

# Understanding the Geopolitical Implications of the Global Financial Crisis

Although the global financial crisis breaking out in the fall of 2008 seems to be drawing to an end, it is still too early to tell exactly how big a loss it has caused to the world economy. Viewed through a macro politico-economic lens, the global financial turmoil formally put an end to the unipolar post-Cold War era, in which the U.S. power preponderance, its alleged universal politico-economic model of development (often referred to as the Washington Consensus), and its overwhelming international influence had been a defining feature. The looming new era is characterized by the emergence of a multipolar power structure, plural politico-economic models, and multiple players on the international stage.

## What the United States Suffered

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The preeminent U.S. position in the world has been mainly supported by two pillars: its overwhelming military and economic might. These two pillars, however, have been shattered in the past decade. The Iraq and Afghanistan wars testified to the limit of U.S. military power, while the financial crisis revealed the fragility of the U.S. economy. In the 1970s and 1980s, Japan and West Germany, respectively, once posed ever-rising economic challenges to the United States and undermined its economic superiority. But in the 1990s, the United States reaped the longest cycle of an economic boom, leaving Japan and unified Germany further behind.

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*The Washington Quarterly* • 33:4 pp. 155–163  
DOI: 10.1080/0163660X.2010.516648

From 1999 to 2001, U.S. annual gross domestic product (GDP) accounted for over 28 percent of world GDP, the highest in decades. Since 2002, however, the U.S. share of world GDP has been in relative decline due to the slowdown of its economic growth and the rise of the developing economies, with China and India at the forefront.<sup>1</sup> The crisis merely highlighted the weakness of the U.S. economy and a major change in the international economic landscape because: 1) Washington heavily relied on the financial support of China and other countries to withstand it, 2) China and other developing economies had a better performance during the crisis in 2008–2009 than the United States, and 3) China and other developing economies, not the United States, took the lead in the recovery of world economy. Broadly speaking, however, the financial crisis may be only an episode in the long-term change of the world economy. It can be argued that the crisis did not start a new trend, but rather expedited a preceding one, exposing the depth and breadth of the changes that have been brought about.

The United States, at the origin of the crisis, drew widespread criticism for its development model. The end of the Cold War and the economic boom of the

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1990s had enhanced the U.S. status as the beacon of economic policy and performance, and Washington began to enthusiastically promote its development model labeled as the Washington Consensus. The core of the so-called Washington Consensus is the myth about the free market, which holds that the market can most effectively and efficiently generate economic growth, while the role

of state and government in economic life should be kept to a minimum. The financial turmoil, however, revealed the unlimited greed and immense destructiveness of Wall Street, highlighting the ugly and dangerous face of the free market. The lesson is that the role of the state is not just to intervene and bailout the economy when it runs into deep trouble, but more importantly to keep a close watch on the market at any time.

In addition to the lack of effective oversight of the financial market, over reliance on the virtual economy is also believed to be a major cause of the financial debacle. Since the 1970s, when the manufacturing industry in the United States accounted for 23.8 percent of U.S. GDP,<sup>2</sup> that industry has been in decline, while the financial sector has become a more prominent part of overall U.S. economic output. In 2007, one year before the arrival of the financial crisis, the virtual economy already occupied around 8 percent of U.S. GDP, whereas the manufacturing industry was down to about 11.7 percent. (In

China in the same year, these two figures were 4.4 percent and 43 percent, respectively.<sup>3</sup>) It was apparently a growing reliance on the virtual economy that created the huge financial bubble that finally burst in the fall of 2008.

The financial turmoil also questioned the stability of the U.S. dollar, thus weakening the world's confidence in its role as the single major reserve currency. On March 24, 2009, one week before the G-20 London summit, the governor of China's Central Bank, Zhou Xiaochuan, called for the creation of a new currency, which would eventually replace the dollar as the world's standard.<sup>4</sup> He proposed to expand the use of Special Drawing Rights, a kind of synthetic currency created by the International Monetary Fund (IMF) in the 1960s, so as to move from the dollar reserve system to a global reserve system. Zhou's proposal reflected China's concern over the stability of the global financial system, which was shared by many other countries, such as Russia, and reiterated by a UN report that proposed that "[a] new global reserve system could be created, one that no longer relies on the United States dollar as the single major reserve currency."<sup>5</sup>

While the creation of a new international reserve currency is a long-term goal, China, which holds a significant amount of U.S. government bonds, called on Washington to pursue more responsible financial and economic policies to avoid further devaluation of the U.S. dollar. At the fourth G-20 summit in Toronto in June 2010, President Hu Jintao of China reiterated his remarks at the September 2009 Pittsburgh meeting, calling on the major reserve currency issuing countries to "take into account and balance the implications of their monetary policies for both their own economies and the world economy with a view to upholding stability of international financial markets." He also stressed the need to "strengthen supervision on macroeconomic policies of all economies especially the major reserve currency issuing economies."<sup>6</sup> In the past, it was Washington that often pointed a finger at others' financial and economic policies. The financial turmoil has now given other countries the opportunity to shake their fingers at Washington. The crisis has not only weakened other countries' confidence in the stability of the U.S. dollar, but also raised concern over the soundness of Washington's macroeconomic policies.

