

The Impact of the Economic Crisis on the International Strategic Configuration

Edited by
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Institute for Security
& Development Policy

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Military Sciences

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Introduction

The annual conference, arranged by the PLA Academy of Military Science and the Institute for Security and Development Policy in 2009 focused on the “Impact of the Economic Crisis on International Strategic Configuration.” The conference was held in Beijing in July and the practical arrangements were handled superbly by the PLA Academy of Military Science. Eight international and three Chinese scholars presented papers on the topic from their own perspectives, ranging from economics, foreign policy and military aspects. The audience consisted of specially invited scholars and researchers from security policy related institutions in Beijing. After each presentation, there was a Questions and Answers period, where the presenters and the audience could exchange views. Judging from the level of participation, it was obvious that the topic engaged everyone who was present.

As expected, and hoped for, the presenters covered the topic from many different angles, thereby illustrating the wide range of complex questions that have to be analyzed when studying the interplay between economics and security.

In the area of military spending, Steven Rosefielde pointed to the problems Russia may experience in the future when following their modernization plan for the military. The idea that Europe and the United States may also face similar problems was clearly shown by Zhang Shiping. At the same time, Yasuhiro Takeda pointed out that military spending, although affected by the economic crisis, was still on the rise in Asia. In this context, a hypothesis was suggested: perhaps the risk of conflict has become smaller because no one has the money to wage war.

John Rydqvist and Fredrik Erixon pointed to the financial markets where money flows and currencies can be greatly affected, which in turn can have an impact on security. This aspect was also taken up by Leif Vindevåg and Yasuhiro Takeda who explained how reduced investments in developing countries could lead to conflicts and increased poverty. Indirectly, this might also affect the willingness and possibility of NATO (and other similar organizations) to act, as was pointed out by Willem van Eekelen. The new role of NATO to a large extent involves nation building, which is a costly

af air. If the money for that is not there, what then will NATO do, especially with shrinking defense budgets in Europe and the United States?

Many of the presenters, such as Niklas Swanström, Leif Vindevåg and Huang Xing, touched on how the sometimes neglected fact of global interdependence has influenced thinking on security. The freedom of action for almost all countries has been curtailed. Yuan Peng suggested that this “discovery” might lead to reduced tensions between countries that have territorial disputes, or similar quarrels, where there is too much to lose and very little to gain by continued saber rattling.

Much of the discussions that took place during the conference, both during sessions as well as during breaks, concerned how the economic crisis might affect the relative power between different countries. Fredrik Erixon coined the expression “EU, a diminishing giant.” Several factors such as rigid institutions, demography and complicated decision making processes contribute to this decline of European economic power.

Regarding the United States, there were some different interpretations. Huang Xing pointed to “imperial over stretch” as a danger for it. Yasuhiro Takeda and Yuan Peng had doubts about the revitalization of the U.S. economy. Perhaps not so much in terms of a decline, but rather, they pointed out that other economies were catching up, changing the relative power between nations. This is especially true when it comes to China and the United States, as we are moving towards a multipolar world. Edward Lutwak was more optimistic concerning U.S. prospects. Historical crises have always been a catalyst for the United States when trying to revitalize its economy. The same might happen this time (if it does not adapt too many European ideas about the labor-market and welfare).

The presenters seemed to agree that it is impossible to draw any firm and detailed conclusions on what the economic crises will lead to when it comes to global or national security. There are too many “ifs.” But hopefully the papers will give the reader a better understanding of the factors that are involved, and will also help him or her to identify the challenges that lay ahead.

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The World Strategic Structure in the Shock of Financial Crisis

Huang Xing

The world-wide financial crisis and the economic crisis that has spread rapidly since last year intensifies the turbulence and hastens profound changes in the post cold war world strategic structure. We have never experienced such a crisis in terms of the affected areas, its profound impact, the strength with which it hit the world, and its unpredictable future direction.

Chinese President Hu Jintao announced that “it is unusual since the 1930s.” Premier Wen Jiabao claimed that “it pulled the world into the most difficult times since the Great Depression last century.” The public opinion in the West regards it as “a shocking financial tsunami.” Dr. Henry Kissinger and Alan Greenspan, the ex-chairman of the Federal Reserve, said “it is a once-in-a-century credit tsunami,” and the Hungarian-born George Soros, an American investor, said “it is the worst financial crisis since the Great Depression.”

It is necessary and important to review the Great Depression from 1929 to 1933 so that we can understand the current financial crisis and predict its future direction in a reasonable way. During the economic crisis 80 years ago, one third of industrial products and two thirds of external trade had been reduced in the capitalist world. In America, more than 500 banks closed down and one quarter of the labor force was unemployed. The industrial growth and national income were reduced by 50 percent. 34 million people had no income, with 11 million rural people not included. At that time a family needed US\$2000 a year for the minimum living standards. However, 60 percent of families could not reach that level.

The current crisis is far more serious than the one that occurred in the past. Wall Street, a 500 meter long street, which is the heart of the U.S. financial system, once contained the wealth of 35 times of the U.S. Gross Domestic Product (GDP) in value. The Wall Street financial domain, which took 200 years to form, was changed radically in a just couple of days last year, and many states and regions that looked on with folded arms just days

before, now became victims themselves. In 2008, the value of the global total financial wealth was shrunk by 51 percent, which means that all the value aggregated by shareholders since 2003 was completely lost. From subprime mortgage crisis to sub debt crisis, collateralized debt obligation (CDO), credit default swap (CDS) and CDS market, several hundred billion debt surged to US\$62 trillion due to repetitive speculation. The so-called “wise men” appeared to be crazy and failed to notice the upcoming catastrophe.

Finance is at the core of the modern economy and the crisis undoubtedly caused the recession of the world economy. The worldwide recession was to have an impact on every facet of society and would influence states' strategic choices and the trends of the international strategic structure.

We are very happy to take the opportunity to co-chair an international seminar with Sweden, to discuss important issues concerning the current financial crisis and the developing international strategic situation with scholars both home and abroad. Now, as a Chinese military scholar, I would like to share my views with you.

The Characteristics and the Main Causes of the Current Financial Crisis

Today, nobody can doubt that it is an unprecedented worldwide crisis. If approached in an inappropriate way, the financial and economic crisis could evolve into a political and social crisis. As for the main causes of the current crisis, there are various viewpoints. In summary, eight will be presented.

The first is sub-prime lending theory. This is the earliest and most common view. Presently, the CDS market is valued at US\$62 trillion. If only 10 percent defaulted, that is US\$6.2 trillion, the U.S. government would have to pay US\$100 billion to purchase the CDS, which are valued at US\$30 billion. As for the remaining defaulting CDS, the government would have to pay more than US\$20 trillion. Otherwise, the government would see them becoming bankrupt.

The second is over consumption theory. In simple words, that is “people don't want to work, but yearn for large houses.” People consume much more than they earn. How does one acquire such material wealth? Cheating by financial tools and claiming bankruptcy when one can cheat no more. There was a popular story about an old Chinese lady and an old American lady. When they are dying, the old Chinese lady said “finally I have saved

enough money to buy a house,” while the old American lady said “finally I pay of my house.” The story not only demonstrates the cultural differences on consumption between the Chinese and Americans, but also the philosophical implications. In 2007, U.S. debt was valued at US\$73 trillion, while U.S. total capital assets were valued at 76 trillion. Now the capital value has shrunk by 30 percent to the level of less than 50 trillion. It is out of balance. The reason that the United States did not go bankrupt is because its stakeholders do not want to see it going bankrupt.

The third is dereliction of duties theory. The United States upholds financial freedom, advocates “the least control is the best” and indulges in the flooding of financial products derivation. Many organizations, such as the Federal Reserve (FED), the Department of Treasury (DOT), Federal Deposit Insurance Corporation (FDIC) and the U.S. Securities and Exchange Commission (SEC) have not prescribed the responsibilities of financial derivations and overall risk management. This credit evaluation organization, which should be fair and authoritative, became confederates of financial trickery and sold their soul to the devil.

The fourth is honesty lacking theory. Compared to the capitalism Karl Marx criticized, modern capitalism enhances capitalism trust responsibilities with legalized rules of the game. Trust responsibilities are the soul of modern capitalism and it was to become an evil one without soul. In the chain of the capital flow, we see that honesty is lacking and morals are corrupted rather than executing trust responsibilities. After the crisis erupted, the whole world was surprised at how such states and financial organizations could have existed. Thus, the trust for U.S. bonds was dismissed and overdraw led to the collapse of banks.

The fifth is the robbery intrigue theory. Many states, such as the United States, Japan, European and Southeast Asian countries, etc., declared that they were out-of-pocket. But according to the law of conservation of matter and market economy, the loss for some must be a gain for others. If this is the case, where can the capital be found and by whom is it held? This question has been largely unanswered to date. Many tried to discover the cause, only to find out that the financial crisis seemed to be a plot designed by developed countries and their financial organizations. Here are the facts: when its companies and banks suffered financial crisis, the United States quickened its steps to expand abroad rather than shrinking business to overcome the

dif culties. According to the estimates by a U.S. economy analysis agency, the United States held US\$3.56 trillion in 2007 when the sub-prime crisis erupted and spread, which was the highest record in history. The United States ignited the crisis, but shif ed the losses onto the world. As for the money gained, some shell companies are the most suspicious, such as those registered in of f-shore centers in Jersey Island, the Caribbean, the Cayman Islands or Bermuda. The Special Purpose Vehicle (SPV) is one such example.

The sixth is the strategic crisis theory. Some scholars think that the f nancial crisis is only the tip of the iceberg, ref ecting the greater U.S. strategic mistake. The U.S. intention to lead the world makes its burden heavier and heavier. If we say the f nancial crisis is a myocardial infarction, then the Afghanistan and Iraq war are two deep bleeding holes. The global f nancial power is seriously out of balance, which may lead to radical changes, similar to that which happened in Great Britain and the United States from 1941 to 1945. It seems that it is an inevitable trend that the international center of focus is moving from the West to Asia.

The seventh is “the China responsibility theory.” The theory criticizes that China has overabundant foreign exchange reserves and U.S. Treasury Securities, excessively cheap labor and export commodities, as well as well developed manufacturing industries. The outbreak of the global f nancial crisis is therefore attributed to the phenomenon that the western world can buy Chinese commodities at rather low prices and has earned the majority of prof ts, while Chinese enterprises have earned only a fraction of them. Some scholars even claim that they have found an instance – a mathematical formula called “Gaussian copula function” put forward by a Chinese mathematician and quantitative analyst David X. Li in 2000 – as the theoretical basis for the designing, pricing and risk rating of f nancial instruments such as Credit Default Swaps. This formula is used by brokers in New York and London to create the largest bond markets in history and acquire billions of dollars, which eventually brought about the f nancial tsunami. Evidently, both the arguments and the grounds of their arguments are absolutely absurd.

The eighth is “the f awed system theory.” The global f nancial crisis spreading rapidly is in nature the crisis of the capitalist system. That is to say, the most important inducement to the crisis is the system’s failing to function rather than problematic strategies and f nancial supervisions of

western countries. Although the first round of impact of the crisis is far from completely shown, the second round will possibly appear this year or in the next few years. The socialist factor having saved the capitalist society several times can have no role to play this time. As early as in 1970s, Paul A. Samuelson, who has received the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel, found out that *Das Kapital* by Karl Marx attracts much attention in capitalist states whenever crisis arises. Today, the book becomes a best-seller once again in the United States, Great Britain and Germany, and is even out of stock in some parts in China. Its readers include French President Nicolas Sarkozy, German Finance Minister Peer Steinbrück, and former U.S. president George W. Bush. Germany even plans to re-edit the *Marx-Engels Gesamtausgabe*. The international society always feels confused about the occurrence and development of a financial crisis because they attach much importance to microcosmic issues while overlooking laws on macroscopic issues. *Das Kapital*, on the contrary, reveals the inevitability of the crisis by analyzing the inherent contradictions in capitalism between the over-enlargement of production and the relative decline in people's purchasing power caused by the private ownership of means of production. As the statistics show, the average wage per hour has decreased from US\$17.6 to US\$10 in U.S. enterprises, while the disparity in wages between senior executives and ordinary employees has increased from 40:1 to 357:1 from 1971 to 2007, and private consumption on credit has risen from US\$120 billion to US\$2.5 trillion during the same period. We can see that the income is absolutely declining. It has been almost impossible for ordinary workers to find a job with a yearly wage of US\$50,000 ever since 1990 and numerous high-income engineers and senior technicians have to work as waiters, salesmen, care staffs or even volunteers. What can be done in the circumstance that economic growth needs to be pushed up by the increase of consumption while people's income continuously decreases? The way western countries choose is to further lift monetary control so as to let people be able to consume by borrowing. As the Chinese saying goes, it is "to relieve thirst by drinking poisonous water." The outcome is obvious.

Except for "the China responsibility theory," it is my opinion that there are many reasons for the occurrence and development of the crisis, including what is mentioned above. But the most fundamental and important one is the contradiction inherent in capitalism. As analyzed by Marx, the blood

of capital is saturated with greed. Mankind, whether they are individuals or groups, in developed or developing countries will be driven mad by the lust for money when profit is over 300 percent ever since capital is born. In the infamous Rio Tinto Gate scandal, for example, a group of people motivated by the allurements of RMB 700 billion (US\$100 billion) were turned into economic traitors. It is the function and responsibility of the state to reduce the negative impact of capital while utilizing it, rather than indulging it or speeding up its trend toward an impasse where moral standards are discarded and no one benefits from it.

The Origin and Trend of the Crisis in a Forward-looking Approach

We have repeatedly expressed our idea that the “trend of development is more powerful than people” in our research and on many occasions. Facing the trend of history, those who follow suit will survive and prosper, and those who go against it will be doomed. Today, this irreversible trend of history is demonstrated in the theme of “peace and development,” the integration of informatization, globalization and multipolarization as well as their profound influence on international strategic structure and the global situation.

These influences can be felt by looking at the essential characteristics of “peace and development” and “informatization, globalization and multipolarization,” and play important roles in the advance of history. What “peace and development” pursue are equal chances, reasonable orders and stable environments for development and common prosperity. “Informatization” becomes a joint cause with the nature of interoperability and sharing. The positive value of “globalization” is to reject an unreasonable political and economic order with mutual benefits and an all-win attitude at its core. The fundamental feature of “multipolarization” is mutual tolerance and coexistence with all the people rather than a situation where one has the final say.

From the above we draw the conclusion that today’s world is at an unprecedented turning point. There are more and more common interests among various countries, regions and peoples, even closer interactions and interdependence in international society, more and more correlations among domestic, regional and international affairs. And security and development will be achieved through bilateral and multilateral cooperation

rather than through competition and confrontation. It has increasingly been the major and prior strategic choice of countries and even nongovernmental organizations to resolve disputes and contradictions through dialogue and discussion.

However, due to the long existing traditional law of survival and unreasonable political and economic order, many areas relating theories and concepts, domestic and foreign affairs, policies, systems and strategies fail to keep up with the trend of the times. Politicians and strategists, consciously or unconsciously, have realized the overall inadaptability and begun to push reform or transformation to some extent. But the contradictions and problems accumulated in some countries are too many and too intense so that its results in crisis in a shocking way. The crisis warns those woolly-headed leaders that they are in a different age when states cannot survive without change. In this respect, we can say that the spread of the crisis is speeded up by informatization; the damages magnified by globalization; and the signal warning highlighted by multipolarization.

If this view is correct, or reasonable to some extent, then we cannot cope with the crisis by profiting at others' expense or taking stopgap measures. Our solutions should follow the historical trend and public opinion, address both the symptoms and root causes, and contribute to long-term cooperation, common development, peace and an all-win result. Correspondingly, the post-crisis future will be either establishing a wonderful world within the framework of common interests, or getting trapped in the vicious circle of continuous infighting.

The United States, the dominant country in the international financial crisis, sustains its overconsumption by the savings of the whole world, while retrieving back oil dollars from resource exporters and Asia dollars from manufacturing exporters, issuing excessive government bonds, transferring its huge risks to the world, and realizing global resource allocation in its own interests. It is highly possible or perhaps even inevitable that the financial crisis will hit again unless the system is corrected, or the root cause is eliminated.

Future World Strategic Structure

How to understand the historical trend of the world is a question of primary importance with regard to strategy.

There are six theories about the trend of the international strategic structure with the impact of the ongoing financial crisis.

The first one is the “one superpower with multiple powers” theory, or “one superpower being the only hegemony while several powers existing simultaneously.” This used to be a prevailing opinion at the time of radical change in the former Soviet Union and Eastern Europe and the end of the Cold War. But the reality today can hardly support such a theory anymore.

In the twenty or thirty years to come, or even over a longer term, there may be no fundamental changes to the fact that the United States remains the world's most powerful country and its goal of establishing global hegemony. Accordingly, there will be no probable great changes in the U.S. national strategies of engagement, containment, prevention, westernization and division toward some nations. In the near and medium term, however, the United States will be in the present new phase of strategic adjustment and contraction. The U.S. posture in general embodies both expansion and contraction with more contraction; both offense and defense with more emphasis on defense; both inflexible contraction and flexible offense; both soft power and hard power with an increasing role of soft power; and the aspiration to make sensible strategic adjustments both on its own initiative and by forced choice in the case of dealing with dilemmas.

The wars in Afghanistan and Iraq are just like two nightmares, indicating the failure of the U.S. theory and the design of “winning two simultaneous wars,” or “one and a half wars.” They also demonstrate a remarkable decline of the comprehensive national power of the United States and its power of world dominance. The United States takes nuclear proliferation and terrorism as number one and number two threats to countries, and has given nuclear terrorism top priority since last year. It is impossible for the United States to eliminate all the geopolitical obstacles on the crescent starting from the Greater Middle East region to the Korean Peninsula within twenty years or even a longer period of time. The impact of the two wars on the United States is greater than that of any other war in history. After the end of the Cold War, the United States used to undertake four or five overseas military deployments per year on the average. But there has been almost none since the war in Iraq began. The war in Afghanistan, with thirty-seven nations mobilized in the name of the United Nations, has been fought for eight years, but only resulted in more terrorism and

larger Taliban-controlled areas in the end. As a direct result of the two wars, the U.S. military has made some important adjustments recently, such as “starting from the result” principle for war design, stressing that “irregular warfare” has equal priority with “regular warfare,” abandoning the “effect-based” operational guidance and the concept of “military operations other than war.” Frank Hoffman, a combat expert of the U.S. Marine Corps, has advanced a new theory of “hybrid war,” emphasizing that the biggest threat to the United States is not the traditional threat posed by traditional powers, but a variety of enemies alternately using traditional and non-traditional methods to pose the “mixed threat”; and that in the future, U.S. military forces will conduct various types of combat and military operations within one battle space at a time. This theory soon received attention by top leaders of U.S. military and was recently incorporated into strategic documents such as *The Quadrennial Defense Review and Mission Report*. A book entitled *America’s Defense Meltdown*, written by thirteen famous retired generals, severely criticized America’s new revolution in military affairs and military transformation since the days of Donald Rumsfeld.

The second one is the “Chimerica” or “the Group of Two” theory, or the “G-2” theory. The theory of “the Group of Two,” consisting of China and the United States, was first advanced by C. Fred Bergsten, director of the Peterson Institute for International Economics, in his article “A Partnership of Equals” published in the summer issue of *Foreign Affairs* in 2008. The concept of “Chimerica” was created by Niall Ferguson, a professor of economic history at Harvard University, who elaborated on this concept in his article “Buy Chimerican” published in the *Los Angeles Times* on March 5, 2007. More importantly, the former U.S. national security advisor Zbigniew Brzezinski made a formal proposition of “the Group of Two” at the Beijing conference in commemoration of the thirtieth anniversary of the establishing of Sino-U.S. diplomatic relations in mid-January 2009, and published his article entitled “The Group of Two that Could Change the World” in mainstream U.S. and British media, which has attracted world-wide attention and even concerns of some countries.

Interestingly, these opinions have drawn basically opposing responses from the Chinese and the American public. Most Americans disagree and believe that it is completely out of the question for the two countries so different in social system and ideology to form a “Group of Two” or “Chimerica.”

