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The Shifting Global Balance

Chapter contents

A. The Post-2007 Economic Crisis

Origins of the Crisis

Countries of the developed world and, particularly those in Europe, had seemed to enjoy prosperity as consumerism blossomed in the late 1990s and early Noughties, notwithstanding the creation of the euro in 1999, while in Asia economies were recovering from the 1997 crisis. In Latin America even Argentina, which had suffered the worst from the debt problems of the previous decades, achieved a trade surplus and a growth rate of 9 per cent that year. Three years later the problems flowing from Europe and the US were so big, and were becoming so difficult to resolve quickly, that the future of capitalism itself was being questioned. The starting point for the doubts was the self-evident assumption (at least for those able to face the implications) that the 'credit crunch has destroyed faith in the free market ideology that has dominated Western economic thinking for a decade. But what can—and should—replace it?' It was as if the Cold War had been fought to produce a highly successful failure. The next day, the London *Financial Times* quoted a banker, lamenting that he did not know what could replace it—an indication that it might have to continue.[1]

For a considerable time before the 2008 crisis, the US and most European states had been living on high levels of debt both national and individual, public and private. The effects of this had been exacerbated by the faith invested in 'free' market changes to the globalized financial world since the 1980s, and the accompanying loss of government power over an increasingly deregulated economy. Widespread distrust of the state, despite its provision of benefits for many individuals, especially the poor and the disadvantaged, was increasingly evident as the consumption boom, funded more and more by debt, continued to expand. Manufacturing in the developed West, and its provision of secure jobs for many workers, was undermined by the new economic environment of globalization, as well as the growth of cheaper manufacturing in China and the other BRIC countries. A new epoch of financial capitalism, which had emerged since the

1980s, was in full swing by the start of the Noughties. In the new millennium, it was particularly aided by new regulations that allowed commercial banks to operate as investment banks in a world which already allowed cross-border flows of capital in a globalized international financial system.

The maintenance of high levels of government expenditure and personal consumption in much of the developed world was sustained, not by revenue from manufacturing and production, but from service industries and borrowing achieved at ever-higher levels of risk. In addition, increased oil prices were the result of the 2003 Iraq war, when the US spent hundreds of millions of dollars importing oil, at a time when demand for energy from expanding economies like China and India was rising significantly. Financially,

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Bail-out The financial rescue of a struggling borrower. A bail-out can be achieved in various ways:

- providing loans to a borrower that markets will no longer lend to;
- guaranteeing a borrower's debts;
- guaranteeing the value of a borrower's risky assets;
- providing help to absorb potential losses, such as in a bank recapitalization.

Bond A debt security, or more simply, an IOU. The bond states when a loan must be repaid and what interest the borrower (issuer) must pay to the holder. They can be issued by companies, banks, or governments to raise money. Banks and investors buy and trade bonds.

Collateralized debt obligations (CDOs) A financial structure combining individual loans, bonds, or other assets in a portfolio, which can then be traded. In theory, CDOs attract a stronger credit rating than individual assets, owing to the risk being more diversified (securitization). But as the performance of many assets fell during the post-2007 financial crisis, the trading value of many CDOs was also reduced.

Credit crunch A situation where banks and other lenders all cut back their lending at the same time, because of widespread fears about the ability of borrowers to repay. If heavily indebted borrowers are cut off from new lending, they may find it impossible to repay existing debts. Reduced lending also slows down economic growth, which thus makes it harder for all businesses to repay their debts.

Credit Default Swap (CDS) A financial contract that provides insurance-like protection against the risk of a third-party borrower defaulting on its debts. For example, a bank providing loans to Greece may choose to hedge the loan by buying CDS protection on Greece. The bank makes periodic payments to the CDS seller. If Greece defaults on its debts, the CDS seller must buy the loans from the bank at their full face value. CDSs are not just used for hedging—they are used by investors to speculate on whether a borrower such as Greece will default.

Derivative A financial contract which provides a way of investing in a particular product without having to purchase it. For example, a stock market futures contract allows investors to make bets on the value of a stock market index such as London's 'FTSE 100' increasing by so many points or not. If the bet is successful, interest on the cost of the contract (i.e. the amount invested) is paid to the investor without the individual or bank having to buy or sell any shares. The value of a derivative can depend on anything from the price of coffee to interest rates or the weather as well as stock market values. Derivatives allow investors and banks to hedge their risks, or to speculate on markets. Futures, forwards, swaps, and options are all types of derivatives.

Dodd–Frank Legislation enacted by the US in 2011 to regulate the banks and other financial services. It included:

- restrictions on banks' riskier activities (the Volcker rule, on which see below);
- a new agency responsible for protecting consumers against predatory lending and other unfair practices;
- regulation of the enormous derivatives market;
- a leading role for the central bank, the Federal Reserve, in overseeing regulation;
- higher bank capital requirements;
- new powers for regulators to seize and wind up large banks that get into trouble.

EFSF The European Financial Stability Facility, a temporary fund worth up to €440 billion, set up by the Eurozone countries in May 2010. Following a previous bailout of Greece, the EFSF was originally intended to help other struggling Eurozone governments, and has since provided rescue loans to the Irish Republic and Portugal.

Eurobond A common, jointly-guaranteed bond issued by the Eurozone governments. It has been mooted as a solution to the Eurozone debt crisis, as it would prevent markets differentiating between the creditworthiness of different government borrowers in the Eurozone. The Germans, until June 2012, resisted the idea.

Fiscal policy The government's borrowing, spending, and taxation decisions. If a government fears it is borrowing too much, it can raise taxes and/or cut spending. Alternatively, if a government wants to avoid the economy going into recession it can engage in fiscal stimulus, which can include cutting taxes, increasing public spending, and/or borrowing more.

Freddie Mac, Fannie Mae Nicknames for, respectively, the Federal Home Loans Mortgage Corporation and the Federal National Mortgage Association, in the US. They never provided mortgages directly to homebuyers, but obtained a large part of the money that is lent out as mortgages in the US from the international financial markets. Both privately owned, they now operate as agents of the US federal government. As a result of the financial crisis, the government put them into 'conservatorship', guaranteeing to provide them with any new capital needed to ensure they would not go bust.

G8 The seven major industrialized economies of the US, UK, France, Germany, Italy, Canada, and Japan (the old G7), plus Russia.

G20 The G8 plus developing countries that play an important role in the global economy, such as China, India, Brazil, and Saudi Arabia. It gained in significance after leaders agreed how to tackle the 2008–09 financial crisis and the recession at G20 gatherings.

Glass–Steagall A US inter-war law separating ordinary commercial banking from investment banking. The commercial high street banks, which lend to consumers and businesses, are deemed vital to the 'real' US economy. The law was designed to protect their depositors from the risky speculation of investment banks. The law was repealed in 1999, largely to enable the creation of the banking giant, Citigroup, a move that many commentators say was a contributing factor to the 2008 financial crisis. (See also, Volcker Rule.)

Hedge fund A private investment fund that uses a range of sophisticated strategies to maximize returns including hedging, leveraging, and derivatives trading.

Hedging Making an investment to reduce the risk of price fluctuations in the value of an asset. For example, airlines often hedge against rising oil prices by agreeing in advance to buy their fuel at a set price. In this case, a rise in price would not harm them—but nor would they benefit from any falls.

Investment bank Investment banks provide financial services for governments, companies, or extremely wealthy individuals. They differ from commercial banks, where you have your savings. Traditionally, investment banks provided underwriting, and financial advice on mergers and acquisitions, and how to raise money in the financial markets. They and commercial banks now engage in the more risky activities, often referred to as 'casino capitalism' including trading directly in financial markets for their own account.

Leverage Leverage, or gearing, means using debt to supplement investment. The more you borrow on top of the funds (or equity) you already have, the more highly leveraged you are. Leverage can increase both gains and losses. 'Deleveraging' means reducing the amount you are borrowing.

Liquidity crisis A situation in which it suddenly becomes much more difficult for banks to obtain cash, owing to a general loss of confidence in the financial system. Investors (and, in the case of a bank run, even ordinary depositors) may withdraw their cash from banks, while banks may stop lending to each other, if they fear that some banks could go bust. Because most of a bank's money is tied up in loans, even a healthy bank can run out of cash and collapse in a liquidity crisis. Central banks usually respond to a liquidity crisis by acting as 'lender of last resort', providing emergency cash loans to the banks.

Loans-to-deposit ratio For financial institutions, the sum of their loans divided by the sum of their deposits. It measures a bank's vulnerability to the loss of confidence during a liquidity crisis. Deposits are usually guaranteed by the bank's government and are therefore considered a safer source of funding for the bank. Before the 2008 financial crisis, many banks became very reliant on other sources of funding—meaning that they had very high loan-to-deposit ratios. When these other sources of funding suddenly evaporated, the banks were left critically short of cash.

Mortgage-backed securities (MBS) Banks repackage debts from a number of mortgages into MBS, which can be bought and traded by investors. By selling off their mortgages in the form of MBS, it frees the banks up to lend to more homeowners.

Securities lending When one broker or dealer lends a security (such as a bond or a share) to another for a fee. This is the process that allows short selling.

Securitization Turning something into a security. For example, taking the debt from a number of mortgages and combining them to make a financial product, which can then be traded (see mortgage-backed securities). Investors who buy these securities receive income when the original home-buyers make their mortgage payments.

Security A contract that can be assigned a value and traded. It could be a share, a bond or a mortgage-backed security.

Separately, the term 'security' is also used to mean something that is pledged by a borrower when taking out a loan. For

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example, mortgages in the UK are usually secured on the borrower's home. This means that if the borrower cannot repay, the lender can seize the security—the home—and sell it in order to help repay the outstanding debt.

Shadow banking A global financial system—including investment banks, securitization, SPVs, CDOs, and monoline insurers—that provides a similar borrowing and lending function to banks, but is not regulated like banks. Prior to the financial crisis, the shadow banking system had grown to play as big a role as the banks in providing loans. However, much of shadow banking system collapsed during the credit crunch that began in 2007, and in the 2008 financial crisis.

