form, Russia's proposal has much less substance than the EEC and is not that dissimilar to it. Both agreements are being sought to maintain the transparency of the energy trade and the security of transit. The difference is that the Russian version is less binding and puts emphasis on both the sovereign right of the state to exercise control over its natural resources and have open access to investments in the energy sector. The proposal also mentions the possibility of the exchange of assets between exporting and importing countries, which has been part of Gazprom's strategy to bolster its presence in Europe by acquiring infrastructure and energy companies in the EU.

Yet, at the same time, Moscow remains unwilling to give other countries protection for foreign investments in Russia. It is unclear

how far Russia would be prepared to go with this proposal. For example, will the Central Asian countries be given the opportunity to monitor their gas and oil transit through Russia? Or will foreign investors be able to review Gazprom's strategic plans?

It is understandable that Russia is concerned about its strategic isolation. However, it remains unclear whether the country is prepared to play by the set rules it so actively promotes. It may well be that Russia is mainly interested in having a high-level grand project which would help change its "lone bear" image, while still conducting most of its diplomacy and trade outside this cooperative framework. This might be the reason why Russia's proposals are initially so vague, but as such, they will bring little added value for Russia and hardly herald any change in the country's relations with the West.

3.5 Strategic interdependence

Yet Russia is dependent on the West not only financially, as many corporations face loan payments due next year, but also in terms of infrastructure and technologies. A good example is the recent opening of a fast-track train connection between Moscow and Saint Petersburg in July 2009. Such a train connection between Russia's two capitals had been in the offing for a decade. Earlier attempts to develop the country's own express train model, dating back to the 1990s, were unsuccessful and have become obsolete by now. This time, Russian Railways, headed by Vladimir Yakunin, and in association with Putin, opted for a contract with Germany's Siemens in order to finally complete the project. Even though the new train has been showcased as a unique project, it is not that dissimilar to its clones, which have been in service with Deutsche Bahn for a long time.

Russia's dependency on the West is also of a strategic nature. Of all possible allies, it is the US and the EU who have invested the most in supporting Russia's economic transition and structural reforms since the end of the Cold War. China, which is often cited as a prospective ally, is only willing to offer Russia the role of a junior ally given the discrepancy between Russia's and China's economies and Beijing's growing political weight. Finally, Russia is dependent on the West, and on the EU in particular, as the largest market for its energy reserves.

In other words, the West has been perceived as an unwanted external political factor on the one hand, and as a source of profits and financial stability for the Russian elites on the other. The current crisis has served to expose this dependency. However, for most of the Russian elite, the only imaginable response to this dependency is to overcome it through geopolitical competition or, if the latter proves to be an unattainable goal given Russia's limitations, camouflage it with active diplomacy in those fora where the West is not present, such as the Shanghai Club, and with resurgent policy in the post-Soviet space. The crisis, as it lingers on and continues to affect Russia's economy, may also prompt the Russian government to isolationism, particularly if its attempts to forge anti-Western alliances fail. In this case, the (unrecognized and unwanted) dependency on the West will become ever deeper. This will undoubtedly present the Russian leadership with increasingly delicate challenges.

3.6 Conclusion

Russia's response to the global economic crisis is essentially reactive and conservative in nature. The crisis is perceived as an external challenge – a tsunami of sorts – and therefore Moscow's response to it is geared towards protecting the current leadership and maintaining its position of power. The tendency to increase the paternalistic rule of the state becomes reinforced as the focus shifts towards extending the presidential term and expanding state control over the economy. However, while the framework of the system gets buttressed, the quality of its economic and social foundations gets put to the test.

In light of the aforementioned problem of "rescuing" the indebted oligarchic capital and the possible redistribution of assets in the country, the measures adopted to strengthen the regime seem to correspond with the general logic of the current political system. However, this might not be sufficient to lead the country out of the economic crisis, should the crisis continue. In order to address the crisis in earnest, the government would need to implement more than the proposed tax cuts. Furthermore, it will need to bolster the optimism and appearance of stability which existed before the crisis with real deliverables in order to reassure the population that the state is able to deliver on its guarantees. In this context, the mix of

conservative and populist measures that the government is prepared to take will inevitably prove insufficient.

In the short run, however, Russia's paternalistic, self-centred political regime is not likely to respond to the challenges of the crisis effectively. However, it is possible that it will withstand a brief or medium-term economic crisis given the financial resources it has accumulated in previous years. Nevertheless, if the crisis continues, it will fuel internal dissension in the regime, namely the conflict of interests among the state-business elite, posing challenges to the system from within.

4. China, the financial crisis and the Sino-American relationship

Matti Nojonen

4.1 An inconvenient interdependency

Over the past few years, a symbiotic relationship has emerged between the surplus economy of China and the deficit economy of the United States. This relationship, for reasons presented below, is an inconvenient one and reminiscent of an unhappy Catholic marriage. The two countries are like spouses who are unable to file for divorce despite having markedly different perceptions of the world order and not sharing any common set of values.

