Center for Security Studies

STRATEGIC TRENDS 2013

Key Developments in Global Affairs

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STRATEGIC TRENDS 2013 is also electronically available at:
www.css.ethz.ch/publications/Strategic_Trends

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This publication covers events up to 4 March 2013.

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ISSN 1664-0667
ISBN 978-3-905696-40-0

CHAPTER 1

The De-Westernisation of Globalisation

Jonas Grätz

Global economic integration is unprecedented. However, the appeal of globalisation is fading. As growth emerged as the main focus of Western political leaders, they are now changing the rules to rein in globalisation. New borders to investment have been erected and free trade agreements with selected partners increasingly replace global rules. Money supply has been increased to fuel growth, but this helps to distort markets and elevates future risks. Power moves to the forefront and economic and national security concerns are again perceived as being interlinked. Whether the West can regain global leadership will depend on its ability to solve domestic problems and reformulate a coherent economic agenda.

A forum staff stands in front of an enlarged printout of a Renminbi banknote at the Asian Financial Forum in Hong Kong, 14 January 2013

More than five years after the global financial crisis began with the bursting of the US housing market bubble, the world economy has been thoroughly transformed. China has developed into a growth magnet in East Asia and emerged as a political challenger. The rapid ascent of China was the result of a closed political system, capable of selectively opening up to global competition, while leveraging cheap labour. This 'Beijing consensus' led to economic distortions, which were a precursor to the financial crisis. Other emerging market countries such as India, Brazil and Russia have been less successful, but still add to the overall picture of an economically-weakened West. South Korea is an exception, but the US, many EU states and Japan are all burdened by mounting economic problems.

Having previously encouraged the global spread of markets and the integration of new countries into the global economy, Western states are getting more selective about economic globalisation in the new context. If one wants to find examples of the 'Washington consensus' today, Washington, Tokyo or Brussels might not be the best places to go to. Realising that 'free markets' would inflict high domestic adjustment costs, Western leaders and central banks are experimenting with more restrictive foreign investment provisions and unconventional monetary policies such as excessive use of the printing press. But these measures are not integrated into a new economic framework.

The link between the economy and national security concerns has been strengthened. US foreign policy is changing, coupling economic and security relations in a flexible manner. This acts as a temporary remedy for the current cracks in the US economy. But with a weakened EU, the West is losing rule-setting power in the global economy, and no other player is ready to take over this role. This is unsettling the global economy, which remains in a state of unprecedented interconnectedness, but is being increasingly politicised.

A world unmade: Free trade, convergence, and consumer welfare

At the beginning of the 21st century there were high hopes that universal free trade and globalisation would be the chief tools for bringing about development and fostering the spread of Western values abroad. Economic openness and its promotion was the key item on the agenda. The supposed political effects justified temporary sacrifices such as higher unemployment in the eyes of Western leaders, particularly the Clinton administra-

tion in the US. The 'Washington consensus' encompassed a whole set of policies aiming at market reform and privatisation which would cause the abandonment of distortive state policies and lead to greater welfare.

Its closed political system and large size meant that China was the main testing ground for Western globalism. As China was granted permanent normal trade relations by the United States and accepted into the World Trade Organisation (WTO) in 2000, the expectation was that the Chinese Communist Party (CCP) would progressively open up the Chinese economy and reform the polity. The trade deficit with the US was already high at that time, but the prevailing belief held that openness would pay political dividends later on, and the WTO entry would at least reduce the trade deficit with China. In the meantime, 'consumer welfare' would be maximised in the West, as lower prices for consumer goods would make household budgets go further. This focus on trade as an economic and political development tool was also embodied in the WTO's 'Doha Development Agenda', launched in 2001.

Things took a different turn, however, and Western hubris was soon to be unmasked. The intended political spill-overs failed to materialise and the Doha agenda became bogged down. Economically, trade indeed progressed quickly and millions of people were added to the global middle class, but political reforms were less forthcoming. As emerging markets flourished, they grew more nationalist, rather than becoming more open to Western influence and ideas. The most important development in this respect was the success of China, which found broad resonance across the other emerging markets.

China's ascent

China did indeed reform, but the permission of greater economic competition and the sidelining of central planning agencies ultimately resulted in political recentralisation. Central party control and state capitalism were strengthened, keeping local lords on a tight rein and ending the experimentation of the 1980s. This prevented regional economic competition from spilling over into a political struggle. Macroeconomic institutions were strengthened and parts of the economy privatised, while the most important sectors of the economy were brought under central control. The CCP thus squared the circle between economic competition and political power.

In the 1990s the state sector was downscaled significantly by the clos-

ing or privatisation of small, unprofitable state companies. At the same time, however, Beijing strengthened its control over the most important sectors of the economy. About 200 state-owned enterprises (SOEs) were brought under central control. These companies were active in strategic sectors of the economy, such as finance, natural resources, metallurgy, information technology and infrastructure. As their profitability increased, they came to provide an important economic and political base for the central party cadres. The power of the CCP was also strengthened by the huge inflow of foreign currency accumulated at the People's Bank of China and in China's sovereign wealth fund.

SOEs and selected private companies were also able to boost the influence of the CCP in the international arena. 'National champions' were promoted to the global level through various benefits including preferential access to land and subsidised credit, provided to them by the state-owned banks. SOEs are used to implement the government's policy goals in economic diversification and resource sufficiency and constitute about 70 % of foreign investment.