Short selling A technique used by investors who think the price of an asset, such as shares or oil contracts, will fall. They borrow the asset from another investor and then sell it in the relevant market. The aim is to buy back the asset at a lower price and return it to its owner, pocketing the difference. Also known as 'shorting'.

Spread The difference in the yield (on which, see below) of two different bonds of approximately the same maturity, usually in the same currency. The spread is used as a measure of the market's perception of the difference in creditworthiness of two borrowers.

SPV A Special Purpose Vehicle (also Special Purpose Entity or Company) is a company created by a bank or investment bank solely for the purpose of owning a particular set of loans or other investments, and distributing the risk to investors. Before the financial crisis, SPVs were regularly used by banks to offload loans that they owned, freeing the banks up to lend more. SPVs were a major part of the shadow banking system, and were used in securitization and CDOs.

Stability pact A set of rules demanded by Germany, at the creation of the Eurozone in the 1990s, that were intended among other things to limit the borrowing of governments inside the euro to 3 per cent of their GDP, with fines to be imposed on miscreants. The original stability pact was abandoned after Germany itself broke the rules with impunity in 2002–5.

Sub-prime mortgages These carry a higher risk to the lender (and therefore tend to be at higher interest rates) because they are offered to people who have had financial problems or who have low or unpredictable incomes.

Swap A derivative that involves an exchange of cash flows between two parties. For example, a bank may swap out of a fixed long-term interest rate into a variable short-term interest rate, or a company may swap a flow of income out of a foreign currency into their own currency.

TARP The Troubled Asset Relief Program, a $700 billion rescue fund, set up by the US government in response to the 2008 financial crisis. Originally, the TARP was intended to buy up or guarantee toxic debts owned by the US banks, hence its name. However, shortly after its creation, the US Treasury took advantage of a loophole in the law to use it instead for a recapitalization of the entire US banking system. Most of the TARP money has now been repaid by the banks that received it.

Tobin tax A tax on financial transactions, originally proposed by economist James Tobin as a levy on currency conversions. The tax is intended to discourage market speculators by making their activities uneconomic, and in this way, to increase stability in financial markets. The idea was originally pushed by former UK Prime Minister Gordon Brown, in response to the financial crisis. More recently, it has been formally proposed by the European Commission, with some suggesting that the revenue could be used to tackle the financial crisis. It was opposed by the post-2010 UK coalition government, which argued that, to be effective, the tax would need to be applied globally—not just in the EU—as most financial activities could quite easily be relocated to another country in order to avoid the tax.

Toxic debts Debts that are highly unlikely to be recovered from borrowers. Most lenders expect that some customers cannot repay, but toxic debt describes a whole package of loans that are unlikely to be repaid. During the financial crisis, toxic debts were very hard to value or to sell, as the markets for them ceased to function. This greatly increased uncertainty about the financial health of the banks that owned much of these debts.

Volcker Rule A proposal by former US Federal Reserve chairman, Paul Volcker, that US commercial banks be banned or severely limited from engaging in risky activities, such as proprietary trading (taking speculative risks on the markets with their own, rather than clients' money) or investing in hedge funds. The Volcker Rule follows similar logic to the Glass–Steagall Act (see above) and a modified version of the rule was included in the Dodd–Frank financial regulation law (see above), passed in the wake of the financial crisis.

Yield The return to an investor from buying a bond implied by the bond's current market price. It also indicates the current cost of borrowing in the market for the bond issuer. As a bond's market price falls, its yield goes up, and vice versa. Yields can increase for a number of reasons. Yields for all bonds in a particular currency will rise if markets think that the central bank in that currency will raise short-term interest rates owing to stronger growth or higher inflation. Yields for a particular borrower's bonds will rise if markets think there is a greater risk that the borrower will default.

the iron law of capitalism, which states that the greater the return on the use of capital the greater the risk in such a use, could no longer be regulated by the realities of repayment or governance. Hence, the increased role of derivatives, hedge funds, collateral debt obligations (CDOs) (known, without any hint of irony as 'securitization' in much the same way as 'securitization' was introduced into the military world of strategy), credit default swaps (CDSs), and short-term selling, in a high-risk world often referred to as 'casino capitalism'. As paper financial transactions became increasingly subject to the charging of high fees, to boost the profits of banks and the financial service industry, new priorities and incentives were provided by more complex financial schemes to make money from debt. The false premises of this new financial world were soon to be dramatically exposed. The catalyst of the crash producing the changes was the huge amount 'sub-prime' mortgage debt in the US and its contribution to 'securitization'. Just as the medieval alchemists attempted to transform base metal into gold, so the modern sorcerers aimed to 'securitize' high-risk loans which were unlikely to be paid back. In essence, this modern alchemy meant packaging debts with other debts, thereby transforming them into products with high credit ratings. Thus began the failure of the regulators to counter the opportunities and incentives presented to the bankers, in order to encourage them to make greater profits from castles built on the sands of debt.

For small businesses and householders in particular, the debt obligations were underwritten by dramatic increases in property prices. This was the bubble that burst in a US-dominated globalized economy where international movements of capital were unregulated. In the UK, the property bubble was helped by the shortage of new houses, which followed the failure of governments to see that housing provision was a key part of social policy. Consumerism and material gain were replacing values of social responsibility, not just internationally but within nation states. The main aim of the financial sector was no longer to provide the monetary means for entrepreneurs to achieve profits out of the 'real economy'; it was to maximize the revenue from financial transactions. As the property bubble of casino capitalism burst in many parts of the developed world, individuals were also trapped with credit card debts in states whose own indebtedness from wars and social security payments was to increase dramatically.

Casino capitalism was the effect, rather than the cause, of the crisis of capitalism. It was significantly aided, especially during the 1990s, by concerted efforts of governments to deregulate the financial markets—measures favoured widely by financiers in the US, from the chairman of the Federal Reserve downwards. 'Big bang' deregulatory reforms in the City of London had begun in 1986. Deregulation meant the removal of controls which had forced the banks to follow strict capital reserve and liquidity ratios as part of a set of rules to limit risk taking. The provision of unsecured high-risk loans, particularly on sub-prime mortgages, was accompanied by a naive faith in the infallibility of the market, and in the new technological methods and smart accounting procedures having ironed out any problems with the money making capacity of the banking system. The idea that 'securitization' virtually eliminated risk became the gospel, spread by Alan Greenspan, chairman of the Federal Reserve Bank. As investors, particularly pension fund managers, demanded higher returns on lending, the tsunami of 2007–8 was created, which quickly threatened to sweep away important elements of the banking system.

The actions of some bankers were helped by a belief, which turned out to be correct, that the mismanagement of risk and the misallocation of funds would not produce disastrous losses for themselves. Either by the time any losses happened their particular profits would have been made, or else governments would not allow manufacturing companies that got into difficulties to collapse. Instead, the system would be bailed out with taxpayers' money: the implications of not helping extract bankers from the mess they had got into would be disastrous for all those involved in the real economy. Two important accompaniments to deregulation were the importance of fees in providing incentives for more financial transactions (without adequate management of the longer-term risks) and the need to drive up stock market prices by deceptive (or 'creative') accounting. This was to produce the final obfuscation of who owned what debt. However much or little banks might know about their own debts, they were unable to accurately evaluate that of others or to estimate the consequences of a price fall. The result was that, as soon as the crisis broke, banks were unwilling to lend to other banks and all economic activity was under threat.

In April 2007, the New Century bank in the US became the first to file for bankruptcy. In July, the

New York investment bank Bear Stearns shut down its $42 million hedge funds, after massive losses on mortgage-backed securities, and announced that its CDSs were worthless. In Europe, it was the French bank BNP Paribas that announced liquidity problems in August. Then, in September, problems at the Northern Rock bank in Britain led to a request for help from the Bank of England, the country's central bank. As the government dithered, the request produced a 'run' on deposits, with account holders withdrawing large amounts of money, which put the government under pressure to step in and prop it up. If the government did not act, then the consequences for everyone involved, including ordinary people who might be unable to access their money, in what were once purely commercial banks, would be very severe. The traditional role of banks in making money from providing loans to businesses, many of them in the local community, was fast disappearing. In February 2008, the cash assets of Bear Stearns in the US had gone from $18 billion to $2 billion within days, and its shares which began the year at $173 were now only worth a few dollars. It became an early candidate for a bailout. In July 2008, Indy Mac became the third largest bank to fail in US history and this was followed, in September, by the disintegration of Fannie Mae and Freddie Mac, the world's largest mortgage lenders, whose $200 billion debts had to be taken over by the US government. The crisis was rapidly spreading.

Responses to the Crash

The global nature of the crisis was emphasized when, the week after Bear Stearns' demise, the collapse of Lehman Brothers produced the largest bankruptcy in US history, at $635 billion. After allowing Lehmans to go under without a rescue plan, the following day the US government bailed out AIG, the world's largest insurance company. Wall Street investment banks, Goldman Sachs and Morgan Stanley were turned into holding companies to get some government protection and, in Europe, several banks failed, while governments began to pour money into others facing collapse. In Britain, two major banks were almost completely nationalized, in that the government now owned over three-quarters of their shares. The Prime Minister, Gordon Brown, shrank from the final, if logical, step of nationalization and this was to become a significant moment for the way in which the problems were subsequently tackled.

In Washington, the incoming Obama administration was already deeply troubled by high spending on the wars in Iraq and Afghanistan, launched under President Bush, and the US entered recession from mid-2008 to late 2009, its worst performance since the 1930s depression. Despite grave doubts from Republicans, Congress passed a $700 million rescue package, in October 2008, which helped to stabilize the banking sector. This amount, known as the Troubled Asset Relief Program or TARP, was already looking grossly inadequate. Vast amounts went into propping up vehicle manufacturers, but the world's largest, General Motors, still had to seek bankruptcy protection in June 2009. Led by Gordon Brown, world leaders, meeting at the G20 summit in London, in April 2009, did try to coordinate their actions. For the moment, Brown's chairmanship prevented 1930s-style protectionism (when states put up tariff barriers against each other) taking hold and important elements of international cooperation were maintained. The International Monetary Fund (IMF) stepped in with money for the Ukraine, and there was G20 help for less developed countries. The US introduced some stricter banking regulation, while avoiding a major change in the operation of financial capital, and Obama increased federal spending, linked to tax cuts, at the beginning of 2009. Yet some states, like Germany, were critical of the government investment strategy favoured by Obama and Brown. Despite the formal end of the recession in the US, still the world's largest economy, during 2009, that year saw the lowest growth in the world economy since 1945. Furthermore, with debt emerging as a new threat to financial confidence, it was soon clear that there would be no rapid recovery from the 2008 downturn.

