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Seismic Shifts or More of the Same? The Impacts of Global Economic and Financial Crises

In this feature we examine the impact of economic crises on global polititial and economic relations. Will the West fall behind emerging powers as a result of the current 'contained depression?'

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Over the course of this week we have not only tried to chart the evolution of international economic and financial systems , we have also highlighted some of the reforms that are needed to make multilateral institutions and trade regimes more relevant within these system. Indeed, as we lurch from one economic crisis to another, the need for institutions and processes that are ‘fit for purpose’ has arguably never been so great. But what about the actual impact of economic and financial crises, especially at the macroscopic level. Are they mere historical updates of previous cataclysmic events? Do they accelerate, for example, the emergence of new global hegemons and a shift in the economic balance of power?

In their recently published *This Time is Different: Eight Centuries of Financial Folly,* Carmen Reinhart and Kenneth Rogoff respond to the first question quite simply: as far as economic crises go “we have been here before.” Martin Wolf’s talk of a “contained depression” currently debilitating the West may at first blush support this argument, but the more sure-footed recovery by China from this situation prompts him to suggest otherwise. If we are then to believe Wu Xinbo’s *Understanding the Geopolitical Implications of the Global Financial Crisis*, that’s a problem. In his view, the current economic crisis is only accelerating China’s hegemonic political aspirations. But finally, can the West only (and haplessly) stand by in the face of such aspirations? Well, if we are to believe Michael Cox’s revealingly titled *Power Shift and Death of the West? Not Yet!*, it is far too early to write off the dominant economic players of the past. Fair enough, but in order to see if these collected arguments are indeed substantive, let’s explore them a bit further here.

We Have Been Here Before

By relying on historically-based quantitative analysis, Reinhardt and Rogoff conclude that financial crises are much more alike than most of us would like to believe. They argue that the single most important cause of all financial crises is excessive debt accumulation by governments, consumers and businesses. Such an accumulation then erodes creditors’ confidence in their return on investment, which then causes markets to tumble and economies to slow down. So, while it is difficult to predict the exact timing, severity and duration of economic crises, it can be taken for granted that the combination of these two factors – high debt and lost confidence – will eventually cause some type of financial meltdown to occur.

Reinhardt and Rogoff's statistical analysis also demonstrates that there are a number of familiar side-effects that follow virtually every financial crisis. The aftermath of a banking crises, for example, frequently results in a protracted and pronounced contraction of economic activity and significant strains on government resources. On average, government debt rises by 86 per cent in the three years following a banking crisis. A higher fiscal deficit then leads to higher interest rates for government bonds, making it more expensive for governments to maintain their current level of debt. And if this sounds all too familiar, it is because a significant part of the international system is currently trying to cope with the fallout of two consecutive financial crises in a row.

Life in a Contained Depression

Indeed, the fallout of the most recent global recession continues to negatively impact the economies of the United States and European Union. The public debts of both the United States and Spain, for example, more than doubled between 2007 and 2011. Credit spreads (the rates governments pay to finance their debts) also exploded, thereby severely damaging investors' confidence in their ability to re-finance massive debt burdens. In a recent LSE lecture (see second tab), Martin Wolf characterized this state of affairs as living in a "contained depression" – a depression where economies are fending off a 1930s-style depression only because of massive bailouts and austere monetary policies. In keeping with Reinhardt and Rogoff's analysis, Wolf also argues that the "extraordinary" accumulation of debt is the root cause of the most recent financial and economic crises. However, in contrast to them, Wolf also paints a much gloomier economic outlook. According to him, we are nowhere near being through with the current economic crisis and the "contained depression" that engulfs us is likely to remain in place for the foreseeable future, as will high unemployment and the sluggish growth of Western Gross Domestic Products.

Meanwhile, the economic growth of emerging powers continues to expand at a relentless pace, as the following interactive graph shows. China continues to lead the way, with its economy increasing by a staggering 60 per cent over the last five years. Accordingly, it remains on schedule to overtake the United States in terms of GDP before 2020. In sharp contrast, none of the G7 economies (with the exception of Canada) have GDPs above pre-crisis levels. Yet, even before the most recent economic crisis it was widely assumed that the BRICs and other developing economies would reshape the global financial and economic landscape in the decades ahead. What is now different, argues Wolf, is that the most recent global recession has provided new impetus to this shift in economic hegemony. In other words, this change is now happening much faster than most analysts had thought it would just a few years ago.

