Center for Security Studies

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Key Developments in Global Affairs

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CHAPTER 2

Financial crisis: Geoeconomic twist, geopolitical stick

The financial and economic crisis has been a defining trend of international affairs over the past two years. The West now has huge liabilities from stepping in to save the financial system, and took a further fiscal hit when launching stimulus measures to rekindle economic growth. China adopted similar measures, but has emerged far stronger from the crisis so far. The East's new found geoeconomic clout will take a long time to translate into geopolitical gains, but international institutions have to adapt sooner rather than later to these power shifts.

New York Stock Exchange, 20 November 2009, Reuters / Brendan McDermid

The financial crisis and global recession of 2008/9 have been a defining trend in international affairs over the past year. The causes of the crisis are well-established, but the effects remain less certain into 2010. Geoeconomic shifts are, however, more visible than geopolitical change at this stage. A deep depression has been avoided for now, but the damage remains considerable, if unevenly spread. Developing countries took the hardest hit, while the West has accrued massive liabilities from the crisis and has undoubtedly lost ground on key emerging market economies, especially China.

Those worst affected were always going to be risk-laden developing states falling on the wrong side of the commodities export/import divide and lacking the capacity to deal with the downturn. Meltdown on Wall Street came in quick succession to the food and fuel crisis, which plunged millions more people into extreme poverty. Economic frailties in previous rising stars of Eastern Europe, such as Latvia and Romania, and in the so called Next-11 emerging markets (N-11, including countries like Egypt and Nigeria) were exposed. Even some of the BRIC countries (Brazil, Russia, India, and China) took a hit. As the example of Russia also shows, resource-rich states remain largely dependent on prevailing commodity prices.

The West managed to avert total economic meltdown and even managed to register short-term growth, but this has come at major long-term cost. Private risk was taken onto sovereign balance sheets in order to save the banking system, and stimulus packages were launched to rekindle growth, but the result is that the West is now drowning in debt. 'Demand' remains an expensive fiscal and monetary experiment rather than a privately driven process. The problem is that spending can only last for so long as debt stacks up, but at the same time, no one wants to destroy the economic progress that has been made by removing government support too early. This is a difficult decision that will have to be made some time soon: Greece's partial 'default' serves as a reminder as to the danger of sovereign risk. Jumping out of the financial frying pan into the fiscal fire is clearly something governments need to watch closely, and particularly those in the West.

One country that has little fear of 'default' is China. It has emerged from the crisis far better than developed states, and indeed other emerging markets. If 'geoeconomics' now firmly stands aside 'geopolitics' as a key

ingredient of international affairs, the overriding conclusion into 2010 has to be that China has gained considerable ground on the West. China now has a seat at the table that really counts for global growth: the G2 of Washington and Beijing. China plays the role of the creditor to the US debtor. This relationship is becoming increasingly complex, however, given that China is priming domestic consumption and looking towards commodities as a plan B to maintain economic growth beyond fuelling US consumption.

The financial crisis has thus acted as a catalyst for geoeconomic shifts that were already underway from West to East. But the key point is that despite geoeconomic movement, it will still be decades before the full effect of any fundamental geopolitical realignment will be felt. Despite structural flaws and mounting debt, the US still has ample political and economic pull, though it will need to draw more heavily on Asia, the Middle East, and Eurasia to maintain a leading global role.

Reflecting this accelerated diffusion of economic power, the crisis has also intensified debates to adapt international institutions. The G20 has replaced the G8 as the key forum for economic decisionmaking. The snag is that it currently remains 'long' on membership and very 'short' on ideas. The great irony facing leaders now is that by falling back on broken markets and familiar economic concepts, expectations are already outpacing weaker economic fundamentals. Protectionism is on the rise, regulation remains weak, and the credit lines of many governments are overstretched. Out of drastic change has so far come all too familiar continuity. This could pose major political and economic downside risks for the future.