The financial crisis has given state-controlled capitalism in China a further boost. In effect, a drive towards greater privatisation of SOEs was reversed in the aftermath of the financial crisis. Although the number of central SOEs shrank to 117, their size almost quadrupled between 2002 and 2011. SOEs now account for about half of Chinese GDP. Furthermore, bigger private sector firms are monitored with the help of party cells, which provide crucial information.

Once in the WTO, state-controlled capitalism gave a head start to the CCP in global competition. Ways of bending the rules so as to reap maximum benefit from foreign investment were easy to devise. In most industries, local production is required. Investors are forced to form joint ventures with local partners, transferring technology and financing as they go along. Imitation has been spurred by lax enforcement of property rights and pronounced Chinese patriotism, which often results in low levels of loyalty to the foreign employer. A whole body of literature on how to protect trade secrets in China has emerged. In addition, separate national standards and other barriers give a head start to domestic manufacturers as part of an indigenous innovation strategy. Also, the CCP may determine the location of factories in order to spur the development of frontier regions, such as the underdeveloped and violent Xinjiang in the Northwest.

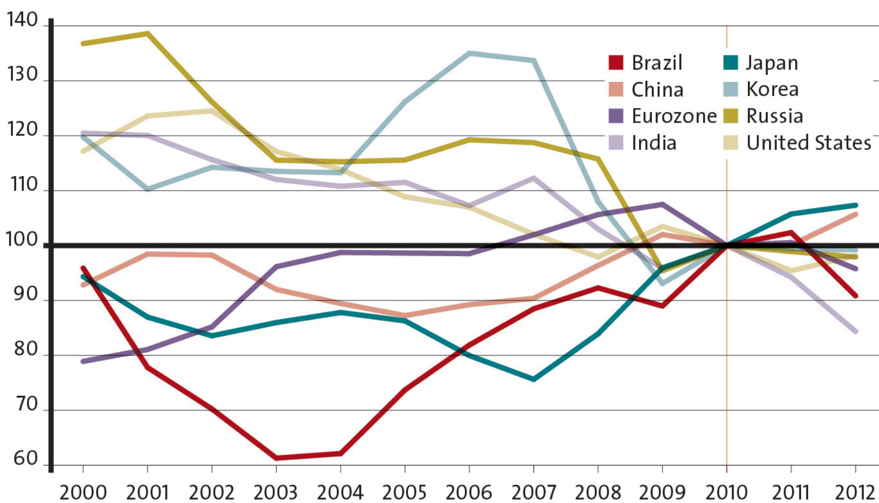
These conditions notwithstanding, multinational companies were happy to invest, enticed by low labour costs and the huge Chinese demand. Labour costs have been driven down by the undervaluation of the yuan exchange rate, which has served as a tax on imports while subsidising exports. Multinationals became China's key ambassadors, pushing for continued openness and a low profile in the West. The reforms thus led to swift growth. In the space of ten years, China rose from the 6th to the 2nd largest economy in the world. There was a convergence in living standards and private entrepreneurship is thriving, but the CCP is still in control of the key levers of the economy and polity.

The Beijing consensus

The success of China and the discrediting of the 'Washington consensus' encouraged other emerging markets to look towards the 'Beijing consensus'. Its components, such as export-led growth, incremental, rather than swift reform, indigenous innovation and experimentation, as well as authoritarian state-controlled capitalism, form a rather demanding catalogue of requirements. Elite nationalism should also be added to this list, since incremental reforms, as well as authoritarianism, are prone to go down a much more corrupted road in its absence. The 'consensus' will thus face difficulties when implemented in other countries. The dependence of

Nominal effective exchange rates

Base year: 2010



Source: Bank for International Settlement

Chinese success on a supply of low-cost labour to be leveraged in global markets makes this point even more explicit. It is no wonder that China has not explicitly tried to formulate, let alone export its model to other countries so far.

Nevertheless, Brazil has been looking towards the Chinese experience, implementing local content rules and also forming 'national champions'. Lacking many of the tools that Beijing can muster, Brasilia now orchestrates mergers of private businesses with the help of state-owned banks.

Russia has embraced state capitalism, which has taken a turn towards rent-seeking rather than development. The Kremlin has long protected domestic manufacturing and domestic capitalists from global markets, and so local content rules, import tariffs, and restrictions on foreign direct investment from abroad have been common. Russia's efforts to form 'national champions' are based mainly on the extractive sector.

India's economy is based on small and medium-sized enterprises as well as a few large family-owned conglomerates, so developing 'national champions' has been less successful: China has seven companies in the top fifty of the Forbes Global 2000 list, Brazil three, and Russia one, but India's largest company comes in at 124. Instead, India has been trying to grow domestic manufacturing using less intrusive methods, such as local content rules, tax concessions, and government subsidies. Without the stabilising factor of one party rule, however, none of these players has reached the policy coherence, sophistication and success of China.

