

The Impact of the Economic Crisis on the International Strategic Configuration

Klas Marklund

CONFERENCE REPORT
December 2009



Institute for Security &
Development Policy

The Impact of the Economic Crisis on the International Strategic Configuration

Klas Marklund

Institute for Security and Development Policy
Västra Finnbodavägen 2, 131 30 Stockholm-Nacka, Sweden
www.isdp.eu

The Impact of the Economic Crisis on the International Strategic Configuration is a Conference Report published by the Institute for Security and Development Policy's Asia Program. The Institute is based in Stockholm, Sweden, and cooperates closely with research centers worldwide. Through its Silk Road Studies Program, the Institute runs a joint Transatlantic Research and Policy Center with the Central Asia-Caucasus Institute of Johns Hopkins University's School of Advanced International Studies. The Institute is firmly established as a leading research and policy center, serving a large and diverse community of analysts, scholars, policy-watchers, business leaders, and journalists. It is at the forefront of research on issues of conflict, security, and development. Through its applied research, publications, research cooperation, public lectures, and seminars, it functions as a focal point for academic, policy, and public discussion. This publication is kindly made possible by support from the Swedish Ministry for Foreign Affairs and the PLA Academy of Military Sciences. The opinions and conclusions expressed do not necessarily reflect the views of the Institute for Security and Development Policy or its sponsors.

© Institute for Security and Development Policy, 2009

ISBN: 978-91-85937-73-8

Printed in Singapore

Distributed in Europe by:

Institute for Security and Development Policy
Västra Finnbodavägen 2, 131 30 Stockholm-Nacka, Sweden
Tel. +46-841056953; Fax. +46-86403370
Email: info@isd.eu

Distributed in North America by:

The Central Asia-Caucasus Institute
Paul H. Nitze School of Advanced International Studies
1619 Massachusetts Ave. NW, Washington, D.C. 20036
Tel. +1-202-663-7723; Fax. +1-202-663-7785
E-mail: caci2@jhuadig.admin.jhu.edu

Editorial correspondence should be addressed to Dr. Bert Edström at: bedstrom@isd.eu

Contents

- Executive Summary5**
- The Impact of the Economic Crisis on the International Strategic Configuration6**
 - Security Threats8
 - China10
 - China’s Military12
 - Europe12
 - The United States.....13
 - Sino-U.S. Relations14
 - Russia14
 - Russia and the Economic Crisis15
 - Geo-political Aspects of Russian Development.....16

Executive Summary

During the conference on the Impact of the Economic Crisis on the International Strategic Configuration that took place in Beijing, July 15–16, 2009, a number of topics were presented and discussed. Participants mainly focused on the influence of the financial crisis and its impact on the world economy, such as the downsizing of the financial economy, the challenges to the monetary system, the changes in economic development patterns, as well as the implications for international security issues. The security issues brought to the fore included traditional as well as non-traditional issues. A particular issue in focus was the increase in securitized areas.

The economic crisis has not changed power politics. The United States is still the sole superpower, but China's influence has partly increased and the Sino-U.S. relations have improved during the crisis. Developments in Russia were also brought up with a particular focus on the economy as well as security issues and energy policy. Attention was also paid to the role that the EU plays both in the crisis and in the seemingly more multi-polar world.

The Impact of the Economic Crisis on the International Strategic Configuration

The conference on the Impact of the Economic Crisis on the International Strategic Configuration took place in Beijing, on July 15–16, 2009. The implications of the ongoing economic crisis were in focus for the discussion. One participant argued that the current global economic crisis was more severe in comparison with the crisis that began in 1929 and was going to affect all parts of society. Emphasizing the seriousness of the crisis, worries were aired that the sheer magnitude of the crisis could develop into a social, as well as a political crisis. Nevertheless, despite the severity of the crisis that was generally acknowledged, it was also described as a mezo-depression, that is, a medium severe economic downturn in-between two larger depressions.

The reasons for the unfolding of the crisis were seen to be overconsumption and inadequate regulation of financial markets, but it was also recognized that there is no academic consensus on the causes of the crisis. Rather, it was agreed that bold statements and descriptions of the economic state of the world should be treated with caution.