According to some wise strategists like Henry Kissinger and some rational research findings such as those of Princeton University, the two nations should strive for the realization of diversified cooperation under the framework of seeking common interests. On the contrary, in China, the majority of people accept those opinions, and most media reports are positive, which is similar to the response to the propositions of Sino-U.S. “joint governance of the world” and “joint domination of Asia” a few years ago.

All this automatically reminds us of Eisenhower’s and Khrushchev’s talks in Camp David in September 1959, another “G-2” plot selling the concept of Soviet-U.S. cooperation and seeking joint domination of the world.

In fact, the background to these U.S. propositions lies in the growth and decline of the relative strength of China and the United States caused by China’s rapid rise and the weakening power of the United States. Some Americans believe that the old containment strategy toward the Soviet Union and China is no longer as effective as it was in the past, and that soft power and nice packaging should also be used to make China willingly incorporate into the U.S.-led western system. To Americans, this is the best and most reliable strategy.

Now look at what they have said. Fred Bergsten said that Washington should modify its economic policy and strategy toward China, and that “the Group of Two” is the only way to lure China into joining the present global economic system. Former U.S. Deputy Secretary of State Robert Zoellick said that the United States should prevent China, a Water Dragon, from turning into a Fire Dragon. Even more bluntly put in his speech, former U.S. Treasury Secretary Lawrence Summers said that the United States should remold China through establishing the “Group of Two.” And Niall Ferguson’s words revealed, in the most expressive way, the intention of making China become a vassal to America: “The United States and China are engaged in a marriage like my wife and I.” According to him, the man in this marriage is China, and the woman is America. “East Chimericans are savers; West Chimericans are spenders. East Chimericans manufacture; West Chimericans provide services. East Chimericans export; West Chimericans import. East Chimericans pile up reserves; West Chimericans obligingly run deficits, producing the dollar-denominated bonds that the East Chimericans crave for.”

It has been borne out by history and reality that both “the Group of Two” and “Chimerica” are infeasible and unrealistic. To us, making such a choice would result in dire strategic and serious consequences. In the first place, it will badly harm China’s image as a socialist nation, and cut ourselves off from the large numbers of developing nations and the “South.” (According to Deng Xiaoping, global issues merely fall into two categories: issues between the East and the West and those between the South and the North.) In the second place, it will seriously hold back China’s development and, more importantly, restrict our independent innovation capability and inhibit us from being a country of innovation. Obviously, we cannot allow this to happen.

The third one is the “three major power center” theory. The leading exponent of this theory is Igor Panarin, professor at the Diplomatic Academy of the Russian Foreign Ministry, Doctor of Political Science and the author of *The Division of America*. He predicted that the global financial crisis and the decline in U.S. strength will change the world’s geopolitical situation, and that the world’s three major power centers will come into being around 2012. They are China (referring to the Chinese Union that has completed the integration of the Pacific region), the European Union No. 1 (referring to the European Union that has incorporated Latin America into its sphere of influence) and the European Union No. 2 (referring to the European-Asian Union that has recovered Alaska and the former Soviet regions and with Russia as the core).

These “three poles” are particularly characterized by high levels of integration with uniform constitutions, congresses and currencies.

The fourth one is the “balanced four poles” theory. The four poles are China, the United States, the European Union and Russia. This theory has been in existence for a long time and there is no need to go into details.

The fifth one is the theory of “balanced five poles,” including China, the United States, the European Union, Russia and Japan.

The sixth one is the theory of “balanced six poles,” including China, the United States, the European Union, Russia, Japan and India. It is based on the assumption that India has unlimited prospects in development and can even exceed China.

Our understanding as to the future strategic structure of the world is definitely multipolarization. The crux of the matter lies in the fact that

multiple poles can form a stable relationship of dynamic balance, regardless of how many and who those poles are. And the pattern of multipolarization conforms to the general expectation of most nations, including China, for “the construction of a harmonious world within the framework of multilateral common interests.”

We do not deny the fact that there are many contradictions and problems in the process of China’s economic and social development. And we do not evade in face of these contradictions and problems. But we know that problems rising from development can only be resolved in the process of development. Being brave in practice has always been a valuable experience since 60 years ago when China was born. We should never stop learning to construct our nation in construction, to reform in reformation, and to develop in development.

An extremely important trend is: the world balance of power is likely to change in an unprecedented and fundamental way around 2020, or 2030 at the latest. The GDP of the “BRIC countries” is likely to exceed that of the western Group of Seven. The thirty biggest emerging economic entities will rise in groups, and the ratio of their GDP in the world total will increase from the present 41–42 percent to above 60 percent. All this will certainly bring about a series of radical changes, including a profound change in the world political structure. Meanwhile, we should not neglect the revolutionary impact of the progress in human political civilization, science and technology. Only driven by synchronized construction in material, spiritual and political civilization, can we achieve rational international relations and scientific development in the future.

A fact of great significance is: we will consistently adhere to our strategic orientation and basic national policy of “not seeking hegemony” no matter how many poles there is in the future strategic structure of the world and how powerful China becomes. China will never forget the humiliation of being enslaved and colonized over a hundred years, and will always regard national unity and security interest as our primary concern. And meanwhile, China will always be a force for peace on the side of the majority of nations and the peoples of the world, and will never do “self-defeating” silly things. China will join the world in an active way, playing and steadily expanding its positive role that commensurate the status of a responsible and constructive power.

Two Fundamental Issues to be Properly Considered and Handled by a China Open to The World

Of the two issues facing us, one is how to reconsider the world and to be better integrated into the world, the other is how to make the world reconsider and better accept China.

We can say that both these issues will exert influence for a long time, or even dominate China's internal and external affairs. They will also affect the formulation of China's national and military strategy, and the selection and flexible application of specific policies. Only by properly handling these two issues, can China maneuver in the complicated international game, seize critical opportunities, and take the initiative. To manage these two issues, we must proceed from both overall international and domestic situation with long-term, microscopic, holistic and strategic perspective.

On a broader view, it seems that every nation is faced with two types of important issues, that is, "to re-evaluate itself" and "to re-evaluate the world." And the simple reason is that the relationship between China and the world has changed, and that the relationship between each nation and the world has also changed. Without world peace, a nation cannot achieve prolonged political stability; without world development, a nation cannot fully develop itself. The most important opportunity to overcome the current crisis is to further internal social reform, transform the mode of development, and strive for changing the unequal political and economic order of the world. In the face of changes, especially the radical and rapid ones, it is important to look beyond, think sensibly, brave the storm, keep the correct direction, and steer the ship of the Chinese nation to the bank of success.

Enduring rapid growth is the most striking characteristic of China's economic development in the past thirty years. Our political and economic status has changed to a great extent. Decades ago, we were extremely poor and faced with enemies from all sides. Today, we have become the focus of two G-20 summits and are the world's third largest economic entity. And this year, we are likely to exceed Japan, ranking second as the largest economic entity in the world, 16 years earlier than the U.S. Intelligence Committee predicted in 2006. During the past 30 years, China's GDP has increased from 568.9 billion yuan to 30,067 billion yuan; in the first half of 2007, the state revenue exceeded the total national GDP of 1978, and per capita GDP increased from 381.2 yuan to over 20,700 yuan; the total amount of import

and export increased from US\$35.5 billion dollars to 2,500 billion; and foreign exchange reserve increased from US\$2.15 billion to over 2,000 billion. What big changes they are!

China's foreign policy has changed from emphasizing the export of revolution and fighting against imperialism and revisionism to striving for the construction of a harmonious world of peace, development and cooperation. The security environment has changed from a threat-oriented one in the past to one that is shaped on our initiatives today. China advocates a new security outlook of peace, equality and mutual benefit, and sets the national strategic objective of building a country of innovation and achieving scientific development, national rejuvenation, a harmonious society and a harmonious world. The essence of China's strategy will be more self-oriented with the emphasis on domestic development and stability.

With rapid integration into the world, China has acquired the external conditions for rapid development and, at the same time, contributed to the enduring peace and prosperity of the world. As President Hu Jintao announced last year, China's contribution to the rate of world economy was about 4.8 percent. This year, it reached 10 percent as announced during the National People's Congress and the Political Consultative Conference. Just two months later, the central bank revised the figure to 50 percent on the basis of the situation of the financial crisis and big economic entities such as the United States, the European Union and Japan.

We cannot help thinking about a great man as we are experiencing these great changes. We will never forget the two important strategic judgments made by Deng Xiaoping. Both of them have had an impact on the history and future of China, and on the history and future of the world. Of these two great judgments, one focuses on the settlement of China's issues, emphasizing that reform and development are essential to the settlement of all Chinese issues; the other focuses on the settlement of world issues, emphasizing that the best way to settle disputes is not through war, but peaceful means.

These two judgments have laid the foundation of our present domestic and foreign policies. Since reform and opening up commenced 30 years ago, we have been adhering to "one central task and two basic points" and to the guidance that "science and technology is the primary productive force" and that "development is of overriding importance" in dealing with domestic

affairs. In the field of foreign affairs, the foreign policies of peace, development and cooperation, as well as the new security outlook of peace, equality and mutual benefit, are a continuation of our consistent domestic and foreign policies, and have greatly influenced the development of both China and the world. As servicemen, we are never afraid of war, and prepare ourselves for war every day. But we will go into war only for self-defense purposes, adhering to the principle that "we will not attack unless we are attacked," and that "if we are attacked, we will certainly counterattack." War is the last resort and should be subordinate to and service political objectives. And it should also be a rational action that ensures a complete victory.

Our utmost strategic interest for decades to come is to achieve another period of strategic opportunity, in which we can, on the premise of our national security interests, transform the mode of development by furthering reform and development, so as to promote our rapid and scientific development, to lay a solid foundation for the Chinese nation's rise in the world and its influence on the world strategic situation and international affairs, and the realization of a harmonious society and a harmonious world.

China's experience and development mode are drawing worldwide attention. China's contribution to the international community is on the rise, which is conducive to the improvement of our international status and image, the protection of our overseas interests, the increased role as a force for peace as well as the strengthening of our defense capabilities, so as to defend our national sovereignty and territorial integrity. It can be predicted that future international relations and the settlement of global issues will be increasingly characterized by "multi-actor participation and comprehensive multi-level management." The way in which traditional security issues are settled will inevitably change and will have a profound impact on the international relations and the thinking and strategies in the international system.

In the political report of the 17th National People's Congress of the Chinese Communist Party, President Hu Jintao solemnly promised on behalf of the Chinese government and the Chinese people: "We are committed to combining the interests of the Chinese people with the common interests of the peoples of other countries, and always stand for fairness and justice." The recent past since the breakout of this financial crisis has repeatedly demonstrated that both the way China understands and copes with the

financial crisis and the strategies China adopts in dealing with the changes in the international strategic situation will not deviate from the above general judgments and trend of development, and will not deviate from this solemn promise by President Hu Jintao.

Five Propositions for the Post-Crisis World Order

Edward N. Lutwak

Proposition 1: The Failure of Europe

The regional and global hierarchies of world order are always changing as states gain or lose in relative power and influence¹, though such changes are usually very slow, because even vigorous newcomers lack accumulated prestige, while on the other hand, historic “Great Powers” can live off their reputations for decades or generations.

Large wars and major economic transformations can accelerate the rate of change, and this is duly happening in the present global economic crisis, perhaps the largest since 1939.² France had no role in causing the crisis and the United Kingdom only had a secondary role, through its own housing bubble and imprudent mortgage lending, but mostly as an “off shore” base for American finance. Yet it is the United Kingdom and France that seem to be the largest losers in relative power, along with the European Union as such. Prime Minister Gordon Brown and President Nicolas Sarkozy made strenuous efforts, both are very capable leaders by any standards, and they offered good ideas that others were willing to follow; but neither country was able to play a large role in the stabilization and recovery process that is now underway. Moreover, to the rather small extent that military strength is still important for the two countries in the present era of world politics, it is noteworthy that the United Kingdom can no longer sustain the costs of its current military establishment, let alone the expansive growth plans that seemed feasible just a few years ago (two mid-sized aircraft carriers, etc.). The French armed forces are also underfunded in relation to their force structures, and there have been waves of involuntary officer terminations.

¹ = the correlation of forces = variable combinations of *relative* economic capacity, military strength, cultural attraction, social cohesion, quality of leadership... The complication is that *their* relative significance changes as well—most obviously, military strength rises and falls in importance as combat is more probable, or less.

² Economists cite 1929, or 1931 or the “Great Depression.” But the economic transformations of the Second World War were greater.

All that remains to the British and French are nuclear capabilities that are certainly most formidable in physical terms, but whose political value in present conditions is even less than that of their non-nuclear armed forces.

For the European Union, the global economic crisis was a great opportunity for accelerated institution-building. Because of the sense of emergency, instead of doubts, resistance and outright refusal (e.g. the Irish referendum rejecting the Lisbon Treaty), there was sudden public support for whatever would strengthen the EU's ability to respond to the crisis. It was the moment to force through a strong executive presidency, majority voting and the rest, subject to referenda where necessary. Combined action by the French, German and British governments with the strong support of the European Central Bank (ECB) could have done it, but instead their leaders competed for attention, and bureaucratically there was more rivalry than cooperation, while the ECB evidently prefers to rule alone, with no pan-European minister of finance to dispute its unlimited powers. The result was that the crisis was entirely wasted with the farcical Czech Presidency, embodied in President Vaclav Klaus whose talents are indisputable but who opposes European integration in principle, and a Prime Minister – Mirek Topolánek – who was plainly unready for Europe-wide visibility, and whose government soon fell.

For this reason also, the global economic crisis weakened the relative standing of the Europeans, jointly and severally.

Proposition 2 China Rises Again

In theory, the relative decline of more established powers (for the United States, see Proposition 3) would necessarily imply the corresponding rise of emerging powers, chiefly Brazil and India as well as China. In practice, however, China is by far the largest beneficiary as indicated by the recent talk of a "G-2" consisting of China and the United States, not because its economy is bigger, its dollar reserves are larger, its military strength is greater etc., but rather because the Chinese government responded to the crisis by quickly assuming greater responsibility for the world economy. It did that in the first instance by analyzing the crisis in its totality in conjunction with the U.S., by refraining from taking short-sighted unilateral measures that could have made things worse (e.g. selling dollar instruments), and by promptly employing the only relevant instrument: accelerated public spending. The

abrupt decline in U.S. household demand, caused by the necessary increase in savings, had left a sudden gap in global demand which pushed the world economy into a downward spiral of diminished sales, diminished production, diminished employment...and further diminished sales; only a sharp increase in all other demand could stop the decline and alongside smaller spending increases by Japan and South Korea, it was China that did the most. Its new or expanded public works spending is for the benefit of China of course, but it also inevitably increases global demand to a degree. By contrast, the governments of Brazil and India, in spite of their competent economic management, responded to the global crisis by focusing entirely on their own national economies, without even trying to contribute to global solutions. They still do not recognize any obligation to do so.

Proposition 3 The Uncertain Future of the United States

Even though it was the failure of U.S. trade policy³, of public and private U.S. financial institutions and of U.S. government supervision that caused the global economic crisis, it cannot yet be known if the United States will emerge from it all with diminished relative power, and if so to what extent. Only the loss of “systemic” prestige is evident and beyond question: an entire regime of economic management (it should be called “the Greenspan consensus”) has failed, not just a leader or an administration or even two. Prestige counts because it evokes unrewarded deference and free services, but unlike substantive sources of power (economic leverage, military strength, cultural attractiveness etc.) it can be regained just as easily as it is lost. As for American military strength, whatever its present significance in world politics might be, it is unaffected by the economic crisis in the short term (except positively, because recruiting has been made easier).

³ Actually an ideological failure: the acceptance of unlimited, accumulating trade deficits in the name of “free trade,” even though the latter cannot be sustainable unless deficits are cyclical and self-correcting via exchange-rate changes. When foreign purchases of U.S. debt drove up the U.S. dollar favoring imports and impeding exports, intervention was needed to either stop those purchases with interest-rate penalties or impeded imports with trade barriers; the latter were forbidden by treaty, while the former were never even considered. Instead it kept being said that foreign purchases of U.S. debt were needed to finance the trade deficit; actually it was the other way around – debt purchases caused the trade deficit. See Martin Wolf, *Fixing Global Finance* (Baltimore: Johns Hopkins University Press, 2009), passim.

In the long run, other things being equal (but see below), American military strength must certainly decline relatively if the U.S. economy declines – but that is the very thing that remains an open question because of a peculiar American phenomenon: historically, the U.S. economy has grown from upheaval to upheaval, through recurrent phases of instability that would have damaged less flexible economies. Historically, the United States has always combined political stability with economic instability—indeed because its political stability is believed to be assured anyway, U.S. administrations have never felt compelled to preserve social stability by ensuring economic stability. That has allowed faster growth because all the measures that increase stability inevitably impede growth in one way or another: fiscal and monetary discipline in macro-economic policies, labor protection laws, state-ownership, industrial policies, “chosen instrument”-enterprises, etc.

Unprotected enterprises with unprotected labor forces are more productive other things being equal, because unimpeded “creative destruction” automatically re-allocates labor, land and capital resources to the more efficient – and the U.S. economy has historically grown more rapidly than the other large advanced economies of Europe and Japan because its firms were less protected externally and internally (the 2008–09 interventions to prevent the bankruptcies of major firms were described as temporary, emergency exceptions that would soon be reversed; if that will not be so, the United States would be “Europeanized” and its economy would cease to be different).

Creative destruction is especially beneficial when the weakened or destroyed firms are large and monopolistic. The fragmentation of Bell Telephone & Telegraph gave birth to dozens of companies and the telecommunications revolution; the downfall of IBM gave birth to the personal computer industry and all that went with it, including the internet. In both cases, powerful monopolies had seemed to be very advanced – the Bell laboratories were world famous, IBM’s “mainframe” computers were the very emblems of technological progress. But in reality they only achieved less significant innovations while blocking much larger innovations – the kind of innovation that creates entirely new industries.

Although GM, Ford and Chrysler were not monopolies or even oligopolies because they had vigorous foreign competition, they were certainly

not innovative. Their large market shares discouraged innovation – they naturally wanted to protect their established products made for established markets. It is only now that creative destruction and real innovation have started in Detroit and many other places where cars were designed, developed and assembled: new firms with new ideas and new products can now rent empty car factory spaces very cheaply, they can purchase production machinery and tooling at scrap prices and can find many unemployed automobile workers who are eager to work for US\$25/hour instead of the US\$45 or US\$65 that GM used to pay. New small manufacturers are emerging which have no established market positions to protect and which therefore can and must innovate (localized/personalized modular electrical automobile designs are already beginning to emerge).

There has certainly been much destruction in the U.S. economy. Many of its financial and industrial giants have either declined drastically (like Ford Motors) or have disappeared altogether (like Lehman Brothers) or survive precariously only because of large government loans (like AIG and GM). In the past, the U.S. economy has benefited greatly from the weakening or outright bankruptcy of its giants. If it happens again, the unprecedented destruction of 2008–09 should result in unprecedented growth in the coming years.

If so, the U.S. economy will not decline as compared to the rest of the world. It would only decline in relative capacity as compared to China's economy, assuming that all goes well in *both* economies⁴, with fast growth in the United States facilitating faster growth in China⁵. By contrast, a prolonged U.S. stagnation would depress both U.S. and non-U.S. demand for Chinese exports, reducing Chinese growth rates to a degree that internal demand cannot compensate for because of institutional, macro-economic or structural constraints, including import dependence.

⁴ Given the present structure of the global economy, U.S./China growth ratios can only diverge in limited degree and for a limited time; those limits are relaxed to the extent that internal demand increases as a fraction of total Chinese demand. By contrast, relative increases in non-U.S. demand for Chinese exports may mean little, given the importers' dependence on U.S. demand.

⁵ The gap is expected to decline as the Chinese GDP/capita increases and the Chinese economy becomes more mature, subject to macro-economic policies and demographic factors, including immigration.