The global financial turmoil has also undermined U.S. influence in world economic governance. Many countries, particularly developing ones, attributed the crisis to the drawbacks of the U.S.-dominated international financial system, and called for a fair, equitable, inclusive, new, and more stable international financial order to be established. At the Pittsburgh G-20 summit, leaders designated the G-20 as "the premier forum for the international economic cooperation," and promised a shift of at least five percent in the IMF quota share to emerging markets and developing countries, with an increase of at least three percent of voting power for developing countries and transition countries

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in the World Bank.<sup>7</sup> For more than three decades, the Western countries had used the G-5, G-7, and G-8 to monopolize international macroeconomic policy coordination, and Washington, as the leader of the Western world, had been able to sell its ideas regarding international macroeconomic policy among its developed followers.

Now, with the G-20 replacing the G-8 as the major platform for discussing the world economy, developing countries have a forum to voice their concerns more effectively—and loudly. Unlike developed economies, they are more suspicious of the U.S. role as either a model of development or a leader in pursuing international economic governance. Although the U.S. voting power in the World Bank has not shrunk—nor will its quota in the IMF in the near future—the increase of the weight of the emerging markets and developing countries in those institutions will make it more difficult for Washington to gain support for its positions in the future.

The crisis has even aroused criticism of the U.S. lifestyle, characterized by over borrowing and low savings. It is widely believed that overconsumption, financed by excessive credit, is part of the problem behind the crisis. In fact, the credit card culture has caused many ordinary Americans to take overspending and low savings for granted. For too long, the symbol of the American Dream—living in a big house and driving a fancy car—lured people into enjoying a life beyond their means. For people outside of the United States, this is not just an individual's financial issue, but an environmental and energy issue, as the United States consumes too many resources and produces too much greenhouse gas, in both aggregate and per capita terms. In the past, the U.S. mode of life provided an attractive example of a modern lifestyle for people in the developing countries and galvanized them to work hard for economic prosperity and material abundance. Nowadays, however, as a simple and eco-friendly life becomes a more progressive fashion, the U.S. lifestyle is synonymous with extravagance as well as wasting resources and energy.

### **What China Gained**

While China suffered moderately from the crisis economically, it has gained remarkably in politico-economic terms. For one thing, the Chinese model of development—featuring by a strong role of the state in economic development, stress on the real rather than the virtual economy, a high savings rate, measured financial market liberalization, etc.—has empowered China to better resist the

financial storm and minimize the losses associated with it. As a developing country, China's experience appears more applicable to the developing world. For instance, as Alex Perry of *Time* magazine observed, "African governments look at Western economic instability over the past two years and find a better model in Asia's extraordinary growth."<sup>8</sup>

In the post-Cold War era, the U.S. model used to be hailed as the only way to economic prosperity. Now, the Chinese model seems to provide an alternative. To be sure, the Chinese model is not perfect and is actually confronted with many challenges such as a widening income gap, serious environment pollution, and rampant corruption. Yet, the record of tiding over two financial crises (the 1998–1999 Asian financial crisis and the 2008–2009 global financial crisis) and securing three decades of a high economic growth rate testifies to its strength. Unlike Washington, Beijing does not like to boast of its model and impose it on others, but the increased appeal of the Chinese experience will certainly enhance Beijing's international status and augment its influence among developing countries.

Even before the recent crisis, there was already discussion of decoupling Asian economies from the United States, given growing intra-Asian economic activities.<sup>9</sup> The reality that China has already become the largest trading partner to some major regional economies, such as Japan, South Korea, and Taiwan, provided an additional incentive to further East Asian regional economic cooperation. Even in Japan, where the Democratic Party of Japan (DPJ) rose to power during the crisis in August 2009, Prime Minister Yukio Hatoyama noted that:

[T]he recent financial crisis has suggested to many people that the era of American unilateralism may come to an end. It has also made people harbor doubts about the permanence of the dollar as the key global currency. I also feel that as a result of the failure of the Iraq war and the financial crisis, the era of US-led globalism is coming to an end and that we are moving away from a unipolar world toward an era of multipolarity.<sup>10</sup>

Hatoyama continued that, "Current developments show clearly that China, which has by far the world's largest population, will become one of the world's leading economic nations, while also continuing to expand its military power."<sup>11</sup> He pledged to strengthen relations with Asian countries, particularly China, and work to build an East Asian Community. Behind this lies a recognition of China's growing importance to Japan's economic future.