Global crisis: Economy and security reintegrate

For much of the 2000s, economic globalisation seemed to yield favourable results for both developed countries and emerging markets. Emerging markets, first and foremost China, rapidly expanded their share of global GDP. As parts of their populations were able to work their way out of poverty, emerging markets were transformed into new centres of global demand. In the developed West, the cheaper supply of tradable goods and capital from abroad allowed a continuance of the liaison of rapid growth with low inflation that had been in effect since the mid-1980s. Low costs for both private customers and the state permitted elevated consumption and eased the costs of the war on terror and the disastrous Iraq war. This kept down the costs of higher unemployment and shallow wage growth. In addition, Western corporations

could increase their profits handsomely as a result of low labour and financing costs. The West thus thoroughly enjoyed the drugs of cheap goods and capital.

The global financial crisis changed the Western perspective on the economy. The focus was no longer on globalisation's advantages; instead, the costs of globalisation now moved to the forefront. The growing current account deficits of many Western countries, once explained as a sign of trust in the US dollar and of 'excess liquidity' in the global financial system, are now seen more as a drag on the economy, leading to high unemployment. The record amounts of debt are no longer explained as 'optimising intertemporal consumption paths', but are seen as a challenge to economic growth.

The West emerged weakened from the crisis not only economically, but also politically and ideologically. Although the US is still the undisputed leader in security affairs, the overall situation is unprecedented in the post-war order. The main challenger to the US, the Soviet Union, was not integrated into global value chains and played by totally different economic rules. It could be contained, and it eventually faltered. Other contenders, such as Germany and Japan, posed a challenge that was of an economic nature only, since they were integrated into the Western system. They were also quite small in comparison. China, by contrast, has neither been transformed into an ally, nor, having become an integral part of the global economy, can it be contained in a similar way as the Soviet Union was. The tight integration in production chains and financial markets means that economic developments in the developed West have a direct impact on China, a relationship that holds true in the opposite direction as well.

In this new situation, unprecedented interconnectedness and interdependence on one hand meet growing rivalry on the other. This serves to bring the relationship between military and economic statecraft to the forefront yet again. The provision of security and statecraft remains a key backbone of US economic power in the global economy, as emerging markets and other Western states alike rely on the US for the provision of a secure economic environment. Yet the balance of interests in this complex relationship is becoming more fragile, as emerging markets advance.

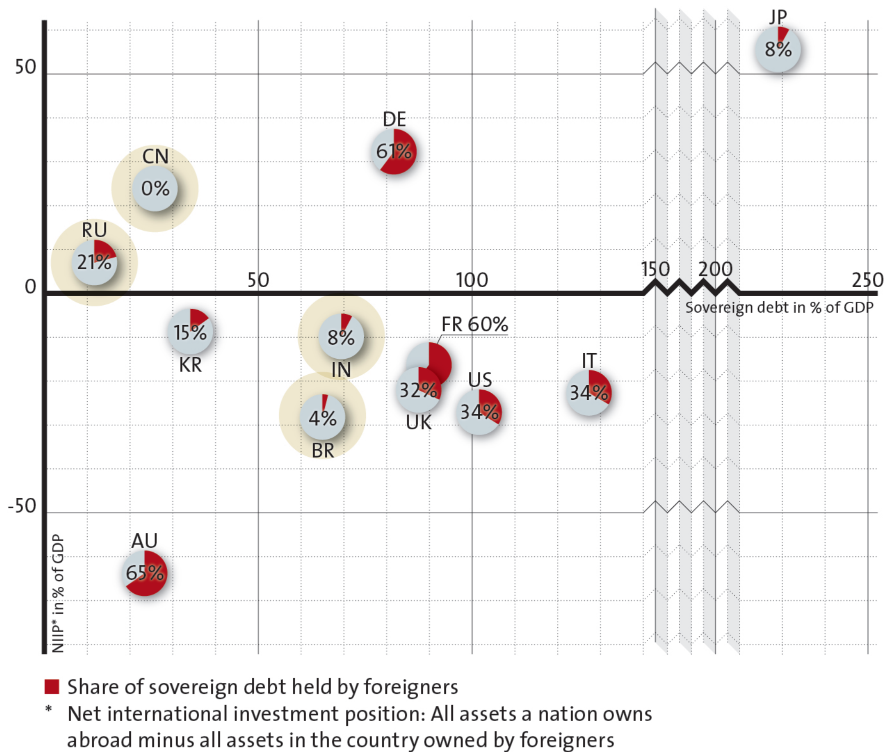
Economic dynamism moves east

The crisis uncovered fault lines in the global economy, laying bare the structural weaknesses of many West-

ern economies and the corresponding frailties of a world economy relying on Western demand. Demand destruction would hit China first, with massive ramifications for China's Asian, European, African and Latin American trading partners – in short, for the global economy. Economic stagnation would endanger the political stability of many emerging markets, not least China. Reflecting this vulnerability, many emerging markets embarked on a heavy stimulus programme during the crisis, allowing for some temporary decoupling. Stimulus spending in emerging markets also helped to lift export-oriented Western economies out of recession, a sign that the global economy has developed into a two-way street.