The financial crash produced three significant consequences, essentially conservative in nature. First, although pension funds and small enterprises, along with corporate owners of capital and the small percentage of the population with enormous individual wealth, all faced problems left by the crisis, the main burden would be shouldered by individual taxpayers. The immediate reaction had been for governments to pursue policies which injected taxpayers' money into the undercapitalized banks and prevented significant losses to investors' money. Thus shareholders and bondholders gained some protection, reversing the normal operation of capitalism that penalizes unsuccessful risk takers. Shareholders of manufacturing companies, or corporations faced with liquidation, would normally expect to lose their money if their decisions misfired and they would effectively be replaced by bondholders, if the failed company or bank were to survive. But now they found themselves protected by governments and taxpayers.

Second, while the economic failure of communism had eventually produced an attempt at top-down radical reforms in the 1980s by Mikhail Gorbachev, in order to rectify the failures, the failed neo-liberal system produced no such reactions. Western elites were intent on preserving the essence of neo-liberalism, with failed banks, like the Royal Bank of Scotland, limiting the loss to shareholders with the provision of government money, but eager to preserve the bonus culture and the benefits it gave to bankers who had overseen the losses in the first place. The third consequence was, therefore, that nothing of major significance was done to reform the system that had allowed the financial crisis to happen. Perhaps the greatest irony, though, was that massive state intervention had been necessary to save many of the self-same ideologues who had, for decades, decried state involvement in the economy. In effect, banks were 'feather-bedded' by states and protected from collapse, just as nationalized industries had been protected by government-funding before 'privatization' took hold. One might have expected a return of adequate regulations—this seemed necessary, not just desirable—but it was done only in a half-hearted fashion and there was a new bout of evidence of bankers breaking the rules in 2012, when crisis engulfed another major operator, Barclays in the UK. Thus, the system has been criticized as 'corporate socialism' or 'socialism for the rich'.

World governments had long run up debts to pay for social security, wars, and expensive defence equipment, as well as health and education but, with an ageing population leading to higher pension payments and increased pressures on health services, even more money had to be found. With unemployment higher, thanks to the recession (which was now turning into another depression), expenditure was rising at a time when income from taxation was falling, both because of decreasing numbers of earners and significant reductions in taxation in many countries. Even servicing debt—that is, paying the interest on what had been borrowed—was becoming a major liability for some states before the 2008 crisis required trillions of dollars of debt to be incurred through the bail-out of banks. There were other problems, which soon added to the sense of economic woe. After some falls in energy prices with the improved situation in Iraq in 2009, there were renewed price rises in 2011 because of the instability in Libya. Also, the mushrooming world population and severe climatic problems, such as those that led to a disastrous Russian harvest in 2010, brought about a general increase in food prices. In Japan, problems were intensified by the earthquake and tsunami that struck the north-east in March 2011, leading to a fall in manufacturing output and exports.

However, in general, concern on the money markets focused on levels of state indebtedness and, specifically, worries about the ability of governments in Europe to finance these loans, especially when refinancing them would be subject to abnormally high interest rates. This offered large profits to bondholders willing to take the risk. The mostly right-of-centre European governments sought a reduction of their, now, massive debts by austerity measures that would cut public services and benefits. Countries outside Europe and North America were not immune to the crisis. One of the earliest confirmations of the globalization of capital movements and debt problems was in Dubai, in the Persian Gulf, in November 2009; but Dubai was rescued at that point by one of its oil-rich neighbours, Abu Dhabi. Attention continued to be focused over the following years on Europe, in the hitherto successful Eurozone, where the future of the common currency (the euro) was called into question by those states with the highest levels of debt relative to their GDP and the problems proved persistent over several years.

Problems in the Eurozone

High levels of public expenditure and increased consumerism continued after the creation of the Eurozone, which had been established when twenty member states of the European Union launched their single currency in 1999. Ironically, the Eurozone was designed to bring further growth in Europe, stabilizing exchange rates and giving confidence for trade, but its intrinsic flaws were bound to produce a degree of economic instability. The political requirements of the leading European states might be met by a single currency, but all their economic needs could not, unless fiscal policies were coordinated to offset the lack of competitiveness of some European economies. The process would resemble the incorporation of the economic backwater of East Germany into the reunified German state after 1990, which brought considerable

The European Union: from Nice to Lisbon

After some difficult years in the late 1990s, the successful introduction of the single currency, the euro, in twelve of the member states in January 2002, led to a revival of confidence in the European Union (EU). The euro became the most important trading currency after the dollar and, for several years, under the guidance of the European Central Bank, it seemed to guarantee members of the 'Eurozone' sustained growth and low inflation. The major challenge of the early twenty-first century was to expand the Union eastwards, to states that had formerly been part of the Soviet bloc. As with previous enlargements, it was felt necessary to strengthen the cohesion of the Union through bureaucratic reforms in order to compensate for any centrifugal forces that an expanded membership might bring. Already, in February 2001, a treaty had been signed in Nice which, among other steps, altered voting arrangements, reduced the number of European Commissioners appointed by each member and expanded the size of the European Parliament. But the process of reform did not prove easy. There were bitter arguments about the voting rights that should be apportioned to particular states and the complicated, compromise treaty was initially rejected by Irish voters in a referendum of June 2001. Some concessions (including an assurance about Ireland's continuing neutrality, notwithstanding the EU's move towards cooperation on security) helped reverse the vote in October 2002, paving the way to it entering into force the following year. But it was a warning of problems to come.

Meanwhile, in December 2001, a Convention was set up in Brussels under the chairmanship of former French President, Valéry Giscard d'Estaing, to draw up a Constitution for the EU. This was designed both to supersede all previous treaties and to push the process of integration further forward. It was also supposed to make the organization easier to understand and more genuinely democratic, with a number of principles set out to guide future integration, including the principle of 'subsidiarity', by which decisions were to be taken at the lowest appropriate level. This was calculated to reassure those who feared the creation of some impersonal European super-state. The Convention produced a draft document in July 2003 and symbolically, after considerable wrangling between the member governments, the Constitution was signed in October 2004 in Rome—the same place where the original European Economic Community (EEC) treaty had been signed forty-nine years earlier. The EU also continued to expand, with an unprecedented number of countries joining in May 2004—the ten included eight East European states (Poland, Hungary, Czech Republic, Slovakia, Slovenia, Estonia, Latvia, and Lithuania) and two Mediterranean ones (Cyprus and Malta)—with two more East European states, Romania and Bulgaria, following in January 2007. By then, however, the sense of progress had been marred by the defeat of the Constitutional Treaty. In mid-2005 it had to be abandoned because voters in two key states, France and the Netherlands, both founder members of the European Community, had rejected it. The French vote, by a decisive 55 per cent on a high turn-out, was especially shocking, though it could be blamed on it having been turned into a vote on the performance of President Jacques Chirac, rather than as reflecting a fundamental French turn away from the dream of European unity.

The situation was salvaged by drafting yet another treaty, signed in Lisbon on 13 December 2007, after only six months' work by an intergovernmental conference, which effectively included many proposals from the Constitution. The Lisbon Treaty simplified the workings of the EU by ending the existence of three, separate 'pillars' (including one on justice and home affairs, and one on foreign and security policy) that had figured in the Maastricht Treaty. It strengthened the powers of the European Parliament, further extended the use of weighted majority voting by the Council of Ministers and sought to raise the profile of the organization as an international actor by creating the positions of a President of the European Council and a 'High Representative' for foreign affairs. It included a Charter of Fundamental Rights for EU citizens, a document that had first been published in 2000, but had hitherto lacked full legal force. It also declared the euro to be the EU currency, even though member states could continue to opt out from using it. Another 'no' vote in Ireland ensured delays in the ratification progress, but the Treaty finally came into force in December 2009, when Belgium's Herman van Rompuy became the first President of the European Council and another little-known figure, Britain's Catherine Ashton, became High Representative. By then, the organization was being buffeted by the global financial crisis which, by leading to severe economic problems in Greece, Ireland and Portugal, called into question the stability of the euro. Far from being an entirely negative experience, the crisis led to calls from some members for deeper integration. Thus, at an EU summit in December 2011 all members except Britain agreed to establish an agreement on Eurozone budgetary controls, which would cap spending deficits; while, in June 2012, continuing problems in the financial sector led to plans for a banking union.

costs. Otherwise, the single currency would prevent the less competitive southern European countries being able to offset this disadvantage through devaluation of their currencies. Just as the other element of Keynesianism, higher taxes in times of boom, had been ruled out by consumer-driven liberal democracy, so the balance of payments problem could no longer be resolved by devaluation once a single currency was created. Not all countries could emulate the economic successes of German industry, nor could they always guarantee to run similar trade surpluses to Germany's within Europe.

The initial crisis struck in Greece, where the Socialist government, elected in October 2009, announced a few months later that debt had reached more than 110 per cent of GDP (the true statistics having been hidden previously). This was well above the level that was supposed to be allowed by Eurozone rules and led to fears that Greece might have to leave the zone, and maybe even default on its debts. In February 2010, the introduction of an austerity package sparked the first of many street protests in Athens; in May, the Eurozone and IMF, rather than see Greece collapse, put together a rescue package of €110 billion. Action in Greece, however, only focused attention on similar problems in another Eurozone member, Ireland, where government debt had been increased by the need to bail out one of its largest banks, Anglo-Irish, back in January 2009. In November 2010, the Eurozone and IMF had to put together a rescue package for Ireland, too, this time totalling €85 billion linked, as in Greece, to a swingeing austerity package. Similar measures were required in Portugal in May 2011, when a €78 billion bail-out fund was created. The Eurozone's leaders eventually hoped that the creation of a €500 billion 'European Stability Mechanism' would prevent any further problems on the money markets. But, instead, problems persisted. Greece was still saddled with enormous debts, its people were demoralized and there seemed little chance of a quick recovery. By mid-2011, there were renewed fears that it could default on its debts and yet another round of austerity measures had to be introduced before a second rescue package, almost as large as the first, was put in place. All of this, however, added to the indebtedness of the rest of the Eurozone and there were now fears that the next crisis would occur in one of the big economies, like Italy or Spain. Italy's economy was larger than those of Greece, Ireland, and Portugal combined.