It was also argued that the economic crisis could make the United States move towards nationalization and increased state control over the economy. At the same time, it was mentioned that, on a global scale, the crisis could increase multilateralism in the international community and make cooperation prevail over conflict. The crisis was seen to have highlighted the vulnerability of the national economies in a globalized world, resulting in economic issues being given a higher priority in matters of national security.

The implications for a redefinition of the security paradigm of the amassing of China's currency reserves surfaced during the discussion, and it was pointed out that China could use its economy as a potential "weapon" against the economies of the United States, Russia, Europe and, even more so, smaller states. Such behavior would be discouraged, since a reasonable scenario is that China would face an Economic Mutually Assured Destruction. The use of such a weapon by China would trigger a massive economic retaliation, and severely reduce its reputation and trust that it now enjoys. Since China is highly dependent on other countries and amicable relations

with them, such a development could only be devastating to the Chinese economy. Nevertheless, some argued that the crisis would not have an excessive impact on international politics, for the simple reason that it is unlikely that the economic crisis would lead to a war between major powers.

G-2 has become a buzzword. This term refers to the United States and China. While it can be compared with configurations like G-20 and G-8, it is problematic to make a comparison between bilateral relations and multilateral arrangements. According to many observers, the announcement of the establishment of the U.S.–China Strategic and Economic Dialogue (S&ED) on April 1, 2009 increased the importance of the Sino-U.S. relations as the main component for ending the global economic crisis. To be able to discuss the term G-2 one must not only understand its meaning but also the framework within which it is used. It is imperative to understand the nature of G-2 since the term can be seen to refer to a general model for two major powers or as referring to Sino-U.S. relations during a certain period of time.

Attention was paid to the nature of G-2 and the question whether this concept is relevant outside of the academic discourse. One view was that both the United States and China needs Europe as an economic partner, and that the discussion cannot be restricted to merely the G-2 perspective, even though Europe plays a weak role in many cases, or is even lacking the institutions necessary to take on a leading roll. Some saw the G-2 as nothing more than an academic invention, where China represented savings and the United States represented the West. In addition to this, it was pointed out that even though the concept G-2 is far from perfect, it is viewed by some as a preferable order in comparison to a more multi-polar world. It was argued that the crisis has brought the United States and China closer to each other, since the world economic system has never liked multi-polarity. One perspective brought up illustrated the idea that the G-2 was not a description of Sino-U.S. relations, but rather a model of the relation between a rising power and a status-quo superpower. It was argued that there is a danger in using terminology in International Relations (IR), which is defined by someone else; new labels should not be put on what already exists. In this respect it should be acknowledged that Sino-U.S. relations do not need a new label such as G-2. However, it was also argued that, from a U.S. perspective, the launching of a concept like G-2 is the direct consequence of the crisis, since the United States needs a partner that is willing to respond to the global

crisis. The idea was forwarded that actors who do not act will become insignificant in a crisis situation and that the United States needs a partner and that China is willing to act, which makes the concept of G-2 become a reality.

Another point that was made claimed that China, among other emerging powers like Brazil and India, has become a focus for U.S. policymakers and for the process by which the United States is alleviating, as well as recovering, from the crisis. China retains this position due to its response to the crisis. It was argued that the Chinese government was helping to halt the global economic decline by increased public spending and by refraining from taking short-sighted unilateral measures, which made it position itself as the only partner for the United States in a G-2 constellation.

Yet, it was also argued that the idea of G-2 builds on two misconceptions. First, the strong interdependence between the United States and China is only partial, especially in the economic sphere. Secondly, the U.S. economy and defense expenditure is considerably larger than China's, resulting in a power gap between the two countries. However, the crisis has created an image of China as a country with strong economic growth and one which is starting to replace the declining United States.

Security Threats

The security implication of the current crisis was described as a potential cause or enhancer to several security challenges, which not only opens up the possibility of decreased defense expenditures, but also results in threats to economic sovereignty, increased domestic instability and the rousing of terrorist activity. Moreover, political implications of the economic crisis are the growth of poverty and income inequality. This can increase the risk for turmoil and threaten the stability of countries with weak political and social institutions, especially in developing countries with authoritarian regimes. In the discussion it was also brought up that the economic crisis would lead to social effects, which can spur religious violence and ethno-nationalist violence in different parts of Asia.