Financial exuberance: The road to ruin

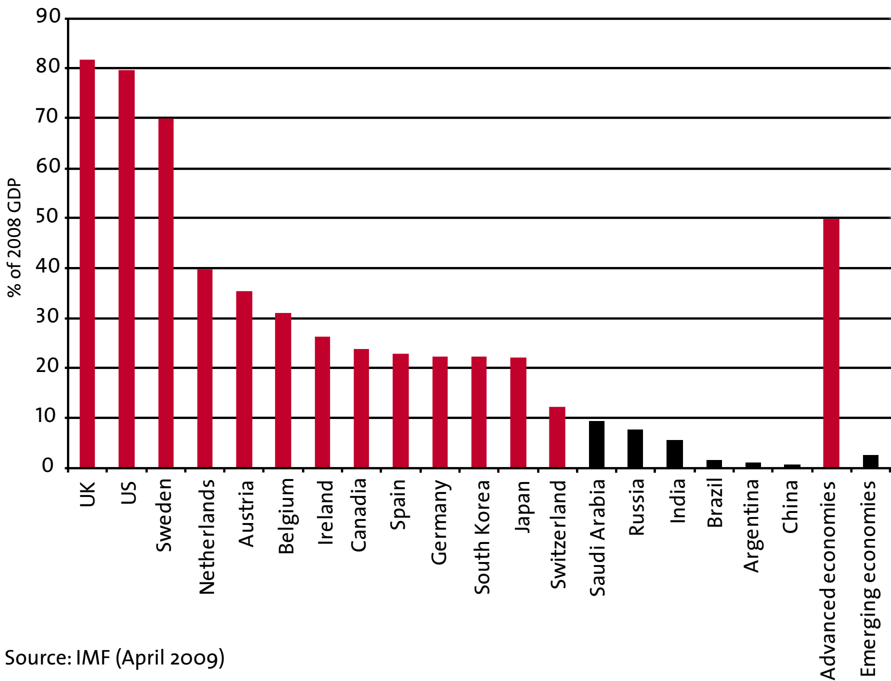
On the face of it, the 2008/9 crash was caused by the collapse of the US housing market and the subprime fallout. In fact, the crisis was a manifestation of far larger systemic risks and weaknesses that had built up at the heart of the global economy. These proved to be geographically and structurally lethal, not least as they allowed the excessive exuberance of banks to play out.

At the turn of 2008, a massive asset bubble in the US housing sector was apparent, with the Federal Reserve slashing interest rates as quickly as possible. Much of this had been driven by excess liquidity in emerging markets, which helped to make money cheap in the US in search of higher yields. This was aided by lax

monetary policies in the developed world, culminating in an unsustainable property bonanza predicated on a one-way bet that prices in US and European markets would continue to inexorably rise.

Global imbalances thus really mattered, albeit not in the way everyone thought they would be in terms of a precipitous unwinding, but by sustaining cavalier lending practices in the subprime mortgage sector. China and Gulf oil exporters soaked up US treasury bonds to help hold down their own currencies, which pushed down bond yields and helped to fuel the housing boom. What made matters far worse was that the loans (of widely varying qualities) had been packaged up and sold on as securities to world markets to allow for far higher returns: The primary aim was to create a saleable asset rather than to consider its underlying quality. In breaking the link between risk and

Public support for financial sector losses: West vs. the rest



Source: IMF (April 2009)

Note: This covers capital injection; purchase of assets and lending by treasury; central bank support with treasury backing; liquidity provision and additional support from central banks and guarantees made, rather than merely noting upfront financing needs. Figures for overall advanced economies and emerging economies are average ppp GDP weights.

reality, a huge error had been made. The US lost a staggering US$ 8.3 tn in wealth from 2006–8 in housing and pensions alone.

With the property bubble burst, putting a price on mortgage securities became close to impossible. The structured investment vehicles that banks had created to hold and trade such securities faltered, with the result that bad loans needed to be written off. Citigroup, Merrill Lynch, and UBS were amongst the first banks to own up to massive losses after Bear Stearns had failed in March 2008. The US government stepped in to save the Federal National Mortgage Association (FNMA, 'Fannie Mae') and the Federal Home Loan Mortgage Corporation (FHLMC, 'Freddie Mac') amongst many others, including the giant insurer AIG. But the Lehman Brothers bank, which was leveraged 26 times over its own balance sheet, was not to be saved. This crash revealed catastrophic risk management failures of opaque financial instruments that no one in the banking understood. Bankers not only failed to master where the ultimate risks from such products would reside, but also how to contain their systemic impacts. Some investment bank assets were so toxic that even state-based Sovereign Wealth Funds (whose own portfolio had dropped from US$ 4 tn in 2007 to US$ 3 tn in 2008) lost their ravenous appetite for recapitalising broken Western banks.

This left governments with no choice but to start writing blank cheques to banks in order to prevent systemic financial meltdown: No more major banks could be allowed to fail. The US unveiled its Troubled Assets Relief Program (TARP), with around US$ 700 bn of emergency finance being made available. Europe followed suit; this was not merely a liquidity issue, but one of fundamental solvency. The IMF thinks that writedowns on loans and securities from 2007–10 will be around US$ 2.7 tn in the US financial sector and US$ 1.2 tn in Europe.

Real impacts: Regional variations

Lehman's demise prompted an immediate and massive loss in confidence, not just on Wall Street but far beyond into the real economy. Inter-bank lending ceased, massive deleveraging and fire-sale assets took place to claw back liquidity. As lending ground to a halt, the global economy went with it. Global unemployment was rising fast, equities and commodities were trading at extremely high and volatile levels, and trade flows slackened. The collapse of financial markets, although not the sole cause of the global recession, ensured that a badly

overextended economy had a major correction.