In August 2011, the European Central Bank took steps to ease the debt burden on both Italy and Spain, but there were doubts about the long-term ability of the Eurozone to continue shoring up economies in this way. There were also doubts about the willingness of voters in Germany to continue paying most of the costs. Germany had good reasons to sustain the Eurozone, where its largest export market lay and which had helped guarantee low inflation over the past decade. The euro also provided a highly competitive currency so far as German exporters to non-Eurozone states were concerned: if Germany had retained its own currency, this would have risen in value on the exchange markets, thanks to the country's buoyant circumstances; this in turn would have made German exports more expensive and acted as a brake on its growth. But, despite such advantages, Berlin was not happy to throw money at the weaker economies. Germany had come through the 2008–9 recession better than most, its manufacturing output remained strong and voters were frustrated by what they saw as the failure of other members to keep their houses in order, while expecting the Germans to pay for their consumption and living standards acquired through borrowing rather than earnings. In other words, rather like the bankers, the weaker Eurozone members were expecting ordinary German people to pay the costs of their misguided decisions. A fundamental difficulty became the German refusal to allow the European Central Bank and German money to guarantee debts of the weaker Eurozone members, at least until a savage programme of cuts in public expenditure had been implemented.

In 2012, the Spanish banks had reached crisis point following the bursting of the country's property bubble and rising mortgage debts. As there had only previously been attempts to put patches on the Eurozone's problems, in the summer of that year what many termed (not for the first time) the 'last chance' for the Eurozone was being faced. As the latest crisis engulfed Spain, the German Chancellor, Angela Merkel, softened her hard-line stance on debt reduction and European bail-out money. Merkel, for the first time, agreed to remove the requirement that preferred creditor status be given to governments over private creditors on the proposed €100 billion rescue package for Spanish banks. In other words, the latter would not play second fiddle to governments if the debt had to be rescheduled, thus making Eurozone taxpayers, including Germans, as much at risk as private creditors. Another concession was to make the bail-out funds directly available to the banks for recapitalization, instead of going through governments and thus adding to national debt levels. Finally, the most significant development was the agreement to set up a supervisory system for European banks that, in reality, would form the first step towards a full banking union, which would mark a significant new step for European integration. Importantly, this last was made a precondition for allowing direct recapitalization, which would only happen when the supervisory system was in place. The existing bail-out funds would become, once all the details were finalized, a new European Stability Mechanism. As a result, the interest rates earned by lenders and paid by the Spanish government on ten-year Spanish bonds, which had risen to an unsustainable 7 per cent, began to fall. But there will be many contentious points to be thrashed out on the details of a banking union over the next few years as the Eurozone moves closer to fiscal integration. Until then, the crisis in the Eurozone remained part of the broader financial crisis of capitalism centred on the developed world.

The Post-Crisis Depression

As a direct result of the state bail-outs of private, Western financial institutions, several advanced economies acquired what was regarded as unsustainable levels of borrowing. Such high levels of debt became a concern for the money markets, as the risks of sustaining those levels (ironically, given the markets' previous behaviour) now appeared to contain excessive risk. There was a political benefit in trying to put the entire blame on the public borrowing of past governments, an accusation that, despite events since 2007, also served to justify continuing faith in free-market capitalism. Nonetheless, the real issue now was how to revive economic growth in a climate no longer conducive to the easy borrowing of money. It was, in part, a choice for governments between the devil, of cutting expenditure and providing no loans to encourage smaller businesses, or the deep blue sea, of providing finance for businesses and more housing, or other infrastructure projects, which would increase public debt levels in the short term. Moreover, directly cutting government expenditure would not reduce the debt by the expected amount, because of its deflationary consequences in producing unemployment, pushing up social security expenditure and reducing household spending: all these would serve to increase spending and reduce government income from taxation. Thus, economic growth and recovery would become more difficult.

It was clear in 2012 in Britain (a non-Eurozone state), where external bail-outs did not require strict austerity, that simply relying only on cuts would restrict economic growth and recovery. The Conservative-led government of David Cameron had planned to achieve debt reduction predominantly through cuts in public expenditure, as opposed to increases in taxation. But this had simply led to a 'double-dip' recession, as growth rates again became negative. In the US, more thought was given in 2012, a presidential election year, to allowing for a mild economic stimulus to alleviate the problems of unemployment and thus a 'double-dip' recession was avoided, although the economy still faced a slow-down, not helped by the knock-on effects of problems in the Eurozone. In both the US and Britain, the burden of debt reduction, to a greater or lesser extent, continued to fall on ordinary taxpayers, rather than the high earners in the banks and financial service industries who had been primarily responsible for the debt problem. Public sector workers, in particular, have paid a high price in redundancies and wage restrictions.

In the US, the debt from the bail-outs was used by some as a reason for reducing the scale of Obama's health-care reform. This was an example of how Western societies have polarized, in a zero sum game, the difference between public and private good rather than, as was the case until the 1970s, believing that individual and social benefits should be reconciled and balanced for the benefit of all. The Obama administration chose not to restructure the banks (meaning reorganizing their liabilities with losses for shareholders, perhaps with some new equity given for those losses). Instead, the federal government continued to give bail-outs to the banks. The initial money in TARP was provided without conditions and, in 2009, the administration announced a new programme, the Public–Private Investment Program, to buy toxic assets from banks, and so remove debt that was unlikely to be repaid from their balance sheets. Like all off-balance sheet transactions this did not mean that the debt disappeared, just that it was redistributed to someone else's balance sheet, in this case the US taxpayer. By 2012, all the bail-outs and guarantees provided by the federal government (though not all of the guarantees will necessarily have to be met) totalled nearly 80 per cent of US GDP—a staggering $12 trillion.[2]

One key question was how best to restore some degree of regulation to prevent a reoccurrence of a financial crisis. The other more immediate task was how best to repair the damage done to the real economy by the 2008 financial crash. In the UK, which returned to recession in 2012, greater liquidity from increased public expenditure was deemed undesirable and thus 'quantitative easing' (effectively printing money and pumping it into the economy via the banks) was first used to try and stimulate activity. Yet, unless the banks were to be nationalized, there was no way of guaranteeing that they would channel the money into the 'real' economy. Bizarrely, on both sides of the Atlantic, governments expected that giving money to the very institutions that had demonstrated such incompetence in risk and credit assessment in the past would now ensure that credit flowed to those sectors of the economy best able to use it to deliver growth. Unfortunately, there was nothing to prevent the banks using the extra money to improve their own balance sheets by reducing debt ('deleveraging') as opposed to providing loans to businesses. This prevented many smaller businesses from getting access to the loans which they required to make a positive contribution to growth. After the 'credit crunch', therefore, the difficulties of accessing loans remained and using banks to promote new enterprises was still problematic. Governments in North America and Europe generally failed to discipline the bankers and prevent them from acting in similar ways to the past. Instead, they cut public expenditure, which provides most benefit to those less well off, in the name of debt reduction, without creating the economic growth for a long-term solution to the debt. Most advanced economies therefore stagnated, with no clear indication of how, or when, a significant recovery would occur.

Keynesian economists claim that a greater role for government is required in the disruption of the market, by directing money into areas, such as infrastructure, which provide jobs and social benefits for the majority. The Right, however, sees the solution in removing expensive social provisions, such as free health care and good pensions, in the continuing belief that the market can operate most effectively without any form of state control. When the market failed to operate perfectly in the advanced economies, the US government chose not to help those losing their homes, but to introduce a corporate welfare system. The consequence was the largest market intervention by governments in history.[3] The impact of this contributed much to creating the new age of globalized uncertainty. The social consequences of the economic changes and their effects on the international system, now less subject to the power of nation states, remain to be determined. Surprisingly, the financial crisis so far shows little effect on the faith of Western governments in free-market capitalism. This may increase the speed of the shift in production to China and other developing countries. On the other hand, the continuing crisis of capitalism, in a globalized system still dominated by the US, may yet severely damage the developing states as well. Nonetheless, the free-market mantra that has dominated the world since the 1980s, has suffered a near-mortal blow. Western capitalism is no longer a fixed point around which the turbulent winds of democracy can flow freely. Thus, while the end of the Cold War may have removed the utopian illusions of Soviet-led communism and its horrors, it may be said that the West clung to an opposing set of utopian fallacies, similarly detrimental to the weaker members of society, which were exposed after 2007. The future of the West in managing its flawed dominance remains problematic and unclear. It is now time to turn to the rise of a major competitor, a survivor of the Cold War, Communist China.

B. The Continuing Rise of China

After the death of Mao Zedong in 1976, China had embarked on a gradual economic restructuring which took the Asian giant down a successful economic path, merging strong elements of private enterprise with a much reduced degree of state regulation. The resulting, positive impact on economic growth, accompanied by greater access to foreign capital, a more open interaction with the outside world and increased opportunities for individual gain, had far-reaching consequences for many millions of Chinese and a major impact on international relations. China remained a communist state in social and political terms, with the Chinese Communist Party continuing to exert enough political control to prevent Western ideological values of democracy, freedom of speech, and information being fully accepted by Chinese elites and absorbed into Chinese society. There was still a big gulf between China, now an apparently successful capitalist state experiencing high economic growth rates of over 9 per cent, and the capitalist, democratic states of North America, Europe, and Japan, who had enjoyed economic growth for much of the post-war period based on state-influenced market economies and a liberal political ideology.