One sign of this decoupling is that the regionalisation of trade in East Asia has strengthened. Asian trade picked up in 2010–11 much faster than global trade, signalling the further regional integration of production chains. After the crisis, China

Sovereign debt and the national reliance on foreign financing



■ Share of sovereign debt held by foreigners

* Net international investment position: All assets a nation owns abroad minus all assets in the country owned by foreigners

Sources: US Treasury, Federal Reserve Bank of St. Louis, IMF, Eurostat

became more important as a regional economic motor: Asian exports to China increased markedly, while exports to the EU 27 and the US declined slightly, both for China and the rest of Asia. Trade between other emerging markets and Asia is on the rise as well, providing an alternative to Western markets: The share of Brazil's exports to China more than doubled between 2008 and 2011.

Another positive indicator is that government spending during the crisis did not have a huge impact on government debt in emerging markets. There is still substantial firepower to deal with similar crises in a Keynesian way, which makes growth prospects more robust. Public debt is at an average of about 40 % of GDP. Brazil and India elevate this figure, as their public debt levels exceed 60 %. But thanks to high growth rates, almost all of the G20 emerging markets started deleveraging after the crisis.

Meanwhile, savings remain at a very high level, mostly between 30 – 60 % of GDP. They have arisen partly as foreign reserves due to export-led growth and currency intervention, and partly as domestic savings. China's reserves are by far the greatest, with claims towards foreigners now exceeding foreign claims towards China by a quarter of Chinese GDP. Two thirds of these external assets are held as foreign reserves and about 60 % of these are denominated in US dollars.

This reveals that the fundamental dependence of East Asia on Western performance persists, not least in the financial sphere. Also, in terms of GDP creation, domestic demand has not supplanted the export-led and capital intensive development model in China. Decoupling is thus not likely to outlast state stimulus. Economic reforms are dearly needed to transition to a more consumption-driven economic model. The recent appreciation of the yuan is only one step into the right direction.

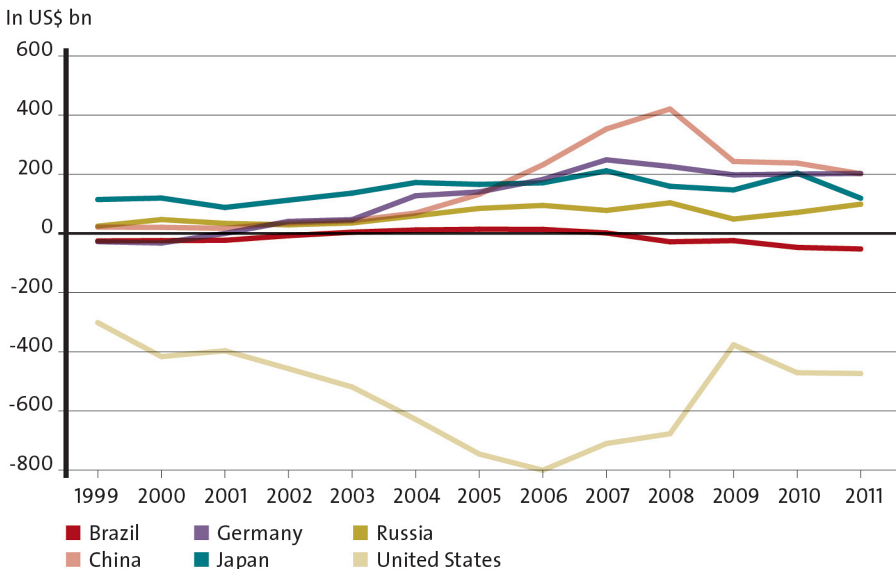
Now that China has become the East Asian growth engine the fate of its economy will have severe repercussions for the region and for the world economy. Changes to the Chinese economic model are needed as the external economic environment has become less munificent than during the 2000s. Since 2008, the economy has gradually upgraded towards more innovative and hightech tasks, and a slow rebalancing towards private consumption seems to be underway. However, political and economic reforms would be necessary in order to put the economy on a consumption-driven path. If anything, the CCP is aware of the challenges and possesses

a relatively long time horizon. But the implementation of reforms may yet hit many roadblocks, as the party and powerful economic groups will have to shed feathers on the way.

A stumbling West

The reform challenges in the West are huge, yet mostly lack a blueprint for resolution. Sovereign debt of most developed countries has increased beyond sustainable levels and is still rising. In the US and UK it increased by two thirds to about 90 % during the crisis. Add in the local public debt and the level is above 100 % in the US, one third of which is held by foreigners. The Central Banks of China and Japan each hold about 10 % of US federal debt. The Japanese government is indebted itself with a record debt-to-GDP ratio of 225 %, albeit predominantly domestically held. Among the bigger economies, only Korea and Australia show healthy public debt levels, way below the 60 % threshold deemed to be sustainable by most economists.

Many Western countries also have a 'twin' deficit, both in terms of sovereign debt and the current account. It is a sign of the lack of global competitiveness of industrial production. The US, UK, France, Spain, and Italy have all ventured into negative territory, and Japan's surplus has been greatly reduced. And unlike other high-



Source: World Bank WDI

income countries such as Australia, or emerging markets with persistent deficits, they have been driven by consumption rather than by investment and savings. Hence, the US and UK, and also France and Italy, will find it difficult to close the deficit by exporting more. Instead they will have to cut imports, which may hurt welfare.