Throughout the global economic crisis, GDP growth has been slow in Western countries. Meanwhile, China's economy continued to expand despite the global economic downturn (vertical axis: GDP growth rates in percentage terms).

Data from World Bank

The Fall of the West?

Further accelerating the shift in economic power, according to Wu Xinbo, have been the US-led invasions of Iraq and Afghanistan. Not only have these excursions demonstrated the limits of U.S. military power, the more-or-less concurrent financial crisis has revealed the fragility of the American economy. Consequently, “the two pillars of U.S. power – military and economic – have been shattered in the past decade.” And with free-market capitalism in crisis, not only may the U.S. dollar soon lose its status as the global reserve currency, the Western model of capitalism continues to lose its attractiveness among developing economies. As a result, the West has lost influence on the international stage. The relevance of the G8, for example, looks increasingly questionable with the emergence of the G20, which better reflects the importance of up-and-coming economies to the international system as a whole.

The sharp economic decline of the West has also allowed China to accelerate its geopolitical leverage. First, the Chinese model of economic growth, marked by its state-controlled economy, has become more attractive to developing countries than the Western approaches tarnished by their own excesses. Second, and as a result of boosted domestic consumption, China will soon be able to de-couple its market from the West, which will further “serve both to thicken China’s economic ties with regional partners and to strengthen its role as an East Asian economic hub.” Indeed, the above chart suggests that this might already be happening, and thereby adding substance to Wu Xinbo’s proclamation that in “international politics, political and economic relations always follow each other.” If so, then the ‘inevitability’ that China and the emerging economies will soon be calling the international economic shots will be with us sooner rather than later.

Or Not Yet?

Michael Cox is one observer who does not buy into the inevitability of China’s economic dominance and a parallel decline in Western influence. True, Cox acknowledges in his *Power Shift and the Death of the West? Not Yet!* that the pace of China’s economic development is shifting the international economic center of gravity eastwards. Such a shift, however, will not necessarily result in the West being pushed to the margins of the international system.

Cox rests this argument on three pillars. First, he thinks that too many analysts have wrongly conflated economic primacy with the ability to apply either hard or soft power. China still lags behind in both arenas and it is not clear just how it might catch up. To partially demonstrate this point, Cox reminds us that the United States and European Union continue to account for over 70 per cent of the world’s military spending. The US’s ‘unipolar moment’ may be over, but it remains the only ‘serious superpower’ operating in the international system for the foreseeable future.

Cox’s second argument is that the West continues to possess many more capabilities and assets than some are willing to concede. While China and other emerging economies are indeed catching up in terms of economic output, they still have a long way to go before they surpass the West in other key economic indicators. These include attractiveness to immigrants, long-term political stability, and the dollar’s status as the global reserve currency, to name but a few. In this respect, it is also important to note that while China may eventually surpass the US in aggregate GDP terms, its per capita GDP is still only a tenth of that of the United States.

Finally, Cox argues that while it would be foolish to underestimate China’s growing economic strength, it is nevertheless important to consider how its rise may be impacting the geopolitical calculations of its immediate neighbors. While China may be able to boast an expanding economy, an extensive list of trading partners and a permanent seat on the United Nations Security Council, it has few *bona fide* allies. And despite their improved ties with Beijing, many Asian countries, as well as regional organizations such as ASEAN, remain suspicious of its intentions. Consequently, not only will they encourage the United States to maintain a robust presence within the Asia Pacific region, they will most likely support its sustained international influence as well.

Underpinning all these arguments, by the way, is Cox's observation that the view from Beijing is actually quite different from that of many Western commentators. Indeed, many influential voices continue to emphasize that China remains a relatively backward country with a host of social and economic problems that will take years to address. This in turn helps to explain why China continues to show little appetite for taking on the type of global leadership it is eventually expected to assume.

So what are we to conclude here? Well, just as the future structure of the entire international system remains unpredictable, the same can very much be said of the economic landscape. True, the West's continuing economic woes are contributing to a shift in economic influence eastwards, but there is no automatic guarantee that hard and soft power will follow in its wake. This may provide the United States (and the West in general) with the time needed to recover from the most recent waves of economic crisis and remain an influential (if not dominant) actor throughout the international system. In other words, recent seismic financial and economic shocks may not necessarily result in seismic political change in the international system.

Editor's note:

For more content on the past, present and future of the international economic and financial system, please see our dossier on the topic.

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