The transformation produced by Deng Xiaoping's economic reforms, which attempted to combine a strong Chinese state with Western-style free enterprise elements, raised a series of questions about China's role in the world, which has been evolving as a direct consequence of the reforms. Economic power is always likely to be accompanied by the acquisition of greater military strength and international political influence by states. With the acceptance of something akin to the Western economic system and the delivery of dramatic economic growth rates, the establishment of capitalist norms and the increasing involvement with international institutions—including, since late 2001, the World Trade Organization (WTO)—have to be reconciled with Chinese culture, society, and its values. If it were simply to supersede Chinese culture, trampling over tradition and history, then the country's positive participation in the international system will face more Chinese questioning. This threat to internal stability and to China's external involvement with the international world, both politically and economically, will grow more acute should economic expansion falter. Indeed, there are arguments that the growing inequality, and consequent resentment, that capitalism engenders when freed from economic state controls and social responsibilities, has already produced significant unrest in parts of China. Equally ominously, there are those who claim that China, as with former economically expanding powers, will demand greater international respect and influence. Thus, it should be assumed, according to these traditional 'realist' thinkers, that China will challenge the status quo which will require other powers, especially the US and Japan, to contain and balance it, before China is tempted to embark on more threatening policies.

Even though China's military power was still, in 2012, much less than that of the US, it could no longer be dismissed as insignificant, as it was in the 1980s. Neither could its economic rise and consequent demands for more resources, in the form of oil and minerals and finite natural resources, be ignored. This was part of a broader challenge to the pre-eminence of North American and European capitalism by the so-called BRIC powers (Brazil, Russia, India, China), to whom could be added other rising economies, like South Africa and Indonesia. The challenge became more marked after 2007 when the international economic order, with its features of high wages and social benefits for employees in the developed world, came to the brink of financial collapse—although, by 2012, there were signs that the continuing economic problems in 'the West' were having a knock-on effect among the BRIC countries and that Chinese growth rates were suffering. Increasingly after the 1980s, high levels of wealth for employees in the West were focused on the financial services sector, as opposed to the manufacturing one, which in essence only survived in low-volume luxury goods in much of the developed world. As China supplied more and more manufactured goods as a percentage of international trade, these momentous changes have been accompanied by the virtual collapse of the Western-dominated global financial system, which was increasingly 'liberated' from government-imposed controls after the 1980s in the belief that freer markets were the best way to deliver growth. The 2007–8 financial crisis was bigger and longer-lasting than any since the 1930s Depression. As shown, in contrast to the post-1997 crisis, which was largely confined to Asia and a few other less-developed economies (notably Argentina), the post-2007 crisis centred on the US and Europe, where high levels of debt, notably in the Eurozone, rendered the financial system unsustainable on the basis of individual nations without massive state and international intervention. The concern at the resulting uncertainty for employment, pensions and average wage levels in the West is more palpable than the uncertain outcomes of Chinese attempts to contain domestic social unrest, created by the growing inequality produced by unconstrained market forces.

This prediction of an uncertain and unstable international future has been accompanied by concerns arising from the experiences of China's unfortunate past, which brought division and subjugation at the hands of the imperialist powers. The humiliation experienced by China at the hands of the imperialist powers in the nineteenth and twentieth centuries, including the Japanese as well as the European powers and the US, provided the historical context in which China's search for identity and development are located. The conflicts imperialism produced in the twentieth century continue to resonate strongly in China. The elements of nationalism and territorial sovereignty have long been present at a number of levels amongst

Vladimir Putin's Russia

Born in Leningrad (later renamed St Petersburg) in October 1952, in the last months of Stalin's rule, Putin studied law at the city's university, joined the Communist Party and, in 1975, entered the Soviet intelligence service, the KGB. In 1990 he began to work for the Mayor of St Petersburg, Anatoli Sobchak, as a foreign policy adviser, but in 1996 he took up a post in the national government. He became head of the Federal Security Service (the main successor to the KGB in Russian domestic politics) two years later. The Russian President, Boris Yeltsin, made him prime minister in August 1999 and, although he was still little known abroad and had some better-known rivals for leadership at home, he was able to exploit the rising violence in Chechnya to make himself the natural successor to his ailing leader (see Chapter 20, B).

Despite his clear election win, with 53 per cent of the vote in March 2000, Putin's slow, and outwardly cold, reaction to the sinking of the submarine *Kursk*, in August of that year, when over a hundred sailors died, was much criticized. But his efficiency and toughness marked a major step away from Yeltsin's volatile, even embarrassing leadership and, helped by growing oil revenues, he soon gave Russians more hopeful economic prospects. The food shortages of the 1990s ended, incomes rose, and poverty was reduced. To strengthen his hold on power, critics also accused him of establishing a semi-authoritarian regime, marked by control of the media, manipulation of election results in favour of the United Russia party, and the intimidation of opposition figures. United Russia easily won elections in December 2003 and 2007: it was even claimed in 2007 that it had secured the vast majority of votes in Chechnya. Putin won his second four-year term as President in March 2004 by an overwhelming margin of 70 per cent. Critics also suspected the government of involvement in the death of key opponents of the regime, including Anna Politkovskaya, a journalist who was shot in Moscow, and Alexander Litvinenko, a former intelligence official who was poisoned in London, both in 2006. Another prominent critic of the regime, the oil billionaire and liberal Mikhail Khodorovsky, was charged with tax evasion in 2003 and faced years in prison.

Some opponents remained active but they were a disunited mix of liberals, nationalists, and former communists. The nationalists found some of their appeal stolen by a president who reasserted central power in the regions; communists found it difficult to compete with a former KGB officer; while the liberals who had been brought into power by Yeltsin, were now gradually pushed aside in favour of Putin loyalists. Rallies against him in 2007 were broken up by the police or banned. The Russian constitution would not allow Putin to serve a third consecutive term as President, but he was able to put a close ally, Dmitri Medvedev, up for the post instead. Medvedev, born in 1965, was a fellow native of St Petersburg, a lawyer who had met Putin after entering the city's politics. He helped run Putin's 2000 election campaign and became a deputy Prime Minister five years later. In May 2008, after winning the presidential elections, he made Putin his Prime Minister, but with the latter continuing to play the dominant role in Russian political life. Putin's predominance was confirmed when he decided to run for the presidency once more in 2012. His popularity was called into question by large-scale demonstrations against supposed irregularities in December 2011 parliamentary elections, which were again won by United Russia—but with its share of votes falling below 50 per cent. He easily won the March 2012 presidential election, with almost two-thirds of the votes cast. Some irregularities were reported again, sparking further demonstrations against him, but his hold on power seemed secure enough.

Putin not only maintained the firm policy towards Chechnya that had helped secure his succession to Yeltsin, but was also prepared to be tough in relations with the states of the former Soviet Union. There was a brief dispute in 2003 with the Ukraine over control of the Kerch Strait between the Azov and Black Seas. In the Ukraine elections of 2004 Putin controversially supported Victor Yanukovich, but—following the so-called 'Orange Revolution'—he was eventually defeated by the independent Viktor Yushchenko. The most serious differences arose with Georgia, which steered a pro-Western policy, but was weakened by the continuation of separatist movements in Abkhazia and South Ossetia. In August 2008, after Georgian troops entered South Ossetia, Russian forces launched a week-long invasion of Georgia, after which Moscow recognized the independence of both the rebel regions.

One element in Russian policy was the use of its privileged position in terms of energy reserves, as one of the world's richest sources of oil and the largest potential supplier of natural gas. Putin's government played an increasing, direct role in the energy industry. The state-owned oil company, Rosneft, was able to take over part of the operations of the imprisoned Khodorovsky and in 2005 the Kremlin took a majority stake in the gas company Gazprom, which then expanded its operations and struck major deals with foreign firms to develop gas fields and pipelines. Gas was supplied to much of Europe and to China. Control over huge gas reserves allowed Russia to flex its muscles against uncooperative neighbours, as in January 2006, when it cut supplies to the Ukraine during a dispute over prices, and in January 2007, when an argument about a transit tax led it to cut supplies through Belarus, a step which temporarily halted supplies to the rest of Europe. A similar, but more serious dispute blew up two years later, when renewed differences with

(*continued*)

Vladimir Putin's Russia (*continued*)

the Ukraine cast uncertainty over gas supplies to parts of Europe for a month.

In foreign policy, Putin at first seemed to maintain Boris Yeltsin's policy of cooperation with the West and China. In July 2001 he sought to re-establish close relations with China, signing a friendship treaty with its visiting President, Jiang Zemin. In May 2002 he agreed both on a new round of nuclear weapons reduction with the US and to set up a Council for cooperation with NATO. Russia also continued to integrate into the world economy, with the rouble becoming a convertible currency in 2006. But soon after that, as he sought to assert Russian power, Putin began to show that he was prepared to risk tension with the West. In 2007 he became highly critical of US President Bush's attempt to create a new missile shield in east-central Europe, including Poland and the Czech Republic. Washington said the shield was to defend NATO against the possible development of an Iranian threat, but Putin accused the US of starting a missile race with Russia. The rhetoric on both sides was reminiscent of the Cold War. In November, Putin also suspended Russia's participation in the 1990 Conventional Forces in Europe Treaty, one of the major East–West agreements that had marked the end of the Cold war. Around the same time, relations with Britain worsened when Moscow refused to extradite the main suspect in the Litvinenko murder, while Canada was upset by Russia's attempt to assert rights in the Arctic. The western powers were generally sympathetic to the Georgians, in the short-lived war with Russia in August 2008.