Naturally, current account deficits have to be financed by countries with a positive current account. The most important is of course China, but Korea, Germany, Sweden, as well as oil and gas exporters, are also significant contributors. In most non-oil and gas exporting countries the surplus has been accumulated on the private accounts of exporters. In China, foreign reserves are held by the Central Bank, as exporters have to exchange US dollars into yuan. These stocks of foreign exchange have been reinvested in the US, mainly in federal debt, but also in corporate stock, securities, and direct investment. In the run-up to the crisis, Beijing had factually pegged its currency to the US dollar, helping Washington to sustain its consumption-driven economic model by bringing borrowing costs down while boosting its own exports. Similarly, Germany had financed the Spanish and Italian deficits, but as the result of productivity differences within the Eurozone, not as the result of currency manipulation.

Politically, Western societies are challenged by slow growth, deleveraging, and some also by high unemployment. Inequality has re-entered the political agenda: In contrast to the Great Depression, income inequality has not been reduced substantially. The middle class in the West is losing out and educational inequality is growing, endangering the backbone of democracy. The political deadlock in the US and the fragility of political systems in the EU are lively examples, both leading to unstable governance and high political risk. Inaction will lead to yet higher debt burdens, as pensions in many EU countries and healthcare entitlements in the US contain an implicit debt 'time bomb'. In many European societies, ageing and shrinking populations provide further challenges. This means that commitments need to be scaled down and taxes need to be raised in many cases.

In this situation of the West's relative economic weakness, the US is in a special situation, as it can use its trump card of global security provision in order to stabilise the economic situation. The perception that the US is still the only actor capable of forming lasting security alliances and partnerships acts as a backstop for the US dollar as a reserve currency. This is vital for the financing of the twin US deficits. In effect, the relationship

between the economy and security provision that had been disregarded during the last few decades has again moved to the forefront.

For example, the countries of the Gulf Cooperation Council chose to peg their currencies to the US dollar and trade their oil in dollars in exchange for Washington's security role in the region. This takes on particular relevance given Iran's ambitions as a regional power and the unstable situation in Iraq. A further example is Japan, which is the second largest foreign investor in US federal debt and receives US security guarantees in return. As China's rise is perceived as threatening by its East Asian neighbours, the US has found it easy to find new allies in the region. The largely symbolic 'pivot' towards Asia may yield economic benefits as well. China has so far also relied on the US for the policing of global sea lanes and for force projection in the Arab world.

But specialising in security provision can only serve as a temporary means of papering over economic deficiencies. An increasing reliance on security cooperation to prop up economic deficiencies may look rather like a protection racket to some observers and also runs the risk of overextension. The US is thus treading a very thin line. In the longer run, military power will not be sustainable without independent economic might – even more so as key allies like Japan or the UK are being weakened economically as well. The prime challenge to US power is thus economic, not military.

Politicised markets

Security partnerships and alliances are thus increasingly relevant for economic cooperation as well. This is especially true for the US, where a new alignment of military cooperation with trade policy is emerging. The EU has kept both realms separate so far, but is set to move closer to the US in free trade.

This is in line with a general trend towards centralised interference in markets in the West. State leaders and central bankers in the West are trying to steer markets in an effort to strengthen their economy and reduce adjustment costs. Arguably, some measures have saved the world economy from a severe recession. But as the West is in an economic slump it is abandoning its focus on free markets and mutual gain in favour of domestic development. Instead of trade diplomacy, economic diplomacy has moved to the forefront. The focus is no longer on consumer welfare, but on creating jobs at home. Still, this shift has been uneven and is not embedded in a new concept of economic governance.

Since the West is now intervening in the markets it once advocated, an alternative model to globalisation is still lacking. In effect, greater interference is reducing the predictability of Western economic policies and thus the economic performance of the West in the longer run. This has an impact on the strategies of emerging markets as well. For the time being, everyone is just trying to get a better place in the existing system, further undermining global rules and increasing the potential for conflict.

Trade and investment: Getting picky

Trade flows have increased much more rapidly than world GDP during the last decade. This is the result of the emergence of global production chains, spanning multiple countries. Western multinationals greatly profit from their management of global production chains. Therefore, it is costly to interfere with the process of further global integration of production. Global trade and investment have thus been the most robust areas of economic globalisation even in the aftermath of the crisis. Nevertheless, states have been more active in defining the conditions for access to local markets, and protectionism has reared its head. The link between investment and national security has been more pronounced in the US than in the EU, which remains pretty open to investment.

Responses in the US have been geared toward a re-industrialisation of the economy. Requirements such as the widening of 'buy American' provisions in public procurement, as well as new legislative proposals to tax the outsourcing of jobs, are being advanced. Politicians are trying to put pressure on businesses to 'in-source' jobs back to the US. However, it is not easy to get off the drug of cheap Chinese goods and production facilities, as indicated by the numerous exemptions to 'buy American' rules. More protectionism may thus mean less growth and higher inflation and hence be very costly in the short term.

It has been much cheaper to enforce protectionism against Chinese multinationals, highlighting the strong relationship between national security and the economy. The congressional banning of the Chinese telecommunications multinational Huawei from the US market or the veto of the takeover of the American oil major UNOCAL by China's state-owned CNOOC are cases in point. Chinese investment in Canadian oil is also hitting limits: Prime Minister Stephen Harper approved the takeover of Nexen by CNOOC, but announced that further investments by state companies would not gain Canada's approval.