Global output deteriorated sharply in the fourth quarter of 2008 when GDP fell at an annualised rate of over 6 per cent. The rate of decline in advanced economies hit 7.5 per cent. Japan was forecast to show a 6.2 per cent contraction in 2009, Germany 5.6 per cent, and the US 2.8 per cent. Global trade declined by around 9 per cent in 2009, with the latest estimates suggesting that the world economy is now 8 per cent smaller than it would have been had the crisis not occurred. The chain reaction from banks to markets to consumers to individuals has similarly been reflected by millions of job losses. The ILO thinks that global unemployment could rise to over 7 per cent.

What these statistics also show is that developed and developing market growth could not be divorced from each other. True; global output from the G7 has shifted from over two-thirds of world GDP in the 1980s and 1990s to under half as emerging markets took off. Ultimately, however, it was not only monetary policy that has remained linked between these 'two worlds', but also economic fundamentals. As Western demand evaporated, emerging markets not only lost their biggest customers, but also their biggest investors. Decoupling was dead; a global contraction was born. This is where the 'real' economic (i.e., human) costs reside.

Developing states hit worst

A 9 per cent fall of OECD import growth duly prompted average GDP growth in small and vulnerable economies to decrease by 2.4 per cent. The World Bank now thinks that 89 million more people will be living in extreme poverty (below US$ 1.25 a day) at the end of 2010 than expected before the crisis, and an additional 64 million will have to live on under US$ 2 a day.

With far less fiscal and monetary space and ongoing pressures from the food and fuel crises, developing countries have found it hard to orchestrate countercyclical policies. Falling export prices hit some balance sheets hard, and despite best efforts, fiscal deterioration has averaged out at around 4.4 per cent in non-OECD states, while remittances have dropped by 7 per cent in 2009. Total private capital flows to developing countries have also fallen to US$ 707 bn in 2008 (down from a peak of US$ 1.2 tn in 2007) and are projected to drop below US$ 200 bn in 2009/10. The financing gap for new infrastructure projects has already risen by over US$ 20 bn as a

result, while a far larger financing gap of US$ 635 bn has developed in order to return output in developing countries to pre-crisis levels.

The world's least-developed states taking a 'great leap backwards' might not really be a significant geoeconomic or geopolitical game changer. But if they were marginalised before the crisis, they are even more so now, as chronic poverty and serious capacity constraints are likely to take an enormous human toll.

Falling stars

It is by no means only the most vulnerable states that have had major frailties exposed from the crisis. Numerous states previously regarded as the new locomotives of economic growth were also severely bruised.

Eastern European stars of the EU waned (at least in the short term), particularly those running large current account deficits while building up substantial foreign debts. Latvia, Estonia, Hungary, and Romania fall in this bracket. Several states across the Commonwealth of Independent States have also incurred 'stagflation' as their GDPs tumble and inflation soars. Only funding from the IMF and development banks has kept these states afloat. But the prize for the IMFs 'best customer' of 2008/9 still goes to Iceland, whose economy was devastated by subprime exposure. This stands in sharp contrast to the 1990s, when Latin America suffered most from financial crises. Argentina is just about still standing, and some progress has been made in Colombia, Chile, and Peru, but corresponding losses can be seen in more left-leaning states such as Bolivia and Ecuador.

The newly emerging markets of the N-11, including Vietnam, Turkey, and Mexico, also saw capacity constraints catch up with market sentiment. While the use of raw data to predict economic outcomes has always been a dubious exercise, the prospect of countries like Pakistan and Bangladesh becoming the economic champions of tomorrow looks increasingly remote, given the pervasive political risks in play.

The BRIC countries remain considerably steadier by comparison, and are still expected to account for 20 per cent of global output by 2013. But even here, Russia is starting to seriously lag given its ongoing dependence on hydrocarbons, while India has shown major capacity constraints on infrastructure. Brazil is more reform-minded than most, but still needs to navigate the choppy political waters of South America to make economic growth stick. China is now

effectively in a league of its own, leaving its BRIC 'alphabetical' allies behind. Of the 20 per cent noted above, 11 per cent of this will come directly from China. The PRC not only has the prospect of one day genuinely becoming a superpower, its economy is already roughly three times as large as those of Russia and Brazil, and almost four times larger than India's. Changing the acronym to BIIC by dropping Russia and bringing in Indonesia, a new economic 'star', still fails to make compelling economic sense.

The GCC states, meanwhile, have been wounded from oil price corrections and financial contagion. Sitting on 45 per cent of the world's oil and gas reserves helps to launch counter-cyclical measures of course, but the upshot is that their economic outlooks still remain tightly linked to oil prices. The same logic applies to Iran, Venezuela, and Central Asia. In Africa, primary commodities remain the main economic drivers for the richest and poorest states alike, as the contrasting fortunes of South Africa and Guinea attest.

The politics of Western debt and Eastern credit

If the geoeconomic landscape of the financial crisis shows that the least developing states have taken a political step backwards, and that the N-11 have stood still due to deep-seated capacity constraints, while resource-rich states remain dependent on prevailing commodity prices, what can be said about the West and a rising Asia? After all, their tight linkage has driven economic growth over the past decade, and will probably be the key political ground over the next 50 years as well.