One view that was aired claimed that the best path to a swift normalization of economic growth in the global context was to reduce the security threats that the crisis has resulted in. Although there might appear to be no major dangers of normalization in the developed world, developing nations are in a precarious situation, where a failure to recover will have far-reaching

consequences. Economic support of developing countries should focus on poverty reduction and national security, since they are essential for bringing back and enhancing foreign direct investment, as well as for trade relations. To further facilitate the economic recovery in the third world, the elimination of trade barriers will often have a larger impact than that of aid. An additional factor behind a positive development that was observed was that the crisis could have a sizable impact on developments in developing countries, not only directly on the economy, but also through the declining willingness of European states and the United States to support UN missions in conflict areas, due to decreasing defense budgets.

A part of the discussion also focused on the subject of financial statecraft.¹ While the crisis results in destabilization, which increases the impact of security threats, the response to these threats – as well as the increasing numbers of areas becoming securitized – requires growing attention of financial statecraft. Actions to address security threats, active as well as passive, will affect the economy. Depending on the scope and size of the measures taken, they could have far-reaching implications, while confirming the order of cause and effect could prove difficult. Hence, the outcome is hard to predict in most cases, for passive as well as for active financial measures, such as currency manipulation. It was suggested that financial statecraft will not only be difficult to pursue, but that it will also be hard to come up with efficient measures, since it can comprise a broad spectrum of activities, such as quotes on oil output by OPEC members. One participant cautioned about the use of terms passive and active financial statecraft, since there is no freedom to act; not to act is also to act.

It was observed that the influence of the crisis on military affairs is potentially a security issue. Tightened military spending means a decrease in equipment, as well as in research and development funding, and slackening the pace of military reforms and transformation, can all foster instability.

Different points of view on defense spending in the light of the economic crisis were also presented. The lack of money would lead to decreased spending, but could result in increased spending as well. One possible

¹ Financial statecraft implies a use of financial market institutions, instruments, and practices in the service of foreign policy. See Benn Steil and Robert E. Litan, *Financial Statecraft: The Role of Financial Markets in American Foreign Policy*, New Haven: Yale University Press, 2006.

reason for this increased security spending could be due to the effects that the crisis is having on developing countries that could, or are, experiencing increased instability. A contrasting perspective on defense spending and financial means was also presented – the pursuit of nuclear programs in countries such as North Korea (DPRK) will always be funded despite the poverty of the country. Since DPRK is not pursuing economic ends with nuclear means, it should not be viewed as an economic issue.

China

China as an emerging power was discussed. Contributing to the Chinese development are factors like foreign relations that are peaceful and stable, which have made it possible for the country to focus on internal security and stability. Another factor is the IT revolution which has resulted in the development of a service economy as well as enhanced technological development. Furthermore, the trend towards multi-polarization has increased China's global impact. It was anticipated that policy changes in China, due to the economic crisis, will result in more noticeable currents of isolationism.

The developments of the Chinese economy was seen the result of a number of processes. One of them is the transformation of the Chinese foreign policy from embracing socialist revolution and anti-imperialism to relying on concepts such as a harmonious world. The process of changing the strategic orientation from a threat-based assessment towards a strategy of capability orientation and adaptation was also mentioned. Peace, development, harmony, mutual benefit and cooperation were described as the guiding principle for the pursuit of China's policy. Despite the fact that expectations are growing on China to act on security issues on the Korean peninsula and its increased willingness to involve itself in multilateral engagements, it is likely that China will continue its present security and foreign policy course, including pursuing a low profile policy and taking modest positions, with a few exceptions, like the Shanghai Cooperation Organization. It is not likely that this pursuit will change as a result of the financial crisis. Although it was pointed out that China would stick to soft power in its foreign policy, it was also suggested that there is no such thing as hard or soft power, only the ability to persuade others.