This contrasts with the EU, where the economy traditionally has been much less linked with national security considerations. The backlash against Chinese investment is therefore almost unnoticeable, although investments have been larger than in the US. Chinese companies have targeted existing natural resource and processing industries as well as firms in hightech sectors such as automotive and renewable energy. Notably, Chinese companies such as Huawei also invested in new facilities, such as R&D centres in Germany or car manufacturing in middle-income EU member states such as Bulgaria. Chinese investors may thus be cherry-picking, but they are also bringing new jobs to EU countries.

National security concerns begin popping up in the case of Russian investment in energy assets, however. This has to do with the already strong position of Russian oil and gas in the EU market. As China increasingly invests in EU assets, similar learning effects are likely to occur, meaning that security concerns will become more pronounced.

In any case, EU leverage is more constrained than in the case of the US, since China is an important export market for many of the stronger EU economies. In addition, the EU does not issue the world's reserve currency, nor is it a global military actor upon which China depends, as the US is. Furthermore, Beijing has invested handsomely in the Eurozone bailout funds: The rumour is that China purchased 30 % of the bonds issued by the European Financial Stability Facility.

Foreign investment will be a recurring topic, since Chinese firms have only begun to internationalise. Furthermore, China wants to transfer some of its unprofitable currency reserves into real assets abroad. In an effort to diversify away from US federal debt, the People's Bank of China has announced a new fund to directly support the foreign investments by Chinese companies with its currency reserves. This is in line with the strategy of moving into higher value-added activities such as services by globalising.

In response to Chinese activities, developed economies are crafting state support mechanisms for their companies as well. The bigger EU economies are concerned about the loss of influence of their companies in the global competition for resources – not so much oil, but minerals. The German government has set up a new initiative to promote German investments in resource-rich countries, including a subsidised loan facility. Japan, which is increasingly being squeezed from its markets by Korea and China,

has reciprocated as well. Despite high sovereign debt levels, Prime Minister Shinzo Abe has announced a new state fund to foster strategic industries as well as to support Japanese multinationals in their acquisitions abroad.

Multilateral governance, meanwhile, is weakening. The WTO is still a vibrant forum for sounding disputes, but looks increasingly ill-equipped to deal with the new world of global trade. Russia became a new member last year, but is already installing new measures to circumvent WTO rules. The Doha round of negotiations is stuck, as emerging markets are not keen to agree to the strengthened rules on intellectual property protection demanded by the West. Meanwhile, the West has got cold feet about enhanced market access for non-agricultural goods and the 'less than full reciprocity' rule for developing countries, since emerging markets also claim to belong to this category. 2012 saw the launch of 26 new dispute settlement cases, the highest number in a decade. With even more disputes in the pipeline, the WTO has had to reallocate personnel and is hiring new experts.

Instead of multilateral cooperation, regional and bilateral trade deals are used in order to complement security partnerships. In conjunction with its new commitment to security partnerships in Asia, the US is actively promoting the Trans-Pacific Partnership (TPP) free trade agreement. Aimed at bolstering trade with US allies and other non-Chinese partners in Australasia, it includes far-ranging provisions on intellectual property protection. The Obama administration is also pushing for a transatlantic free trade agreement with the EU, which would reinforce the existing alliance in the NATO and the transatlantic resolve against Chinese trade practices. This holds the perspective of integrating EU partners into the 'pivot' to Asia in order to increase leverage.

However, Chinese economic influence and the confluence of the economic and security 'pivot' may act as roadblocks to the US strategy of coupling economic and security leverage. Washington thus has to tread very carefully in order to succeed. Already, officials from Australia and New Zealand have voiced concerns that the TPP might be seen as an effort to contain China, which would pose problems for their participation. For its part, Beijing has entered into a broad range of bilateral agreements in order to spread its influence around the world. It is negotiating a deal with the countries of the Gulf Cooperation Council, with other resource-rich countries such as Australia and Norway, with global hubs and technology

leaders such as Switzerland, and with geopolitically important states like Iceland, which might become the hub of a future Arctic trading route. The stark integration into global production chains and financial flows thus requires readjustments to be cautious, but does not prevent the evolution of new economic and security arrangements.

Monetary policy: The unconventional age

Monetary policy and, correspondingly, the degree of openness to financial flows, has become the second arena for fights over economic resources. As trade is internationally much more regulated than financial account policies, manipulating a currency's value via capital controls and foreign exchange interventions has become the default measure of many emerging and even developed countries for enhancing their prospects in international trade.

In many Western countries, policymakers have sent central bankers to the front to ease the debt pains, while themselves taking a back seat. In response to the liquidity crisis, Western Central Banks have embarked on unconventional monetary policies, most importantly quantitative easing (QE). This is based on a rapid increase of the money supply – in essence using the printing press to pump liquidity into the economy. By creating money, the central bank can buy assets, such as sovereign debt. During the liquidity crisis this policy was geared towards keeping banks afloat and stimulating lending to the real economy. But with successive rounds of easing – which are now in their fifth year – some central banks have crossed the line and moved away from their traditional tasks towards financing the sovereign.