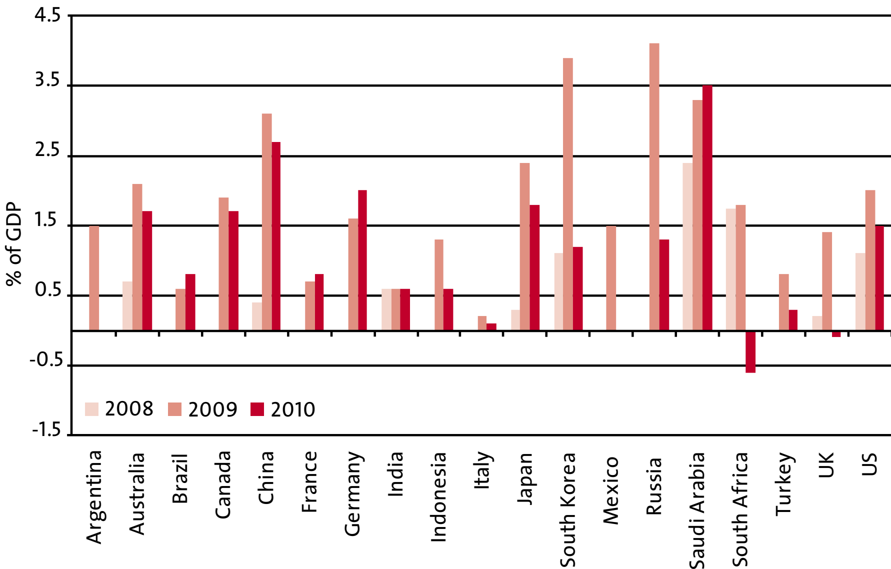
Demand-side intervention in the West has achieved considerable short-term success compared to what many analysts had feared. But a look at the balance sheets reveals the problems now lying ahead for the West. By stepping in to save the global economy, governments from London to Washington, Tokyo, and Seoul have now put themselves entirely at its mercy. Without a serious upturn in economic fortunes, governments could eventually fail to make sufficient repayments on their debts.

Across the OECD, fiscal stimulus has been worth about 2 per cent of GDP in 2009, and is expected to dip only moderately to 1.6 per cent in 2010. The biggest sums were spent in the US. In addition to the TARP funds, President Barack Obama secured a further US$ 787 bn stimulus package in February 2009 to arrest sharp declines in the US economy amounting to 5.6 per cent of GPD. Washington effectively made itself the financial

capital of the US by supplanting New York. Whitehall also tipped the financial balance away from the City of London towards Westminster by virtue of a US$ 400 bn rescue package in the UK. Germany has ramped up its spending, as has South Korea; Japan launched a further US$ 81 bn stimulus at the end of 2009. Even France, which has fared considerably better than most in the crisis given its small financial sector, had to use some discretionary spending measures.

Putting this much money into the system and resorting to quantitative easing to get credit flowing again did help stem the economic rot once contraction slowed and financial markets bounced. However, balance sheets have been utterly decimated as a result. Fiscal deficits are projected to increase from pre-crisis (2007) by around 3 per cent of GDP on average across advanced economies. In addition to this, government debt ratios across Europe as a percentage of GDP are expected to reach 123 per cent in Greece, 119 per cent in Italy, 82 per cent in Portugal, 73 per cent in Ireland, and 64 per cent in Spain in 2010. The figures do not look much better in Canada, while the UK will see debt soar to over 38 per cent of GDP from 2007 levels.

G20 stimulus: Discretionary spending 2008-10 (relative to 2007 baseline)



Source: IMF (April 2009)

Deficits can only run for so long without adversely affecting the cost of financing and indeed raising thorny questions of medium-term debt sustainability and fiscal solvency. Indeed, developed countries were forced to issue US$ 12,000 bn of sovereign bonds in 2009. But as the Japanese experience in 1997 also attests, tightening fiscal and monetary policy too soon can come at serious costs if governments remove the stimulus driving growth and further drive up unemployment, which already stands at 9 per cent across the OECD. The global economy will remain on state-based life support mechanisms for some time to come, but a credible exit strategy for historically loose fiscal and monetary policy is now badly needed. Failure to do so could lead to unmanageable fiscal exposures, shaky bond markets, and inflationary pressures developing.

Politics is, however, a major problem here. Although escalating deficits and public debt levels are bad news for governments, losing elections is even worse. In most countries, the amounts being spent are set to peak in the first half of 2010 before gradually declining in the later quarters and into 2011. The time lag between the disbursement of stimulus funds and their impact on the economy means that GDP growth in many countries in 2010 will still be propped up and inflated by government support. The fear is that without a serious upturn in growth, the global economy could falter again in 2011. This is a prospect no incumbent government is relishing. The EU is set to amass a 2 per cent deficit in 2009, despite needing a budget surplus of around 2.7 per cent of GDP to get public debt under control. Gordon Brown, for one, has decided to maintain unsustainable levels of public spending and borrowing until after the 2010 general election in the UK.