This union was formed in a rather subtle manner during the first decade of the 21st century. The gravity of power between China and the United States is gradually tilting towards Beijing as the Obama Administration has been shifting away from value-driven China politics in favour of a more cooperative and constructive set of policies. In these circumstances, China has more room for manoeuvre, but it faces an increasing risk of domestic turmoil, while domestic political pressure to rectify its potentially risky dependency on the United States is mounting. However, these two spouses are joined at the hip; and any drastic motion by either one will cause both to stumble and fall.

4.2 America's shift away from value-based politics

Since the inauguration of Barack Obama's Administration, the United States' China policy has witnessed an almost complete turnaround. Washington has started deviating from its conventional value-driven approach to China and, to Beijing's relief, has all but dismissed questions like human rights, freedom of expression and religious rights. In fact, the portents of change were even evident during Obama's presidential campaign when his leading China advisor, Jeffrey Bader, provided an interview for the liberal Chinese newspaper

Nanfang Zhoumo (Oct 29th, 2008), saying that Obama's victory in the presidential elections would likely mean changes in America's stance on human rights in China and on the matter of the exchange rate of the Chinese yuan. Indeed, Obama has kept his electoral promises to China's leaders. When Secretary of State Hillary Clinton visited China in February 2009, she refrained from naming dissidents and did not mention human rights during a half-hour television interview. Secretary of the US Treasury Timothy Geithner adopted the same stance during his visit to Beijing in May 2009 by not raising the issue of the artificially low exchange rate of the yuan, which usually tends to be a priority issue.

The Obama Administration has understood that China's relative power has increased and that surviving the financial crisis requires cooperation. President Obama's opening speech in August 2009 at the high-level Sino-US Strategic and Economic Dialogue meeting in Washington further highlighted America's new switch to realism, backed up by Hillary Clinton's comments in Beijing when she stated that "we are truly going to rise or fall together".

In fact, President Obama himself, as well as the US, depend on Beijing's economic support. Obama needs this support to keep his electoral promises to implement economic stimulus packages, reform healthcare, tackle the growing budget deficit and finance America's military operations in Iraq and Afghanistan. China is the single biggest foreign creditor of the US economy, covering more than one-tenth of America's mushrooming national debt. Beijing possesses more than a quarter of all foreign-held Treasury bonds, or T-bonds. Consequently, no other actor could presently replace China's support. Never before has the US economy been so deeply reliant on the economic support provided by a foreign country. The US, the strongest democratic country in the world, now finds itself in the ironic situation of relying upon economic support from a country run by a Communist party. Without China's help, Obama's economic policies would sooner or later come up against a brick wall, causing recovery to stall, and his chances of a second term in the White House would be very slim indeed.

Sino-American economic relations are not, however, entirely lopsided. Although the US is burdened with masses of debt, it remains of great strategic importance for China to secure the vitality of the American market, because China's success depends on America's

fortunes. China, with its developing market and export-driven industry, has accumulated the largest foreign exchange reserves in the world. By 2009, their total value surpassed US$2.3 trillion, out of which Beijing has invested an estimated US$1.7 trillion (about 70 per cent) in dollar-denominated financial assets: US$900 billion in T-bonds, US$550 billion in Fannie Mae and Freddie Mac, and the remaining US$250 billion in corporate bonds and equities. In other words, China's dollar assets constitute no less than roughly 40 per cent of China's GDP, which means Beijing is bogged down in a strategic dependency on the US economy and a stable US dollar. Any downturn in the US will have a commensurately negative impact on China's enormous dollar assets.

4.3 The "dollar-circulating pump"

At the heart of the Catholic marriage between China's surplus and America's deficit economy lies a "dollar-circulating pump". This dollar pump circulates money between the relatively poor China, which provides credit for the richest economy of the world, and the US. The pump has a pivotal domestic political and economic importance both for China and the US: loans from China allow Washington to balance its budget deficit and keep interest rates low. Meanwhile, as America consumes Chinese-made products, dollars flow to manufacturers located in China, finally ending up in the vaults of the Chinese central bank, the People's Bank of China.

The US market has traditionally been the most important market for China. It has been the driving force behind two decades of growth in global consumption power, with an indispensable capacity for absorbing Chinese products and keeping China's factories running. Therefore, demand in the US market is directly linked to China's economic growth. China's economic growth, in turn, is crucial for maintaining the stability of the country's fragile social order – according to Chinese government figures, 87,000 riots and mass incidents took place in 2006 (no official statistics have been published since).

