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Multipolarity, Financial Statecraft, and the Liberal World Order

Since financial power is more dispersed today than at any time since 1945, will states continue to use it for their own ends or will they accept its increased regulation at the global level? According to Saori Katada and Leslie Armijo, an "uneasy truce" will revail between these options.

By Leslie Armijo and Saori Katada for ISN

The most significant shift in the character of international relations in the 20th century was an enormous acceleration in economic growth around the world. The foundation for this growth – and the intertwined economic fortunes it has produced – remains cross-border trade and direct investment. In contrast, global finance has been a secondary factor. Over the past several decades, growth has been fastest in newly industrializing economies, several of which have caught up with the advanced industrial countries in the overall size of their economies if not in terms of per capita income. This means that the 21st century will be a characterized by a return to the kind of multipolarity last seen in 19th century Europe – but on a global scale. The club of powerful nations will eventually include two superpowers, the U.S. and China, alongside a host of major powers including Germany (or possibly a united Western Europe), Japan, Britain, France—and probably Russia, India, and Brazil. This dynamic could also result in a global politics organized around world regions. On the whole, multipolarity will make managing the international system more difficult and the achievement of stability more problematic.

An important feature of these developments is that emerging powers with robust financial capabilities have begun to employ them to achieve their foreign policy and security goals. This is what we call “financial statecraft.” Although it is often assumed that market forces motivate most financial flows, sovereign states in fact regulate and intentionally bias a wide range of international money, credit, investment, and/or currency value dynamics, and derive advantages from doing so. Because Western powers dominated international finance in the post-World War Two era, most analysts of international relations in advanced industrial countries conceptualized financial statecraft narrowly in terms of bilateral financial sanctions applied by these major powers against “rogue states.” This formulation, however, is changing as emerging powers are getting in on the game.

The shield and the sword

One important distinction is between defensive or protective (“shield”) and offensive or assertive (“sword”) financial statecraft. Over the past decade, emerging powers have dramatically improved their financial “shields.” After the financial crises of the 1980s and 1990s, governments of major emerging powers, including the BRICS and other large Asian and Latin American countries, concluded that they needed to protect themselves against external contagion through two types of defensive measures. First—as recommended in the "Washington consensus" reforms promoted by the IMF and World Bank—they spent budget resources and annoyed entrenched domestic interests by introducing greater competition, honesty, transparency, and stability into their domestic banking systems. Second, governments around the Pacific Rim (as well as in Brazil and India) followed "developmentalist" prescriptions to protect themselves by amassing an unprecedented quantity of foreign exchange reserves—thus simultaneously ignoring advice from international financial institutions.

Surprisingly, this pragmatic synthesis worked. In 2008, as the global financial crisis began to spread beyond the U.S., experts were anticipating significantly larger drops in the growth rates of countries such as Brazil, Chile, Indonesia, and South Korea than those expected in the advanced industrial countries of the U.S. and Western Europe. But this did not happen. Instead, in major emerging markets in Asia and Latin America (although not in Eastern Europe) the drop was modest and the recovery more rapid than in the industrial core. Both the neoliberal banking reforms recommended by the Washington consensus and the 'developmentalist' buildups of foreign exchange reserves were key factors in these outcomes.

From mid-2013 onwards, emerging power governments have again feared the consequences of the "taper" of quantitative easing by the U.S. Federal Reserve. The worry is that rising interest rates in the U.S. will encourage liquid capital to flee emerging economies and flow back to the U.S. As anticipated, countries with current account deficits financed by capital inflows have come under pressure. Brazil's central bank, for example, raised interest rates on eight different occasions, and for a total of more than 325 basis points, between April 2013 and February 2014. As of yet, however, major emerging economies have avoided a hard landing. With the exception of those governments—including Venezuela and increasingly Argentina—whose macroeconomic policies have succumbed to economic populism, there is every reason to believe that intelligent and independent financial statecraft are providing an adequate shield against crisis.