QE is a Keynesian policy, since it increases immediate spending by driving down credit cost for both government and private actors. Higher spending feeds into higher growth. Deflation is held at bay and the world economy enjoys the extra demand. But by depressing bond yields it penalises savers such as the middle class and rewards debtors. Thus, consumers are enticed to spend rather than to save, impacting the viability of the economy in the longer term. The same incentives hold for politicians, since the costs of putting off reforms are lowered if real borrowing costs are not painful, or even positive. Also, asset prices such as corporate stocks or real estate are being elevated, risking yet another financial bubble.

As in the case of debt, the problem of liquidity reduction is left for later, supposedly when the economy has picked up again. But the exit from QE programmes is fraught with uncertainties. Borrowing costs for gov-

ernments may suddenly become untenable, as inflation and the economy pick up. Harder tools of financial repression such as forced loans, currency devaluation, and capital controls might be a political answer in the developed world.

In open capital markets, quantitative easing is taking on a global dimension. By depreciating the issuer's currency it shifts the costs of economic adjustment on to others. The foreign assets of other countries are being reduced in value. If emerging markets were to use QE in retaliation, high inflation would be a likely result since their economies do not suffer from Western problems such as overcapacity. They are therefore left with capital controls to manage the exchange rate. QE is thus triggering protectionist measures. In the case of the US dollar, QE policies have an additional dimension, as important resources such as oil are traded in US dollars. Since the dollar-denominated value of these goods increases as the dollar depreciates, inflation is being imported. The effects of QE are accelerating Chinese efforts towards internationalising the yuan.

Quantitative easing: Refuelling the helicopter

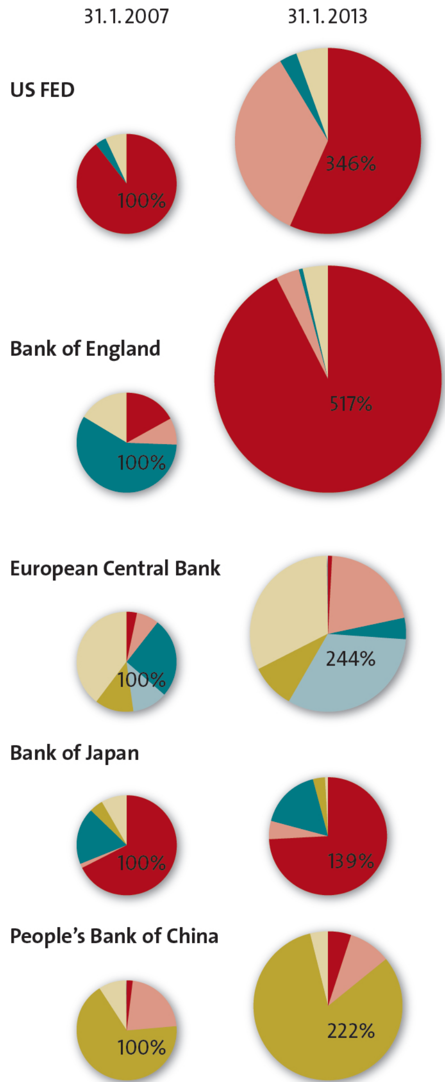
In the US, the Chairman of the Federal Reserve (FED), 'Helicopter Ben' Bernanke, is dropping free cash on the economy at an unprecedented rate. In September 2012 the third round of QE was announced, along with a policy change in December. From now on, inflation will be less important than unemployment for the FED's policy. Zero interest rates are to prevail until the unemployment rate has reached 6.5 %, if inflation does not rise above 2.5 %. The third round of QE will add some US$ 85 billion in mortgage-backed securities and treasuries to the FED's balance sheet every month. About 11 % of US federal debt is already on the FED's books, more than held by China or Japan. In effect, the US has turned away from China and towards the printing press for sovereign debt financing. By linking the policy of easy money to the unemployment rate, Bernanke may have sent a message to Beijing as well: The yields of Chinese assets in the US will be depressed further unless Beijing lets the yuan appreciate to a level that would create sufficient jobs in the US.

Other economies are pursuing QE policies as well, albeit with a smaller global impact due to the lesser status of their currencies. In the EU, QE has been pursued as a substitute for policy action as well. The main aim was to prevent a breakup of the Eurozone. The European Central Bank's balance sheet doubled after the onset of the crisis, mostly to recapital-

ise banks on the southern periphery, and has shrunk slightly since then. In 2013, the ECB might become directly involved in government financing under its bond-buying programme. Yet it has vowed to shed other assets instead of oiling the printing press. The euro's value is already increasing against the other main currencies, since QE has not been as aggressive as elsewhere. This will make for new discussions about the EU's external competitiveness.

The Bank of England (BoE) is already monetising debt on a large scale. The new BoE Governor, to take office in June 2013, was deliberately chosen by the Tories because of his positive view of QE policies. Meanwhile, the Bank of Japan (BOJ) is probably the most openly politicized. As past monetary expansion has not brought about the desired effect, the BOJ has come under increasing pressure to do even more. A new governor in favour of QE has been selected by the Abe government, as the old governor had resigned early. The BOJ started to buy government bonds in 2012 and is expected to expand this programme. The yen has started depreciating sharply at this prospect.

Many emerging markets retaliated as they were hit by the wave of excess capital. The movement was headed by



Source: Respective Central Banks

Brazil, which in 2010 installed capital controls on portfolio inflows to resist further appreciation. Taiwan, South Korea, Indonesia, and Thailand followed suit. Although the Brazilian real weakened again during 2012, only one measure has been dropped. In this way, unconventional monetary policy is rolling back financial globalisation.