One aspect of the financial crisis that was brought up was the level of influence on the security sector that the emerging economies and new

strategic constellations will have in the future. Of particular interest to participants were the possible alternatives to U.S. dominance in certain security areas. It was claimed that the financial crisis has hit China hard. For 2009, the IMF has estimated that China's economic growth was 6.7 percent, which can be compared with the GDP growth of 9 percent in 2008 and 13 percent in 2007.²

It was argued that China has responded to the crisis by decreasing its export and favoring a development of its domestic market. In its relations with resource-rich developing economies, China has increased its import while export has been sustained through a diversification of export products. This can lead to increased Chinese influence on emerging economies since the trade of Western countries with them has declined. It was pointed out that while this influence can be positive on the governmental level, its impact on the grassroots level must also be taken into account. An increase in the Chinese market share of the emerging markets can result in resentment among local traders and producers, who are facing harder competition. Although a shrinking economy will have consequences for China's security and foreign policy, its relations with developing economies have not changed despite the financial crisis. Moreover, technology transfer to China is the result of its thriving export-oriented industries and outsourcing from technologically more advanced countries. Hence, it will be complicated for China to switch from an export-driven to a domestic market-driven economic growth, and that it would not be easy to create economic growth by stimulating the domestic market. A note of caution was added during the discussion, claiming that official figures for the Chinese growth might be exaggerated.

The demographic situation was also brought up. To promote economic development, the one-child policy had been eased in underdeveloped parts of China in order to meet the future's demand for cheap labor force. There is a great diversity in economic development between different parts of the country, but China will be able to handle the problems of an ageing population in more developed areas by an influx of young people from less developed areas.

It was argued that economic instability will invoke changes in China's security policy, such as an increased engagement in multilateralism. The

² Economist Intelligence Unit, *Country Report: China*, May 2009.

economic flux will increase China's willingness to engage in multilateral arrangements and take part in efforts to manage security issues such as the environment, terrorism and economic instability, as long as China's sovereignty is not jeopardized.

China's Military

It was anticipated that the Chinese military development will make China a strong regional power along with Japan and India. However, the outlook for Chinese involvement in military expeditions or interventions is not bright, since they could have a negative impact on its economic development. It was claimed that this is a valid assertion unless Chinese vital interests are threatened. China will increase its international presence but is seeking harmony and is keen to avoid becoming a "bully." On this matter it was suggested that strength brings peace and peace is backed by strength.

In terms of military strength, China is unlikely to become militarily dominant in the region in the near future, since it will take the country 47 years to reach the level of U.S. military spending. It also has to be taken into account that economic development is vital for China's capacity to modernize its armed forces, which makes economic development a priority over military expansion. However, it was also claimed that to properly tackle the effects of the global economic crisis, investments in the military are needed in order to boost both the economy and facilitate recovery, as well as benefit the national security. Consequently, large-scale cutting of military expenditures should not be implemented, since they are a financial aid to Chinese economy and security. In the case of China, military spending should be viewed as a multi-stabilizing factor.

Europe

It was argued that the global economic crisis will bring about public support for the strengthening of the European Union (EU), which would constitute an opportunity for accelerated institution-building. However, there is an inability of several leading countries within the EU to seize the moment; the internal competition creates more rivalry than cooperation. Moreover, for the United Kingdom and France, the crisis has influenced their military capacity and future prospects by weakening the financial situation for the

armed forces. As a result, the economic crisis has harmed the Europeans, individually and as a union, both on traditional and non-traditional security issues. A possible response to rectify this situation would be for Europe to implement changes through a decrease of military budgets along with changes in NATO's agenda.

Both the EU and the United States will see a reduction in the tax-financed part of the economy as well as an increase in public spending on welfare.

The possibility to save by cutting defence spending will cause problems, since numerous arms contracts are long term and cannot be instantly altered, for obvious reasons. In addition, the methods for deflecting a financial deficit in state finances – such as increased taxes – in a time of crisis were discussed.