Proposition 4 The U.S./China Military Balance

Standard relative growth expectations imply a relative decline in the total, potential resource base of U.S. military strength as compared to China's. Over time, that should result in a changed U.S./China military balance to the extent that all other things are equal, a very long and very diverse list of things:

- The fraction of total resources that each nation allocates to its military establishment.
- The relative efficiencies in each function, from research & development and production to personnel recruitment and training, officer selection, etc.
- The quality of civilian and military leadership at all levels;
- The quality of operational methods in the different services and branches.
- The degree of operational/strategic coherence in the armed forces as a whole, including the suitability of force structures for imminent, probable, possible and plausible combat at any given time.
- Internal demographic, cultural and political factors.
- The net gain/loss from current or recent combat, including impacts on domestic political support, internal morale, institutional integrity, relevant doctrinal, operational, tactical advancement, equipment wear and tear, inventory levels, etc.
- Above all, the configuration of world politics at any given time, as modified by the quality of statecraft at the time, and the resulting array of active and potential allies, neutrals and opponents.

In other words, so many non-economic factors are involved that even total military balances are only sensitive to gross differences in total economic capacity, regional/local balances are even less sensitive, and in protracted non-conventional wars, there is no meaningful relationship between resources and outcomes. (The Axis Powers, Germany, Italy and Japan had less industrial capacity than the United States alone, but it took years of hard combat by the British Empire and the Soviet Union as well as the U.S.

and Chinese forces, and huge casualties, and the atom bomb to defeat them; in post-1945 conflicts, resource balances were even less decisive).

Hence the U.S./China military balance need not be sensitive to the expected divergence in relative growth rates, even when the Chinese economy overtakes the U.S. economy in total capacity, as it does under all normal/optimistic scenarios that exclude upheavals and catastrophic events.

Moreover, the configuration of world politics tends to move against the military balance: rising powers are increasingly opposed as allies retreat into neutrality and neutrals shift to opposition, while declining powers are propped up by former neutrals, even former opponents.

Perceptions of military strength are different: Firstly, perceptions of military strength rarely reflect current balances, they usually anticipate future balances. Therefore rising powers are seen as more “powerful” even when they are still relatively weak, declining powers are seen as “weaker” even when they are still relatively strong. Secondly, perceptions of military strength are strongly influenced, even dominated by culturally-determined inferiority/superiority expectations derived both from historical memories and from current self-images. For example, as good Muslims to whom superior power has been promised by god himself, even very professional Pakistani military officers find it very difficult to accept the idea that the Indian armed forces are much stronger overall.

It follows that misperceptions of power can easily create false expectations of combat outcomes – many wars could not have happened if both sides did not expect to win. More important, in peacetime misperceptions of military strength distort threat perceptions, generating both unjustified fears and pre-emptive over-caution, and unwarranted overconfidence that encourages provocative conduct. The particular problem of China in East Asia is that the powers on its periphery, from Korea to Myanmar, are relative newcomers to international politics, not especially well-staffed to respond realistically to rising Chinese military strength.

Proposition 5: The G-2 From Myth to Reality

Born as nothing more than a journalistic invention that neither the United States nor the Chinese government especially desired, “G-2” decision-making for the global economy has only become reality because of the failure of all alternative frameworks.

When the sharp decline in U.S. household demand called for quick action in early 2009 to increase non-U.S. demand, the European Union was the most obvious partner for a recovery effort. At the time the Czech Republic held the rotating presidency, but there could not be a U.S.-EU negotiation with the Czech PM Topolánek, because French president Sarkozy, British PM Brown and German Chancellor Merkel all refused to accept his leadership. But then they also refused to form their own “E-3”-or “E-4” with Italy – to talk with the United States, instead preferring to act individually.

In any case, it turned out that of all U.S. allies only the United Kingdom, Japan and the Republic of Korea were willing to increase public spending, accepting the resulting burden of public debt and the risk of inflation. The governments of Germany, France and Italy flatly refused to increase spending, giving contradictory reasons for their refusal (e.g. Italy cited its high public debt, but Germany’s is much lower). That made it impossible for much to be achieved at the G-8 or the G-20 summits. Nothing came out of those elaborately-staged meetings except a modest recapitalization of the IMF.

The first premise of G-2 decision-making is that the United States and China can agree on most economic issues, including all the really important ones; when there is disagreement, it is a matter of degree, not an absolute clash; for example, the RMB has been allowed to rise against the dollar year by year, just not fast enough for the U.S. Government.

The second premise of G-2 decision-making is that political issues on which there can be no agreement (e.g. Taiwan, Tibet and democratization) can continue to be set aside indefinitely, perpetuating the practice first established in the original Henry Kissinger-Zhou Enlai/Richard Nixon-Mao Zedong accords. At the time, the common objective was to deter a Soviet attack on China and to weaken the USSR. More recently, the common objective has been China’s continued economic development and peaceful rise, including increasing Chinese responsibility for the world order.

The third premise of G-2 decision-making is that more immediate frictions of all kinds can be managed jointly. Each side advocates free trade and practices free trade but with exceptions, such as Chinese refusals to allow the acquisition of important Chinese companies, or the U.S. refusal of export licenses for the use of Long March satellite boosters. These refusals cannot always be reversed but they can be traded off.

The fourth premise of G-2 decision-making is that military or espionage incidents will not be allowed to escalate. The April 1, 2001 air collision (an incident, not an accident) near Hainan Dao was a perfect example of a deliberately created dangerous situation (repetitive patrols, repetitive close intercepts) that duly resulted in a perfect escalation scenario, complete with “angry young nationalist” internet jockeys. It could have led to a total breakdown in U.S.-Chinese relations and the collapse of U.S.-China trade. Instead the incident was controlled, and more important, joint efforts for active “de-confliction” were launched to prevent further incidents. Because military activities on each side continue to evolve, unless the “de-confliction” effort evolves there could be more incidents, any one of which could escalate. Nor can formal arrangements suffice without the informal understandings generated by military visits, school exchanges etc.

The fifth premise of G-2 decision-making is that its existence and results are accepted by Japan, so long as it continues to serve Japanese interests as well – which it does.

The sixth and final premise of G-2 decision-making is that there is no usefully functioning larger framework, no G-4, G-7, G-8, or G-20 that can deal with real problems and, above all that there is no bilateral framework for a useful U.S.-EU dialogue.

That was certainly the conclusion of the Obama Administration within 90 days of assuming office: you can have nice dinners in Europe but in Beijing you can have useful negotiations – because each side is committed to their success.

From Inflation Bubbles To Economic Pandemia: How the Global Financial Crisis Can Undermine Global Security

Leif A. Vindevåg

The world has seen many examples of inflation bubbles that have had an impact on the global economy. In the seventeenth century, Dutch speculators created an extreme bubble based on the prices of tulip bulbs and in the following century the development in the Caribbean region sparked the South Sea Bubble. When these bubbles collapsed the effects were mainly confined to the speculators. However, the stock market bubble in the United States, in the late 1920s, had a more far reaching impact.

When the U.S. Federal Reserve tried to curb price rises by limiting liquidity, i.e. money, in the system, the financial decrease jumped over into the real economy. Due to restrained payments, private consumption and aggregate demand fell sharply, forcing factories and service outlets to lay off people. These national problems, originating in the United States, then spread to other countries where, in many of them, protectionist measures were introduced. During the second half of the twentieth century the world has seen relatively few pandemic global economic problems. Even the effects of the two periods of oil crises in the 1970s and the global financial crisis in late 1987 disappeared quite soon. The effects of the latter were principally contained in the financial sector and borne almost exclusively by the players in the securities markets.

However, the global financial problems, since 2007, may deserve another label since they bear clear witness of the impact from a globally interconnected economy. The build up was paved by a constant and unparalleled over-spending in the richest country of the world, the United States. Current account deficits became endemic and foreign debt kept growing. The private sector imbalance was further aggravated by a tax policy that fell short of public sector spending at home, and even more when you consider the global ambitions of the world's premier strategic power. This could persist only because there were surplus countries in the world, not least

the People's Republic of China, willing to finance the U.S. deficits. Another important factor was that the stability pact forged around the euro had brought the European Union close to external financial balance.

The bubble burst when the U.S. Government decided to let the major U.S. bank Lehman Brothers default and go bankrupt. In hindsight it is easy to say that this was based on a clear misunderstanding of the extent in which international financial markets today are interconnected. The default of Lehman Brothers meant an instant stop in global payments. The Bank for International Settlements in Basel and a number of central banks had to intervene with massive guaranty schemes in order to restart the engine. Without these far-reaching interventions none would have dared to take a risk on even the best rated institutions in the world.

In the months that followed, we have entered into a phase of trying to calculate and find the enormous volumes of new funding needed to write off defaulted credits and restore equity to debt ratios in financial institutions to feasible levels. The magnitude of the problem gives a clear signal that it will take many years to solve.

The problems in the United States with excessive consumer credits and in particular so called subprime loans is the probable key to how this financial crisis could leap over into the real economy and reach other countries. Households defaulting on their loans were quickly forced to cut down on all forms of consumption. The financial crisis also brought a sudden stop to all forms of credits. Purchases of, in particular, private cars were postponed, forcing the producers to cut production and lay off workers. The sharp decline in the U.S. market had a particularly rapid impact on producers of capital goods in both Europe and Asia, forcing the world economy to a sudden and unprecedented halt.

Due to rising unemployment rates, politicians in all countries are likely to cry for more protectionist measures, which may, as in the 1930s, increase and proliferate the problem.

Recent forecasts, from the World Bank this year, point to an expected decline in global real GDP by roughly three percent, which is quite unprecedented in times of peace. The effects may, however, be much stronger in poor nations or less diversified economies. In the multi-year boom period that started this millennium, many countries dependent on raw materials and energy exports both prospered and were spoiled by the high prices and

strong demand on their exports. As their revenues have been reduced, it has had a dramatic impact on their economies. Also, some well populated OPEC countries are hard hit since they need the constant flow of oil revenues for their public sector expenditures.

Even developed countries are severely affected. Iceland and the Baltic countries will face many years of austerity due to earlier over-borrowing in the private sector. Russia is another clear example where roughly 40 percent of their federal budget is based on revenues from the oil and gas sector. A sharp decline in those revenues is the prime reason why GDP may fall this year, with close to 10 percent compared to 3–4 percent for the European Union and the world at large.

A common pattern across almost all countries will be that the necessary restructuring of their economy and “refinancing” of national institutions will take many years and in the process will call for strict prioritizing and strong political and fiscal discipline. This will most likely give us a more risky world than before. The economic ranking of countries will change. The United States, the EU and also Russia will for many years find it more difficult to meet their previous global strategic ambitions. For Russia it is clear that there is a large gap between the need to support the living standard of its people and combine it with their ambitions of being an active and visible global player.

The United States and the EU may have less ultimate economic restraints, but they have obvious political limitations. Their defense spending includes a very large portion of multi-year arms contracts that cannot be quickly changed. At the same time public spending for various welfare programs will increase, while the tax base is reduced. If one includes the obvious public resistance to higher taxes, then the equation becomes very difficult. The revised ranking and change of economic resources will also have its implications on world security. We may see some of the more distant trouble areas of the world with far less active policing from the United Nations if the missions are largely to be carried out by the United States and the EU.

The poorer countries will be under even more stress to cut public spending. They will face a very difficult balance between the need to feed their people and the necessity to guarantee civil order in the country and to protect it against outside threats, since their resources may not be sufficient to meet both targets. There is an obvious risk that insurgents will capitalize

on the increased poverty or that hostile neighbors will make advances. The result will be a world with a significantly increased level of risk.

Erosion of local stability will open for a vicious circle of development where the increased risk level will dampen foreign interest in making direct investments. The World Bank has recently pointed to the alarming decline of foreign direct investments in the third world. Added to this, measures in developing countries to combat unemployment may cause problems for the poor countries.

Support of local production in the developed world can change the global price level and create non-tariff trade barriers. Traditional markets at home and abroad for both finished products and commodities from developing countries may be destroyed. The World Bank has concluded that the economic slump and such protectionist measures have already wiped out the effects of more than a decade of direct foreign aid.

Thus, for an extensive period ahead the developed countries and the international community must make unprecedented and coordinated efforts. The aim is to fight poverty and instability in the third world in order to avoid a proliferation of the current threats and to promote growth and prosperity in the world. This will also include concerted and efficient efforts to combat piracy and safeguard the traffic in international waters in order to support the normal international exchange of goods; a responsibility that will fall upon all countries that command the necessary resources to participate.

The Financial Crisis, International Configuration, and China's Security

Zhang Shiping

The global financial crisis that broke out in 2008 was called “a financial storm” by some and “a financial tsunami” by others. Regardless of the different names people attribute to it, it is recognized, by all, as a major crisis, similar to the Great Depression that occurred in 1929. As Karl Marx once said: “Economic basis determines superstructure.” Hence, such an unusual turbulence will inevitably have a profound influence on the configuration of world politics, world military affairs and national security. Of course, different people have different perspectives, and my understanding of it includes three aspects discussed below.

I. The Influence of the Financial Crisis on International Configuration

After the Cold War, there has basically been one superpower and several major powers in the world. Power politics and the influence of superpowers, dominated by the United States, have lasted about twenty years. However, the influence of this financial crisis on international configuration is objective and profound.

In the field of economy, firstly, global financial economy has greatly reduced in scale. It is true that virtual economy still exists, but its scale can never reach the level that existed before September 15, 2008. Secondly, the global monetary system faces grave challenges. Although the U.S. dollar cannot be replaced within a short period of time as an international currency, reform of the international money system is imperative under the current situation. Thirdly, great changes take place in the pattern of global economic development. The contribution of “financial and consumptive” economy in countries like Great Britain and the United States to the world economy will decrease to a large extent, while emerging economies like China will contribute more. Fourthly, global financial supervision will be

strengthened as the global financial crisis requires enhanced financial management, supervision and macro-control in the globalization era.

In the field of politics, it is a fait accompli that G-20 is taking the place of G-8. The 2009 G-8 Summit held in L'Aquila, Italy has clearly foretold that the era of G-8 in leading global issues is drawing to an end, while international and regional organizations are playing a more and more important role on the world stage. It is increasingly obvious that the seven major powers are "sitting side by side" on an equal footing. Among them, the United States has suffered the most severe impact by the global financial crisis, which can be manifested by the following four aspects:

(i) A return to nationalization and the dealing out of "relief grain" again at home. At present, 80 to 90 percent of U.S. banks and investment banks are nationalized. Besides this, the U.S. government has infused capital into and granted loans to some backbone enterprises, which is the first time this has occurred since the Neo-liberalism initiated by President Ronald Reagan and Prime Minister Margaret Thatcher at the beginning of the 1980s, and of the largest scale since the New Deal of President Franklin D. Roosevelt in 1933. The drastic adjustment in U.S. economic policy reflects a pursuit of scientific economic mode by human society, a necessity of the transformation of economy from being random to being orderly.

(ii) A return to multilateralism in the international community. Multilateralism is a traditional U.S. policy in international relations. Both the League of Nations, established after World War I, and the United Nations founded after the World War II, promoted their fundamental orientation of policies when dealing with international relations. However, since the end of the Cold War, as the single superpower, the United States began to pursue unilateralism, not only disregarding the United Nations, but also deserting its old pals and friends in Europe and Asia. The outbreak of the financial crisis made the U.S. realize that unilateralism has come to an end. At the two G-20 summits, the United States not only discussed with veteran developed countries, but also conferred with rising countries on countermeasures. As commented on by some mainstream media in the UK, the biggest victim of the financial crisis is the U.S. traditional monarchal leading style. When facing the world, as U.S. President, Barack Obama behaves like a listener rather than a preacher, a mediator rather than a commander. It is a blessing

to replace arrogance with modesty for both the United States and the whole world.

(iii) For the first time, economic issues are given top priority in national security. For decades after World War II, the United States has regarded some big power, “rogue state,” “loser state” or terrorism as its No. 1 enemy. After the outbreak of the financial crisis, the U.S. government declared in public that at present and in the near future, the United States faces three security threats: economic issues, terrorism and weapons of mass destruction (WMD). The change answers the requirement of the times, and also objectively reflects the pragmatism of U.S. statesmen and strategists. War and revolution have become history, and in the time of peace and development, people are paying more and more attention to the question of “who are our friends.” It is undoubtedly a political and strategic mistake to look for some enemy all over the world.

(iv) Lastly, emphasize “helping each other when in the same boat” in Sino-U.S. relations. Since the founding of the People’s Republic of China in 1949, the Sino-U.S. relations have undergone the four historical stages of confrontation, alliance, cooperation + fight, and development and cooperation and no confrontation. In 1971, President Richard Nixon opened the door to China. After 9/11, the Bush administration has made great progress in Sino-U.S. relations. Since President Obama took office, he has ushered in a new era of cooperation between the United States and China. The will and choice to “help each other when in the same boat” will surely bring the Sino-U.S. relations into harmony. Experienced strategists such as Henry Kissinger, Zbigniew Brzezinski and Madeleine Albright have come up with similar notions of a G-2 (Group of China and the United States). Although China is not yet ready to assume a greater number of international obligations with increased importance, the mode of “G-2 + the influence of a superpower” is an inexorable trend of world development in the future, and the best choice to avoid chaos without any pole, multipolar dissension, or bipolar confrontation. Objectively speaking, the outbreak of the financial crisis has not only consolidated the foundation for the Sino-U.S. economic relationship, but also deepened the Sino-U.S. political relationship. The adjustment in the U.S. attitude towards China, to some extent, accelerates China’s transformation from a regional power to a global power, and speeds up the process of world peaceful development.

The financial crisis stems from the United States, which seems to have suffered the most. Therefore, it is not useful to continue to put the burden of blame on the United States. However, we must be aware that the impact of the crisis on the United States is not as severe as was claimed by some people. The financial industry only occupies about 20 percent of the GDP of the United States. The financial crisis has inflicted the heaviest blow on the financial industry, including the virtual economy, the media, a decaying auto industry, the air transport industry, and the real estate industry, which has made enormous profits through speculation. Nevertheless, the real U.S. backbone economy, particularly the manufacturing industry, energy industry, science and technology industry, electronic industry, military industry, aerospace industry, agriculture, and retailing, have not been affected to the same extent. Although the unemployment rate by the end of June 2009 reached 9.5 percent, there is still a large gap between the unemployment rates of the Great Depression in 1929, which were 25 percent. According to the report in *Fortune* on April 19, 2009, the profits made by U.S. top-500 enterprises plummeted by 84.7 percent over 2007, but still gained US\$98.9 billion. Among them, Exxon Mobil ranked first with a growth rate of 19 percent, and the second one was Wal-Mart, whose growth rate was seven percent. It can be said that the financial crisis has not plunged the United States into an abyss of suffering. Using some common expressions, in this financial game, stocks have disappeared, "money bubbles" burst, and "virtual capital" evaporated, but bread, houses and cars are still there, and the sky has not fallen down!

In addition to military strength, cultural influences and the power of setting international rules, one of the elements supporting the position of being the single superpower is mainly the U.S. dollar. Again, the U.S. dollar has shown its uniqueness as a "crisis currency," namely, the severer the crisis is, the harder they become. While the euro, Japanese yen, British pound and most currencies around the world are substantially depreciating, the U.S. dollar is appreciating. At present, the U.S. dollar takes up 68 percent of the total of foreign currency reserves; 32 percent in stock markets, 42 percent of the total volume in foreign exchange transaction, and 78 percent of the total volume in foreign exchange balance and clearing all over the world. The U.S. economy constitutes 25 percent of the total volume of the world economy, while its financial market accounts for 65 percent of the world financial

market. Besides this, in historical retrospect, it is not new for the United States to witness financial or economic crises. Since 1851, there has been a small crisis almost every five years, and a big one every ten years, kicking up a storm from time to time. After the burst of the “network technology bubble” in 2000, some people preached that the United States was over! What is the result of their prediction? Everybody knows. The cause, form and scale of every crisis may vary, but all of them can spur the United States to adjust and reform. Despite the fact that this financial crisis is not periodic, it will always abide by the law of “crisis-reform, re-crisis-re-reform.”

According to my judgment, in the near future, the United States will maintain for a long period of time, the high level of 20 percent in the total volume of world economy, and the globalization drive just plays into its hands. In international regulation, the United States still has the initiative and takes control. In science and technology, it holds a safe lead. Due to its long-time practice of recruiting talented people, it is conducting 40 percent of R&D projects and holds 50 percent of all patents around the world. It is very likely that the United States will further increase its superiority. If it abandons the financial and consumptive economy, and turns to a new high-tech economy, it will increase its superiority again. In military affairs, U.S. military expenditure still occupies about 40 percent of that of the whole world, and the United States still possesses the most powerful war machine.