Measures taken by governments to protect their economies against future crises have also, rather unexpectedly, led to improved offensive financial capabilities. In terms of assertive, or "sword," financial statecraft, these same large foreign exchange reserves have allowed the larger emerging powers—especially the four original BRICs—a greater voice in international affairs. For instance, all four quickly subscribed, and with some fanfare, to the IMF's first ever international bond issue in 2009. China and the other BRICS have continued to press the West (with their ire now focused largely on the U.S.) to ratify the modest shift in IMF voting rights toward greater representation for developing countries that was painstakingly negotiated back in 2010. China is also experimenting with loans-for-natural-resources and "tied aid" to Latin America and Africa. Brazil's national development bank makes loans enabling its transnational construction firms to build infrastructure throughout South America and the Caribbean. However, Russia may find itself facing traditional financial sanctions as the West explores its options for responding to the occupation of the Crimean Peninsula in the Ukraine.

An uneasy truce?

What do these trends mean for international security? First, a gradual shift in the balance of financial capabilities toward the major rising powers clearly is underway. Eventually—or even in less than twenty years, as Arvind Subramanian predicts—the Renminbi will become a global reserve currency, although Chinese domestic politics tends to delay rather than accelerate this transition. Meanwhile, the future of the Euro appears to be almost entirely dependent on intra-European political decisions.

Second, the expansion of the financial capabilities of a rising power is intrinsically less dangerous than the expansion of its military capabilities. Barring the occasional speculator, no one wants exchange rate volatility, banking explosions, and recessions—even in their national rivals, as countries tend to stand or fall together in their financial fortunes. If the advanced industrial powers had to choose between an authoritarian and historically-aggrieved China increasing either its military capabilities or its financial ones, the choice would be clear. Moreover, rises in a country's financial capabilities may "tame" its appetite for military brinksmanship. For example, China's position as the largest foreign holder of U.S. Treasury debt gives Beijing a clear and present interest in the continuing health of the American economy. Japanese foreign direct investment in China is also large, tying the fortunes of the two economies together.

Third, preemptive and generous incorporation of emerging powers into the processes (such as the large economies' G20) and institutions (such as the IMF) of global economic governance ought to be a high foreign policy priority for the major status quo powers – the U.S., Japan, Germany, Britain, and France. Nor should regional multilateral governance, however messy, be understood as undermining global institutions. Over the past 14 years China's joint management with Japan of a regional monetary swap arrangement in East Asia—the Chiang Mai Initiative—has had highly positive effects, running counter to increasingly hostile rhetoric between the two governments. Since the re-democratization of much of Latin America and the Caribbean in the 1980s, economic and political cooperation within the region has also advanced dramatically. These trends bode well for the future of the liberal world order.

Fourth, the preponderance of global monetary and financial resources still remains with the major advanced democracies. The U.S. is the only country with a global currency. At the height of the recent global financial crisis, in 2009, the U.S. Federal Reserve was able to extend $580 billion in swap lines to fourteen other central banks that it considered to hold systemic importance around the world. No other country can do this. Moreover, U.S. markets and institutions are overwhelmingly dominant in global financial transactions and markets. The Dollar remains the safe haven currency of choice. Meanwhile, Japan, and to a lesser extent Germany, hold enormous stocks of overseas financial assets. They are the creditors to the world. In fact, in almost every measure of international financial capability other than holdings of foreign exchange reserves, China and other emerging economies are still minor players. Foreign exchange reserves may be an influential leading indicator, but they hardly represent the sum of global financial resources and influence.

In short, there is not "more" financial statecraft today than in the past. Rather, international monetary and financial influence is more dispersed than two decades ago. In the early 21st century more countries can or will soon be able to exercise financial statecraft. For the time being, we anticipate an "uneasy truce" in most emerging-market statehouses between an impulse to employ the 'shield' and 'sword' of international financial statecraft to promote foreign policy and security interests and competing incentives and pressures to participate actively and "cooperatively" (a la G. John Ikenberry's "liberal internationalism 3.0") in global financial governance. The medium-term trend toward greater global multipolarity – and therefore more ambitious emerging powers – is clear. Fortunately, Ikenberry seems correct in observing that existing international political and economic institutions—at least in comparative historical perspective—are remarkably open, even-handed, and easy to join. We are therefore cautiously optimistic about the future of both financial statecraft by emerging powers and cooperative global financial governance with the active participation of these same countries.

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