After that, Russian confidence was knocked by the impact of economic recession. As elsewhere, share prices tumbled, industrial production suffered and an expensive rescue package was needed to shore up the banking system. Tensions with Washington eased during 2009 when the new President, Barack Obama, ended his predecessor's plans for missiles to be deployed in Poland and the Czech Republic, in favour of a scheme for missiles largely based on US navy vessels in the Black Sea (though with some based in Romania). In April 2010 it was even possible for Medvedev and Obama to sign a new Strategic Arms Reduction Treaty, reducing their strategic arsenals by almost a third. Even the arrest of ten Russian spies in the US soon afterwards, did not disrupt relations for long and when, in 2011, Putin criticized NATO action against Libya's Gaddafi regime, Medvedev—in a unique personal difference with his Prime Minister—publicly rebuked him. With Putin's election to a third presidential term in 2012, however, the situation was rather different and, along with China, he resisted Western pressure for strong UN action against Syria, as it slipped into civil war.

the Chinese population both during and after Mao's dictatorship. In future, this nationalism might manifest itself in positive and peaceful forms, or in harmful and threatening ways. Some issues, such as the British hold on Hong Kong, or the Portuguese enclave at Macao, were peacefully resolved in China's favour, and they reverted to Chinese sovereignty in 1997 and 1999 respectively. Neither, despite protests from some of the indigenous population, does the Chinese hold on Tibet, which Mao's forces invaded in 1950, seem in doubt. However, a key focus of past nationalism and Chinese unity was, and remains, the position of Taiwan following the creation of two Chinas after the Chinese Civil War (the People's Republic of China on the mainland and the Nationalist government on Taiwan). For Chinese elites in the early twenty-first century, economic development and increasing access to wealth form part of a bargain with which to legitimize, and gain acceptance for, reforms and the changing political and economic roles of the communist government. But, if economic growth falters or produces major challenges to the social and political order, then one way of dealing with this would be to 'play the nationalist card' which is always hovering over Taiwan.

The Case for China's 'Peaceful Rise'

There are economic advantages and benefits from increased trade and wealth for elites on both sides of the Straits of Taiwan in maintaining the two-China compromise and the existing status quo, however fragile or imperfect it might be. This provides support for the bigger more general argument made by those, especially in the People's Republic of China (PRC), who see benefits being provided for all, domestically and internationally, by Chinese economic growth. Its origins and development in the context of Western capitalism have only increased the interconnectedness of China and the West, particularly the US and, so the argument goes, have created mutual interests rather than antagonism and rivalries. The large trade surplus and currency reserves produced by the economic expansion serve to reinforce the mutual interests of the Chinese creditors financing the American debtors, through bond purchases and the need to gain good returns from the reinvestment of trade surpluses. Thus, the common economic interest produced by the operations of a stable, profitable trading and monetary system will prevent any rocking of political boats. Moreover, China's acceptance of many of the existing international economic and political norms reflects and reinforces a strategy of 'peaceful rise'. Yet, this interpretation of Chinese policy does beg the question of exactly how high China will rise in the world—could it eventually achieve global hegemony?—and whether the policy is a means to an (as yet undefined) end or an end in itself.

The idea of a 'peaceful rise' for China, or the idea that a policy of 'peaceful rise' is being pursued by the PRC government in Beijing, has strong advocates in East Asia. Supporters of the idea focus not only on the constructive and diplomatic way in which China has acted, particularly with regard to regional issues, but also on how China, in its actions and in its rise, has been perceived and treated by its Asian neighbours. In other words, because benefits and advantages for all powers in the region are seen as stemming from China's rise, which has helped boost economic growth in the whole region, then that rise is welcomed and readily accommodated in East Asia. The signs of opposition and a perceived need to build alliances or take measures against China are simply not there, at least not yet. Moreover, this optimistic position reflects not only the economic growth that capitalism has provided, but also the peaceful quest for a new and modern Chinese identity through successful nation-building within China and the concomitant construction of world power status built on better relations with its regional partners rather than threats and bullying.

For some of these East Asian states, particularly South Korea, for decades now a capitalist state closely allied to the US, whatever the increase in China's military strength, concerns seem still to be focused more on a revival of Japanese militarism. Korea, after all, was subjected to Japanese occupation between 1895 and 1945, and the treatment of its people still rankles. For other local powers, there is no desire to embrace the US even more closely, especially since there seems little fear of increasing Chinese strength. Economic benefits from improved relations with China and increasing economic interdependence in the region offer more attractive ways forward. One example is the new cooperation between China, the Philippines and Vietnam over oil exploration in the contested Spratly Islands. Certainly, China's regional interests have so far predominated over global ones in the form of defining maritime boundaries and developing regional economic interests. Yet, the question remains about the extent to which political relations will be influenced by favourable economic ones, whether or not the latter continue. There is also concern about whether the Chinese emphasis on forging its new identity peacefully and without territorial ambition, despite the Taiwan issue, will become a long-term objective or give way to some less palatable alternative. The prospects hinge on balancing nationalist pressures with friendly external relations (some of which may be beyond China's control). The emphasis that China places on sovereignty through control over its own internal affairs, free from external interference, may not ultimately be so easy to reconcile with the economics of globalization and the free movement of capital across national boundaries, as well as with the cross-border flow of liberal political ideas. Unless the huge market for goods that China provides can continue to persuade others to cooperate willingly in its economic expansion, without arousing fears of Chinese military power and political domination, problems are likely to arise.

The tendency of events to produce an acceptance of China's rise has so far been reinforced by the apparent willingness of China to participate in existing international institutions and their rules, which were originally put in place by the West. At the start of the internal reform process under Deng in the 1980s, the Chinese emphasis on sovereignty and non-interference in internal affairs was accompanied by a preference for bilateral rather than multilateral relationships. In the twenty-first century, however, China, as well as joining the WTO after fifteen years of negotiation, has also cooperated closely with the Association of South-East Asian Nations (ASEAN). China's strategy of upholding regional security and stability as a necessary component of economic development appeared very much on track in 2012, an impression strengthened by its attempts to promote a peaceful resolution of the North Korean nuclear issue (see Chapter 23, B). But it is doubtful whether its overall commitment to stability and acceptance of important Western values will lead China to move closer to, or ally with, the US. China could hardly accept the degree of insubordination to Washington that this would entail. Then again, China could enlarge the areas of common interest it has with America. Relations may always be based on a mix of cooperation and confrontation, with the common acceptance of economic values preventing any escalation into serious threats or challenges to the stability provided by the existing international system.[4]

Economic Change

China's economic rise has been dramatic and substantial. Since the move, begun in the 1980s under Deng Xaioping, away from a centrally planned system to an economy with an expanding private sector, China's GDP has increased tenfold. Between 2003 and 2012, Chinese annual economic growth in GDP terms averaged 9.7 per cent; by comparison, its neighbour Japan grew at an average rate of only 1.2 per cent over the same period. In qualitative terms, the World Bank estimated that, between 1978 and 2005, 402 million Chinese people were lifted out of poverty, meaning that they were now living on more than the equivalent of a dollar per day. There are, however, real problems with measuring wealth given the different currencies' purchasing power, with the cost comparisons between states purchasing the same product only working for those products that are traded internationally. There is an equally tricky problem when translating economic statistics into economic 'power' even within a narrow framework of purchasing power, which in turn raises the vexed question of the contribution of economic strength to a state's 'power' more generally. Yet there is little doubt that China's economy in the new millennium overtook Japan's in its share of world consumption, and would soon become the leading exporter in Asia. The result has been that, in February 2011, China overtook Japan as the world's second largest economy. The vast size of the Chinese population, which the 2010 census put at 1,340 million, is recognized as both an opportunity and a drawback, providing a huge workforce and market, but also many mouths to feed and individuals to rule over. Since 1979, the government has tried to enforce a 'one-child policy' on families. But, if it ever achieved a per-capita GNP of just a quarter of that of the US, it would have a total GNP greater than the US.[5]

Collectivized agriculture has been phased out in rural China and a more diversified banking system has also been put in place. With the establishment of stock markets and a dramatic rise in foreign investment, the march of financial capital has begun. China has already established itself as the world's largest manufacturer of a significant number of goods. While these were initially in the areas of cheaply produced clothing, toys, and footware, China is now manufacturing large numbers of advanced electronic and computer goods. Its technological potential was emphasized by the launch of its first manned spacecraft in October 2003. Most importantly, state enterprises have been given more autonomy in developing, producing, and marketing goods, while at the same time the government has increased its financial support for the more important state-owned enterprises. In other words, the economic changes have not simply incorporated 'free' market reforms but, in contrast to the West, the Chinese have attempted to build more effective links between the still-vital public sector and the emerging private one, as Chinese foreign exchange reserves exceeded $2.3 trillion in 2010.

Political Change

At the political level, the pattern of a government dominated by a single individual leader, exercising power through the communist party machine and the role of the People's Liberation Army (PLA), has been changing. The governmental structures and involvement of more elements of the communist party have broadened the base of decision-making, which in part reflects efforts to separate the state from the communist party. While Deng Xiaoping's position as supreme leader in terms of decision-making was achieved by complex political manoeuvring after 1976, he never held the top position of General Secretary of the Chinese Communist Party. Between 1989, in the aftermath of the Tiananmen Square unrest, and 2002, that post was held by Jiang Zemin, who had helped push the policies of market economics and export-led growth, especially in coastal cities, while maintaining the firm political control of the Communist Party under a privileged elite. Hu Jintao, the party leader from November 2002 (and President after 2003), inherited a more fluid situation in which the assumptions of a 'Mandate from Heaven', epitomized by Maoism, were increasingly filtered through the influence of important interest groups. These reflected the more open and diverse roles that the Chinese state fulfilled after Deng's reforms and given the meteoric growth of the Chinese economy. As an aspiring member of the international community, with growing contacts in the Western world, the effect has been to unleash new forces in Chinese society. For the moment, their political dimensions only rose beneath the surface and were still contained. One adverse consequence of the growing economy has been the temptation of senior officials to use their political position for financial advantage, otherwise known as 'graft', which has led to a number of anti-corruption drives since 2000.

With no strong memories of life before the Communist Revolution (he was born in 1942), Hu Jintao formed a close alliance with his close contemporary, Wen Jiabao, who became Prime Minister in 2003. Cautious, thin on charisma, and lacking any radical, ideological drive, together they shifted China's policy from a focus on growth in major coastal cities to one which benefited the rest of the country, and they tried to protect the position of Chinese agriculture. They thus sought a stable, broad-based economic development that minimized the dangers of social division and maintained the Communist Party's firm hold on power. They were also responsible for China's moderation abroad, focusing their international efforts on the development of trade and investment, the success of which served both to justify their policy choices and strengthen their hold on power. There were problems, including those already mentioned, of growing inequalities and high-level corruption. But there was no serious political challenge to the communist system such as had occurred in 1989. There were individual dissidents, such as the artist Ai Weiwei, the blind lawyer, Chen Guangchen, and Chen Wei, who had helped organize the Tiananmen Square protests. There was also a wave of protests in several cities in February 2011, apparently inspired by onset of the 'Arab Spring'. But such threats were ruthlessly dealt with by the police. Ai Weiwei, who had helped design the main stadium for the 2008 Olympics—which was turned into a celebration of China's growing international status—was accused by the authorities of tax evasion in April 2011. Chen Guangchen was imprisoned for several years, before being allowed to leave for the US in April 2012. Chen Wei was imprisoned on a number of occasions. There were also outbursts of regional, ethnic-based discontent, including periodic unrest (in 1997, 2000, and 2009) in Xinjiang province, in north-west China, involving clashes between Uighurs and ethnic Chinese, as well as continuing opposition to Chinese rule by Tibetan Buddhists, with particular problems in March–April 2008. But these were kept easily under control with no serious threat to Communist authority. The problem, rather, was the international embarrassment that dissidence and regional unrest could cause. The Tibetan violence of 2008, for example, came in the build-up to the Beijing elections and, in 2010, the dissident Liu Xiaobo won the Nobel Peace Prize.