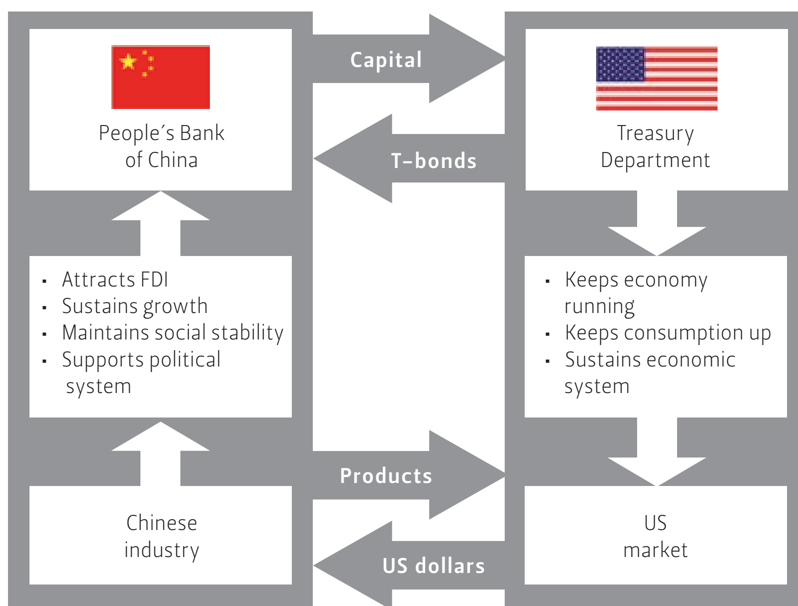

Figure 4.1. The rotation of the dollar-circulating pump

The global economic benefits of the dollar pump between these two economic powerhouses have been palpable. During the last five years, China, currently the world's third biggest economy, and the US, the world's biggest economy, represented roughly 60 per cent of global economic growth and 30 per cent of global GDP.

The dollar pump emerged at the beginning of this decade as a result of two simultaneous, but different, processes on the two opposite shores of the Pacific Ocean. The Bush Administration practised a debt-driven growth model and laissez-faire economic policies; during George Bush's eight-year term in the White House, America's national debt more than doubled, topping US$11,000 trillion. The budget balance made a sharp switch from surplus digits to a deficit of more than US$455 billion at the end of 2008. The Fed fuelled economic growth by keeping interest rates at artificially low levels. These cheap loans were financed with debt, in particular with T-bonds. Washington found that the liberalist economic model was working and the economy kept growing.

There is a historical precedent for this: in the 19th century, the US government built its railway network with foreign debt. This time,

however, foreign loans have not been invested in infrastructure to support economic growth, but instead have been channelled into supporting consumption mania and less profitable ends, like financing bigger cars, commodities and housing. Due to increasing consumption, the US trade deficit with China skyrocketed by more than 220 per cent between 2001 and 2008, up from US$83,096 million to US$268,039 million.

Meanwhile, in the early 21st century, Beijing decided to start investing its foreign reserves in low-yielding but safe US T-bonds. In 2000, China had US$92 billion worth of T-bonds and a rather modest foreign exchange reserve worth US$156 billion. By 2005, China was witnessing an increasing influx of speculative capital. Investors had realized that the dollar was depreciating against the yuan at the same time as China was offering higher interest rates, which caused an escalating inflow of "hot" money into China and beefed up the country's foreign exchange reserves at an accelerating pace. During 2008, the inflow of foreign currency was in excess of one billion US dollars per day throughout the year. After the first uncertain months of the financial crisis in 2009, the inflow of foreign currencies stabilized back to normal. Consequently, the dollar dependency headache still throbs in Beijing.

4.4 The financial crisis's impact on China

The financial crisis is a serious threat to Chinese social stability. It has exposed the biggest drawback of China's economic reforms model: too strong a reliance on foreign markets. Over the last thirty years, China's economic growth model has been based on infrastructure building, integrating the Chinese labour force and the economy into global production chains, and on alluring foreign investment and production-oriented export activities. Consequently, China's economy has become strategically dependent on the global markets. Today, exports make up roughly 40 per cent of China's GDP.

The global market's growth over the last two decades has facilitated demand for Chinese products and kept tens of millions of Chinese employed on factory production lines. However, as global consumption power began to fade due to the financial crisis, Chinese exports declined by between 10 and 25 per cent on a monthly basis

after the second half of 2008. More than 90,000 factories have been shut down and an estimated 20 million people have lost their jobs since early 2008. Moreover, one million young people enter the Chinese job market on average every month, and now they face increasing difficulties in finding work under the current circumstances. As China's social security system is weak, people who are struggling to make ends meet pose a risk for more demonstrations, and social outbursts have been increasing dramatically across the country.

The Chinese central government began to stimulate the economy during the latter half of 2008 with a series of measures. The People's Bank of China lowered interest rates on several occasions, deregulated the real estate market and provided banks with more possibilities to provide credit to enterprises. These measures alone were insufficient to steer the economy back on track, and in November China announced a US$568 billion stimulus package that was later cut by half. China has announced that the stimulus package will be used for railway improvements, other forms of construction work, education, and rural development.