South Korea also expressed enthusiasm for forging a free trade agreement with China as early as possible. Taiwan signed the Economic Cooperation Framework Agreement (ECFA) with mainland China in June 2009, marking a major step forward in relations across the Taiwan Strait. The agreement, focusing on tariff concession and easier market access, will remove tariffs within two years on 539 Taiwan export items to the mainland worth \$13.84 billion, as well as

267 mainland export items to Taiwan valued at \$2.86 billion. The pact will also give Taiwan firms access to 11 service sectors on the mainland including banking, accounting, insurance, and hospitals.<sup>12</sup> The financial crisis also prompted Beijing to boost its domestic consumption. As the great potential of its internal market is further released, it will serve both to thicken China's economic ties with regional partners and to strengthen its role as an East Asian economic hub.

In a nutshell, the financial and economic turmoil underscored China's position as the engine of the Asian regional economy and even the global economy as well. In international politics, political and economic relations always follow each other. After World War II, many regional members developed close economic ties with the United States, following tight political and security arrangements with Washington. By the same token, today and in the future, China's deepening economic connections with its regional partners promise to expand its political clout in East Asia.

Given China's growing economic size and its excellent performance during the crisis, it is no surprise that the financial turmoil served to raise China's status in global economic governance. The G-20 emerged from the crisis as the premier forum for international economic cooperation, shadowing the traditional role of the G-8 in world economy. China, as the world's third largest economy and the largest foreign reserve holder, ascended to center stage within the G-20. The idea of a G-2, consisting of Beijing and Washington governing the world economy or managing international geopolitics, was tossed around among U.S. scholars and former government officials (although not endorsed by either Beijing or Washington), reflecting a recognition of China's newly-acrued economic and geopolitical weight. In April 2010, the World Bank decided to increase China's voting rights, making it the third largest voter in the institution. The IMF is also expected to raise China's representation in its current round of reconstruction endeavors. All in all, the financial crisis benefited China by quickening the pace of the global economic and financial power transition, turning China from a peripheral member into a key player.

Last but not least, the crisis gave credit to China's currency *Renminbi* (RMB) for its strength and stability. Even before the crisis, the RMB was already used in some of China's neighboring countries for settling accounts in border trade. The financial storm revealed the volatility of the U.S. dollar and highlighted the strength of the Chinese yuan. Although the RMB is not yet freely convertible, some of China's major trading partners saw the desirability of increasing its holding as the U.S. dollar has been getting weaker, arousing concerns that an unstable dollar would lead to increased costs and risks for traders. Since the onset of the crisis, China has signed bilateral currency swap agreements with Argentina, Belarus, Iceland, Indonesia, Malaysia, Hong Kong, Singapore, and

South Korea, with a total amount of 803.5 billion yuan (about \$118.1 billion). Some countries also moved to take the RMB as one of its reserve currencies.

It was the crisis that caused Beijing to think seriously about the regionalization of the RMB. To enhance that goal, the Chinese government undertook to push the RMB settlement pilots in the trade between China's two most important exporting regions, Guangdong and the Yangtze River Delta, with Hong Kong and Macao, and between two Chinese provinces bordering Southeast Asia, Gaungxi and Yunnan, with the members of the Association of Southeast Asian Nations (ASEAN). In early 2009, Beijing also approved Shanghai's ambitious goal of turning itself into an international financial center by 2020, matching China's economic influence and the yuan's international position. It will be a long journey for the RMB to become a major international reserve currency, but it seems that the global financial crisis has turned out to be its starting point.

**The crisis may turn out to be the starting point for the RMB as a major international reserve currency.**

## **What is Changing in the World?**

Viewed from a broad historical perspective, the global financial crisis underscored and expedited some developments that will have a significant long-term impact on the world political and economic situation. First is the evolution of the international power structure. If there was a unipolar moment in the 1990s, it is now gone and the world is rapidly moving away from it. Whether the new world power structure is multipolar, non-polar, or something else, one thing is clear: the leadership of global governance will be restructured. The developing countries, or the non-western world, are going to occupy a more preeminent position in the new leadership and will have a louder say in global governance. The economic rise of the emerging markets and developing countries was already evident well before the crisis. Yet, it was the crisis that brought about the opportunity for their growing economic weight to be translated into politico-economic influence.