The ousting of Bo Xilai, in April 2012, from the Politburo and his communist party posts was a rare public sign of differences among the party leadership. Bo, a former provincial governor and Minister of Trade, had joined the Politburo five years earlier and seemed to be a rising star. The son of one of Mao's closest colleagues, he had been something of a critic of free enterprise measures, recently winning popularity in the populous city of Chongqing by cracking down on corruption and advocating egalitarianism over the increasing tendency to amass private wealth. At the same time, he achieved high growth rates in the city and was happy to attract Western investment. But his wife was implicated in the death of a British businessman and he was himself suspected of spying on other leaders—including President Hu Jintao—who were increasingly suspicious of his ambition, ruthless methods, and Maoist leanings which made him a threat to other leaders. Bo's fall came only months before the President and other senior party figures, including Premier Wen, were thought to be planning a mass retirement, to be replaced by a younger generation.

The future course of events is difficult to predict. On the positive side, the involvement of more individuals in political life, even if only through better provision of information, may sow the seeds for a less-centralized communist party. On the other hand, the rise of various coordinating groups which wield power over the party, state and military organs may increase confusion. China still lacks a well-defined bureaucratic hierarchy and the Politburo's Standing Committee has to rely on a complicated array of civil and military bureaucracies to implement policy, which is itself frequently shifting. The Foreign Affairs Leading Small Group (FALSG), concerned with defining China's role in international affairs, and chaired by Hu Jintao, is an example of a group that has grown in importance since the 1990s. Partly thanks to the growth of rival bodies, the influence of the People's Liberation Army (PLA) over the party and government, particularly in external affairs and defence policy, is no longer as absolute as it once was, whatever continuity there has been in the strategic principles underlying Chinese security policy since Deng's death. The reduction of the PLA's power and the strengthening position of FALSG could be interpreted as an attempt to bring together the Party and the state government bureaucracies, including the Ministry of Foreign Affairs, involved in the formulation and implementation of international policy. But the precise aim, if there is one, is uncertain. This is of some concern because the PLA's role is highly relevant to any analysis of the long-term goals of Chinese foreign policy. There also remains inherent tension between the role of the Politburo's Standing Committee and the informal, personal relationships that still characterizes the post-Mao leadership system and which make it enormously important who succeeds Hu and Wen.

Of course, for many Western observers, the problem remains China's lack of real progress towards basic freedoms, liberal democracy, and human rights. As long as people in China remain at risk of imprisonment for their political views, the possibility of a worsening of relations with the West will be there. Both sides may have to restrain their rhetoric on such sensitive issues to preserve better relations. The dilemma for China is that, by allowing greater political freedom, including such simple steps as greater access to the internet, it may weaken the degree of government control necessary to avoid the more negative repercussions of the dramatic economic change.

Military Change

The increase in China's military strength, alongside its remarkable economic growth, has increased the intensity of the debate about whether China's power can be reconciled with the existing international order, or whether significant revisions of the latter will be required. In the late twentieth century it was possible to downplay the hard power issues, including the importance of military strength, by arguing that China was insignificant in these terms. In the new millennium this is no longer possible. One military element that has been relatively constant since before the Communists even took power, has been the importance of the PLA, which includes all the branches of Chinese armed forces. In 2005, China had 2.3 million members in the armed services: 1.7 million in the army, 220,000 in the navy, and 420,000 in the air force. But since the end of the Mao era in the 1970s, the PLA has been subject to greater civilian influence. Technology has also become an ever more important component of military strength, and the Chinese have begun to make up the considerable technological gap with the West and the US in particular. Alongside increases in the production of consumer goods, has also come the greater production of arms for export. Although China has yet to match the West and Russia in this field, it has found particular markets in some less-developed states including Sudan and Zimbabwe, which has drawn criticism because of the authoritarian nature of the countries involved. China has also helped arm Pakistan and Iran. Some of its weapons have found their way to Iraq and Afghanistan, giving the impression of some anti-Western design, but the weapons may pass via the black market and the Chinese government introduced tighter controls on such exports.

Progress in the development of the air force has been significant, even if China has had only limited success in producing cutting-edge supersonic aircraft and has thus relied on Russian technology. Of particular importance is the Russian Sukhoi SU-27, which is their major fighter aircraft. China initially received 50 planes in the 1990s and planned to assemble 150 more. Before that it had an air force of antiquated aircraft including 450 MiG-19 and even some Korean War-era fighters. Chinese strike aircraft carried unguided bombs or missiles, which could be operated only within visual range. It was thus unable to carry out effective air to ground attacks, as it lacked the modern weapons necessary. The primacy given to holding air superiority over China and defending attacks on the country made the PLA Air Force an essentially defensive force. It had no long-range strategic bombers and its bomber force was small. Since 2000, not only has more advanced equipment arrived, but also Chinese armed forces have become more 'professional' with a drop in numbers accompanied by improved training. The number of advanced 'fourth generation' aircraft, similar to those operated by the US, has quadrupled. These include China's own advanced fighter jet, the Jian-10, deployed since 2002 and comparable in performance to the US F-16. The Chinese have now tested their own air-to-air missile, the PiLi-12, and in 2007 they even test fired a missile into space, successfully hitting a redundant satellite. In part, all this may simply be a natural 'modernization' of equipment, but advances in the air force also provide greater offensive capabilities. A greater proportion of fighters are now capable of attacking ground forces.

Any increase in offensive capabilities obviously has significance for an attack on Taiwan. Yet a key element in any invasion would be airlift capability, to carry troops to the island, and there has been no significant development of such a capacity, even if the 2008 National Defence Review talked of improving its 'strategic force delivery'. Meanwhile, the lack of a mid-air refuelling capability limits China's ability to project air power on a global scale. The obvious conclusion is that China remains a long way from challenging the US in terms of air power, but its military strength from projecting that air power on a *regional* basis can no longer be dismissed. For example, China has 2,600 combat aircraft, compared to Japan's 350, and the technological gap continues to close. In December 2010, the first pictures appeared of an advanced Stealth fighter, which the Chinese government later confirmed had undergone test flights and which could propel China into the front rank of the world's air forces.

Turning to naval strength, in July 2011 China acknowledged it had an aircraft carrier programme to enhance its capabilities. The first carrier was actually built from a former Soviet vessel, acquired from the Ukraine, and had its first sea trials in August 2011. With only one carrier, the projection of Chinese naval power is clearly subject to considerable constraints and it effectively relies on US naval power to protect its shipping lanes. Cooperation with the US is so vital that Chinese ships docked in the US Navy base at Guam in 2003, a month after US ships docked in the port of Zhanjian, in Guangdong province. But China has also begun construction of its first fully domestically-built carrier, in Shanghai. When it is completed, around 2017, it will bolster the regional significance of Chinese military power. China already has 149 surface combat ships compared to Indonesia's 51, giving it regional naval dominance within South East Asia. Again, as with the air force, questions have to be asked as to the purpose of these developments, not least by the Taiwanese. In a future limited conflict with Taiwan the Chinese navy might be able to blockade the island long enough for its ground forces to overwhelm the island's defences. China also has 67 submarines, a number of which are nuclear-powered vessels armed with ballistic missiles, even if the boats are unreliable and rarely venture out to sea. Once again, since 2000, a number of these have been bought from Russia. But in 2004 China launched a new, Shang class of nuclear submarine and in 2005 it successfully tested the Jilang 2 intercontinental nuclear missile with a range of nearly 10,000 kilometres.

C. International Reactions to China's Rise

East Asia

China's recent increase in defence expenditure, which had already doubled between 1985 and 2002, has not yet produced counter-measures by other East and South-East Asian nations. South Korea and Vietnam, despite past hostilities with China, have both reduced defence expenditure in the new millennium. Even the Japanese have not matched China's increases in defence expenditure and in 2005 Japan reduced its defence budget. This is despite the fact that, since the 1990s, Japan has tried to become less reliant on the US to deter aggressors and has shown some willingness to send forces overseas. While China was named as a potential threat in the 2004 National Defense Program Outline, the document emphasizes economic interdependence, rules out the idea of becoming a major military power and shows no desire for a leadership role in East Asia. What has changed is the economic role of Japan in the region since the 1997 financial crisis. By 2001, Japan's share of Asian trade had dropped from 45 per cent in 1992 to 30 per cent with a relatively stagnating economy. By contrast, China's share *over the same period* grew from 6 per cent to 15 per cent, and this with considerable foreign direct investment (FDI) from Japan. Japan's economy has shown a turn to Asia, reinforcing the increasingly Sino-Centric Asian economic order. Sino-Japanese relations have been marred by some heated rhetoric, including diplomatic exchanges in 2005 over the content of Japanese historical textbooks on the Second World War. Yet relations recovered by the time Wen Jiabao made the first visit of a Chinese premier to Japan in April 2007. Economic relations have grown closer and Japan may even have accepted that China will eventually dominate the region. In 2004 Japan became China's largest trading partner and commerce between the two has continued to grow throughout the decade—faster than US trade with China. Thus, as with the South East Asian states, the rising economic influence of China offers prospects of encouraging new opportunities.