The US faces a similar dilemma. GDP growth is expected to fall from 2.5 per cent in 2010 to just 1.3 per cent in 2011. Such forecasts run headlong into US electoral demands: A mountain of debt *and* lagging growth would leave Obama with the worst of both worlds as seats in Congress are contested in 2010 and the race for the White House heats up to 2012. The US president is well aware that berating tax havens to return lost US treasure can only do so much to reduce debt and that with household balance sheets in disarray, the economic fundamentals do not bode well for the US dollar. According to official projections, the ten-year cumulative deficit will reach US$ 9tn, while federal debt has already increased by about a third since the crisis began. Gross debt is likely to hit 100 per cent

of GDP within the next five to seven years. Even if the US economy starts to recover, the trade deficit will merely widen further, and it will not be all that long before total debt is six times total tax revenue.

China's credit line

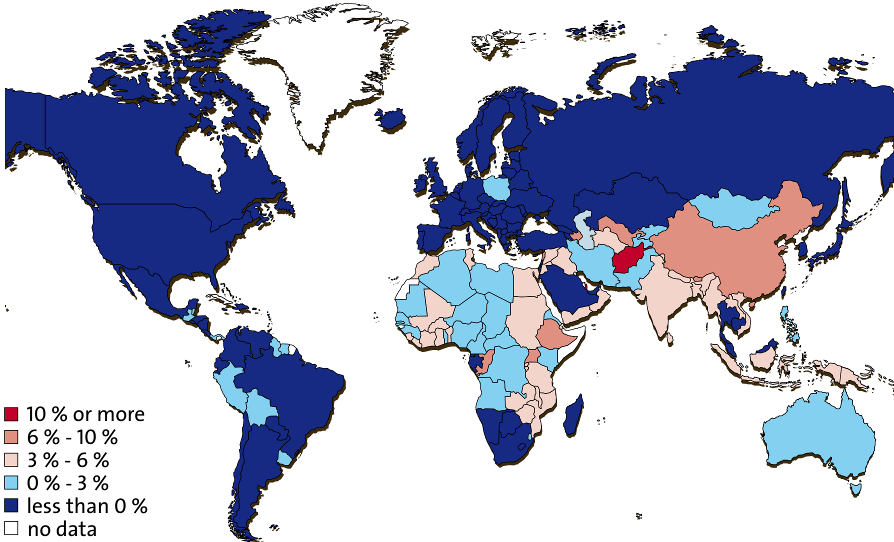
This is where China comes into the equation. Until recently, the US could rely on China to finance a substantial part of its borrowing, whether measured in terms of the current account deficit or the federal fiscal deficit. China was driving its growth through an export-led strategy to Western markets, and primarily to the US, by providing direct credit lines to US consumers. Holding US dollar reserves has clearly helped Beijing keep the renminbi low while boosting China's exports and generating record trade surpluses. This debtor-creditor relationship between Beijing and Washington, although hardwired into the global economy, could be slowly starting to change.

A number of Asian markets launched their own stimulus in response to the downturn as far back as 2008. Delhi stepped in for Mumbai in India by launching a 3.5 per cent of GDP stimulus. Beijing similarly stepped in for Shanghai by launching a whopping US$ 585 bn stimulus in China. This amounted to 8 per cent of GDP in China alongside US$ 1.5 tn of state enforced lending to the private sector over the space of a year.

The results have been staggering. China saw a 17 per cent increase in GDP in the second quarter and India 6.5 per cent, spurning considerable speculation from the 'decoupling school' that such a divorce might work this time on the way up between emerging and developed market economies. At the very least, China now has a far stronger incentive to build domestic and regional consumption rather than fuelling Western markets indefinitely.

In the first half of 2009, China absorbed less than 10 per cent of newly issued US treasury bonds. This compares to a peak of around 75 per cent before the crisis began. Many in Washington remain relatively sanguine about this, given that China has no real option but to plump for the dollar, but domestic demand is only part of the Chinese equation. The other is Beijing's new found commodities hedge to fuel domestic growth as indigenous supplies dwindle. It spent around US$ 25 bn on commodities in 2007, US$ 52 bn in 2008, and considerably more in 2009. This has not only enhanced Beijing's natural resource portfolio, but also increased its political and economic stake in resource-rich states at the expense