One should note that U.S. statesmen and strategists have the strong capability of self-error correction. American history has shown that the reason why the United States is powerful is not that it did not commit errors, but that it corrected errors whenever it became aware of them. Maybe September 15, 2009 is another day of moon-landing by Apollo for the United States.

Let's have a look at today's six major powers of the world.

The European Union is powerful in economy, science and technology, and has good prospects. However, both the cultural tradition of “city-state” for thousands of years, and the disunity, after eight hundred years of division, cannot be changed within a short period of time. Therefore, the EU with different aims and unaligned actions is no match for the United States. After the outbreak of the financial crisis, on the one hand, Europe contends with it endlessly, on the other hand, European countries quarrel among themselves endlessly.

The development of Russia is not too slow, and its nuclear weapons are not too few. Besides, from time to time, Vladimir Putin showed his “strong muscles” and hunted “tigers” in the zoo. However, overall economic size is only 1/16 of that of the United States, and the decreasing population has begun to restrain the sustainable development of Russia. After the outbreak of the financial crisis, Obama just extended the olive branch and Dmitry Medvedev quickly sent him “warm kisses” in return.

Japan remains stable, but there is no ongoing improvement. Its economy is further burdened by the biggest deficit in the world. In addition, with zero interest rate, an ageing population and nine changes of prime ministers within ten years, and without economic stimulation or cultural tradition of assuming international political obligations, Japan can never be an important player in the world, though it always wants to “manage the world.”

Although India always thinks that it “fares better” than China does, and its IT industry as well as space technology are indeed better than China’s, it only got its first gold medal in the Beijing Olympic Games. With its poor, dirty conditions and a state of turmoil, it will take at least 10 to 15 years to catch up with China, let alone the United States. During the terrorist attack in Bombay, this big country was tormented by ten terrorists for two to three days, clearly showing that it does not amount to anything big.

Brazil is famous for its samba and football and boasts favorable geostrategic position, but within a short period of time it cannot uphold one corner of the world.

Although China develops at a fast speed and has huge foreign exchange reserves, there is a wide gap between China and other big powers in terms of industries, technology and reservoir of talents. Besides, China has been confronted with three acute problems of unemployment, disparities between rich and poor, and energy supplies. Since the outbreak of the financial crisis, China, which is “not short of money,” seems to have become a global Savior overnight. Undoubtedly, China has not been shattered by the financial tsunami, and will be the first one to step out from the shadows of the financial crisis. However, China is far from being able to save the world.

It can be asserted that in the next two decades, great changes will not take place in the international political configuration dominated and governed by big powers. The United States is still the only superpower. The

seven major powers, especially the the United States, the European Union and Russia, will not rashly provoke a war among themselves, nor will they aggravate their relations. China is more influential in the international community, but the degree of influence is still limited.

Speaking of the global financial crisis, it has been more than two years since its first indication in February 2007 and widespread outburst in September 2008. The G-20 summit meeting in London was an important turning point of the financial crisis. I predicted in my book *Financial Crisis and International Political Configuration* published this April that China's economy would get out of difficulty in the first half of this year, the U.S. economy would recover by the end of the year, and the world economy would take a favorable turn in the first half of next year. In other words, if the global market saving of the millennium cannot hold back or shake off the financial crisis of the century and save the world economy, can we expect to have some Savior in the world?

II. The Influence of the Financial Crisis on World Military Affairs

To this day, many people still have fresh memories of the great social disturbance all over the world, great disarmament by major powers and great stagnation in the R&D of weaponry and equipment during the Great Depression. Similarly, the influence of this financial crisis on the military field is obvious.

Firstly, there is an increase in the potential factors of instability around the world. The direct social reflection of a global economic recession, which is induced by the financial crisis, is that rich people become poor, and poor people become poorer. As a result, radical and violent activities can occur, due to a lack of food and proper living conditions. Governments cannot control the situation without using force, whereas the use of force will inevitably intensify confrontation and conflicts. At the same time, terrorist forces such as Al Qaeda also find new opportunities to impede social progress.

Secondly, some countries have tightened their military expenditure, decreasing equipment R&D and slackening the pace of reform. For example, in its budget of the new fiscal year, the United States has slashed the high-tech weaponry budget by over US\$180 billion, aborted many new projects in military industry, and even reduced the plan for new reconnaissance satellites. As for Russia, military has adjusted the time when its reform will end

from 2012 to 2016. France has also adjusted its plan for reforming national defense systems. Sweden has decided to freeze the defense expenses by 2014, and cut one third of its 20,000 servicemen. European countries have also reduced troops stationed overseas.

Generally, it is unavoidable to reduce military expenditure after the outbreak of an economic crisis; nevertheless, in history there were some cases going against this trend and defying the crisis. During the Great Depression, according to the plan of President Roosevelt to stimulate the economy, the U.S. Navy accelerated its development, boosting great progress in American shipbuilding and other relevant industries. It is during that period of time that the Norfolk Naval Shipyard, which is of the biggest size, with the most advanced facilities and strongest capabilities of ship-repairing and shipbuilding in U.S. Navy, grew and laid a solid foundation of maritime force for gaining victories in the Pacific War and even during World War II.

Japan is another example. In the 1980s, after the economic bubbles burst, the Japanese government on the one hand increased investment in large-scale projects for both defense and civilian purposes, and on the other hand increased investment in equipment development for the Self-Defense Forces. Within a short period of time, there had been substantial improvement in its equipment.

Judging from the realities, the increase of investment in the military field during some economic crisis is actually an investment in infrastructure and will play an active role in boosting the development of manufacturing, iron and steel, electronics, communications, and precision and advanced products industries as well as in employment. In particular, it will produce far-reaching benefits for national security. After the outbreak of the financial crisis, there were some noteworthy cases going upstream and defying the crisis. For example, on September 24, 2008, the U.S. House of Representatives approved, by the overwhelming odds of 392 to 39, the US\$612 billion defense budget for FY 2009. Such a result has received no criticisms or reproaches from either the public or the media. Another case in point is that Russia's defense orders from 2009 to 2011 are mounting, totaling 400 billion rubles. Its growth rate in 2009 is 28 percent, increasing 60 billion rubles over the previous year. Besides this, at the end of 2008, Brazil and France signed a defense order involving 8.6 billion euros (amounting to US\$12 billion). German Defense Minister Franz Joseph Jung argued: "As an

important consumer with large orders, German Federal Defense Forces will surely make use of every possibility now...to support the development of the German economy." It is under the guidance of this thought that the German government has provided an extra fund of 500 million euros for large-scale "construction," "information upgrading and communications technology" and "arms procurement." In addition to this, on the 2009 International Defense Exhibition & Conference in Abu Dhabi, many CEOs of large-scale military enterprises exclaimed that the gains were "beyond imagination." Some even stated clearly that "the financial crisis has not affected the trade among Middle Eastern countries." The organizers of the exhibition pointed out that the 2009 defense expenditure of the six members of the Cooperation Council for the Arab States of the Gulf, namely, Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates, may reach US\$59 billion. All the above indicates that it is mostly out of consideration for boosting the economy that some countries have increased the investment in the military field.

To sum up, the impact of the financial crisis on world military affairs is profound, but there is no large-scale cutting of military expenses, or large-scale downsizing of military personnel, or even war, which is usually caused by economic crises in history. There are three essential conditions for modern warfare: the first condition is money, the second is money, and the third is still money. During a financial crisis, what we lack most is money! Therefore, the possibility of world war, large-scale local war and war between major powers can be ruled out.

III. The Influence of the Financial Crisis on China's Security

Speaking of the national security of China, I believe in karma, or retribution for sin, which is stressed in China's traditional culture. China advocates building a harmonious world, follows the principle of peaceful coexistence in international relations, and promotes mutual benefit. It has no intention of violating the interests and hurting the feelings of other countries, and it will never allow other countries to violate or hurt China! Of course, there will be some irritating incidents, just like a toad climbing up to one's foot, it won't bite, but it is creepy.

Undoubtedly, the impact of such a large-scale financial crisis on China is strong. Since reform and the opening up of markets, among the troika of

China's GDP growth, import and export have made the greatest contribution. Furthermore, China's export has concentrated on the U.S. and European markets. Governmental statistics show that in 2008, products exported to the United States account for 18 percent of China's total volume of export. U.S. statistics indicated that the United States received 24 percent of China's exports. The outbreak of the financial crisis has had a great impact on China's export, bringing along serious problems in manufacturing and employment. However, such an impact has not been so severe as to affect China's security. Its sources of means of production overseas are basically secure. Besides, its overseas markets are secure. There are threats of pirates to China's strategic sea lines of communication, but they are regional and controllable. In China's neighboring areas, though there are the Afghanistan War, the DPRK nuclear issue, the Indo-China Peninsula (Myanmar) issue, and the India-Pakistan conflict, these issues will not pose serious threats to China's security.

In the face of the unprecedented financial crisis, the reason why China can remain stable is that the Chinese government has adopted correct policies and taken effective measures. In addition, there are some basic factors contributing to the stability of China. Firstly, in the financial field, the proportion of virtual economy is not large, and among the seven trillion total assets, the financial assets only amount to 580 billion. The overall level of indebtedness is not high, with individuals only accounting for 20 percent and that of enterprises 80 to 100 percent. Besides, the exchange rates are stable. By the second half of April, China's foreign exchange reserves have accumulated to US\$1954 trillion. The reserve gold has reached 1054 ton. Although China's stock market fell sharply last year, up to the beginning of July 2009, the Shanghai Exchange Index returned 3000 points, with an increase rate of 65 percent, which ranked second among all stock markets in the world. Secondly, in the industrial field, despite the fact that there have been declines since the last fourth quarter, now the consumer goods industry is forging ahead, the situation in equipment industry and some industries of raw materials is taking a favorable turn, and the declining of electronics industry is getting slower. Among the 39 industries, 33 are gaining, constituting 80 percent of the total. Among the 30 provinces, autonomous regions and municipalities directly under the control of the Central Government, 21 (70%) maintain upward growth rates. Among the 500 kinds of industrial

products, more than 60 percent have an increase in production or a reduction in the extent of decrease. Secondly, Chinese people uphold frugality and take precautionary measures to avert danger. Although the standard of living in China is not high, Chinese people are “not short of money.” It is very common in China to spend only half and save half of what we earn. Hence, in the face of the financial crisis which is shaking the world, Chinese people have no acute feelings of hardship. Even though the migrant workers are laid off, they don’t have to worry about food or clothing. Since the outbreak of the financial crisis, there existed more than 20 million laid-off migrant workers. However, those migrant workers are both workers and farmers. When they are unemployed and laid off, they can go back to their land in rural areas, and still have self-produced grain. Therefore they will not be the source of social turbulence or even riots, like those unemployed in some developed countries.

Undoubtedly, many problems exist objectively, including the employment of migrant workers, employment of college graduates, increase in crime rates (mainly robbery and theft), group incidents, corruption and the “three evil forces,” i.e. terrorism, ethnic separatism, and religious extremism. Among them, the rate of re-employment of migrant workers has reached about 90 percent. Among the 6.11 million new graduates from colleges in 2009, 4.15 million had been employed, with an employment rate of 68 percent.

However, it is still the mainstream in China’s society to “seek stability in mind and seek fortune in stability.” The possibility of large-scale social unrest can be basically ruled out. The large-scale beating, smashing, looting and arson atacks in Urumqi on July 5, was only a unique case, just as a very healthy person will occasionally reach boiling point. Don’t turn it into a big deal.

Speaking of the “7/5 Incident,” I have noticed that the Shanghai Cooperation Organization condemned harshly the three evil forces for the “7/5” riot. Online readers of the weekly American newsmagazine *Time* felt indignant for those brutal acts. German media also criticized the rioters for their acts of barbarity. However, important media in some developed countries, such as the Associated Press, *Los Angeles Times*, *Sankei Shimbun* of Japan, and *Le Figaro* of France showed a kind of “bloodthirsty excitement.” It is very hard to understand! It may well be asked, if such an incident happened in

Los Angeles, or Hokkaido, or Marseille, how would they deal with it? Just let the mob indiscriminately slaughter the innocent people, or employ some coercive power to safeguard national security and stability? In China, it is immoral to gloat at and try to profit from others' misfortune. It will be punished by God.

What is Rebiya Kadeer? A peddler evading taxes, a fraudster getting rich overnight like Bernard Madoff, a criminal imprisoned for endangering national security, a separatist, and a woman regarded as "spiritual mother" by "East Turkestan Independence Movement" separatists. How can such a woman be treated as "guest of honor" and "fighter for democracy" in some developed countries? I cannot understand who can accommodate such a woman? Which country can endure such a scourge! Now I'd like to say a few words of praise to our Swedish friends here. Mahinur, head of the "East Turkestan Independence Movement" in Sweden, is a "goddaughter" of Rebiya. She intended to apply for refugee status in Sweden by cheating. It is praiseworthy that the Swedish government refused to grant her refugee status.

To sum up, the financial crisis of the century brings along issues of the century, and the advancement of human civilization has been put to new tests. The worldwide experience of coping with the crisis further expresses people's hope for harmony, amity and bright future!

Chinese Foreign and Security Policy After the Financial Crisis: Change or Continuity?

Niklas Swanström

For a long time, China, and generally Asia, has been viewed as a potential challenger to U.S. primacy in the security field. It has recently been debated, in light of the financial crisis, whether China will increase or decrease its influence in the security sector. Some of the arguments have been that China's currency reserve will enable the country to strengthen its soft and hard security, regionally as well as internationally. Others have argued that the economic crisis has weakened the United States to such an extent that the emerging economies (with China leading the group) will surpass the United States, almost by default. There are others that argue that the crisis has hit China at least as hard as the Western world, and the biggest challenges for China still lie ahead. It is interesting to note that the most pessimistic views of China's relative rise actually come from China. To be able to investigate this observation further, we need to understand how hard the crisis hit China and the rest of the world, and what the results of this are?

The financial crisis did hit China hard and in 2008 its real GDP growth amounted to a modest (from a Chinese perspective) nine percent, down from 13 percent in 2007.¹ In 2009, the IMF estimated growth at a, by Chinese standards, meager 6.7 percent. Conversely, the premier of China, Wen Jiabao, suggested that for 2009 growth would approximately land at around eight percent. A point to note is that in the last quarter of 2009, the Chinese economy recovered significantly, and certain regions and cities, such as Tianjin, seem to have had a very good quarter.² A third projection from Western researchers suggests that unless the global economy continues to weaken considerably, Chinese growth for the year should reach around 7.5

¹ "Country Report: China," *The Economist* [Economist Intelligence Unit], May 2009, http://O-www.eiu.com/library/lausys.georgetown.edu/report_dl.asp?issue_id=224475207&mode=pdf (accessed May 20, 2009).

² Interviews in Beijing, December 2009.

percent.³ This projection is based on a successful boost from the considerable fiscal stimulus package backed by less restrictive credit policy.⁴ At the surface, this is not a bad development, keeping in mind that most economies have been in the midst of an economic retraction. In fact, despite serious layoffs in the south of China and in the export industry, China seems to have gone through the financial crisis with a reasonably good economy. Needless to say, any reduction in the economy will have definite security and foreign policy consequences, but also potentially serious domestic consequences. High unemployment and low domestic purchasing power could be destabilizing, a situation that was seen in Xinjiang, where the reason for the conflict was much more socioeconomic than ethnic.

This chapter will look closer into what the financial crisis, in reality, has resulted in for China's security policy and relative strength, and what could be expected from the future of Chinese security policy. Examples will be primarily taken from Central Asia and are, in no way, an indication of an international trend.

China's Domestic Focus and Its Impact on China's Regional Role

China's response to the financial crisis has been to reduce its export dependence and focus on its domestic consumption and demand. Much of China's external influence has been accounted for in its economic resources and its ability to fulfill the needs of rich and poor states.⁵ The question now, is how much the new policy has changed the influence of China? Exports have dropped by 20 percent, and imports have decreased by 31 percent during the crisis.⁶ This suggests a substantial decline in China's economic clout. On

³ *The Financial Times* wrote on April 30, 2009. "Opinions over the prospects of the Chinese economy this year are polarizing into two camps... Prominent in the optimistic camp is Goldman Sachs, which revised upward last week its estimates of GDP growth in 2009 from 6% to 8.3%...Key naysayers...says that excess capacity in manufacturing is so large that it will take the economy several years to digest it."

⁴ Wing Thyee Woo, "China's Short-term and Long-term Economic Goals and Prospects," *The Brookings Institution*, February 17, 2009, http://www.brookings.edu/testimony/2009/0217_chinas_economy_woo.aspx (accessed June 1, 2009).

⁵ Niklas Swanström, "China's Role in Central Asia: Soft and Hard Power," *Global Dialogue*, Vol. 9, Nos. 1-2, 2007.

⁶ Albert Keidel, "As China's Exports Drop, Can Domestic Demand Drive Growth?" *Carnegie Endowment for International Peace International [Economic Bulletin]*, April 2009, <http://www.carnegieendowment.org/publications/index.cfm?fa=view&id=23000> (accessed June 4, 2009).

the other hand it seems as though export and import to and from less developed states have increased, along with increased investments. The trade with, for example, Kazakhstan went up by 29 percent from 2007 to 2008 and the trend is similar in the other Central Asian states.⁷ It seems as much of the Chinese increase in trade is with resource-rich states, a trend that could also be seen before the financial crisis and which seems to have increased. Resources, as a commodity, have increased in importance and are increasingly important for the Chinese government. Nevertheless, the Chinese trade with many of the less developed states, outside of natural resources, have sustained itself or at least not declined in the speed of many western states. Chinese products have, in fact, not only increased, but diversified as a result of the decreased prevalence of more expensive western products. An indication of the continued Chinese interest and eagerness to invest is the agreement and initiation of the new 1,833 km long Turkmen-China pipeline that will provide China with 40 billion cubic meters (bcm) of natural gas by 2012.⁸ In addition to this, China and Turkmenistan have already signed an additional agreement of 10 bcm and the system will be reinforced with 10 bcm of natural gas from Kazakhstan.

What is striking is that when most states have decreased their economic activities in Central Asia, China has stepped up its engagement. This creates two very different impressions in the region. One is that China is to be trusted even in difficult situations and is there to stay as a partner to the region. The other is the increased fear of Chinese dominance in economic and political life. This is a continuation of the old concerns of the Central Asian states, but the question remains if the increased economic clout in many states tends to be a positive and increasing influence or vice versa. Before and during the financial crisis, China has been heavily criticized by the regional governments in Central Asia, but also by some Southeast Asian and African states, due to Chinese companies' cultural insensitivity and their tendency to compete with, and push out, local business. The larger the Chinese market share is, the louder the criticism has been. This is a tendency

⁷ V. Paramonov, A. Stokov, O. Stolpovskii, "Ekonomicheskoe prisutstvie Kitaia v Kazakhstane" [China's Economic presence in Kazakhstan], May 29, 2009, <http://www.ia-centr.ru/expert/4811/>

⁸ Bruce Pannier, "New Turkmen-China pipeline breaks Russia's hold over Central Asian Gas," Radio Free Europe, December 14, 2009, http://www.rferl.org/content/TurkmenistanChina_Gas_Pipeline_To_Open/1903108.html

that has also been noted in the case of the U.S. trade in, for example, Latin America. It is undoubtedly true that increased trade has increased its influence, but primarily on the governmental level, as on the local level resentment has risen sharply as trade has increased. Governments in Central Asia, Southeast Asia and Africa have developed a very positive picture of China, but the local merchants and people at large do not necessarily share this view.

The financial crisis has not changed this trend and in some ways it is hard to note that there has been a financial crisis. If there is one way to note this, it is that the price and quality of the Chinese (and all other states) products on the Central Asian bazaars and in the local markets in Myanmar, Africa, etc. have decreased. This is something that has increased resentment, but nevertheless increased the Chinese market share, as more expensive products are hard to sell to populations that are partially facing economic deprivation.

