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How will the financial crisis affect EU foreign policy?

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›› With a host of major banking-sector bail-outs having been agreed across Europe, attention is beginning to turn to the broader political impact of the financial crisis. The question arises of whether the crisis will affect the EU's broader foreign policies - and if so, how.

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

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

In this regard, two arguments are advanced here. First, the financial crisis is unlikely to represent a watershed moment for EU foreign policy. It is more likely simply to reinforce a number of trends already in train. Second, it would be wrong for the EU to respond to the crisis by withdrawing into itself and abandoning the cause of liberalism - in either its economic or political dimensions. To suggest that the crisis reflects an excess of political and economic liberalism is misleading and likely to lead to damaging policy responses. The EU has been

HIGHLIGHTS

- The financial crisis will have a significant impact on the EU's foreign policies, but is unlikely to represent an epochal turning point in the way that many predict.
- The EU would be mistaken to react to the crisis by turning in on itself and further diluting its commitment to supporting economic liberalism.
- The crisis may even present an opportunity for the EU to assume a lead role in pressing for better multilateral regulatory structures that are compatible with the promotion of economic liberalism and good governance standards.
- A major shift in the balance of power towards non-democratic states such as Russia and China is by no means guaranteed, and the EU should not react in an overly-defensive manner with regards to its own values of political liberalism.

shifting away from liberal trade and foreign policies for a number of years. The crisis threatens further to tempt European governments away from cosmopolitan internationalism. This might seem an apparently paradoxical conclusion to draw at present, but one that would better safeguard long-term European interests.

LIBERALISM'S FATE

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

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

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

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

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

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

The EU has already done more than its fair share to undermine the Doha Round. It has ended its own moratorium on bilateral trade deals to pursue talks with important Asian economies to the detriment of its supposed commitment to the multilateral trading system. The EU is seen around the world as the worst culprit of intensified 'standards protectionism'. Most EU governments and the Commission have adopted restrictive positions in relation to sovereign wealth funds. A number of member states are now pressing for restrictions on state aid to be relaxed in order to protect European industry from global turmoil and competition. A number of (French- and Italian-driven) proposals are being forwarded to restrict access for non-European capital. For several years now the rhetoric of most EU ministers and commissioners has constantly stressed what there is to fear from globalisation more than the benefits that flow from it.

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

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

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

The EU would be mistaken to react to the crisis by turning in on itself

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

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

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

POWER SHIFTS

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

However, that the crisis will unleash such a fundamental shift in relative power is by no means certain. Few commentators have resisted the temptation to draw parallels with 1929 and its subsequent global after-shocks. But for the current financial crisis to end up triggering serious international conflict the whole framework of collective security put in place since the 1940s would have to unravel. The cushioning effect of international institutions and cosmopolitan civic organisations simply did not exist to the same depth in the 1930s as today.

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

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introversion in promoting a broad set of global liberal values.

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

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

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

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

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

RESOURCE DIVERSION

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

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

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

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

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

RECUPERATION?

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

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

The crisis may even provide a positive service if it convinces the EU that simply declaring ad nausuem that Europe has a wonderfully successfully and progressive model of 'normative power' no longer suffices when events increasingly reveal exactly the opposite to be true - and increasingly require real effort and conviction to be invested in ensuring that liberal foreign policies regain some reality.

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