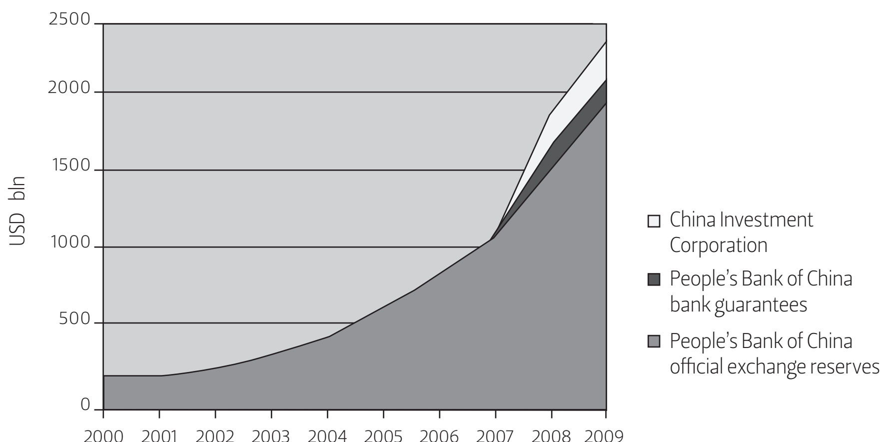

Figure 4.2. Increase in total Chinese foreign exchange reserves from 2000 to 2009. Source: compiled by author, based on PBoC figures and other sources.

However, the stimulus package will not promote the much-needed sustainable structural change of shifting China's economy from its reliance on international markets to the largely untapped

potential of its domestic markets. China has the highest savings rate in the world with a public savings rate of roughly 50 per cent and a domestic savings rate standing at nearly 40 per cent. The reasons for these high savings rates are not cultural, but primarily structural. In the Chinese socialist market economy, people have to save in order to cover their possible healthcare expenses, children's education and retirement. In reality, the Chinese pay for most of their public services. In order to make people spend their savings, the government would have to build a nationwide social security network, a process that would take years, if not decades, but China has no other means by which to improve its ability to withstand fluctuations in global supply and demand.

4.5 China's emerging critical voices

A heated and rather critical discussion on China's strategic economic dependency on the USA and how to invest its increasing foreign reserves has emerged in the country. On the one hand, Beijing is facing increasing domestic political and public pressure to diversify its strategic dependency on the US. On the other hand, there is a growing demand to divert foreign reserves to the development of the domestic market. Opinions on the matter come in a range of tones, from the moderate to the extreme.

The extreme end is composed of a marginal group of ultra-nationalists, whose sentiments are voiced mostly on the internet and in populist publications. They insist China dumps its dollar investments to bring Washington to its knees. Proponents of such views, who gain plenty of media attention in the West even though they remain politically insignificant, overlook the fact that if China were to realize this "financial nuclear option", it would also destroy its own economy and would most likely cause the current Chinese regime to collapse.

However, a number of influential nationalistic political scientists do demand a diversification of China's dollar dependency. In 2007, He Fan, a research fellow at the Chinese Academy of Social Sciences, proposed that if the US did not stabilize the value of the dollar, then China should gradually divert its dollar investments to a more reliable

option. His idea received broad support among nationalistic scholars. In general, however, the opinions of Chinese economists tend to be more moderate. The reason behind this may be that economists have a more profound understanding of the nature and indispensability of the Sino-American economic relationship.

The critics do share a common objective: to support the growth of the internal market. Those from the radical end judge the Chinese regime to be more interested in supporting America's deficit economy and its "pathological disease of consumerism", to quote Professor Qin Hui of Tsinghua University, than in developing a social welfare system, providing free education or developing a domestic demand structure for the Chinese people.

Scholars and netizens have also expressed their concern about the loss of Chinese dollar assets due to the depreciating US dollar, which has lost more than a fifth of its value against the yuan since 2005. In 2007, Beijing made an effort to divert its dependency on T-bonds and the government established the first sovereign wealth fund of China, the China Investment Corporation (CIC). However, the executives of the CIC and the ministries behind the decision-making have become the target of furious criticism as two major investments by CIC failed as a consequence of the financial meltdown. In a short period of time, the CIC lost almost 84 per cent of its US$3 billion investment in Blackstone. The CIC made a 5-billion-dollar capital infusion into Morgan Stanley in December 2007, before the financial bubble burst.

Criticism has emerged not only among the public, but from within the circles of political power, too. The governor of the People's Bank of China, Zhou Xiaochuan, suggested in March 2009 that the global financial system should decrease its dependency on the US dollar, and should instead strengthen the special drawing rights system of the IMF. Xia Bin, director of the Financial Research Institute of Development Research Center of the State Council, stated in the summer of 2009 that China should use its dollar assets to boost its bargaining power against the US.