The fact that Europe is dependent on gas from former Soviet areas, in many cases controlled by Russia, should not result in the EU feeling threatened or scared of a GASPEC,³ since it would be an organization that is dependent to a large extent on the European market. Nevertheless, the EU should be aware of the risk that Europe might become dependent on gas controlled by Russia, which should make it develop relations with gas producers in North Africa and other regions, in order to avoid what one participant called “black mailing scenarios.”

It was also alleged that Europe's main problem is the lack of coherence among the EU members, which makes it problematic for the EU to compete or act as a global leader. In a scenario with the United States declining as an economic center, it was said, that the Euro is to be the only alternative to the U.S. dollar, as a world currency.

The United States

A discussion of the United States as a hegemony in need of reforms was then initiated. Instead of clinging to the role of being a dominating power, the United States should look upon itself as the first among equals. The need for lower goals and profile on the part of the United States was pointed out. Even though some concern surfaced regarding the U.S. as a declining superpower, few were ready to subscribe to this view. It was argued that,

³ GASPEC should be understood as organization for gas producers equivalent to OPEC.

the strength of the U.S. military in the short term is not influenced by the economic crisis but it will certainly be affected if a severe decline occurs in the U.S. economy. However, in a scenario where the U.S. economy goes into prolonged stagnation, other economies – like China – will also be affected due to the large U.S. share of the world economy.

In the exchange of views, attention was brought to the current instability of the U.S. economy that is detrimental to social stability; while, at the same time, political stability is taken as a given. Economic instability has allowed faster growth through creative destruction. Concern was voiced over the current approach where troubled firms in the United States are bailed out, since it will hamper its economy in a longer-term perspective.

Sino-U.S. Relations

It was pointed out that the dynamics of Sino-U.S. relations in general – and the security aspect in particular – are affected by economic fluctuations, as well as the fact that the economies of the two countries are intertwined. Questions have been raised asking whether China needs to diversify away from its foreign demand-driven economy to a domestic demand-driven economy. It leads to a discussion of the possibility that a reduction in U.S. consumption levels would result in a new crisis. With less demand for its export, will China be able to increase its domestic consumption to make up for the lost market in the U.S? It was argued that the Sino-U.S. relations will be influenced by a number of factors such as the quality of military strategy to meet threats and to reform, the quality of civilian leaders, demographics, as well as the ability to learn from history. These are factors which all will determine the development of economic and military capacity of the two countries. Furthermore, both share some optimistic views but perceptions do not reflect current reality and perceptions have a tendency to dominate over reality in policy formation; that is, if a country is perceived as getting weaker, it will be treated as weak.

Russia

The developments in Russia were also in focus during the conference. It was argued that Russia is trying to regain the strength of the Soviet Union and gain influence in former Soviet areas. To reinstall its former power and

influence, the development of fifth-generation military capacity is an imperative step for Russia. However, it is important to take into consideration the back-drop of the end of the Cold War, the dissolution of the Soviet Union, the developments in the energy sector and conflicts among former Soviet states in front of which future events will unfold.

Yet, the attempts to modernize and rebuild the Russian military capacity have not been a complete success, due to the economic system, including “rent seeking” and cronyism. Still, as far as the model of rent seeking and the Russian claims, it was cautioned that the official statistics and figures should be approached with some skepticism. The struggle for economic favors and lucrative positions within the security sector has delayed important defense projects. Nonetheless, with an arsenal dominated by products from the 1980s and with its nuclear capability, Russia can project power. It was suggested that the economic crisis could create a political climate that would usher Russia back to a Soviet-style power projection, especially if it would lose the “energy weapon.”

It was pointed out that if the crisis will be of short duration, the future Russian scenarios could be very different. It was also claimed that a renationalization of the Military Industrial Complex (MIC) in Russia was certain, and argued that it is necessary to keep in mind that the abundance of cheap resources that will allow openings for financing the procurement of high-tech weapons. In relation to energy and military developments, it was argued that the amount of resources available for military development is decided in competition with the program for developing the energy sector. The view was forwarded that Russian planning contained a lot of wishful thinking and that, ultimately, Russia will have to choose between developing the military or the energy sector, since it does not have the capacity to pursue all projects.