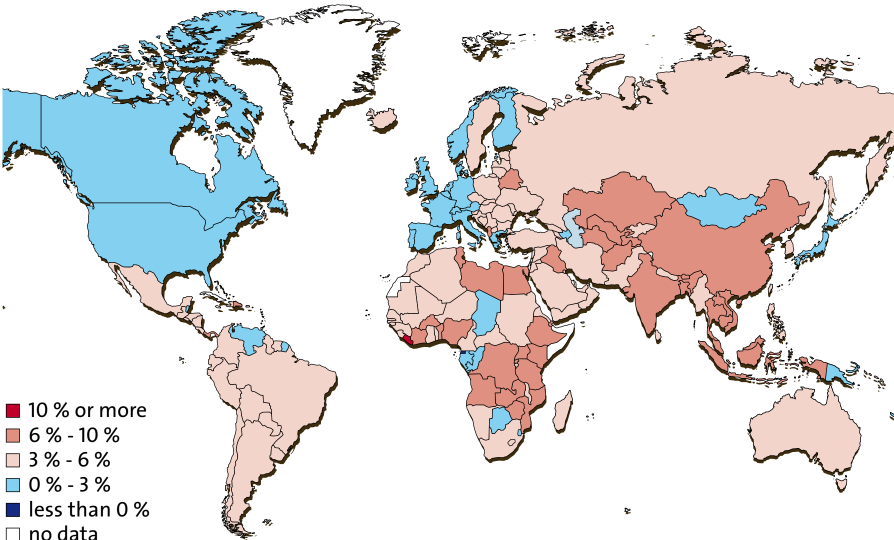
GDP growth 2009



Annual percentage change

Based on: World Economic Outlook (October 2009)

GDP growth 2014



Annual percentage change

Based on: World Economic Outlook (October 2009)

of the West. Financing of emergency loans and badly needed credit lines has also helped China to open new natural resource doors to Russia, Brazil, and the Middle East.

The upshot is that China's GDP is set to surpass that of Japan by 2010 to become the world's second-largest economy, accounting for 28 per cent of world economic growth. Not only is it leaving its BRIC partners behind, it is also set to eventually surpass US GDP over the next 20 years to take top spot. China's economic and financial power has thus undoubtedly strengthened relative to others from the crisis given its limited exposure to toxic assets and the large-scale foreign reserves that it can bring to bear.

But as with most geoeconomic issues, the looming separation between Beijing's credit and Washington's debt should not be overplayed at this stage. China is still dependent on exports for the time being and has no truly comprehensive outlet for non-dollar securities to provide alternatives to US markets. The euro still lacks sufficient depth to be a fully-fledged reserve currency, and instruments such as the IMF's Special Drawing Rights remain no more substantive than they were in the 1970s. The renminbi is not convertible, nor will it be as long as China maintains capital controls. If anything, China will want to avoid a fire sale of US dollar-denominated bonds over the next few years, as it holds over US$700bn of them. They will also remain a useful 'weapon' to use against the US at some point should currency wars hot up.

Even with 6.5 per cent growth recorded last year and around 10 per cent forecasts slated for 2010, the Communist Party still remains acutely aware of its own political, social, and environmental frailties at home. Millions of people lost their jobs in China due to the crisis, and overcapacity remains a real problem. GDP growth might be picking up strongly, but job creation and private investment and consumption could remain more challenging. Any tightening of fiscal and monetary policy will still be very cautious in order to strike a balance between growth without inviting inflation or asset bubbles, or indeed eroding the healthy balance sheets and sound financial systems that allowed for such resilience in the first place.

How China continues to handle its domestic economy, not only on vexed currency and policy pressures, but also on painful reforms to unleash domestic private demand, will thus have repercussions beyond its borders, and not least in the US. If China is slowly shifting away from the 'Chimerica'

model to focus on commodities and regional demand, this poses major questions as to who will absorb the US$ 9 tn of new US issuances over the next decade. Middle Eastern petrodollars will only be able to take up so much debt.

If fewer countries want US treasuries, the interest rate will have to rise to make them more attractive, which by implication will merely compound long-term US indebtedness. Depending on inflation, this could be extremely painful for the US in terms of real interest rates. The US economic recovery could thus prove to be distinctly sluggish. Spontaneous shifts towards viable regional currencies in South America, ASEAN, and the GCC remain highly unlikely at this stage, but at the very least, Gulf States will start to seriously reconsider a potential basket currency for oil revenues beyond the US dollar. It makes little economic sense to keep selling oil in a falling currency.

Geopolitics on the horizon

The geopolitical impacts of the current geoeconomic shifts are difficult to predict at this stage. Economic returns invariably translate into political and military capital to some extent. It will, however, take a long time to shift the military balance of power away from West to East in any material sense.

The US will remain the most powerful player in the foreseeable future. President Obama has made it clear, however, that the US will not be able or willing to underwrite global security indefinitely as it faces major economic challenges at home, growing difficulties to maintain the current levels of defence expenditure, and changes in the international system calling for a more cooperative approach. It is against this backdrop that the US is looking for long-term exit strategies from protracted conflicts in South Asia and the Middle East (see Chapter 3).