A substantial and drastic shift has occurred in Sino-US economic and political rhetoric. It used to be customary for Washington to offer a carrot on a stick to Beijing and demand reforms or the release of dissidents, but now Beijing swings the baton while Washington keeps quiet. This change materialized in November 2007 when

Chinese Premier Wen Jiaobao stated for the first time that China is worried about how US economic policies are affecting China's dollar holdings and its assets in the US. Criticizing and lecturing the US about its economic policies, its need to boost its savings rate and, most importantly, to safeguard Chinese investments in the US, has become a hallmark of Chinese leaders. At the same time, Washington has taken a much softer and adaptive stance towards China.

4.6 Centrifugal forces on the rise

During the course of the financial crisis, China has, in relative terms, gained power. Despite the country being far weaker than the US in absolute terms, it is obvious that Beijing currently has more room for manoeuvre than Washington does in its deepening spiral of debt.

Obama has responded to this shrinking leeway by changing Washington's tone to a more constructive and cooperative one. Moreover, Washington is strongly demanding Beijing to join the table of decision-makers in the IMF, the World Bank, and other global multilateral organizations, with the strategic aim of binding China to existing Western-made institutions. On the other hand, the current circumstances have afforded China an advantageous position and the opportunity to demand a bigger role in such institutional structures. Nevertheless, China is simultaneously adhering to its core principle in international politics, the "non-interference policy", referring to the demand that no state has the right to interfere in another state's internal affairs.

Yet Washington still has one strategic advantage over China: the US dollar. The dollar is the leading currency of the global financial system and the most used currency in international trade. It is also the main reserve currency of many countries. China is concerned about the depreciating dollar because it comprises a threat to China's dollar-based assets. However, China itself is part of the problem – as Washington issues new T-bonds and Beijing is forced to purchase them in order to safeguard its own assets by helping the US economy recover, it is exacerbating the forces that already depress the dollar. China is also afraid of Washington alleviating its growing debt burden by depreciating the dollar even further. This is why Chinese leaders constantly demand guarantees from Washington for a stable dollar.

Beijing, due to its greater financial muscle compared to the US, has announced three different strategies aimed at gradually reducing its dependency on the US and its dollar, and thereby saving China from future financial crises. First, it has started a series of domestic, regionally limited trials in developing a social security system to boost domestic demand. The purpose of these experiments is to gain knowledge, and to single out and employ successful models to cover broader regions and, eventually, the entire population. However, building a social security system is a daunting task in a country with 1.3 billion people, and one which is plagued by great regional socio-economic variations, administrative malpractice and corruption. In 2008, China also made currency swap agreements with countries like South Korea, Malaysia and Argentina, enabling these countries to conduct bilateral trade with China in their own currencies. Although these agreements are quantitatively insignificant and so should be seen as experimental in nature, they provide a strong signal of China's willingness to raise the international importance of the Chinese RMB as an alternative to the dollar. In July, Beijing announced stronger support and promised more (financial) resources for China's strategically important industries to carry out overseas direct investments (ODI), in the hope that Chinese energy and raw material companies in particular would become more active investors overseas. Chinese ODI has been one of the fastest growing economic phenomena in recent years, increasing from US$590 million in 1999 to over US$12 billion in 2005. This figure would be an estimated 50 per cent higher if it included investments by all overseas incorporated Chinese companies, and it is expected to reach US$60 billion by 2011. Given China's endless need for raw materials and energy, its still rising US dollar reserves and its political desire to reduce dependency on the US, it is likely that Beijing will supply Chinese companies with the assets to carry out even more ODI in the coming years.

These steps are still very much incipient, and China and the US will remain tightly joined at the hip for years to come. However, both Washington and Beijing do recognize that the implications of this type of Catholic marriage are unsustainable in the long run. The forces of the financial crisis have drawn these two countries uncomfortably close to each other, and both are now struggling to loosen the ties as much as possible without crippling their own economy – and political stability. The fate of the Sino-American relationship will be determined by how China and the United States, together and separately, emerge from the financial crisis.

5. Concluding remarks: Vain dreams of economic immunity

Kristian Kurki

5.1 Uneven regression and resurgence

The consequences of the financial crisis can be evaluated in terms of a raft of statistics, ranging from economic to political and social. Typically, such an evaluation could be carried out simplistically, by making rough comparisons between parameters like growth figures. Assessing the impact the crisis has had on overall relations between states requires far closer scrutiny of the subtle connections between economics and politics, and domestic and foreign policy. The outcome is complex and susceptible to a multitude of interpretations, yet certain important observations can be made.

