

# Implications of the Current Crisis

## A Post-Summit Examination

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October 21, 2008 – The current financial crisis will undoubtedly have significant implications for the US and the EU at both the state and the collective level.

Due to the concerted action of central bankers and politicians over the past 10 days, there appears a chance the immediate signs of the crisis – liquidity and credit – will abate. Nonetheless, the markets are still extremely unstable, and the dangers of a global recession remain very evident. The conclusions of the EU Summit (15-16 October) clearly reflect these trends, in sentiment as much as words.

Beyond these immediate developments, the true implications of the situation will take much longer to unfold. The end result may well be shifts in political power and resources, within the EU and the US, and across the globe. The aim of this paper is to look deeper into the future geo-political implications of the current financial crisis.

### **An International Political Crisis**

The spread of the financial crises has not been confined to the Transatlantic world: across states and continents the same symptoms have been noted, from Australia to Dubai, from Tokyo to Moscow, from Malaysia to Brazil. Conventional wisdom initially attributed this to the power of the US, along the lines of “when the US sneezes, the rest of the world catches a cold.” This may have once been the case, but the basic truth now is somewhat different: in a globalised world everything is linked. Geography no longer has the same, if any, meaning – in money, or politics. A person can be on holiday in the Caribbean and legally shift money between accounts in Germany and France by simply entering a password on a website. The stocks of a Swiss bank can be traded in London, Hong Kong or Shanghai; a US bank can sell securitised loans into the German, Japanese or Australian markets; a Dutch-Belgian bank can buy part of a Dutch-British bank as part of a multinational consortium.

The flip-side of this technological evolution is that traditional modes of governance and regulation, based in a state, no longer apply. Put another way: a globalised world is demanding globalised governance, and that is a long way off. Politicians across the globe have struggled to come together over the crises in a meaningful way until far too late: on each occasion the financial situation had already begun to unfold before any form of significant coordination began to be apparent. As a result, their actions often contributed to the economic crisis, and deepened the political one. It remains to be seen whether the more concerted actions of this past weekend will go in the same

direction – or else offer something of a framework for greater stability that could in turn indicate a more positive long term outcome.

At the EU Summit late last week, a call was put out for a “Bretton Woods II” i.e. an international meeting to redefine the rules of the post World War II financial system, established in the first Bretton Woods meeting. In the official conclusions, this was formulated as:

“The European Union must work with its international partners on a genuine, all-encompassing reform of the international financial system based on the principles of transparency, sound banking, responsibility, integrity and world governance. The aim is to take early decisions on transparency, global standards of regulation, cross-border supervision and crisis management, to avoid conflicts of interest and to create an early warning system, so as to engender confidence among savers and investors in every country. The Union will quickly take appropriate initiatives in consultation with its main partners and the relevant international financial institutions. These initiatives will be carefully prepared within the EU.”

Such a move appears closer after President George W Bush invited world leaders to gather in the US by the end of the year to discuss reform of the global financial system. The summit would be the first of a series although the agenda remains unclear. However, it remains to be seen whether such steps will suffice to truly re-establish calm and equilibrium in the international arena, and especially the western world.

### **Broad Areas of Impact**

At this stage it is not possible to understand the impact on every corner of the globe, but the following offers brief summaries of the main areas:

**Global:** It is far too soon to tell how this spread of crises will impact across the world or the modes of operation in a globalised world. However, it is possible to state with some assurance that there will be changes to international banking rules. Equally, there is every possibility that due to the size of the US debt, and the significant holdings of sovereign wealth funds from China and other cash rich states in the US, global interdependence will at least remain stable if not actively increase.

To this extent there will be an active interest in cooperation on specific rules, but it is doubtful whether global political will can be found to fundamentally change the international financial system.

As such, in the short term it is not apparent that all wealth and power will immediately shift out of the US or the west. In the medium or longer term, however, there is a strong possibility of a shift of some sort occurring.

**The US:** Whilst the current administration seems to have finally begun to address the economic situation more systematically, it is clear the combination of crises will only begin to be resolved once a new administration takes office in January 2009. In the interim, the best that can be hoped for is a ceasefire between the political forces, and a slender sense of stability on financial and economic direction. This does not seem to be happening, not least because every measure of government intervention to calm the situation seems to be countered by fresh news of economic troubles, from the size of the outstanding national debt to the unemployment figures. As such, the US markets remained depressed, in fears of a national, and global, recession.

Externally, the US is in clear danger of losing not only its status as the lone superpower – which relies heavily on its apparent endless supply of economic and military resources, both of which are currently much depleted – but also its moral authority as leader of the democratic world. For deeply embedded within these crises is a sense of trust betrayed, wrong paths chosen, and simple negligence – all of which are significant to undermining the case for leadership of democracies, and spreading the creed.

**South East Asia:** Whilst so far the economic impact upon the region has been mainly upon stockmarkets, there is a danger that deeper economic instability can adversely affect the region in two major ways: First, the major economies of Japan, China and India may find themselves more deeply affected by the outright crises – or, conversely, by the knock on effect of losing markets for their products due to the economic challenges faced by the west. Second, the other states of the region may be more deeply affected, ultimately therefore being in danger of losing the economic gains, and political stability, of the past decade.

The Middle East: The most significant collateral damage to the cause of democracy is the Middle East. Those states already alienated from the US – or at least the US under the Bush administration – are rejoicing at the apparent downfall of the superpower. Those that are favourable to the US, such as Saudi Arabia and many of the Gulf States, fear a backlash from those elements within their own populations that are anti-western; in addition, those governments have also heavily invested in the US and the Dollar, and fear the economic impact of the crises upon them. Those regimes, such as Jordan and Egypt, which are not only favourable to the US but are also supported by it, fear the same internal backlash, but also the disappearance of funding.