There is one factor that the Chinese government is increasingly taking into consideration, especially in the light of the financial crisis. A slowing down of the Chinese development could potentially create instability in China, but this problem is manageable. In the Central Asian states the situation is much worse and there are clear indications that weak economies lead to weak governments, which in turn can lead to organized crime and extremism in many different forms.⁹ To avoid further instability on its borders, the Chinese government has begun to trade with Central Asia more and more, not only for its own profit but also to secure stability in these different states.

The domestic effects have, in other words, not changed the situation for China in terms of foreign policy and influence in the region. It follows the same trend as it did before the financial crisis, even if the trend seem to strengthen rather than to decrease despite the financial crisis and the inward looking economic policy.

Can We Expect a Change in the Chinese Security Policy?

Undoubtedly there will be changes in China's security policy as a result of the current economic instability. Most notably, economic factors and issues

⁹ Niklas Swanström, "Political Development and Organized Crime: The Yin and Yang of Greater Central Asia?" *China and Eurasia Forum Quarterly*, 5:4 (2007).

will be even more relevant when speaking about security. There will also be a strengthening of China's multilateral engagement. China has been increasingly engaged in the multilateral community since 1994 with its inclusion in the ASEAN Regional Forum. The current and the prior economic crises have increased the need and willingness among the Chinese elite to engage in multilateral attempts to securitize the economy, but also other issues such as environment and anti-terrorism activities (as long as it does not challenge China's sovereignty).¹⁰ The Chinese engagement in multilateral organizations is fully embedded in the faith that some of the issues are better handled multilaterally, as well as in the belief that it is much cheaper to act multilaterally than unilaterally. This belief is embedded in a *Realpolitik* notion and not a liberal post modern expression of China's willingness to surrender sovereignty to international organizations. On the contrary, this is simply a tool for the Chinese government to increase its own economic and political security.

Increased multilateralism and engagement in the light of the financial crisis is understandable in terms of lower costs, technology and resources, as China lacks much of the human and financial resources and technology to tackle potential future problems. Because of this, the Chinese government recognizes that other organizations and governments could add much needed value. From a purely financial point of view, the Chinese government and financial institutions have recognized that the costs would be significantly lower in multilateral organizations, even if we talk about anti-terrorist operations or financial rescue operations. This is highly appreciated by many of the Chinese leaders that still consider China to be a developing nation rather than a developed country, despite its currency reserves.

This multilateral engagement is very much in line with the policy to lay low, avoid leadership and guard China's position. This is something that will be increasingly difficult for China, as the world is increasingly expecting it to act on many issues and in numerous regions, not least in North Korea and Myanmar today. However, there is very little reason to think that China will change its security and foreign policy in the light of the financial crisis.

¹⁰ Niklas Swanström, "Economic Cooperation and Conflict Management in Central Asia: What Role for Northeast Asian Actors?" in Chris Len et al, eds., *Japan's Silk Road Diplomacy: Paving the Road Ahead* (Stockholm: Institute for Security and Development Policy, 2008), pp. 143–56; Niklas Swanström, *Regional Cooperation and Conflict Management: Lessons from the Pacific Rim* (Uppsala: Uppsala University, 2002).

On the contrary, it has only strengthened the Chinese view that keeping a low profile is valuable and that increased multilateral cooperation without taking too prominent a position is vital in this policy. The Shanghai Cooperation Organization (SCO) is one of the few exceptions, where today China has taken the lead and is moving the organization forward with a strong commitment, albeit without openly dictating the terms for the other members. Interesting to note is also the current heavy focus on economic issues, in contrast to the prior focus on counter-terrorism. To a certain extent it is possible to see some supra national tendencies in the SCO and especially in the economic field that could potentially be far reaching.

The question if China will use the economic situation to further boost its military power in the region and counter the U.S. presence, has surfaced with some regularity. It is true that the Asian states are upgrading their military strength, but their combined military spending in 2008 was still only a third of that of the United States. It will take the average Asian 77 years to reach the income of the average American. The Chinese need "only" 47 years. For Indians, the figure is 123 years and Asia's combined military budget will not equal that of the United States for 72 years.¹¹ This is something that the Chinese military is well aware of and there is simply no military or economic sense in trying to outspend the United States on this front. If a Chinese threat to the U.S. is to be found, it will take some time before it can be found in the military area, even if the regional actors are concerned with the Chinese military build up.

The financial crisis has only mildly reduced the speed of the military modernization and over a longer time perspective China will undoubtedly be a great military power in the region, together with Japan and India. The implications of this are unknown, but tensions between China and other states in the region will most likely increase despite the Chinese lack of interest in increased tension and military adventures. It is true that the highest military spending in the world is in Northeast Asia, but many of the states initiated its military growth from a relatively low level and Japan, China and South Korea need to prepare for a possible U.S. reduction of forces from the region to avoid a potential power vacuum.

It has been argued that China would use its military to secure its energy needs in Central Asia and Africa, and that the financial crisis would

¹¹ Minxin Pei, "Think Again: Asia's Rise," *Foreign Policy*, June 22, 2009.

strengthen this tendency. It is not unlikely that China will use its own means to protect pipelines etc., but to engage in the domestic development of another state is very unlikely, especially in a military sense. Not only because the very backbone of Chinese foreign policy is based on non-intervention, but more because it would be expensive and create grave suspicion regarding China's intentions and growth. If China intervened in any Central Asian, Southeast Asian or African state, it would not only be difficult to accomplish, it would most likely minimize China's engagement with a number of other states. Stability and free trade is very much the foundation of the Chinese future, and military adventures are not only expensive in military terms, they would also destroy the confidence and market share that the Chinese economy has built up to date. Therefore it is not likely that China would change its military policy unless its own interest would be severely threatened.

Financial Terror Balance!

The Chinese currency reserve would be, and is, a much better tool to hurt people than military force at the moment. With the largest currency reserve and loans both to the United States and Russia (in exchange for oil) that could potentially put China in a position to hurt both states severely, the question has been asked if China would use this tool? It is true that China would have the potential to hurt the U.S., Russian and European (not to mention the smaller states) economies and that it has become a deep desire of many "Red Fear" advocates to speak about this. The problem for China is that it would not only trigger a massive retaliation in terms of reduced investments, trade and a potential blockade of the Malacca Straits etc., but maybe more significantly, it would severely reduce the reputation and trust that China has built up among its friends and neighbors. China is much more dependent on other states' perceptions and good relations than the United States or Europe, and it would hurt Chinese trade to such an extent that it would be possible to speak about E-MAD (Economic-Mutually Assured Destruction). Moreover, the economies today are so interdependent that even if the international community would not actively punish such an action it would hurt itself. China is heavily dependent on international economic development to secure its export needs, as China still is, and will continue to be dependent on export for its economic development.

Continuity or Change?

It is striking how much continuity the Chinese foreign and security policy has shown during the financial crisis. Much of this is due to constraints, but there is a significant dedication to its current policy that guarantees stability. The development of a more aggressive Chinese policy seems to be far from what can realistically develop, as it is neither in the Chinese interests nor can the means to develop such a strategy be easily developed. When some states tend to be more restrictive in its foreign relations when times are bad, China has shown a great deal of engagement with the international community, and this speaks well about the future.

This does not mean that China will not be considered a threat or that much criticism will be directed to it. As China embarks upon a greater international role it will not, and should not, accept a position in the international system that does not reflect its growing power. As China takes a more prominent role internationally, criticism will unavoidably come, either for taking too large a role or, as in my case, taking a lesser role than it should. The financial crisis did potentially speed up this process (but more likely slowed it down) but it did in no way initiate negative perceptions of China.

The Changing International System and China's Strategic Choice

Yuan Peng

The world is witnessing unprecedented change. The transition of the international system is the key issue the world is facing today. This article contains perspectives about China's new status and strategic choices in the developing global order.

Four Major Incidents During the Transition

Since the end of the Cold War, discussion of the new round of transition in the international system has become popular, especially in China. This transition was not subject to rigid academic analysis until the 9/11 attacks in 2001. After the financial meltdown in 2008-10, these developments became a major concern among leading strategists. Dr. Henry Kissinger argued that the world is experiencing the greatest change in over 400 years, while Dr. Zbigniew Brzezinski said that it is the fourth historic change of the international system. Richard Haass described the pattern as the "nonpolar era." Russian president Dmitry Medvedev stated that the era of the multipolar world is already a fact, while French president Nicolas Sarkozy said that the coming era is one of the "relative great powers." These statements were made before the financial turbulence that began on September 15, 2008.

This dramatic transition had already begun before the financial crisis. In other words, the crisis is just the catalyst. The previous transition of the international system was triggered by a worldwide armed conflict which is easily observable and can be used as a dividing point in modern history. This transition, however, is taking place in an era of peace and it is therefore more difficult to observe and analyze. Despite this, four major incidents took place in 2008-10 that illustrated the fact that a new international system is developing.

Firstly, the Russia-Georgia War; Russia struck Georgia severely, but Georgia's allies, the United States and the European Union, did not move to enact sanctions. One reason is that, benefited by the soaring price of oil and gas, Vladimir Putin's Russia has re-emerged as a vital player on the international stage, after two decades of painful political-economic changes. The United States and the EU face several domestic and foreign policy constraints and are dependent on Russia for energy. In general, the 20 years post-Cold War era has ended.

Secondly, in 2008 China successfully arranged the Olympic Games in Beijing. It was a milestone as far as the West's view of China and China's rise is concerned. After the Cold War, the perception of China in western countries can be divided into several stages. The first stage ended in 1992, when Deng Xiaoping's Southern Tour speech and the policy of building a socialist market economy was adopted in the final resolution of the 14th National Congress of the Communist Party of China (CPC). Then the discourse of China's economic collapse disappeared. After the peaceful power transition at the 16th National Congress of the CPC in 2002, western society learned that China would not crumble politically. In 2008, the western world concluded that the Chinese society is unlikely to disintegrate. Several great challenges such as the March 14 riots in Tibet, the May 12 earthquake in Wenchuan, and the disruption of the Olympic torch relay in Paris happened within the space of one year. Tested by these events, China did not retreat but rather experienced a strengthened cohesiveness of the whole nation which increased the power of social mobilization. The new generations who were born in the 1980s and 1990s have shown their patriotism in an intelligent and rational way. Pointedly, during a global recession, China's GDP has sustained a growth rate of eight percent whereas the rest of the world's major economies have struggled severely. Therefore, the claims of a new world order, including the talk of G-2 and "Chimerica" are not totally groundless, based on China's development. There is no doubt that the 2008 Olympic Games in Beijing was indicative of China's rise. Accordingly the rest of the BRIC nations – Russia, India and Brazil – are emerging too, transiting the center of gravity from west to east. These facts support Dr. Kissinger's comments on the unprecedented change taking place.

The third incident is the September 15 financial meltdown. Parallels can be drawn with the September 11 attacks. These attacks weakened the natural

security sense of Americans which is derived from vast protective distances of the Pacific Ocean and the Atlantic Ocean. The attacks changed the American strategic view of the world, while the financial meltdown overthrew other countries' confidence in Wall Street, the foundation of U.S. financial hegemony. The superpower is confronting a severe, protracted challenge. Barack Obama's victory is not a milestone for ethnic reconciliation but a victory for the two doctrines' battle. Faced with disorders domestically and internationally, Americans seem unbothered by experience and race but on who lead the change and revitalization. Hence the unipolar world is fading while a post-American world is approaching.

The fourth incident is the 2008 Mumbai terrorist bombings. The so-called "India's 9/11" emphasizes that terrorism is a threat to the international community as a whole, rather than to the United States, the EU and Middle East exclusively. China also invests huge resources in counter-terrorism and seeks international cooperation. It is the first time on the global level for all countries cooperatively to response to issues like the H1N1 virus epidemic, rapid climate change, energy concerns due to soaring oil prices and historic transition on population structure.

All the incidents mentioned above have helped trigger the transition from one international system to another. Emerging countries rise as we witnessed at the end of the post-Cold War era. Great powers cooperate on global issues in the coming post-U.S. era. Briefly stated, the paradigm shift in the international system becomes a reality after several years of rhetoric.

What is the Transition Like?

Currently the structure of world politics is changing with the previous U.S. supremacy waning. Even if Obama's "New New Deal" revitalizes the U.S. economy and increases its power, the United States is not expected to return to the Golden Age of the 1990s. The U.S. will remain the leading power in the global order but will be relatively weakened. The second assumption is that a bipolar system is not realistic. Although the media is in frenzy about G-2 the basic assessment of this claim is that the United States is not interested in sharing power equally with China. There is a huge gap between the U.S. and China in terms of both hard and soft power and the other great powers are also unable to match the United States. Thus, the multipolar system might seem plausible but is ultimately not realistic. If the international

system after the Cold War could be described as “one hegemony, many powers,” the order might be reversed to “many-powers, one hegemony” for the next decade. The reason for this is that the power structure is not changing in a completely fundamental manner. The United States has dominated the world order for a long time but it now needs cooperation from other powers in order to enforce order. China has become one of the leading members of the group of powers, rather than one of the weaker ones.

More importantly, the international economic landscape is changing. The economic center is moving from west to east. Much of the world's manufacturing capacity has transitioned from the traditional powers in the west to emerging powers in the south and east. The financial world order, hitherto dominated by western firms and nations is involving more negotiations as well as coordination between developed and developing countries. The influence of the G-8 is decreasing and is being replaced by the G-20. The future of the world economy may be determined by the ongoing restructuring of the financial industry, the energy and information technology sectors that will stimulate innovation and offer momentum for economic development.

The international security situation changes rapidly as well. Although several great powers are calling for a nuclear-free world, some medium powers continue their efforts towards acquiring nuclear weapons. These trends are incompatible and the coexistence of an arms race and non-traditional cooperation among the great powers make the international security system more turbulent and complex. Worldwide conflict is impossible, but some form of regional conflict is inevitable. Furthermore, non-war military action is an integral and essential part of military modernization.

It is a new situation where several divergent models of development are competing and coexisting. The dominant Anglo-Saxon model which is characterized by liberal democracy and market economy has been tarnished by the financial meltdown. People are beginning to realize that development can come in many different forms, including the continental European model exemplified by France and Germany, the Chinese model, the Russian model, the Gulf model, the Latin American model and the ASEAN model. Although these models are enduring great challenges in the post-financial crisis era, the dominance of the Anglo-Saxon model is gradually weakening and other regions are starting to learn from each other.

Additionally, a series of new agendas are more important than ever before. Previous non-mainstream issues such as climate change, the need for new energy technologies, the demographic challenges, the warming of the Arctic Ocean, maritime rights, piracy and maritime communication will be at or near the top of the agenda in the next decade. These issues help create a major change in the dominant paradigm of international relations. We have to keep pace with the times by refreshing our perspectives and research methods otherwise they become outdated.

China's International Status and Its Strategic Choice

What place does China have in the changing system and what's the appropriate strategic choice?

Firstly, we need to keep in mind that China is just like the earth, always in the process of "rotation, and revolution." What is worth our attention is that China is a key driving force in the changing process of the international system, and at the same time its driving role itself is also one of the most important results of this revolution. In another words, China combines the role of reason and result in itself. It used to be the bystander, watching the change of the international system, but this time, be it the change in global political structure or in the economic structure, the changing process from quantities to qualities is coming with its rise. Meanwhile, China is also among the group who are first to enjoy or suffer from the change of system. Therefore, China, on one hand, needs to deepen its reform to continue "rotating," and on the other hand, it has to follow up closely with any change in the system to keep with the "revolution" of it. Hence, China needs to be more sensitive to and be more prepared for the coming results and the uncertainty from the system change.

The second question that should be asked is what the exact position China has in the changing system? Nowadays, a hot topic among the Chinese scholars is "who we are," or say, how should China position itself? There has been no unanimous answer thus far. Arguably China has four different identities, or is a "four in one" country. First, China is among the developing countries, no matter what standard is used when evaluating China. Looking at the political principles, foreign policies and developing strategies, the conclusion is that China would remain with its "developing" identity for quite a long period. Second, China is a rising power, one of

the BRICs, and also the symbol of emerging countries. Thirdly, China is a global power; it cannot be regarded as a regional power anymore. If it were excluded from the global power list, then, except the United States, who would be qualified as one? China is a global power, not only because it is one of the Permanent Five, or because some statistics, like the GDP, foreign exchange reserve, the population and the size of its territory, but also from its international influence and its developing momentum. As for its fourth identity, China is a “quasi-superpower,” been regarded as the superpower, just second to the United States, it is not a matter of liking it or not, will or won't. China has been imposed with that title by many countries. The “four in one” identity shows its different sides in different situations, which demonstrates the complexity of Chinese national characteristics and the diversification of the identity.

Thirdly, the “four in one” identity determines the diversification of Chinese national interests. For instance, China is a developing country when dealing with the climate change issue, we would not burden the responsibility imposed according to the western standard when cutting down the emission. Undisputedly, the United States and the EU have finished their industrialization, and they are entering the new age of post-industrialization and the information time, while China is still in a period of industrialization. Therefore it is not reasonable for western countries to demand a developing country to shoulder the same responsibility set by the standard of post-industrialized countries. Therefore, China emphasizes more on the historical standard and per capita standard; in areas of economy, sea rights, for example China is a rising power; and in this logic, Chinese national interests would inevitably extend to these areas. Even in history, China was not a pure land power, “going out” is very natural as China continues to develop. In the arena of international economy, China is a world power; no issue would be resolved if China is not around the table. China is conducting itself with the standard of a world power to aid in solving global issues, and is ready to lead in the new-born G-20. With regards to international security, China has already become a world power; it is only the cooperation between China and the United States that will assure the peaceful resolution of many security issues like the North Korea Nuclear issue and the Af-Pak issue, etc.

Fourthly, China is within the complicated process of the system change. First and foremost, there are six simultaneous "zation" processes. China is amid industrialization while merged in the age of informatization. It is at the beginning of the urbanization, but partly entering the internationalization; it has not finished the outline of regional concentration, and now comes the challenge of globalization. There is no doubt that China will have some benefits from the special position, but each coin has two sides; China is also confronted with more risks and difficulties. Secondly, two "isms" stand out in contradiction. Within China's borders, a new "nationalism" is taking shape owing to the single market binding different regions and different national groups together, which is applaudable, but it also brings some problems including increasing gaps between different regions and the tension between different national groups. Beyond the territory, a new "nationalism" (patriotism) fares up in Chinese minds, which includes not only the rational nationalism but also the irrational populism as well. The rise of neo-nationalism and neo-patriotism, on one hand, helps to win much popularity for the rising of the country, but on the other, it also helps to ferment some irrational "temper," which adds some variables to the foreign policies. Thirdly, China needs to notice that the inner situation has never been so closely linked with events beyond its borders, like the Af-Pak issue and the tension in Xinjiang Autonomous Region, India and Chinese Tibet, Burma and Yunnan, Sichuan and Guizhou provinces, North Korea and northeast China, Inner Mongolia and Mongolia. The advantage is that China is able to develop its national interest from within to the outside, while the disadvantage is that the risks outside may gain access inward to China, making the national interest susceptible to the outside circumstances. Fourthly, China needs to pay attention to structures at the global level as well as at the local or regional levels. A Chinese saying tells that "the wind goes to those big trees." Although China is not that big, the wind has come toward it already. Look around, the trapped Af-Pak disorder, the zigzag North Korea nuclear issue, the Burma crisis and the Sino-India mutual suspicion, the South China Sea disputes make it seem as if China is surrounded with disputes and problems if you evaluate its environment from a local level. If you shift the perspective to the global level, you will see a generally healthy Sino-Russia relationship, a warm cross-strait relationship and a more prom-

ising Sino-Japanese relationship; in a word, the coming macro-international system will be a favorable element for China.