First of all, the crisis already seems to be affecting the relative political power balance between economically interconnected states, admittedly to varying degrees. For some 75 years, the United States' share of global GDP has on average hovered around 20 to 25 per cent, albeit peaking at times. The shares of China and India have been on the rise, while those of Japan and Europe have diminished. The US, too, is now struggling to hold its own. The EU needs to seriously embrace the idea of common policies on global issues in order to have leverage on the international stage. Failure to do so is likely to shift even more influence to the United States and China, forming an informal G2, as elaborated by Martin Wolf of The Financial Times, in spite of the EU being the world's largest single economy.

On a global scale, states that have traditionally been in an advantageous position as a consequence of their highly developed industrial base and strong economy have witnessed a challenge to their predominance of a nature they have not confronted since the Second World War. At the same time, the strained fiscal situation is fragmenting the internal politics of countries and unions. In the public's imagination and the mainstream media, the present crisis is often juxtaposed with the Great Depression of the 1930s. Yet in terms of international relations, comparisons are difficult to make, as

international interdependence today is at a far more complex level, and in the 1930s Western nations probably did not feel compelled to yield international leverage to non-Western nations (with the possible exception of Japan).

Non-Eurozone and non-EU countries are seeking support and protection from the EU's core, Russia is struggling to afford its staunch line of foreign policy, but for domestic political reasons is obliged to press on regardless, while America is less demanding of China and more conciliatory with most of the other antagonistic countries than before. The economic frailty of one versus the economic leeway of the other gives the upper hand in negotiations to the latter. It is, however, risky to make long-term assessments based on the assumption that the financial crisis has nudged the world onto a fixed track; it is fairly easy to draw potential trajectories for the future development of the power balance between the aforementioned parties if one, perhaps naïvely, supposes that the likelihood of further disruptions occurring is small. If the US economy stagnates and enjoys only limited growth over a long period of time, while China's growth continues at a much greater rate, it is inevitable that China will, eventually, surpass America's economy. In 2008, as the financial crisis was just beginning to bite, Albert Keidel of the Carnegie Endowment of International Peace published a study suggesting that China's economy was on track to surpass that of the United States by 2035. In light of more recent statistics, the crisis's relatively heavier impact on the US than on China might mean that China will overtake the US even sooner. Nevertheless, such scenarios are calculated with a wide range of variables, leaving an equally wide margin for error. Yet one landmark change is just around the corner: Japan, after decades of being the world's second biggest economy, is likely to concede its position to China within the next year or two.

5.2 The fragile political stability of the developing economies

Compared to figures emerging from the developed nations, which are struggling with GDP contractions of several per cent, projections of China's economic growth slowing down to 8 per cent and India's slowing down to under 6 per cent seem encouraging indeed. China in particular seems to have weathered the economic downturn rather well. Nevertheless, the sustainability of economic growth in the developing economies is far more delicate than GDP figures alone would suggest. All of them rely, to some extent, on appeasing the masses by promising sustained economic growth and an affluent future. Typical of these countries is a steady urbanization of the populations, where the rural populace migrates to cities in search of work. When the economy is growing, work is plentiful, salaries can be paid, and cause for societal unrest as a consequence of public discontent diminishes. The rate of economic growth needs to be well above the rather modest growth rate that a developed nation would, in an average year, be happy to achieve, in order for economic growth to stabilize society.

For instance, China's economic growth is particularly vulnerable to domestic political and social instability. This challenge includes the successful adjustment of industrial output to match the conjunctures of the global economy, and to create a solid base for domestic demand. These factors for consolidating economic growth apply not only to China but also to other developing economies – the BRIC nations especially. These countries are characterized by high but often volatile growth rates, combined with sizeable populations distributed across considerable land areas. Governing these large nations is a physical challenge for central authorities with limited resources, posing challenges to domestic governance and internal stability. In addition to this, Russia and China are also institutionally more vulnerable to domestic upheaval, as their ruling parties and elites are indispensable components of the dominant political system in their respective countries. In a democracy, the political institution remains more or less intact even if governments resign. It is unlikely that Russia's or especially China's internal political order would be able to absorb the shock of government failure.

Naturally, the risks of domestic political unrest are not limited to developing countries. Failure to pursue prudent financial policy has proved fatal to a number of European democracies where the governments have resigned, while wherever the government is still in place it struggles to maintain public approval and to keep rival political parties at bay. Still, the EU has demonstrated that, in spite of its internal disagreements, its pooling of resources has worked as an effective stabilizing factor during the crisis. Moreover, member states are protected by two layers of protection in a fiscal crisis: that of the ECB and that of the national state.

The risks in the large developing nations are of a far greater magnitude, as India, China and Russia continue to stretch their resources in the name of maintaining national integrity. Pressure to maintain high growth rates in these countries is tremendous. Russia, now facing steep contraction, is cushioning the fall with its currency reserves, but a prolonged recession could turn it into an example of the disintegrating effect that a financial crisis may have on a developing economy of scale. China's social stability is said to falter if growth dips below 8 per cent. However, this figure is a mere approximation, as are Chinese economic statistics in the main. Without reliable figures, it is difficult to estimate exactly how robust the rule of the Chinese government is.