China will spend more and more on defence – and in particular on naval capabilities to gain a stronger hand in Asia-Pacific. It is making it clear that it plans to be the main naval force in the region (a message Australia has certainly understood). Offsetting US-Indo-Japanese cooperation is somewhat further removed from the day-to-day political horizon, but greater control of the Indian Ocean to further Beijing's 'string of pearls' policy linking energy supplies from the Middle East and Africa to the Chinese mainland is hardly the stuff of conspiracy theorists anymore. Nor is China's intention to build energy links through the Shanghai Cooperation Organization.

Beijing will, however, be careful not to place itself in direct geopolitical competition to the US. The traditional way of addressing this was by deliberately downplaying Beijing's political power and outlining its shared interest in external stability to facilitate domestic stability and development. But given the comparative boost to China's stature resulting from the economic crisis, such a strategy is unlikely to stick on Iran, Sudan, and North Korea, where Beijing has some important political decisions to make. China will, however, continue to test its new found authority in its Asian backyard rather than overplaying its hand in the Middle East, Central Asia, or Africa in terms of 'power politics' projections where its commodity footprint will inevitably grow. At the same time, China's non-interference norm is becoming increasingly complex, as it has troops and police participating in nine UN missions around the world (see Chapter 6).

Other emerging markets will also look to play a greater role to reflect growing economic ambitions. India will seek to compete with China to some degree, but may ultimately be confined to increasing its influence in South Asia. Nigeria and South Africa will similarly be confined to regional roles in Africa for the time being, while Brazil and Venezuela will vie for political ascendancy in Latin America. Russia will continue to make its influence felt in the Caucasus and indeed Eastern Europe, but its ability to project a broader global role remains closely linked to energy prices. Meanwhile, the Gulf States will use their oil revenues to maintain strong security apparatus for domestic purposes rather than projecting power abroad. Checking Iranian ambitions will, however, become a more pressing priority as the nuclear clock ticks down.

As for Europe, it is slowly waking up to the fact that a useful barometer for its own political clout is to set this against US-Asia relations. If the first year of Obama's foreign policy is much to go by, US strategic attention is gradually shifting from the Atlantic to the Pacific – not least because Obama has taken to heart Bill Clinton's adage: 'It's the economy, stupid.' Core US interests now relate to the geoeconomic realities Washington faces from the financial crisis. This explains why Asia, and more specifically, China, is so crucial not only to the global economic outlook, but also to the US political scene in order to sustain growth and credit lines in the longer term. As the defence budgets of most European states are bound to shrink further,

US attention is shifting from the Atlantic to the Pacific

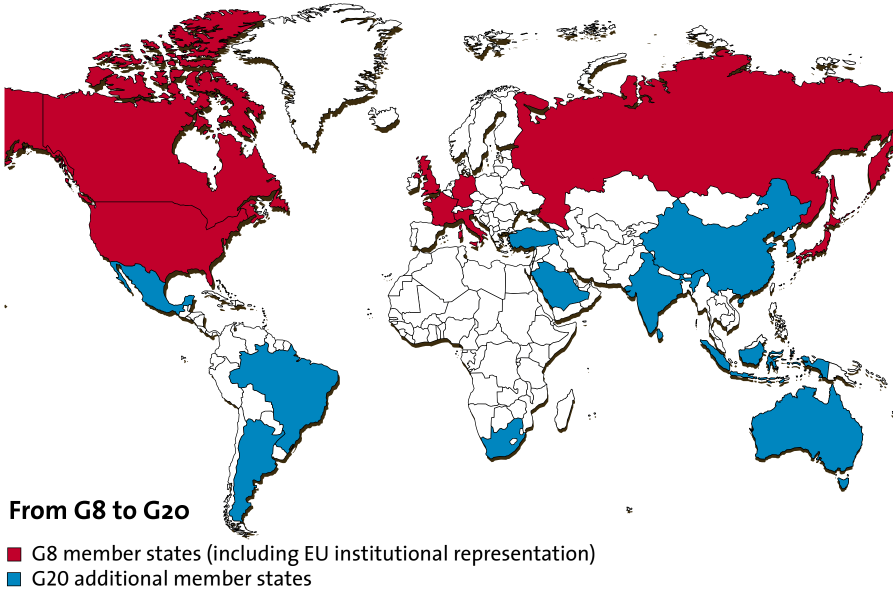
their relevance as key US partners in military crisis management may also diminish. The EU continues to lack political ambition and sufficient capabilities to act decisively beyond its borders, and while Lisbon has helped to foster institutional change, this is unlikely to translate into more action, given internal economic challenges and tensions over further expansion (see Chapter 1).

Revised institutions, old politics

With China the leading economy of the East and the US still the leading economy in the West, it is hardly surprising that both sides want to set and enforce global economic rules in their favour. China undoubtedly sees the economic crisis as a major opportunity to redress the balance. Western policy-makers, for their part, will have to concede that unless institutions are reflective of new global economic realities in structure and design, they will inevitably fail to provide long-term solutions. The World Bank and the IMF will have to yield to such calls sooner rather than later, given their re-found prominence as lenders of last resort.