Overall therefore, these crises are a potential cause of great instability in the Middle East – a reality that can severely impact the already unstable and problematic issue of energy. In addition, greater internal instability within the states of the region could be a source of greater insecurity outside it.

**Russia:** When the financial crisis began to bite in the US, Russia was riding high after its invasion of Georgia and neutralisation of its military capability. As the economic crisis began to afflict it too, however, it initially blamed the west for the knock-on effect, but as its stockmarket crashed quicker and lower than most others, the Russian leadership changed tack and realized its linkage to the international economic forces was absolute. As such, it abandoned its attitude of *schadenfreude* and set about wooing back western investors and attempting to calm its own. Neither ploy has yet shown great results.

In the short term, therefore, Russia will attempt to stabilise its economy at any level possible, hoping it has weathered the worst of the international storm. It will then, most probably, examine its available instruments – mostly energy – and attempt to leverage its economic plight against it. This option is less lucrative than it seemed in the summer, when oil prices were at historic heights – since they have also sharply fallen in the past month. Moreover, as the west, and especially the EU, seems to go into economic decline their consumption of energy is expected to fall, as is that of China and other main manufacturers that are losing their western markets.

Upon this background, Russia's may be in a rapid decline, which puts it in a different situation from the one it expected to inhabit a few months ago – one of needing the income from energy for extant needs rather than as greater reserves and a sign of power.

### Impact Upon the EU

Of all the regions to be impacted, possibly the most complex is the European Union. The interdependence between each state and the union, and states with each other renders the need for clear political, rather than economic, direction an absolute necessity. So far it has not been apparent, other than sporadically.

As the past few weeks have made abundantly clear, the instinct of each leader is to close into a national position, largely because that is where electoral power lies. However, it has become no less clear that such a stance does not work: the problems now engulfing the world are far bigger than the capabilities and capacities of the individual state – even those of the US.

In Europe, the problem is further aggravated by the Euro, since each state within the monetary union maintained its own authority, leaving the ECB only the responsibility and authority for monetary policy. In calm times such a division more or less worked, but in crisis it has proven to be a hindrance: the currency cannot respond to the pressures upon it in a cohesive way because there is no central political strategic authority to direct it.

On the other hand, if these economies sustain themselves to a greater or lesser extent, especially in comparison to the west, there will most probably be a demand to transfer more global power towards them – and afford them a greater say in international, and especially economic, affairs.

The main reason the policy options and cash inflows decided upon in recent days are of greater utility are because they were decided upon collectively, and a framework was agreed within which each state could operate – in coordination with others. To this extent, whilst there is no doubt Gordon Brown showed leadership in the UK, the main reason he joined with the other EU leaders in Paris to work out a common approach was not simply in order to school them in his ideas, but because his plan depended on a common approach: it could not work if the UK implemented it alone.

To a certain extent the EU Summit conclusions (15-16 October) reflected this reality, with the first 14 paragraphs devoted exclusively to the economic crisis and the collective actions taken and projected. In summary these paragraphs:

- Endorsed the bail-out principles agreed by the Eurogroup on 12 October.
- Formally established a “financial crisis cell”:
  - Comprising representatives of the Presidency, Commission President, President of the ECB (plus other European central banks), President of the Eurogroup and governments of the Member States
  - Tasked with information exchange and coordination of actions.
- Welcomed the setting up of the Commission's high-level group on the future of financial supervision.

- Calls for national financial supervisors to meet at least once a month (“to start with”), to exchange information.

These are all undoubtedly significant measures, complemented by a list of specific financial legislation – and they may suffice in order to calm the immediate situation, though the markets now seem more focused on fears of recession than on liquidity, and so continue to be volatile. However, these collective measures are arguably insufficient for the medium or long term since they still attempt to place the solution within broader international agreements (the idea of a Bretton Woods II) or else hobble together specific agreements on an issue-by-issue basis. In other words, the EU has reached a point in which it may no longer be able to function as a system of clear but loose treaties that leave the most difficult issues within the national remit: the problems are bigger than any individual state. As such there are a number of possible scenarios for the EU:

- Open political union: This is not a likely scenario, even if it may seem to some as necessary in order to maintain the euro.
- Euro political union: This is a more possible scenario, in which the greater minds of the Eurozone try and work out how to confine political union to the euro but leave most other areas as is. This is difficult since most areas are actually interlinked: is it really possible to consider trade distinctly from the euro over the long term?
- Areas of political union: This is the most realistic scenario, in which areas of common political activity are established – either openly or else more covertly through policy groups or high level advisory committees – but the actual term “political union” is never mentioned. The high level group on the competitiveness of the agro-food sector established in June in reaction to the rise in food prices is an example of such veiled cooperation, as is the idea defined in the latest Council conclusions of a high level group on the future of financial supervision.

## Conclusions

These are pivotal times in the EU and the world over. Whilst it is clear that there is a need to attain immediate stability in order to avoid a global recession, it is now imperative to look ahead to the medium and long term.

Within this perspective it can be suggested that:

- The trend is clearly towards greater government intervention in every state and across international institutions.
- The EU will probably become empowered, either explicitly but more probably implicitly, to act on the union’s financial health and wealth.
- This collaboration on financial issues will be dependent on political will in each state, which may not be there beyond the actual crisis – a fact that may endanger the union itself.
- In order to avoid recession, there will be attempts to create new modes of international cooperation in the financial world, but it may not spread to the political sphere.

Fleishman-Hillard will be tracking the current financial crisis, with emphasis upon these issues. Regular updates will be provided, coupled with insights and recommendations.