5.3 The precarious trump of protectionism

Mainstream analysis of the origins of the financial crisis is broadly in agreement in acknowledging that the wave of financial failure started in the United States and spread from there to financial institutions elsewhere in the world. In this report, it has been shown that while the US market was pivotal in this chain of events, unsavoury economics has never been the practice of just a single player, but a game played by several parties. Although the US seems to stand out as the chief culprit, other profit-driven parties have contributed to the uncontrolled credit-based consumption that bloated the bubble in the American market.

Notably, the politicians in power in all the ailing economies have, wherever possible, tried to pin the blame for their country's economic woes on an external actor. In the case of the financial crisis,

the source of the problem was overseas, and the domestic economy was susceptible to disturbance from abroad since it was closely linked to and integrated with the international economy, which faced a deteriorating conjuncture. Not only banks but sizeable and traditionally robust manufacturing companies – some of which, like General Electric, had made the mistake of expanding their enterprise by venturing into the financial market – were faltering due to sluggish demand for their products around the world. To defend and, to some extent, to immunize the domestic economy against the global economy's fluctuations, would doubtless gain political support and prop up the national economy to some degree. Therefore, reverting to protectionist rhetoric became a tempting measure for politicians who sought to gain approval from their increasingly wavering electorates, many of whom had their jobs on the line.

While the IMF stated early on in 2009 that protectionist tendencies are on the rise and the press was awash with premonitions about a worldwide wave of protectionism, such a spread of protectionism as a regression from globalized economics seems unlikely for a number of reasons. Abrupt protectionist economic policy typically has a detrimental impact on political relations between economically interdependent states because it immediately alters the structure of the economy. Moreover, the extent to which states are economically interdependent today, and the nature of that interdependence, is incommensurate with past decades. Finally, the global economy is united by a commitment to market economy over planned economy, and where government intervention or regulation to an excessive extent impedes market interests, international pressure is likely to ensue.

5.4 Global governance

Global financial crises could be avoided, or at least mitigated, by effective global governance, yet there is an obvious shortage of global institutions that govern the global economy. This shortfall is likely to continue as there are some fundamental obstacles to its implementation.

One obstacle may be observed in the European Union, in that national interests among member states are sometimes found to

be incompatible with Union-wide objectives. Politicians who have power on a national basis are keen to hold on to their authority, and in order to hold on to that authority they need to satisfy their electorates. By and large, politics and economic policy continue to revolve around single-state units with insufficient concern for international agendas, even within the European Union, which tries to be as politically coherent as possible.

Furthermore, even greater differences of opinion and preference can be found by looking at regional variations in approaches to handling the crisis. While the United States and the EU share a commitment to overcome the financial downturn as swiftly and smoothly as possible, the former proposes substantial rescue policies while the latter prefers regulatory reform. A further dichotomy can be found between government and business, where disagreements abound on the requisite degree of regulation to prevent future financial predicaments.

On the flipside of the coin, common strife during the financial crisis may turn out to be a unifying factor. The multitude of countries incapacitated by mounting bad credit could serve as a catalyst for seeking greater cooperation and integration, which is evident in Iceland's courting Brussels for EU membership and Ireland's recent referendum on the Lisbon Treaty, which ended in a clear victory for its proponents. Efforts to vitalize and – most importantly – to validate the G20 as an institutional framework for multilateral governance on a global scale are further evidence of this, even though the political will to implement mechanisms for effective global governance still remains limited. Nevertheless, the Pittsburgh summit did underline the successes of multilaterally agreed efforts to curb the economic crisis which, at one point, seemed far more cataclysmic than it does today. The coordinated and comprehensive implementation of stimulus packages has largely nudged the economic trend back on a growth track. Yet to surface from all the hyperbole surrounding the G20 are the concrete policy measures that will be taken, firstly, to eradicate the oligarchic political authority wielded by the financial elites and, secondly, to address the global economic imbalances that were at the root of the financial crisis in the first place.

Furthermore, finance officials and leaders of individual developed nations continue to reiterate their pledges to do "everything in their power" to restore a healthy global economy, but these pledges are

predominantly geared towards maximizing recovery while minimizing political concessions. Global economic stability would require efforts to engage developing nations by renewing the structure of international institutions in a manner that would bolster their voting rights and influence. Middle-powers, like France and the United Kingdom, who enjoy privileges beyond the extent of their leverage in the international economy, are loath to make such admissions for fear of compromising their own influence. However, without any assurance of engaging developing nations and countries outside the Western perimeter in these frameworks – most obviously Russia – there is little incentive for these countries to conform to global power structures largely invented and maintained by the Western powers that be.