But the most important institutional development in 2008/9 was the transition from the G8 to the G20. This reflected the new geoeconomic realities of a far more diffuse global economic order by bringing countries such as Brazil, India, South Africa, and Saudi Arabia to the table. The first task of the G20 was to foster synchronised monetary and fiscal policy to soften the blow of the crisis, but having partially achieved this, it ran into the old problem of turning representation into effective policymaking. Well-worded communiqués without effective follow-up action are one notorious problem of global forums; taking on too many issues of global governance is another. If the G20 is to avoid both these fates before it next meets in Canada and South Korea in 2010, it should strictly limit itself to dealing with macroeconomics, regulation, and trade.

On global macroeconomics, the US, the EU, China, and the Middle East have undoubtedly come to the table far too late on imbalances. Serious measures will need to be taken on import/export balances and on savings and domestic demand in advanced and developing economies alike, with currency adjustments undoubtedly thrown into the mix. Making any of this stick on a state-by-state basis will be tough, but the G20 is probably the only forum where this can credibly be addressed without boiling the whole matter down to the G2. The US and China would be thankful for help with some of the



From G8 to G20

- G8 member states (including EU institutional representation)
- G20 additional member states

heavy lifting from the Middle East and Europe.

On financial regulation, the G20 was right to reject German calls to make it little more than the 'political wing' of the Basel Committee on Banking Supervision, but progress still needs to be made. This is true not only on a technical, but also on the geographical level. Unless risk is tackled at a global level and even-handedly across the board, then 'regulatory arbitrage' will undoubtedly come back into play to the detriment of all. This is better done sooner than later, particularly if financial services begin to burgeon where capital actually sits. Regulators would no longer be confined to watching London, New York and Frankfurt, but would also have to keep an eye on Sao Paulo, Shanghai, and Mumbai.

Coming up with the 'perfect' regulatory model is, of course, impossible, and any new recommendations will undoubtedly come with hidden policy costs. 'Basel II' still probably remains a reasonable starting point on capital buffers, liquidity risks, and leverage ratios, but pro-cyclicality measures are a little trickier. If there are to be such buffers or reserves, it is critically important that they can be reduced in economic downturns. The risk, of course, is that in treading this path, regulation fails to rebalance the scales between risk and reward

or to ensure that the financial sector serves its proper long-term function: supporting the real economy. At this stage, financial centres appear to have found a remarkably comfortable path back to the *status quo ante*, even though prospects for a financial transactions tax are not yet moribund.

But perhaps the one area where the G20 should most forcibly expand its remit is on trade. Despite preaching the gospel of liberalisation, no less than 80 per cent of all tariff agreements have been adversely tweaked since the crisis struck. The US has resorted to 'Buy America' clauses in its stimulus, China has reinstated export subsidies and looks set to launch a steel war with Washington, and a number of countries including Indonesia, India, and Russia have raised import restrictions. The upshot of such policy measures is that trade could still contract even further.

This would be a big mistake for all, and most significantly for the US, should it want to drive global growth forward once more. The US economy by most measures is still four times the size of China's. To maintain this lead a little longer, the US should work hard to put Middle Eastern, Russian, and Chinese state-based investments to capitalist ends rather than close its doors. Europe, for one, would have little choice but to follow this lead. Although late in the day, the US still has a chance of correcting its imbalances and regaining its stature as a dynamic and stability-orientated country, provided tough decisions are made.

One crisis to another?

The most urgent consideration for leaders to get to grips with over the coming months is not, however, some kind of global power realignment or long-term economic shifts, but the ongoing threat of reduced economic output and unemployment translating into electoral losses. The ongoing potential for political unrest cannot be entirely dismissed either. This was largely avoided in 2008/9 as public demand kicked in, but has no guarantee of remaining under the surface should fiscal strains eventually show. The governments in Iceland, Japan, and Latvia have so far been the unlikely victims of the crisis, while sporadic riots in Athens keep testing the resolve of the Greek government. The riots that exploded in the first half of 2008 in response to rising food prices in Cameroon, Egypt, Ethiopia, Haiti, Indonesia, Cote d'Ivoire, and Senegal provide more than enough evidence of the potential for political violence as a result of social hardships that governments should take seriously, and not just in developing countries.

Ultimately, the tectonics of global geo-economics have clearly moved eastwards quicker than expected as a result of the crisis, but the fact that all markets remain stuck in a pre-crisis era without being properly fixed to propel long-term growth suggests that the economic crisis, far from being over, could merely be a curtain-raiser for the next crisis of sovereign defaults. Things would probably only get that bad, however, if economically smart moves continue to be trumped by political expediency. Then, and only then, we might be looking at a new geopolitical world map, whether China is ready or not.

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