Second, is the changing role of the United States in global affairs, where the United States is regarded as both part of the problem and part of the solution. From the invasion of Iraq to the global financial crisis, the United States has tarnished its image as either a benign hegemon or a beacon of economic performance and policy. The Iraq war demonstrated that the United States could abuse its paramount power in defiance of the international community, while the financial turmoil proved that it could do more economic harm to the world than many others can. As

**The world is searching for new models for global governance and domestic development.**

Washington is no longer looked upon as the mentor for either global or domestic governance, it will not be able to order others around. To be sure, the United States, as the leading economic and military power in the foreseeable future, will remain indispensable to the solution of the problems confronted by the world, but its relative position and influence have definitely declined.

Third, the world is witnessing more serious efforts to search for new models for global governance, regional cooperation, and

domestic development. Effective global governance calls for progressive concepts, such as “effective multilateralism,” “common but differentiated responsibility,” “win-win,” “balance of interests,” and “a harmonious world” along with the establishment of a fair, equitable, and stable international political and economic order that can best promote international cooperation in global governance. Regional cooperation is geared toward not only promoting economic growth, but also maintaining regional economic and financial stability. As for domestic politico-economic development, countries are walking away from the idea of embracing a universal model and are adopting a more pragmatic attitude, exploring ways most suitable for their own national conditions. The debate over different development paradigms will take place from time to time, but except for a handful of ideologues, such exchanges will be driven more by efficacy than by ideology.

## Notes

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2. This figure is calculated based on data from U.S. Department of Commerce, Bureau of Economic Analysis, “72SIC\_VA, GO, II,” June 17, 2004, [http://www.bea.gov/industry/xls/GDPbyInd\\_VA\\_SIC.xls](http://www.bea.gov/industry/xls/GDPbyInd_VA_SIC.xls).
3. See Brian M. Lindberg and Justin M. Monaldo, “Annual Industry Accounts: Advance Statistics on GDP by Industry for 2007,” U.S. Department of Commerce, Bureau of Economic Analysis, May 2008, [http://www.bea.gov/scb/pdf/2008/05%20May/0508\\_indy\\_acct.pdf](http://www.bea.gov/scb/pdf/2008/05%20May/0508_indy_acct.pdf) and National Bureau of Statistics of China, *China Statistical Yearbook 2008* (Beijing: China Statistics Press, 2008), pp. 38, 42.
4. See Zhou Xiaochuan, “Reform the International Monetary System,” March 23, 2009, <http://www.pbc.gov.cn/english/detail.asp?col=6500&ID=178>.



5. UN Department of Economic and Social Affairs, "World Economic and Social Survey 2010: Retooling Global Development," E/2010/50/Rev.1, 2010, p. XXII. <http://www.un.org/esa/policy/wess/wess2010files/wess2010.pdf>.
6. Hu Jintao, speech, fourth summit of G-20, Toronto, June 27, 2010, <http://www.fmprc.gov.cn/eng/topics/hujintaoG20fenghui/t712730.htm>. Also see Hu Jintao, "Make Every Effort to Promote Growth and Balanced Development" (remarks, third summit of G-20, Pittsburgh, September 25, 2009), <http://www.fmprc.gov.cn/eng/topics/hujintaoG20fenghui/t607838.htm>.
7. See Ministry of Foreign Affairs of the People's Republic of China, "G20 Issues Leaders' Statement of the 3rd Financial Summit," September 26, 2009, <http://www.fmprc.gov.cn/eng/topics/hujintaoG20fenghui/t616883.htm>.
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9. See William Pesek, "Asia's Decoupling from US economy 'a myth'," May 9, 2007, <http://forum.stirpes.net/economics/11637-asia-s-decoupling-us-economy-myth.html> and Bruce Nussbaum, "Coupling and Decoupling in Davos," *Bloomberg Businessweek*, January 23, 2008, [http://www.businessweek.com/innovate/NussbaumOnDesign/archives/2008/01/coupling\\_and\\_decoupling\\_in\\_davos.html](http://www.businessweek.com/innovate/NussbaumOnDesign/archives/2008/01/coupling_and_decoupling_in_davos.html).
10. Yukio Hatoyama, "Japan Must Shake Off U.S.-Style Globalization," *Christian Science Monitor*, August 19, 2009, <http://www.csmonitor.com/Commentary/Opinion/2009/0819/p09s07-coop.html>.
11. Ibid.
12. Xie Yu and Ma Wei, "Cross-Straits Trade Deal to Cut Tariffs, Open Markets," *China Daily*, June 30, 2010, [http://www2.chinadaily.com.cn/china/2010-06/30/content\\_10037141.htm](http://www2.chinadaily.com.cn/china/2010-06/30/content_10037141.htm).