Russia and the Economic Crisis

Like the rest of the world that has experienced the consequences of the current economic crisis, it has also been felt in Russia, but it was pointed out that the country underwent a much more severe crisis when the Soviet Union collapsed. The present crisis should be viewed from this perspective. During the discussion, questions were raised asking if the influence of Russia is larger than had been expected and if Russia has been able to use the crisis

to rebuild its capacity? One response was that if the crisis will last longer than expected, Russia will be hard hit since the price of natural resources will fall. Responding to such a scenario, the Kremlin could attempt to boost the Russian economy by Keynesian methods, such as transferring state-controlled economic means to the Military Industrial Complex (MIC) in order to stimulate the economy. Moreover, Russian society would face two possible outcomes in an economic crisis; most probable would be an attempted continuation of the development towards a self-empowered, Soviet-style superpower. Another option would be to move towards a Western-style democracy and a more open market economy, although signs of the latter are still not seen. The possibility for Russia to develop into a Soviet-style state is an option often overlooked in Europe and the United States.

Even though there is a great deal of uncertainty regarding the size of the Russian military, one participant observed that the Russian MIC is getting smaller, although still intact. Arguments were also heard regarding the fact that Russia is currently developing the full range of fifth-generation weapons systems, although the arms buildup and modernization of the Russian military is progressing at a slow pace. The reasons behind the unsuccessful modernization were said to be the corrupted economic structures and a disorganized weapons developing sector. Additional factors suggested, as an explanation for the current state of Russian military modernization, were system flaws such as corruption and theft. Consequently, it was concluded that the obstacles the Russians are facing are severe and it was argued that, in the light of recent events, increases in Russian military spending are not likely in the near future. It was also suggested that the Russian MIC would have to choose between two directions of its future development. One option is a large-scale privatization in order to increase efficiency; the second is a return to Soviet-style production with a state controlled MIC. In the latter case, the state would guarantee the purchase of all produced weapons, whether they are needed or not.

Geo-political Aspects of Russian Development

With regard to Russian geopolitics it was suggested that Russia's desire to regain superpower status was logical and represents the most coherent security agenda. It was also reiterated in the discussion that Russia's will to revive the former *de facto* Soviet status, with a reinstalled sphere of

influence, and a rearranging of the former Soviet republics into a unified state, is a logical beginning to this pursuit. This ambition is not without problems, since Russia is located between the United States, Europe, and China, and will also face competition in some areas such as in Central Asia, where China has large interests. It was argued that Russia has a clear strategy to become a superpower, and energy constitutes a major part of the power projections of this strategy. Pipelines are of great importance. Russia's dominance in some part of the energy sector could allow the country to create a GASPEC of its own. This will allow Russia to control a large part of the gas in the world through its influence in other gas-producing countries and its control over pipelines. In addition, Russia's security policy has developed out of a culture of complex security. This makes it suitable for the post-Cold War and multi-polar world. It was pointed out that even though some expect too much of Russia's future development and potential, the optimistic outlook for its future is not too far-fetched. It was argued that Russia's infrastructure is old, its financial infrastructure undeveloped, that its education is in a poor state, and its energy reserves, which are supposed to finance the developments, are too small. Yet, since oil and gas is a strategic commodity, manipulation of oil or gas prices could be part of the strategic national security configuration of a country. However, the strategic importance of gas could also increase in the future as a result of climate change and a decline in oil consumption, which would further enhance the strategic importance of Russian-controlled gas reserves.

As far as Russia's dependence of energy is concerned, the country is vulnerable to decreased world demand in oil and gas. The pricing monopoly on pipelines and nationalization of production in the energy sector is also one concern in the development of Russian economic and foreign policies. It was argued that efforts should be made to encourage Russia to join the World Trade Organization (WTO). This would mean that trade relations with Russia would be regulated by the rules of the WTO instead of day-to-day politics as it is at present. As long as Russia has not joined the WTO, trade has to be pursued on a deal-to-deal basis. Despite the problems that this arrangement causes all parties, Russia still does not want to join the trade organization. The problems that will occur if actors on the large Russian market do not want to "play along" have implications for the building of amicable relations with other countries.