5.5 Financial crisis, economic crisis, then what?

If any merit is to be attributed to the ongoing financial and economic crisis, it is the test to which the international system is being put, and the dynamics and structural characteristics of the system which are being revealed. These revelations include the inherent weaknesses and strengths of Western democratic administration and authoritarian rule respectively; the relationship between deficit and surplus economies; and the rapid growth of a number of developing countries which, only decades ago, were not recognized as a force to be reckoned with. Any major change in the global order, however, is still years off, while the main challenge for states in the near future is to curb any further economic deterioration without doing it at the expense of the stability of their relations with other states.

GDP figures for the second quarter of 2009 have hinted at a recovery in the not too distant future, as two of the EU's chief industrial powerhouses, Germany and France, have managed to turn economic contraction into growth, and Japan's economy, lubricated by massive stimulus packages, has pulled off the same stunt. Whether national policies that have enabled such growth are sustainable is as yet uncertain. The growth figures are still meagre, they represent growth from dismal levels to begin with, countries tend to have their own non-standard statistical models to calculate economic growth, and in the longer scheme of things, a quarter of a year is still much

too short a period of time to base conclusions upon. A multitude of Western nations, especially the United States, Japan, and many leading EU industrial powers are struggling with their biggest public debt rates since the Second World War, which will inevitably be a constraining factor on economic policy in the long run. It will also render the debt-ridden nations more susceptible to political influence from countries with major surplus balances. Germany has been a bit of an exception in this respect, displaying a reluctance to invest excessive amounts in stimulus packages which would lead to massive public debt. Russia, which in recent years had been brimming with confidence over its own imminent resurgence as a primary global power, is facing a serious contraction of its economy and is expected to run out of currency reserves (from energy sales profits) by the end of the year. The country's financial leeway is shrinking rapidly, as is its scope for pursuing its line of bold foreign policy – or so one would assume. But Russia's tense domestic situation may not allow the political leadership to display any sign of weakness, not even outwards.

One line of argument concerns the implications of the financial crisis for the future of traditionally Western values: democracy, liberty, and a market economy. The manner in which the financial crisis has created an apparent contrast between economies controlled by a democratic government compared to an authoritarian government has emphasized their relative strengths and weaknesses in an economically competitive world. The notion that optimizing economic growth is easier under authoritarian leadership seemed to spread as, until recent years, China's and Russia's economies steamed ahead at rates that were unmatched even by developing economies like India, let alone the developed West. According to some estimates, individual liberties compromised overall growth rates compared to regimes where the state allowed itself a higher degree of intervention to pursue economic plans that would yield higher national growth.

The economic crisis continues to linger at a point of uncertainty, with statistics, although tilting towards happier times ahead, offering no guarantees of what the long-term trajectory of the global economy will be. Governments in countries hit particularly hard by recession or a steep decline in growth have been pressed to prioritize the national economy over the global one. In states with fragile regimes, the government's legitimacy is often greatly dependent upon

economic growth, but even in robust democracies governments have come under fire for allowing their countries' economies to become so dependent on global economic fluctuations that they found themselves unable to shield the domestic economy from the turmoil overseas. States are, for better or worse, dependent on other states. The financial crisis of 2008 has underlined this and demonstrated the significance of it, as strained economic relations inevitably run the risk of reduced stability in political relations. Without sufficient global governance, its ramifications for international relations are unpredictable and destructive at worst, yet the political will to govern international relations through multilateral institutions always seems to be subject to the state of national politics. Such are the priorities now, and such they will remain for the foreseeable future.

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The Great Regression?

Financial Crisis in an Age of Global Interdependence

Kristian Kurki (ed.), Toby Archer, Vadim Kononenko, Matti Nojonen
and Raimo Väyrynen

The financial crisis and the ensuing global economic downturn have been the focal points of news coverage and policy analysis for over a year now. At one extreme are those who choose to shrug the episode off as a significant yet transient dent in economic development, with marginal repercussions for the global system. At the other end are those who tout it as the first stage in an epoch-making transition in which the redistribution of economic power in the world will allow fast-growth developing economies to move to the centre stage of world politics.

The economic crisis still lingers at a point of uncertainty, and the governments of countries hit particularly hard by recession have found themselves between a rock and a hard place, trying to maintain stable international relations while pressured to alleviate discontent at home with promises of giving the domestic economy top priority. In states with fragile regimes, the government's legitimacy is often greatly dependent upon economic growth, but even governments in robust democracies have come under fire for allowing their country's economy to become so dependent on the global economy and so susceptible to its fluctuations. States are, for better or worse, dependent on other states.

This report is a compilation of analyses by researchers at the Finnish Institute of International Affairs. It takes the reader through a comprehensive overview of the dynamics of the global financial crisis and its challenges for governance across the board, followed by detailed accounts of how key national and institutional relations have been strained by the crisis, focusing on relations within the European Union, Russia's relationship with the West, and China's relationship with the United States.

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