With so many complicated multiple interests in mind, what strategic choice will suit China? China needs to do some adjustment to the traditional perception at first. For example, China will continue to stick to the non-interference principle, but it will neither become the excuse for shirking the international responsibility, nor a "political impediment" for China pursuing its overseas interest. A point in fact, there is much room for operation among non-interference, taking responsibility and pursuing overseas interest. As long as China's actions is under UN authorization and also welcomed by the countries concerned and will be helpful to stabilize the region or the world, then its actions are not violating the principle; what's more, we need to be clear about the status of ideology in our foreign policy. Take Sino-DPRK relation, for instance; which comes first when dealing with DPRK: does our national interest serve as the benchmark or does the ideology matter more? For another, in seeking our overseas strategic interest, we also need to clarify our stance. China's fleet in Aden has brought up the question of Chinese interest in Indian Ocean; does this imply that China is expanding in the Indian Ocean? Certainly not, because the Indian Ocean is not India's ocean, it is international water; similarly, China's influence in the Middle East can neither be seen as expansionism, the reason is very clear-the Middle East is Asia's Middle East, not the west's Middle East (the Middle East belongs to Asia instead of the west). China should not have to share the cheese of the west, but be able to pursue its reasonable right. All of these perceptual misunderstandings have been confusing us for long and also been taken advantage by the west to restrict us. To break this rein, we need to correct them and finish the perceptual adjustment.

When adjusting those perceptions, Sino-U.S. relations will always take precedence since the United States is still the only superpower at present. The bilateral relationship is good from a general perspective, but some frictions remain; the strategic relationship is developing well, while the strategic trust is still the problematic issue. The bilateral economy and trade exchange is extremely strong but the military exchange is slow; the communication among the elites is so abundant while the populist level communication is still in shortage; although the Taiwan issue is under control, the South China Sea dispute is in escalation. As China continues to grow,

the Sino-U.S. relationship is likely to change from “one super and one of the strong powers” to “No. 1 and No. 2” gradually, and some contradictions between the two may deepen. However, the United States is also clear that China will not refuse cooperation with it; it is still 10–15 years from when China really qualifies as a challenger to the United States. It is one of our great topics, how to grasp the opportunity to cooperate with the Obama Administration in handling the financial crisis, climate change and regional security issues to increase the strategic trust, expand the cooperation space and construct a new framework for the bilateral relationship, thereby resolving those embedded contradictions.

Second, how to deal with powers like Russia, Europe, Japan and India, etc. China is not necessarily the power in waiting; all these powers have the potential. China needs to strive forward in areas of development with other powers the focus should be on how to achieve this goal. From this perspective, it is as important as pushing forward the Sino-U.S. relationship on a strategic level that consolidate the Sino-Russia relationship, deepen the Sino-European relationship and strengthen relations between China and Japan, and stabilize the Sino-India relations.

The third is how to deepen the relationships with other developing countries as China is facing marginalization from the developing countries. India, Brazil and South Africa are competing for a dominating position. They all hope to replace China as the voice of the developing world. Other countries from Latin America and Africa are in the process changing their perception over China, under the influence of the United States by way of new developing aids, and the background of contests among powers. “No forward means backward,” which is one way to describe the relationship between China and the other developing countries. In order to avoid this situation, China has no alternative but to change its thinking, make more strategic investment and strengthen the international cooperation.

Forth, the fundamental strategic choice for China is to strengthen itself. This is because China is confronted with problems from inside instead of from outside. In 2008, the series of group events and the national tension in 2009 both demonstrate the inevitable but important difficulties for a rising power. China has caught the “rising syndrome,” as such China has to figure out a way to get rid of it.

The Twilight of Soft Mercantilism: Europe and Foreign Economic Power

Fredrick Erixon

Introduction

This paper is primarily concerned with foreign economic power. The purpose is to give perspectives on the structure and institutions of Europe's foreign economic power – how it practices its economic statecraft on the global scene – and the effect the economic crisis might have on Europe's capabilities to influence economic policy in countries outside the European Union.

The economic crisis is deep. The free fall is over, but recovery will be slow in Europe and the United States, the two main markets in the world. Yet of the profound economic problems facing the world economy, the crisis is only one. The measures governments have devised in response to the crisis will soon likely become a serious problem – inflationary monetary policy, fiscal deterioration, and the decline in competition on many markets will make themselves felt. Yet the many predictions of a collapse of the global economy, or of a profoundly changed policy-texture of economic globalization, have been vastly exaggerated. The crisis is far from as catastrophic as the newspaper commentaries and the glitterati of the economics profession have professed.

The world economy is not experiencing a replay of the 1930s, when economic isolationism followed hard on the heels of a Wall Street crash. Nor are we at a 1944 moment in world economic history – a point in time when the leading economies of yesterday formed new economic and political institutions to govern international relations and limit the raw use of economic power, then primarily embodied in the use of beggar-thy-neighbor policies such as competitive devaluations.

Governments today are not succumbing to economic nationalism as a response to the crisis. Current protectionism is real, and problematic, but it is low-intense and has so far not triggered tit-for-tat patterns or retaliatory action. Equally important, much of recent protectionism was already

underway before the start of the crisis and largely reflects two major trends in the global economy. Firstly, the rising competition to the West from new economic powers in the East, and exaggerated fears in Europe and in the United States that their economies soon will be run from Beijing. Secondly, there has been a sharp slowdown in the climate for economic liberalization of the kind that fosters growth and cross-border economic integration. This shift in mentalities and policies can be seen across the world, in developed and developing countries alike. They profoundly affect the global climate for open trade, especially the desire to keep markets open for goods, people and capital from fast-growing countries in Asia.

Starting in the 1980s, many countries shifted track in economic policy, left the “dirigisme dogma” of the past, and moved towards economic liberalism. In Asia, China started its great opening to the world in the late 1970s, and this opening has been the most important development for cross-border commerce and rising affluence in the past three decades. Southeast Asia started to integrate economically with the outside world well before China’s first steps toward the modern world economy. India followed in the late 1980s, when the “License Raj” of post-colonial India was scuppered and modern, post-Keynesian economics was introduced to Delhi. In various forms, and to various degrees, all rising economies in Asia have grown fast after they introduced outward-oriented economic reforms boosting trade and investment. In the West, the rise of politicians like Ronald Reagan and Margaret Thatcher in the 1980s triggered a wave of economic reforms that liberalized economies, internally and externally.

Broad economic liberalization steered the world economy toward a new structure – a structure in which trade and cross-border investments has grown exponentially. The global volume of trade has consistently grown much faster than output in the postwar era, but from the late 1980s to recently, global trade has grown at unprecedented levels. From 1950 to 2005, global trade grew from US\$400 billion to US\$24 trillion – a 60-fold increase. Global investment increased by almost a ten-fold between 1990 and 2007.

The profile of trade has also changed. Fifty years ago trade was the export of a finished good to another country where it was consumed. Today trade is an integral part of the production chain. Big multinationals have led this trend. Now they operate dense production networks. Supply chains have been fragmented to such a degree it is impossible to give a meaningful

nationality to a good. A mobile phone, for example, is typically assembled in China, but the components of the phone have crossed borders 50–100 times before the actual phone is finally assembled. That is the story of modern globalization. That is also the story of China as an exporting powerhouse. Furthermore, the trade-supply-chain structure of the world economy is also the main reason why governments today have restrained protectionist instincts amidst the crisis. The allure of easing the conditions for domestic firms by raising border barriers is big, but most countries today are too dependent on import for their export – and they are also too dependent on foreign consumers – in order to benefit from short-term protectionism. China, where processing trade accounting for at least 50 percent (two-thirds is probably more accurate) of all trade, is a good example.

This is a long introduction to two simple observations. But nothing goes without saying, and they both merit acknowledgement.

Firstly, a country's conduct of its foreign economic power is today central to all foreign and security policy – to diplomacy as well as to war or threats of war. With key economies as integrated with the rest of the world as they are today, serious disruptions of trade and cross-border commerce will damage economic wealth, a central component of a nation's interest.

Secondly, for the discerning scholar of policy and power, it is not the economic crisis, or governments' responses to it, that is of prime importance when understanding trends and shifts in global economic power. Some of the intellectual fashion designers in the study of international relations and global economic policy will continue to make claims to this end.

But they are wrong. The crisis will change some countries ability to use its economic statecraft, but only at the margin. Fundamental trends before the crisis still remain valid, some of the even more so today than before the crisis.

Which trends are most relevant for Europe's foreign economic power? Let me offer three observations.

Observation 1: Europe Is a Postmodern Construct and its Institutions for Cooperation Behave as Such

Europe has a complex political structure. Europe is a continent of nation-states that at the center has the European Union and common institutions for its 27 members. But the jurisdictional competence of these institutions is

limited. Typically, policy in Europe does not gravitate from Brussels. Many policies are not decided by Brussels and remain in the confines of its member states. Over the past decades an increasing number of policy issues have been centralized to the European Union, and there are few issues without a Brussels dimension.

The European Union, however, is not the only pan-European institution for policy considerations. There is a European Court of Justice which is institutionally unrelated to the EU. There are economic co-operations that have nothing to do with Brussels. Some EU countries share a common currency, but only 15 of EU's members use it as legal tender. Some EU countries are members of NATO, others are not. Some EU members are signatories to the Western European Union, others are not. The varieties of European cooperation are significant and also affect the effectiveness of European cooperation at large. Consequently, European policymaking is a cumbersome, bureaucratic, and time-consuming process – often very difficult for outsiders to understand. Often it is little more than a mental exercise to bridge internal differences between member states rather to achieve the professed ambitions with Europe-wide policy cooperation: to increase the efficiency of European policy (individually and collectively) and enable Europe to exercise greater influence in world affairs by sharing policy and pooling resources.

Hence: any understanding of Europe must start in its institutional complexities. Its foreign economic policy offers a good example.

Foreign economic policy is the power center of Europe's global ambitions. With the size of its common market, Europe could exercise considerable influence on foreign governments by allowing or denying access to its market. From a policy perspective, commercial policy is the backbone of the cooperation in Europe that manifested itself in the European Union. It is a Customs Union and runs a Common Commercial Policy – a trade policy, in normal speak. But this does not mean unlimited power for the European Union. EU's trade policy is constitutionally limited. Issues related to services often do not fall under the power structure of Brussels – these are issues belonging to the jurisdictional sphere of the member states, and many of them have offered fierce resistance against moves of centralizing policies in the services sectors. Thus, Brussels is constrained in negotiating reduced barriers to trade in services with third countries – a constraint

which presents real difficulties in modern trade negotiations and limits Europe's capability of using its economic statecraft internationally.

Furthermore, another central element to the modern world economy – rules and policies on cross-border investment – are almost entirely an issue of the member states. Thus, if China encounters problems with investment access to Europe, there is no point calling Brussels – it must contact Berlin, London, Paris or any other European capital. Henry Kissinger's observation still holds: when you want to deal with Europe, whom do you call?

Moreover, financial issues are largely not dealt with at a European level. There is neither a pan-European bank regulator, nor a comprehensive common policy on issues of cross-border financial flows. The European Union represents Europe in the World Trade Organization (WTO); in the International Monetary Fund (IMF) countries represent themselves.

This list of limits on European internal cooperation could be made longer and comprise salient issues such as energy. The overall pattern is clear: Europe can only have clout internationally if it has opened its own markets internally and formed a joint policy and institutions to exercise it. The fragmentation of power makes Europe weak and undermines the effectiveness of its foreign economic policy and economic statecraft. Europe is the biggest trade bloc of the world, and has the biggest market when measured in aggregate purchasing power, but the fact that it has no common approach to key issues of global economic affairs weakens its hand.

Nor are European member states eager to centralize more economic policies to Brussels. The Lisbon Treaty will add some extra clout, but only at the margins. When Europe is divided, or at least lack a common approach, it also undermines the effectiveness of international economic institutions and make them anachronistic. Take the IMF as an example. Europe is vastly overrepresented in this organization as the quota of votes is based on the relative economic size of countries far back in time. A small country like Belgium, for example, has formally a greater say than China. A common European approach in a reformed membership structure would lead to lower aggregate formal influence in the IMF for European members – but its effective power would increase as the block could exercise an influence not possible today. However, almost all EU countries have so far rejected reforms that would seriously dilute their own formal status in the IMF.

Security policy is another example of the fluid and fragmentary structure of European cooperation. Europe has a common foreign policy, but the power of Brussels is weak. Many issues have to be decided on the basis of unanimity, which clearly weakens effectiveness and makes Europe look like an academic sociology seminar rather than a forum for decision making. Security policy and military policy have even weaker positions. Many EU states, but not all, are members of NATO. NATO, however, is an organization many Europeans have a difficult relationship with – for its own strengths or weaknesses, for substantive or procedural reasons, or for the fluid relation between United States and some European members. France left NATO's military structure in 1966 but has recently returned. Most countries, even non-members, cherish the security offered by the United States, but few are willing to pay substantially to a collective security approach. Most EU governments have cut down considerably on its military spending. While based in Brussels, NATO headquarters appear to be perpetually disenfranchised from the other political scene in Brussels: the EU. There are many turf fights, and often they are about defining the limits of EU cooperation. Symbolism also matters – such as in the rivalries over the accession of Cyprus to the EU. The processes of closer integration with the EU and NATO for countries like Ukraine and Georgia are other sources of conflict. These types of conflicts often pop up in surprising places – such as in EU internal dialogues over a telecommunication chapter in the initial examination of Turkey's policy that is done as part of the process laid down for a potential accession of Turkey to the EU.

In what way can this be described as a postmodern construct? It is quite clear, as Robert Cooper describes in his book *The Breaking of Nations*, that countries, not only in Europe, has evolved away from the classic definition of a state and the security-policy discourse that were closely attached to it.¹ As Leslie Gelb puts it in his recent book *Power Rules*:

The classical masters of power and warfare would be startled at the shifting importance of military and economic power. [...] But the keen eyes of Machiavelli and Clausewitz would

¹ Robert Cooper, *The Breaking of Nations: Order and Chaos in the Twenty-first Century* (London: Atlantic Books, 2006).

be quick to perceive that finance and commerce now occupy a special and unprecedented perch in foreign policy.²

There are many factors at play. Lately, economic globalization has tied countries as close to each other that it is difficult to separate states from each other, or defining broader national interests in a fashion that contradicts general ambition of increased economic wealth and the supply-chain structure of the big multinational enterprises. In some economic respects, but far from all, borders have been rendered meaningless. Yet there is arguably something more to the term postmodern than the mere instrumental aspects covered by foreign policy thinkers. In philosophy, postmodern not only represents a taxonomic position, it sets out a discourse with its own conceptual views, often defined in opposition to views underpinning the era of the modern state. In difference to the United States and China, the European Union – and, by extension, Europe – is increasingly embodying the values of philosophical postmodernism and pays homage to its spatial norms.

How can we translate such a fancy conjecture into intelligible analysis?

Firstly, the fluid concept of the political personality. As previously discussed there is in the new European policy discourse no fundamental concept of the state, let alone a state that is equipped with appropriate institutions for domestic policy as well as to exercise international power. The postmodern state is one in which territory, the core theme in the political personality of the modern state, is secondary to a more fundamental guide for policy. In this case it is transnational cooperation between European nation-states – a cooperation that involves devolution and transfer of power, a deliberate move to weaken your own autonomous authority. This transfer of power is done to gain something else: more efficient governance, a secure Europe, and greater international power. These aims, however, are not always the result of European cooperation. In fact, the fits and starts of European cooperation often weaken national authority without improving policy efficiency or the international power status. European policymaking is no different from national policymaking; people in the process of policy-

² Leslie H. Gelb, *Power Rules: How Common Sense can Rescue American Foreign Policy* (New York: Harper, 2009), p. 206

making gets so bogged down by details and conflicts among key interests that the end result is difficult to link to the initial ambitions.

Nor are these aims of en the guiding ambitions of European policymaking. The key ideology of European institutions is “an ever closer union.” One can share this ideology or not, but one cannot escape the fact this has little to do with the appraised efficiency of closer cooperation. Nor can it conceptually be integrated with a notion of strategic national (regional) interest.

Hence, in Europe’s process of forming a common political personality, the modern, or classic, concept of the state has lost traction in European considerations of policy and power.

Secondly, with mixed jurisdictional competencies, overlapping institutions, and a generous amount of internal rivalry, there is a constant exercise in Europe, in its execution of policy and power, that involves invariable reflection and debates of the authority of institutions – what they can do and what they cannot do. This process of reflection takes primacy over the fundamental principles of a state: protecting the territory and pursuing a policy in the national interest. Of en, process becomes as important as substance and outcome – indeed, of en it becomes the dominant, let alone only, aspect of policy in Europe.

Thirdly, the concept of power gets transformed in a political and institutional atmosphere such as the described. More than anything, the concept of international power has changed. Europe, today, largely embodies a postmodern concept (in a taxonomic sense) of international power – a concept that emphasizes the role of “soft” power over “hard” power, to use Harvard scholar Joseph Nye’s terminology. Process takes primacy over outcome also in Europe’s international relations. There is an inability in this postmodern discourse to gauge power in terms of military capacity. The emphasis is rather on perennial negotiations in international organizations and the multitask capabilities of countries to be hyperactive in all sorts of negotiations and organizations.

At the core of the postmodern concept of power is a refusal to accept genuine power. Power is not hard or soft. It is neither smart nor dumb. Power is power. It is the capacity to get countries to do what they don’t want to do. The postmodern concept of power does not accept this view. It does not understand what Leslie Gelb calls the soul and music of power: defining

and pursuing a national interest. Europe's idea of power is, for good and ill, in a rival business: to weaken national interests in order to build a pan-European interest.

This is not a critique of European cooperation. Europe is what it is – a continent of nation-states that has been plagued by wars. To weaken past concepts about national interest and power has been a survival necessity. But the move of authority from nation-states to pan-European institutions has not enabled Europe to become the sort of international power that corresponds with its economic size and wealth. European power is now living in between the concept of national interest, on the one hand, and pan-European institutions to exercise international power, on the other hand. Member states do pursue interests inside Europe but they cannot do it effectively on the international scene, neither individually nor collectively.

This is not likely to change in the near and medium-term future. In fact, the crisis has amplified the institutional confusion in Europe – conceptually, institutionally and intellectually. Especially in the field of finance and financial regulation. Europe, collectively, is now pursuing regulatory ambitions on three different levels: multilaterally, in the IMF and the Bank of International Settlements; regionally in the European Union; and domestically in each and every member state. It is messy and complicated. Seldom has it been asked: what would be most efficient from a regulatory point of view, and what is Europe's strategic interest? Many member states have strategic interests, and pursue them vigorously. Some also act on ideological pretexts. Even if they know some of their core interests are likely to be trampled on in the process of forming a common policy, many member states cannot refuse to participate in the process. However, no one expects the end result to have sufficient coverage and make it unnecessary for EU countries also to have individual policies and individual authorities to execute these policies. On the contrary, it is widely accepted that Europe cannot form a complete policy. Regulatory ambitions, collectively and for many individual countries, are also as unconnected to strategic foreign policy as it is forgotten that Europe is about to start doing the same things that it wants other countries to do away with.

Observation 2 Europe Is a “Diminishing Giant”

Europe has grown to be the biggest economy in the world. But it has achieved this by expanding the membership of the EU club, not by fast economic growth or a dynamic economy. Despite its ascending size, its relative share of the world economy, or of world trade and investment, has declined as other parts of the world, primarily Asia, have grown much faster. This is a fate that Europe shares with the United States; their relative economic clout is diminishing. In contrast to the United States, which can still claim global leadership because of its military superiority, Europe’s main source of international power has been its economic size. Thus, a shrinking economy is perceived as a threat to foreign economic power and the execution of this power.

From the vantage point of economics, this view merits nothing but ridicule. Economic wealth, which is the sole purpose of production, is not about size. The richest countries on earth are typically small countries, like Norway and Switzerland. The fact that other economies grow bigger is not a threat; it is a development that should be applauded as it offers new opportunities for companies to export more goods and services.

European leaders are well aware of the benefits to European citizens from rising affluence in other parts of the world. They also know that its long-term strategic interest is in growing economic wealth in previously poor countries, like many of the Asian countries, as growth makes countries more stable and economic ventures more profitable. Yet Europe becomes preoccupied with its diminishing foreign economic power. Why?