The international consensus has shifted against the free flow of capital as well. The IMF's new institutional view on capital flows voices scepticism towards free capital movement and expresses support for state management of capital flows in certain situations. This may be justified by the volatility of financial flows, but it is also a slippery slope towards greater interference in capital movement.

One might argue that currency manipulation has been around a long time and is finally being discussed openly, which will open the way towards resolution and the crafting of global rules. The very fact that Brazil brought the 'currency wars' to the G20 agenda in 2010 cast some light upon the problem of the lack of rules. But the Brazilian attempt to bring the US and China to the table and to craft an alternative to the US dollar as a reserve currency fell on deaf ears in Washington. Since then, not much has happened, and the FED has merely continued to test the patience of global finance and central banks. Hence, rather than acting as a precursor for a world with less currency manipulation, QE policies give new reasons for government intervention and help to further undermine the trust in fiat money and the stability of the global monetary order.

Yuan internationalisation

Last but not least, QE is pushing China to speed up its moves to liberalise the capital account, as the costs of using the US dollar are rising. As liberalisation conflicts with the goal of control over the economy, only small steps and experimentation have been seen so far. But imported inflation is giving a boost to liberalisers vis-à-vis domestic manufacturers to move ahead with yuan internationalisation.

The closed capital account, resulting in a lack of yuan convertibility, is still the main roadblock. Since the yuan has appreciated over the course of the last few years, however, it is now not very far away from a market rate, so the costs of liberalisation are shrinking. The main challenge is the reform of the domestic banking sector, as the CCP is unlikely to be fond of giving up political control over capital.

In any case, Beijing is preparing for the internationalisation of its curren-

cy. It has been touring trading partners, tying up more than a dozen deals on currency swaps. Those include big trading partners such as Brazil, Australia, Korea and Japan. However, only about 8 per cent of external deals were settled in yuan in the first quarter of 2012, up from 5 per cent the year before. Direct trading of currencies has started with Japan, Russia and other countries, but the amounts remain small. The main showcase for internationalisation so far is thus Hong Kong, the offshore trading hub for the yuan.

Amid QE policies, global interest in the yuan is growing. Central banks all over the world are waiting in line to add the yuan to their reserve portfolio: Nigeria has moved ahead with holding some yuan, aiming at denominating 10 per cent of its foreign exchange reserves in the Chinese currency. Even the central banks of US allies such as Japan are lobbying for further liberalisation, as they seek to diversify away from the dollar and euro.

Thus, the ball is firmly in the CCP's court. As China's share of the world's merchandise trade already surpassed that of the US, the yuan would be able to take a role as one of the world's reserve currencies relatively quickly, should the CCP choose to liberalise. The US dollar might thus receive yet another challenger sooner than expected.

Anomic globalisation

The world economy today is exceptionally densely networked and integrated, but the very success of integration has produced new political strains. The perspective of politicians in the West has shifted from the gains towards the costs of free trade, from trade diplomacy to economic diplomacy, and from the spread of global rules towards 'nation building at home'. Yet it is a muddled and conditional shift, as Western firms and economies are deeply enmeshed in foreign markets and supplies, as the financial market is globalised, and as an alternative ideology is lacking.

Meanwhile, East Asia will likely embark on greater economic liberalisation as China will gradually abandon capital controls. But political instability in China could quickly spill over into belligerence abroad. Already today, political leaders of the region are carefully hedging their bets in view of China's rapid ascendancy and its more assertive foreign policy (see Chapter 2 in this issue).

Economic integration thus begets new security problems and economic ascendancy reinvigorates political rivalries. As a result, economic and security affairs are re-integrating in the Asia Pacific and in US foreign policy. Interdependence finds itself hand in

hand with a deterioration of the rules and increased conflict. Weak actors such as African states and societies are the losers in this new world. Globalisation is becoming increasingly anomic and hence dependent on power.

As we go forward much will depend on how Western countries will cope with this new reality, both internally and externally. As yet many doubts remain as to whether Washington will be able to shape a lasting system of economic and security partnerships in Asia, given the importance of trade ties with China in the region. The role of old US allies in Europe in the 'pivot' remains unresolved as well. The challenges give an impetus to Western leaders to move closer together, but societies are still unprepared. Going forward, it will be crucial for the West to embark on a new consensus on economic governance if it is to exert global leadership again.

Whether this consensus can be formed will depend on how leaders resolve domestic political challenges. Whereas the middle class is growing in emerging markets, it is losing ground in the West, a development accelerated by the crisis. The repercussions for democratic governance are remarkable. In the US, the decision-making process is held back by trench warfare about the right size of government, designed to mobilise societal strata against each other while deflecting from the common societal problems. The debate in the Eurozone has edged closer towards the core problems, but it remains an elite discussion. Hence, there is still uncertainty over democratic backlash against deeper integration, not to mention resistance to the reforms that would follow. The short-term nature of the political process is thus preserved, resulting in an inability to tackle longer-term strategic problems. Societal mobilisation is therefore needed in order to tackle the problems that lie ahead in the West. If politicians fail to develop a common vision to mobilise their constituencies and continue to muddle through, the West will have a hard time in regaining leadership.