Firstly, many European policymakers, as policymakers from all parts of the world, suffer from what the economist Paul Krugman has called “pop internationalism,” or what former OECD chief economist David Henderson has called “do-it-yourself-economics” – a home-grown idea of economics that only fragmentally correspond with actual economic knowledge of sources of affluence. These beliefs often build on a zero-sum game view of the economy: the wealth of others comes at the expense of your own wealth. Similarly, if companies in other countries perform well, it must mean that your own companies are at a disadvantage. At the center of this misunderstanding is a striking ignorance about the profile of the world economy – corporate development in many new economic powers are driven by West-

ern firms – and about the source of growth: climbing the value-added chain and how trade helps this climb.

Secondly, a falling share of world production and world trade amplifies the need to reform international economic institutions – like the IMF – to reflect the new patterns of production. Such reforms inevitably mean falling influence for individual European countries. For a continent that is perceived to be one of the parents of current international institutions for economic cooperation, such a notion invites dislike.

But there is something more to the story than these instrumental aspects.

There is a growing feeling in Europe that its own model for power and expansion is inadequate to gain, or maintain, international power in future. Europe's foreign economic power has primarily been regional in nature – it has been exercised primarily through ambitions and policies to get other countries in Europe to accede to the European Union. What is Europe's foreign economic power on the global scene has derived from the fact that some of the member states once were the biggest economies in the world and that they have jointly maintained its influence by expanding the membership of the EU club and deepened the cooperation in areas of commercial policy, which has enabled Europe to be influential globally. More than anything else, Europe's power structure has been botched-up – when it has deregulated markets internally and deepened regional policy cooperation, then they have maintained is international economic power.

This model of maintaining power has not passed its sell date, but it is becoming more difficult to run and expand the model. Expansion of membership, for instance, is much more difficult now as (barring potential membership applications from Iceland, Norway and Switzerland) potential candidates are on the periphery of Europe, borders to troubled or troubling countries (Iraq and Russia spring to mind), are poor, and (if Turkey is excluded) will not give Europe more clout internationally. Furthermore, the more Europe expands, the more difficult it gets to deepen policy cooperation as varieties of policy and policy ambitions get more differentiated. Differently put, Europe's global economic power has had its source in expanding membership and deepened regional policy cooperation. One of these sources is now exhausted, the other is in fatigue.

It is also more complicated deepening policy cooperation today than in the past. Europe started its commercial and economic cooperation by

forming a Customs Union and, thirty years later, by eliminating internal barriers to trade in goods. The result was the single market. There are plenty of unfinished businesses: forming a single market for services and a common policy for foreign direct investment, for example. There are also many related ambitions: forming a currency union or establishing common regulations and regulatory bodies in areas of cross-border commerce. But from a political and technical point of view, such reforms and ambitions are far more difficult to achieve than the initial aim to reduce barriers to trade in goods. While barriers to trade goods typically has manifested themselves in tariffs and border barriers, barriers to trade in services is mostly embodied by behind-the border regulations, which tend to reflect political and regulatory cultures. Nor is the economic rationale of some of the ambitions as obvious and strong as it was for reducing barriers to trade. It is not necessarily the case that it is in the short or long-term interest of a country to become a member of a currency union and limit its power to run a monetary policy. It might be in the economic interest of some, but not of all.

The psychology of a “diminishing giant” is thus more complicated than just the perception of falling relative economic power internationally. It is based on the observation that its own model in the past to gain or maintain foreign economic power is no longer sufficient.

Observation 3 Shift in View of Foreign Economic Model and Ambition

There are subtle trend shifts in Europe’s view of international economic cooperation and foreign economic power. These are primarily related to the issues raised above: the postmodern structure of power and the psychology of a diminishing giant. They are also manifested in economic and regulatory ambitions and models.

Hardened Mercantilism

All countries in the world (barring failed states) tend to run a mercantilist trade policy – that is, a trade policy that maximizes export, output (not necessarily GDP) and the buildup of own reserves. This is a policy in which export takes primacy over import. From the vantage point of economics, this is a flawed idea. The principle of free trade is much better than mercantilism, partly because import is the most important flow in trade. It is

through import a country gets access to goods it cannot produce at competitive prices and quality, or produce at all.

Europe's view of trade policy has been mercantilist in nature – but it has been soft mercantilism, resting on the view that reciprocal opening of markets is of benefit to all parties. Furthermore, the model of regional trade liberalization and ambitions of forming common policies have pushed Europe in a free trade direction. Internal trade liberalization has strengthened Europe's interest in subsequent global liberalization as European firms have become competitive and outward-oriented in the initial phase of liberalization. This has also enabled Europe to be one of the guardians of the multilateral trading system.

Differently put, domestic economic reforms in Europe strengthened the free-trade component in its national-interest calculus. It had an economic interest to open global commerce. It also had a strategic interest as it could project its own market reforms and strategically use international economic institutions to that end. Free trade and multilateralism were handmaidens for Europe's policy ambitions.

Subtly but systematically, this model and perception of trade has changed. Europe has moved close to mercantilism in its basic outlook on global trade and commerce. Behind this move is partly a belief that the economic interest for Europe in global free trade is not as strong as before. There is also a belief that it cannot no longer project global economic liberalization to the same extent it could before. Furthermore, inside the Brussels beltway an increasing number of policymakers and intellectual fashion designers hold the view that free-trade ideology undermines foreign economic power and that only a strengthened mercantilism could help Europe leverage its economic statecraft abroad. This is the return of an age-old belief, widely discredited by noted scholars such as Eli Heckscher and Jacob Viner. It is also discredited by modern scholars. At the heart of this notion is the use of punitive measures against countries that do not behave as you wish. There are three problems to this notion.

First, if a country uses a punitive measure against, for instance, the export of another country it is likely to damage its own economy as much as the targeted country's economy. Hence: the economics and political economy of such measures do not speak in favor of them.

Second, if a country uses punitive measures against another country, it can be retaliated against with similar measures. Hence: you can only use punitive measures against countries that are substantially weaker than you.

Third, punitive economic measures are typically inefficient – they do not achieve what they intended to achieve, most often a policy change in another country. Economic sanctions are a good example. Few of them change anything. Nor are they intended to: trade sanctions are often used because a political leader feels pressured to do something but cannot come up with an alternative that is efficient and does not oppose your other interests.

EU's bilateral trade relation to China offers a good example of this shift in thinking.

For years, the EU supported and pushed China's grand opening to the world. Some Europeans believe, rightly or wrongly, that they were responsible, in a positive sense, for getting China to open up for foreign trade and to join the WTO. Now, however, Europe is deeply annoyed with its trade relation to China. It claims that China is manipulating its currency and is building up a bilateral trade surplus because of this currency manipulation. Europe runs an overall balance in its trade account, and hence does not have a general problem in its external economic relation, as the United States have had in recent years, but its bilateral trade deficit to China is annoying to the mercantilist. The purpose of trade to a mercantilist is to generate surpluses, not deficits. Because of this deficit, and a few other factors, Europe increasingly is threatening China with punitive trade measures unless it does what Europe wants it to do.

The economics of this view is flawed, but it is gaining currency in Brussels and in other corners of Europe. Some support such claims for tactical reasons – they believe China is more willing to follow dictums from Europe if Brussels wield the threat of punitive actions in front of Beijing. Others, and this group is growing, see this issue through the lenses of strategic international behavior and power. They assert that the size of Europe's markets are so big that by using trade sanctions against China, or threats thereof, Europe can motivate China to pursue the non-trade objectives it wants it to. These objectives range from signing up to a global agreement to reduce carbon emissions to a new policy on Tibet and human rights. Mercantilism and non-cooperative strategies for international relations are thus merged.

From Multilateral to Bilateral

As Europe's influence in international economic institutions has declined, and will continue to decline, its interest for them has followed suit. This is not to say that Europe rejects multilateralism in the field of commerce and economics. It does not. But it does not believe that they are to strategically benefit as much from these institutions as they did in past. It is rather pursuing a bilateral strategy, and this strategy is bound to be amplified in future. The backbone of Europe's commercial-policy strategies today is bilateral – not multilateral or unilateral. It is eyeing growing economic powers for special trade deals, and believes it has more to gain from such strategies than from other. It is also enforcing the commercial policy relation with its former colonial subjects and with other poor countries, partly to maintain its clout in these regions.

From Deregulation to Regulation of Global Markets

Another subtle shift is Europe's growing interest in establishing global regulations which basically has the effect of closing markets or imposing new barriers to trade: environmental and labor standards regulations, public health regulations, antitrust regulations, etc. Europe's regulations on chemicals, REACH, is a notorious example, demanding excessive testing and registration of all chemicals in a product before it can be sold on Europe's markets.

This interest is partly a consequence of its own domestic regulations, which tend to be more excessive and intrusive than in other parts of the world, and the interest to avoid a situation where its own firms are disadvantageously positioned to their competitors because of EU regulatory zeal. But Europe also believes it has projectionary power in the fields of regulations and that it has the foreign economic power to demand other countries to sign up to the similar policy. Furthermore, it believes that the interest for other countries to keep access to Europe's markets is so strong that they are willing to import Europe's own regulatory model.

There is a clear trend shift in European policy. For many years, its foreign economic ambition underpinned by cynical economic interests and long-term strategic considerations has been to open markets. Instrumentally, its view has been to establish rules that prohibit regulations to interfere with cross-border commerce. This is still an ambition, but it is not strategic

or principal. It is contextual and fragmentary. And it is combined with a new interest for global regulations – regulations that clearly interfere with cross-border commerce. Behind this shift lies an economic defensiveness, but also the idea that one of Europe's ways to maintain its global standing is in global governance.

The Economic Crisis and the Balance of Economic Power

Finally, how do these trends connect to short-to-medium terms aspects of the current economic crisis? Let's look at the United States, China and Europe.

The United States

America is not in terminal decline. It remains the only country which combines economic strength and military capability, and consequently its international power is by far bigger than those of Europe and China, and it is the country everyone looks to for global leadership.

The U.S. economic statecraft has diminished during the crisis. Its consumer power is not as big as before the crisis. It remains a destination for foreign investments, but risks of inflationary pressures, along with its increasing need for foreign capital to finance its vast fiscal deficit, limit its attractiveness. The financial crisis has reduced liquidity on U.S. financial markets, and its relative position has weakened as so much money has been lost in the housing bubble and the financial mania. But few countries are capable of really benefiting from the seriously declining liquidity. Other financial centers are in similar situations as the United States – and emerging financial hubs (e.g. Tokyo, Hong Kong and Shanghai) have far too low quality of its financial infrastructure, and far too illiquid markets, to offer real competition.

China

China's economy has not deteriorated as much as Western economies, but its ability to use its economic statecraft on the global scene is limited by some structural problems in its economy. Far too much of its reserves are locked in underperforming financial assets in the United States. Its growth in the past years has been driven by investment, and Beijing is tailoring its anti-crisis policy to support investment. This is not a sustainable growth model,

and the Chinese economy gets locked into underperforming investments at home (investments with low incremental capital-output ratio). Channeled through its state-owned financial sector, new policy will enforce an underperforming financial sector with low international power and create new problems of non-performing loans. A cementation of the current structure of China's financial sector will seriously block future growth potential and capability of foreign economic leadership. China will continue to increase its foreign economic power, but it will grow more slowly than before, and it needs to undertake further domestic economic reforms to maintain its ascending role on the global scene.

Europe

Europe is in deep trouble. Western European economies have dived deeper than the U.S. economy. Many Eastern European economies have been on the brink of defaults and only survived through the financial assistance of the IMF and EU partners. Fiscal policy in some big EU countries (e.g. Italy and the UK) was in bad shape already before the crisis. With big welfare states, a contracting economy sharply pushes up fiscal spending as more people claim unemployment benefits and similar support. Europe's growth trend was low before the crisis, and growth potential looks even worse now. Too little of Europe's existing growth has been driven by productivity increases and innovation, and a significant part of growth and increases in real income has come through trade (internal and external). Similarly, trade has been the main lever of structural change in the (Western) European economy, and as trade will remain in the low regions in the medium-term Europe is likely to face an increase in its already big problem of structural unemployment. Policy reforms to increase competitiveness are almost non-existent. Hence, Europe's foreign economic power will continue to decline.

The Evolution of Strategic Concepts for NATO and the European Union

Willem van Eckelen

A New Context

The security perspective as seen from Western Europe has undergone enormous change. Twenty years ago the fall of the Berlin Wall marked the ending of the division of Germany and thereby the division of Europe, and soon to be followed by the dissolution of both the Warsaw Pact and the Soviet Union. Today security policy no longer focuses on collective defence against external aggression, but on new threats such as terrorism, the proliferation of weapons of mass destruction and failed states of en in connection with organised crime. Our citizens feel worried about security in their streets, corruption, traf king in drugs and human beings, illegal immigration and recently about the ef ect of impending climate change.

Consequently, internal and external security is being linked to an unprecedented extent which must have its impact on the way we organise our security system and coordinate its various components. In addition, recent experience with peace support operations outside our borders has taught us that no crisis could be resolved with military means only. Instead we are aiming at a comprehensive approach linking security with diplomatic ef orts and development assistance.

The connection between security and development has now been widely recognised, largely thanks to the Organisation for Economic Co-operation and Development and its Development Assistance Committee (OECD/DAC), which has pointed out that without a minimum of security no development projects have a chance of success, but equally that in the longer term no lasting security is possible without sustainable development.

Many of the challenges facing modern society, partly as a result of globalisation and the ensuing increase in communications and interdependence, do not have immediate military implications, but will af ect national interests and therefore might lead to international tension. Dealing with

issues like climate change, competition for energy resources, water shortage etc. are not tasks for NATO but ensuing conflicts could be. The wider scope of the European Union and the instruments at its disposal offer better possibilities for an active role. Nevertheless, both organisations should be aware of these problems which militate in favour of giving more substance to Article 4 of the Washington Treaty which deals with political consultations. Due to the attention given to the operations in Afghanistan the work in NATO has tilted too much to the military side at the expense of the intensity of political consultations.

Some new threats have emerged which clearly have military implications. Cyber warfare could fundamentally disrupt organised society and there is as yet little clarity about effective ways to deal with it. Piracy has acquired a new dimension in the Gulf of Aden, which affects free passage through international waters and could interrupt oil supplies. Here the international community has a common interest in taking action, which could surpass other differences and have a positive effect on international cooperation at sea.

The current emphasis on combating terrorism, both abroad and at home, merits a comment on its nature. Terrorism is a method, which has been used through the ages in the pursuit of different causes. Catastrophic terrorism by suicide bombers has widened its cause to the destruction of Western society through indiscriminate killing. As such it will be more difficult to deal with, unless the population turns against the killers. Our responses will have to be geared to the objectives of the terrorists and demonstrate that non-violent options are preferable and less harmful.

War on terror as a slogan makes little sense because it does not deal with the underlying causes. What is much more useful is enhanced cooperation among intelligence services to provide early warning, and a joint effort to take action in case of disruption of vital installations. The Lisbon Treaty includes a clause for solidarity in this respect when an attacked country needs help. But fighting terrorism at home will be a task of the police forces, with only a back-up role for the military in great calamities.

The Functions of a Strategic Concept

A strategic concept should perform three functions. First, it needs to provide a common rationale for the purposes of the organisation, its priorities

and the means at its disposal and to do so in the political-military context of the next 5–10 years and the threats and challenges expected. Second, it should provide the basis for the planning and functioning of the forces of the organisation, which could be further developed in subsequent documents. Third, it should function as a tool of public diplomacy, both with regard to the own population and to other nations and organisations.

During the early years of NATO the strategic concepts were secret documents prepared by the Military Committee to deal with armed aggression in connection with the Soviet threat and focusing on the role of nuclear weapons. MC 14/2 formulated the concept of “massive retaliation,” MC 14/3 replaced it by “flexibility in response,” which was endorsed by NATO only in 1967 when France had left the integrated military command structure. In that year the political strategy of the alliance (including France) was explained in a separate document, the Harmel Report on the Future tasks of the Alliance. Its twin pillars – defence and detente – would be the mainstays of Alliance policy during the remainder of the Cold War.

After the events of 1989 NATO had to adjust to an increasingly no-threat situation and the EU to implications of a united Germany becoming its largest partner. The NATO Summit in Rome in 1991 adopted a new strategic concept based on “Dialogue, cooperation and maintaining the capacity for collective defence.” The European Economic Communities and the European Political Cooperation merged into a European Union with the conclusion of the Maastricht Treaty in December 1991. Its structure contained three pillars: next to the “communitarian pillar” of the EC, intergovernmental pillars were created for the Common Foreign and Security Policy and a third for cooperation in the fields of justice and home affairs. It also laid the basis for the creation of a common currency, the euro. At that time military cooperation was left to the Western European Union which acted as an intermediate body in between NATO and the EU until its functions were transferred to the EU with the 1997 Treaty of Amsterdam.

NATO took note of these developments in the 1999 version of the strategic concept, adopted during its fiftieth anniversary summit in Washington. It made it possible for the EU to use NATO assets (primarily headquarters and communication facilities) in situations where NATO as a whole would not be engaged. Most of the summit was taken up by the question of further

enlargement (after the initial three of Poland, Czechoslovakia and Hungary) and the crisis in Kosovo.

Subsequently there was little taste for drafting new concepts for fear that they might be too controversial. The terrorist attacks on the United States in 2001 produced a short-lived sense of solidarity and the invocation of Article 5 (even though it was somewhat questionable whether the attack had been “armed” and conducted from abroad), but the formulation of the National Security Strategy of the United States clashed with European notions of multilateralism with the UN Charter as its fundamental framework. Differences widened over the military intervention in Iraq and the American inclusion of “pre-emption” in its strategy. Yet it was clear that the 9/11 attacks and the war in Afghanistan did not fit in the 1999 concept. As a result the communiqués of the bi-annual ministerial meetings took over some of the functions of a strategic concept.

Most notable was the Comprehensive Political Guidance issued at the Riga summit of 2006, which included an important guideline for force planning stating NATO should have:

the ability to conduct and support multinational joint expeditionary operations far from home territory with little or no host nation support and to sustain them for extended periods. This requires forces that are fully deployable, sustainable and interoperable and the means to deploy them.

The Guidance also made a plea for multinational logistic support.

Similarly, the summit at Strasbourg/Kehl in April 2009, celebrating the sixtieth anniversary of NATO, went into detail by stressing the priority of obtaining more helicopters, strategic lift and ground surveillance for the operations in Afghanistan.

The mood changed with the election of President Barack Obama and his renewed emphasis on multilateralism and also with the return of France to the command system. In themselves these positive developments do not guarantee success, but the world has changed so much since 1999 that a new attempt should be made. Moreover, NATO has always benefited from a process of working things out together, even if the outcome was not spectacular. The process was more important than the product.

Strong Points of NATO

In comparison with other international organisation NATO possesses some strong points which are summarised as follows:

- It is a political-military organisation based on consensus, with a long history of defining common positions and joint planning;
- Its treaty contains a collective defence commitment against aggression, albeit with a discretionary element;
- It provides for frequent consultations at all levels, with an active U.S. role;
- Its secretariat plays a key role by chairing all meetings, the Secretary-general being the chairman at ambassadorial, ministerial and summit levels;
- The NATO wide command structure, manned by officers from all participating nations, is able to command a wide range of operations;
- Its standard operating procedures and rules of engagement have had a standardising effect throughout the Alliance and beyond;
- Its NATO Parliamentary Assembly plays a consensus building role among national parliamentarians responsible for defence and security in their national parliaments

The Issues

The member states will have to find a formula which covers both the traditional core function of collective defence and the engagement in Peace Support Operations (PSO) outside their borders. Currently there is a clear difference of perception between the old members of the alliance, who look for a new NATO focusing on PSO, and the new members who, in view of recent history, prefer the old NATO with its overwhelming emphasis on collective defence. A new formula will have to reassure all allies, but also to avoid becoming antagonistic towards third countries, especially Russia. Cooperation with Russia is in the interest of both NATO and the EU for many reasons, ranging from energy supply to crisis management in the Middle East, Iran, Afghanistan and North Korea. Conversely, Russia's western border seems to be the most secure, which nobody wants to change or to trespass

on. The West is prepared to acknowledge that Russia has legitimate interests across its borders, but little work has been done in defining those interests. The only condition the West has consistently put on enhanced cooperation will be the recognition of the right of Russia's neighbours to determine their own destiny. This position is based on the Paris Charter of November 21, 1990, signed by the Organization for Security and Co-operation in Europe (OSCE, then CSCE) countries including the Soviet Union which reads:

With the ending of the division of Europe we will strive for a new quality in our security relations while fully respecting each other's freedom of choice in that respect.

The enlargement debate concerning Ukraine and Georgia has come at an unfortunate time, when Russia seems to be in a nationalistic mood. Currently, it does not seem to be in the interest of stability to push for formal NATO enlargement. Other forms of cooperation with the countries concerned would be preferable.

The same rationale applies to claims for a global role for NATO. Afghanistan has shown that there may be scenarios for operations far beyond our borders and that association of other countries with these activities would be welcome. That does not mean formal links and Article 5 type guarantees with them. In each case an analysis will have to be made whether the NATO label would be helpful to solving the conflict, whether NATO assets could be made available to other organisations, or a "coalition of the willing" should be supported. Partnership for Peace arrangements have constructively provided scope for cooperation with other countries, even some neutral ones.

In itself it is not necessary for all 28 members of the alliance to participate in every operation, but there has to be an overall balance in burden sharing, both in terms of risk sharing, casualties and in financial costs. The current system of "costs lie where they fall," i.e. everybody pays for himself, is not conducive to showing solidarity and should be complemented by a system of joint financing of common costs. The EU possesses such a system in the Athena Mechanism.

The new concept also has to provide a rationale for the delicate subject of nuclear weapons. For the West these weapons no longer have a role in counterbalancing conventional superiority, but only serve as a deterrent to

nuclear use by others. However, in Russia strategic thinking seems to move in the direction of what was called flexible response by NATO during the second half of the Cold War. In any case the arsenals of the nuclear powers could be further reduced.

Finally, the new concept will have to deal with the problem of speedy decision-making. In emphasizing the mobility and flexibility of armed forces, their reaction time is likely to become shorter than the time needed for political decisions. Here NATO has an advantage over the EU to the extent that the North Atlantic Council in Permanent Session already has delegated authority. Yet, member states will often need more time for their parliamentary procedures, especially for participation in peace support operations, so new procedures for early warning and conditional mandates might be required.

The new secretary-general of NATO, Anders Fogh Rasmussen, has started an elaborate programme of consultations, including a series of seminars with experts. A drafting group of twelve personalities will have the first go. If all goes well the process should be completed with the adoption of a new Strategic Concept before the end of 2010. On the EU side the Solana strategy of 2003 had a meagre update in 2008 adding the tasks of prevention and disarmament operations to the Petersberg missions of 1992, which include humanitarian operations, rescue, peacekeeping and peace enforcement. When Baroness Ashton has set led in as the new High Representative cum Vice President of the European Commission as foreseen under the Lisbon Treaty the EU also will have to consider its strategic underpinning. Clearly, it is in the interest of both organisations to harmonise their concepts.

Moment of Truth: Russian Arms Procurement and Great Power Aspirations

Steven Rosefeld

Vladimir Putin has not concealed his intention to restore Russia's military might after the debacle of the Yeltsin Years. His 2002 defense plan envisioned Russia expanding arms production with state of the arts technologies to Soviet levels (territorially adjusted) by 2010. This was to occur in two stages. First priority would be given to research, development, testing and evaluation (RDT&E) to create a full spectrum fifth generation arsenal, and mass weapons production capabilities by 2006.¹ Then it was off to the races, with arms modernization bounding forward full throttle.

Some data suggest that the plan is on track, but the timeline has been stretched. Other authoritative sources portray weapons procurement in disarray. There is insufficient open intelligence to resolve the conflict; however it can be reasonably inferred from the current defense reform debate that the military industrial complex (Voennopromy-Shlennyi Komplex, VPK) is sputtering.²

An audit conducted under the auspices of Defense Minister Sergei Ivanov in 2006, announced at the beginning of 2007 that 40 percent of the defense budget had been stolen, supporting the thesis that the vpk was in disarray. This prompted President Vladimir Putin to replace Ivanov with Anatoly Serdyukov to Minister of Defense (MoD) February 15, 2007,³ who

¹ Steven Rosefeld, *Russia in the 21st Century: The Prodigal Superpower* (Cambridge: Cambridge University Press, 2005), Chapter 6, pp. 86–100; Stephen Blank, "The Political Economy of the Russian Defense Sector," in Jan Leijnhielm and Fredrik Westerlund, eds., *Russian Power Structures* (Stockholm: Swedish Defense Research Agency, 2007), pp. 93–123.

² Steven Rosefeld, "Russian Rearmament: Motives, Options and Prospects," in Leijnhielm and Westerlund, eds., *Russian Power Structures*, pp. 72–96; Vitaly Shlykov, "Military Reform and Its Implications for the Modernisation of the Russian Armed Forces," in Leijnhielm and Westerlund, eds., *Russian Power Structures*, pp. 56–70; Shlykov, "Nazad v budushchee, ili Ekonomicheskie uroki kholodnoi voiny," *Rossia v Global'noe Politike*, 4, No. 2 (2006): 26–40; Roger McDermot, *Russien's Visions*, No. 37, March 2009.

³ Dale Herspring, "Russian Military Reform and Anatoly Serdyukov," *Security*

unlike any of his predecessors, came from the Federal Tax Service instead of the FSB (Federal Security Service), or uniformed military. He moved promptly to formulate and implement a program to reduce waste, fraud and abuse, while simultaneously increasing cost efficiency which is now widely called the Serdyukov military reform.⁴ It included a new process that allows the military to set procurement requirements while civilians assess quality; a plan to reduce the armed forces from 1.13 to 1 million troops, halving the officer corp from 300,000 to 150,000, a restructuring the ranks by moving to an all conscript army, substituting soldiers for officers, replacing divisions with brigades, buying foreign weapons, introducing performance incentives, and augmenting serial weapons production.⁵ The number of officers in the MoD and General Staff will be slashed from 22,000 to 8,500, and ground forces will be reorganized into 172 permanent ready units.

The goal of these drastic measures is the creation of a high-tech strategic nuclear deterrent including weapons based on new physical principles, and an *innovation* army that will allow the Kremlin to fight local wars flexibly with mobile forces capable of utilizing advanced technologies to best effect. According to Vitaly Shlykov, the new military doctrine has a pacific design.⁶ Kremlin leaders, the general staff *genshtab* and the Minister of Defense deny any intention to fight nuclear or major conventional wars with other great powers. World War II scale forces and battle strategies are obsolete and will be discarded because they squander resources and impede construction of mobile troops needed for small regional engagements like Georgia.⁷

Indeed, Russia might only need a skeleton military if Putin were ever to conclude that no-frills deterrence were enough and border threats on the periphery were minor (excluding China and the EU), signaling the death knell of structural militarization.⁸ Where the confluence of demand and supply influences once supported constantly increasing real defense

Studies Program Seminar, November 19, 2008, http://web.mit.edu/ssp/seminars/wed_archives_08fall/herspring.html

⁴ Ibid.

⁵ Ibid.

⁶ Interview, Moscow, March 6, 2009.

⁷ Shlykov considers the Georgia War, August 2008 to have been a military success, but believes performance would have been even better had Serdyukov's reforms been fully implemented.

⁸ Steven Rosefielde, *The Russian Economy: From Lenin to Putin* (Oxford: Blackwell, 2007), pp. 141–44.

expenditure and a correspondingly immense military burden, Serdyukov's reforms appear to herald an era of structural demilitarization and diminishing defense outlays. Insofar as this doctrine is sincere, there are few consequences for failure. Either Russia will have an inefficient, but adequate defense, or an efficient, low cost alternative. Eliminating superfluous missions, waste, fraud and abuse is always best, but failure isn't fatal.

The drama in Russia's military reform only arises to the extent that Kremlin assertions of benign intent are disingenuous; that is, if Putin desires a military that secures Russia's position as a great (super) power capable of projecting force and wielding coercive influence along its frontiers and beyond. Even assuming as Soviet and Russian leaders have always claimed since the era of peaceful coexistence (*mirovoye soshchestvovannie*) that they have no ambitions requiring war with America, the EU, China and Japan,⁹ the aspirations expressed in Putin's great power rhetoric require a larger modernization program than the minimalist approach implies. Seemingly minor interpretative nuances profoundly alter perceptions of Russian defense requirements.

Does Putin desire a high frontier strategic deterrent, or a token capability? Does he want a no-frills brigade system, or one easily transformed for combat with better equipped adversaries? Is he still committed to a self-financing arms procurement program heavily dependent on weapons sales abroad? And if his aspirations are high, is he prepared to dispense with the prevailing arms procurement mechanism?

Putin's aspirations can be divined from available procurement plans and the changing scale of the vpk. These indicators suggest that the Kremlin desires a trim version of Soviet forces complete with strategic nuclear forces, space based combat capabilities, weapons with revolution technologies, advanced C3, large tank armies, aircraft carriers, a modern navy and air force, and high tech arms for mobile brigades.¹⁰ The preponderant share of this procurement is slated for domestic manufacture, requiring an enormous research and development, and industrial effort. If procurement plans were eyewash, this should be telegraphed by a drastic downsizing of the vpk.

⁹ Peaceful coexistence is the Khrushchev era Soviet term for Cold War adversaries respecting each other's territorial sovereignty and interests.

¹⁰ Rosefelde, *Russia in the 21st Century*.

This hasn't occurred, although there has been some sensible organizational consolidation.¹¹ Shlykov maintains however that the preservation of the vpk is a misleading indicator because Putin and Serdyukov have side-stepped it in order to concentrate their f repower on other aspects of reform that will ultimately slenderize the military industrial complex.¹²

He also stressed that there will be no need for large tank armies if the Serdyukov reform succeeds, and that Russia will purchase a wide range of high tech equipment in the international arms market including weapons from Israel, the EU and America.¹³ These policies would not only constitute a major change, but would significantly shrink demand for vpk services. Financial savings from downsizing and competitive international purchase could be prodigious. Serdyukov insists that vpk waste, fraud and abuse is the principal cause of defense cost inefficiency, so bypassing the money pit should be beneficial. The gains may be partly offset by reduced arms sales abroad due to foregone domestic economies of scale and scope,¹⁴ however they won't be crucial if overall spending is sharply slashed. The news in Shlykov's judgment thus is overwhelmingly positive. Serdyukov's reform reflects Dmitry Medvedev's desire to embrace the optimal low war intensity, high efficiency defense posture¹⁵ which Shlykov has consistently advocated since the late 1980s intended to make the Kremlin a partner rather than a predator in the new global order.¹⁶

Suppose however that he is misreading Medvedev; that Putin as he fears is more foe than friend; that the military (including former *genshtab* chief Yuri Baluyevsky), power services and vpk in collusion with oligarchs outmaneuver Serdyukov in the no-holds-barred political wars. Can Russia construct a military that facilitates great power aspirations? The answer is yes, but prospects for success are becoming increasingly murky because of foreign developments beyond the Kremlin's control and a deep reluctance to confront Putin's own flawed vpk paradigm.

China and the mounting global depression pose acute economic challenges to the aspirations reflected in the Kremlin's military plans. Beijing is

¹¹ Rosefeldt, "Russian Rearmament."

¹² Interview, March 6, 2009.

¹³ Interview, March 6, 2009.

¹⁴ Reduction in domestic arms production runs will increase unit cost.

¹⁵ Interview, March 6, 2009

¹⁶ Vitaly Shlykov, *The Crisis in the Russian Economy* (Moscow 1997).

rapidly climbing the high technology ladder, and is constructing a formidable military industrial complex of its own that in the near future will put Central Asian border areas and Russia's lucrative arms markets in jeopardy. China not only will cease being an arms importer of increasingly obsolete Russian weapons, but will displace Moscow as the Third World's main arms supplier.

Until energy prices began plummeting in the Fall 2008, declining arms sales abroad could have been easily financed from the budget. Russia has enough hard currency reserves to deal with the problem, and even expand military outlays for the next two years,¹⁷ but won't be able to do so longer unless energy prices sharply rebound.

Kremlin economists are banking on just such a price recovery in late 2009, driven by an early American business resurgence, and expect additionally that exports will trigger a domestic industrial jolt driven by its recently completed devaluation from 23 to 36 rubles per dollar. Wishes sometimes come true, and the Kremlin could be back in clover, but it would be unwise to bet things this way.

Russia's industrial output has already plummeted 20 percent in February 2009 on a year-on-year basis,¹⁸ assessments of the global depression's virulence and duration worsen daily, and Vladimir Popov has shown that the global petroleum price is more likely to be 20 dollars per barrel than 147 dollars per barrel for the next several years.¹⁹ Kremlin officials in late November 2008 forecast GDP growth in 2009 between 7 and 9 percent.²⁰ Evgeny Gavrilentov, Chief Economist at Troika dialog reduced this to -2.5 percent March 6, 2009,²¹ and Pekka Sutela considers a double digit decline likely over the intermediate term.²² Unless China fares even worse, the

¹⁷ Evgeny Gavrilentov, Chief Economist, Troika Dialog, interview March 6, 2009.

¹⁸ Gavrilentov, interview, March 6, 2009, and Pekka Sutela, Head, Bank of Finland, Division of Economies in Transition, workshop, BOFIT, March 13, 2009.

¹⁹ Vladimir Popov, "Mechanisms of Resource Curse and Economic Policy," paper presented at the 40th Convention of the American Association for the Advancement of Slavic Studies, Philadelphia, PA, November 20, 2008.

²⁰ Shinichiro Tabata, "The Influence of High Oil Prices on the Russian Economy: A Comparison with Saudi Arabia," *Eurasian Geography and Economics*, No. 1, Vol. 50, 2009, pp. 75-92.

²¹ Gavrilentov, interview, March 6, 2009.

²² BOFIT seminar March 13, 2009. Samuel Charap, and Andrew Kuchins, *Economic Whiplash in Russia: An Opportunity to Bolster U.S.-Russia Commercial Ties?* Report of the CSIS Russia and Eurasia Program, February 2009, esp. pp. 4-8.

Kremlin may soon find that it cannot self-finance military modernization with arms exports, and that it lacks the tax proceeds to pay for new weapons itself.

One escape route from this quagmire widely advocated in Moscow today is to kill two birds with one stone using Keynesian deficit spending to finance arms modernization. Instead of building new civilian infrastructure, Moscow could mass produce military hardware, providing jobs to the unemployed with the debt repaid from new value added generated by the multiplier. The suggestion is technically sound, and could work in a competitive military procurement market, if it existed. However, this is the rub.

The vpk Putin designed is anti-competitive without the compensatory virtues of the Soviet command system. In the glory years of Soviet superpower, the weapons procurement mechanism was geared solely to maximizing arms production. Weapons and the capital durables required for mass production were designed outside the factory in special institutes, and managerial bonuses were tied to unit volume. Market demand wasn't a constraint because the state agreed to purchase all weapons supplied.²³

This isn't possible today because Putin's procurement regime delegates decisionmaking authority over all aspects of weapons acquisition including research, development, design and production to rent-seekers within the vpk.²⁴ They determine when new systems are ready for mass production (if ever), and the volumes that are optimal, given their private utility functions. This arrangement provides powerful incentives to fake innovation and divert funds to personal use rather than incur market and government procurement risk. The Kremlin doesn't want more obsolete 1980s equipment, which limits possibilities for mass production, but it hasn't found a way to achieve efficient innovation and serial production within a vpk that anti-competitively excludes rivals. Similar problems beset the western munitions industry, but the magnitude of the disorder in the Russian procurement mechanism is greater.

The Kremlin thus is fast approaching the moment of truth. Wishful thinking served some useful purposes during the first decade of the new millennium, but the disparity between Russia's implicit aspirations and

²³ Rosefeldt, "Russian Rearmament."

²⁴ Rent-granting refers to an anticompetitive tasking mechanism, where leaders assign missions to profit-seeking rent-seekers with no questions asked other than at emptying to get the job done.

capabilities and even between its muddling and basic security needs is climaxing. Putin must either embrace EU type military procurement competition, or revert to the Soviet mass production model. Rent-granting isn't good enough.

The first option is comparable with what appears to be Putin's own great power aspirations and Shlykov's low intensity alternative, but conflicts with Putin's preferred method for building loyal political support.

The second option partially satisfies his aspirations for an awesome military, but runs afoul of quality issues that bedeviled Soviet leaders; and resuscitates the structural militarization Shlykov abhors. Jetisoning vpk rent-granting in favor of the Soviet model is thinkable because the change is compatible with Putin's power vertical. This makes a move back to the future more likely than his choosing free competition and democracy, but there are no signs yet that he is prepared to bite the bullet, even though the costs of temporizing are mounting rapidly. At the end of the day, despite Serdyukov's bold efficiency reforms, the Kremlin seems more apt to shoot itself in the foot than confront the dysfunctionality of vpk rent-granting.

Financial Power: Currency, Crisis and Security

John Rydqvist

Outline of a Forthcoming Study

One important feature in global security has been the increased use of sanctions against actors not conforming to the global system and challenging the global order. States, companies and individuals alike have been targets of sanctions, be it UN or unilateral. Sanctions have been tailored in many different ways, but financial sanctions have been an important part of sanction regimes.

Another feature of international security has been regulation and manipulation to limit financial flows for terrorist use. Proliferation of Weapons of Mass Destruction (WMD) has also been a subject for intense financial scrutiny, especially after the September 11 attacks and the revelations of the H.Q. Khan Network operations, in large parts a money making network in the proliferation business. These two examples of state control and regulation in the financial sector to promote non financial ends are parts of a larger phenomenon that has been called financial statecraft or financial power. It is and will increasingly become a part of the security discourse.

In this forthcoming study, financial statecraft – the use and manipulation of financial instruments to non-economic and specifically security related ends – will be explored. Specifically a subset of the financial market, currency mismatches and currency deficiency in the course of crisis, will be examined. The study will first look at a definition of financial statecraft and present some examples of how financial statecraft has been used. The argument is that the more important the financial sector has become the more active financial statecraft is likely to be contemplated.

Some short reflections on the current crisis and crisis in general will then be made. How currency problems are linked to crisis will be explored. The argument is that for the many countries with weaker and weak currencies any economic crisis is likely to also become a currency crisis seriously affecting the state.

The security implication of currency crisis will then be explored. The argument is that there are several security threats and challenges resulting from currency crisis. Anti-hegemonies, loss of economic sovereignty, internal strife, expanded opportunities for terrorists and proliferators as well as problems in upholding defense spending are among them. The argument will be made that both passive and active financial and currency manipulation is a blunt tool. Outcomes are notoriously difficult to predict and causality hard to establish.

In conclusion it will be argued that as the systemic shock created by the financial crisis reshuffles the global economic order currencies in at least some countries will be severely affected and others put under attack. The general uncertainty inherent in the change brought about by the crisis is in itself destabilising and presents a range of security challenges and threats. These security threats in themselves are likely to require responses also of an economic nature using methods of financial statecraft both active and passive. This can be termed corollary action reaction dynamics in the financial statecraft field.

The crisis, however, also presents tempting opportunities to take initiative and proactively manipulate financial instruments and currency to further enhance one's own security or take actions that are detrimental to the security of others. This is also a function of the wider definition of security used today, in which more and more areas are "securitized." This is a dangerous development and one that may not only be tempting to states but also terrorists, proliferators and other groups that are not only or even primarily driven by economic considerations.

The argument is that the merger of the financial and currency markets with technology, which today provides the foundation for modern financial trade, presents an especially high risk. There are already many examples of state and non-state actors using net based operations for security and political ends. More active use of the financial market, not only web sabotage and overload operations, to attack currencies and induce further economic problems would be a very serious development. Especially as tracking the attacker or perpetrator is notoriously difficult on the web.

A second risk is the wide use of sanctions, in times of non-crisis and crisis without properly evaluating the effect. In this regard Steil and Litan (2006) point out that the distinction between "ability to harm" and "ability

to influence and change behavior” must be made. This however does not mean that sanctions have no effect. They must simply be better explored as a financial instrument of statecraft and tailored to affect behavior, not punish.

The comparatively discrete nature of currency and financial manipulation, you don't see the enemy marching up, is a third risk as the manipulator may judge escalation risk to be less if using economic means rather than military. Such calculation may very well prove wrong.

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