China's trading potential is evidently seen by other East and South-East Asian states as more of an opportunity than a threat. This is particularly the case with South Korea. Apart from Japan, it has the most reasons to be concerned about its giant neighbour, with which it was at war in 1950–3. True, Beijing's close relations with North Korea have continued to encourage South Korea's military alliance with the US. The military umbrella provided by America and the importance South Korea attaches to the future reunification of the peninsula may be seen as challenges to China. Yet economic trends are aligning South Korea more with China. In 2003, China surpassed the US as the largest export market for South Korean goods (a position America had held since 1965). Over 25,000 South Korean enterprises now have production facilities in China and, since 2004, all major South Korean banks have branches there. South Korean opinion seems to support these closer ties as polls indicate that China, not the US, is the most important country with which South Korea should have good relations.[6]

China's apparent acceptance of the status quo in East Asia has been interpreted by some as a tactical ploy, to be pursued until its rise has incorporated greater economic and military hard power, at which point it will become more forceful and less cooperative. Already, it is pointed out, the Chinese can be tough in protecting their own position: they have, for example, resisted pressure to allow their currency, the yuan, to rise on world markets as a way to ease the world's post-2008 problems (although some upward movement came in April 2012). There are some Americans who advocate a stronger US effort to balance Chinese power in the region. But the case for continued Chinese acceptance of the status quo, and a reluctance to become a revisionist power, is strengthened by its approach to territorial disputes. On some contentious issues, China has made surprising concessions in order to reach agreement, notably with Burma, where Beijing accepted only 18 per cent of the disputed territory. While a border dispute with India (which provoked their 1962 war) remains, alongside the unresolved Senkaku Islands question with Japan, border settlements have been reached with Afghanistan, Mongolia, Pakistan, and Russia. The simmering dispute with Vietnam, the Philippines, and Malaysia over the Spratly Islands in the South China Sea, was reduced, thanks to a 2002 agreement by the parties to seek a peaceful settlement and the Chinese renunciation of force in 2005. There was also an oil-gas exploration agreement with Vietnam and the Philippines, covering an area of 140,000 square kilometres, another indication of the importance attached to economic development in the region. Then again, the dispute over the scattered Spratly Islands remains unresolved and there were harsh words between Vietnam and China in mid-2010, with Vietnam—ironically—looking to Washington for support. On this issue, at least, China showed a preference for bilateral talks, presumably because it could exert pressure more easily on this basis. In May 2012, there was a stand-off between Chinese and Philippine naval vessels off Scarborough Shoal, north of the Spratly Islands.

International Organizations

Those commentators who believe China will continue to rise peacefully point to its commitment to work with international bodies like the WTO, which it joined in 2001, and ASEAN, with which it began formal contacts in 1991 and which, since 2005, has included ten members. Both China and states in the developed Western world stand to benefit from a common acceptance of international institutions and the values they embody. Given the course of policy over the last few decades, a rejection by China of the opportunities provided by the international capitalist system is unlikely to occur in the immediate future. The most important argument in favour of China's peaceful rise stems from the economic benefits the country offers to trading partners, as the world's largest market for some goods, including cement, mobile phones, and steel. China's positive approach to international organizations was influenced, of course, by self-interest, including a desire to influence development of their rules and, ultimately, the Western norms which dominate them. Nor has Beijing restricted its policy of cooperation to the West and south-east Asia. It helped establish the 'Shanghai Five' group with Russia and the central Asian republics of Kazakhstan, Kyrgyzstan, and Tajikstan 1996, which was extended to Uzbekistan and renamed the Shanghai Cooperation Organisation in 2001. The organization began with a security focus, designed to reduce cross-border tensions, but it later developed cultural and economic projects.

On the basis of the recent evidence, despite some problems such as respect for copyright law, China generally complies with international norms and has adapted to the requirements of institutions based on Western values. It has also clearly moved from favouring bilateral relations to accepting multilateral ones. Its formal links with ASEAN have included Chinese adherence to the Association's Treaty of Amity and Cooperation in 2003, agreement on an Investment Cooperation Fund in 2009, and the launch, in January 2010, of a free trade area, all of which indicate a deepening commitment to regional cooperation. In some organizations, China's respect for the rules has led to real advantages. For example, China has been a member of the IMF and the World Bank since 1980, after taking over the seat from Nationalist China (whose regime had been a founder member of both organizations in 1945). In 2008, a Chinese academic, Yifu Lin, became the Chief Economist at the World Bank and, in 2010, China was given an increase in its weighted vote, making it the third most significant member after the US and Japan. In 2001 it was given an increase in its quota shares in the IMF and a further increase in 2011 made it the third largest member of that organization.

Taiwan and the Case against China's 'Peaceful Rise'

Chinese national identity may find expression in more assertive ways over Taiwan, which remains the main issue likely to spark a war in the region. Since the 1980s, relations across the Taiwan Strait have been volatile. Visits between the island and the mainland began in 1986 and, during the early 1990s, the two governments were able to communicate using two supposedly non-government bodies as cover, thus avoiding the vexed question of official recognition. But the same decade saw Taiwanese leaders increasingly think in terms of independence, abandoning their previous belief that China and Taiwan could be reunited under Nationalist control. Relations worsened significantly when a pro-independence politician, Chen Shui-Bian, was elected President in 2000. In mid-2001, both sides seemed to be preparing for a possible war. Chen's re-election in 2004 made the situation even worse, with Beijing again showing signs of contemplating an invasion. Yet, even in these difficult years, the attractions of economic cooperation could outmatch the political suspicions: in 2001, Chen allowed Taiwanese businesses to trade directly with the mainland, and 2005 saw the first commercial airline flights across the strait. The Nationalist Party's return to power in 2008 led to an improved atmosphere and the revival of talks via supposedly non-government bodies (which, everyone knows, are actually official talks in disguise). Tensions persist, even though Taiwan has no great strategic significance and constitutes a question of identity and status, rather than power, for both sides. China regards Taiwan's status as an internal matter, although actually the question is whether Taiwan is, or is not, a nation state: if it is not, the implication is that it is part of China. For the moment both protagonists accept the practicalities arising from Taiwan *not* being formally recognized as an independent state, but in practice it behaves like one. The main deterrent to Taiwan actually declaring independence is that this is seen as the action most likely to trigger a Chinese invasion.

The majority of Taiwanese, especially from the business community, accept the present uneasy compromise and the increased economic contacts with mainland China which have been established. In May 2009, Taiwan began to allow Chinese investment on the island and, June 2010, the two sides made an Economic Cooperation Framework agreement to reduce trade barriers further. By then, their bilateral trade already topped the $100 billion figure annually. Yet, while China has rejected force as a means of settling territorial disputes in the case of the Spratly Islands, it has refused to do so over Taiwan and it is openly increasing its military capability to invade, should it declare independence. The military balance is definitely shifting towards China and the issue remains, as it has done since 1949, whether the US would commit forces to protect Taiwan. The development of Chinese nationalism is the key internal factor which may impact on the present government policy of trying to preserve both past rhetoric and mutually beneficial economic relations. It is difficult to see how the US could construct a 'coalition of the willing' to defend Taiwan. In 2005, Japan issued a statement calling on the two parties to resolve the problem in a peaceful manner and Asian states generally tend to favour the Chinese line of Taiwan being an internal issue. But, even alone, the US is a major military player in East Asia and, in January 2010, despite Chinese outrage, the Obama administration agreed on arms supplies to Taiwan worth over $6 billion.

Aside from Taiwan, the other main potential difficulty in implementing China's peaceful integration into the international community stems from the internal problems that threaten to produce runaway inequalities, damaging social and political cohesion. As the pace of growth increases living standards, Chinese people may no longer accept their lack of political freedom. The massive exploitation of resources by Chinese industry has produced severe environmental degradation, while the limited availability of Chinese skilled labour is becoming more significant as the economy expands and diversifies. Economically, there are still some major challenges inherent in China's population size. Such large numbers of people, many of them rural dwellers (only in 2012 did statistics suggest that these had become a minority), meant that China's per capita income in the second half of the first decade of the twenty-first century was $5,000 compared with that of Japan's $28,000. If economic growth should stall, China might also face an outburst of xenophobic nationalism. But the greatest danger may lie in growing inequalities of wealth. Unless this can be tackled effectively, the consequences may be more serious than the failure to extend political freedom. Significant problems already lie in the growth of corruption and the lack of a social security system that properly protects the sick and those unable to benefit from economic growth. In short, the issue is whether gradually rising living standards for the many can compensate for the gulf between them and the more successful, privileged few.

Externally, the way in which the US reacts to increasing Chinese power and influence is also a concern. At present, US policy is ambiguous, some welcoming the opportunities provided by Chinese economic success, others suspicious and resentful. Relations have sometimes been very volatile. April 2001 saw a major diplomatic crisis after a collision between US and Chinese aircraft, yet in February 2002, George Bush Jnr made a successful visit to Beijing—the first by a US President since Nixon. The scale of further Chinese military acquisitions could be crucial in determining US policy, as could the way it builds cooperation with potential allies, like Russia (with which joint military exercises were held in 2005). Whether such actions flow from a Chinese desire for greater recognition or from an intention to use force to back more threatening diplomacy, is less important than the perception in Washington of their ultimate aim. It may be that a unipolar world, based on American hegemony, will ultimately be incompatible with China's peaceful rise. Thus, China's eagerness to play a role in international organizations may count for little. China's policy towards Taiwan and North Korea may also be crucial determinants of US and international reactions. There are other pitfalls, arising from the relative scarcity of crucial resources in China, notably oil, gas, and water. China has only a quarter of the world's average water resources by country; a 2006 drought affected around 20 million people; and its percentage per capita average oil and gas resources is only just into double figures. The shortage of resources in the country is compounded by the government's focus on exports and urbanization, leading to a relative neglect of the domestic market and agricultural production. So far, the Chinese have followed policies which involved the peaceful acquisition of such resources from as far afield as Africa and Australia. China has recently become a key donor of development aid, making $110 billion in loans in 2009–10, in Asia, Latin America, and Africa. There has been a particular drive to build up relations with Africa since 2006–7. But these efforts seemed to be linked to gaining natural resources in return, including oil deals with Brazil and Venezuela, and purchases of agricultural land in Africa. The concern is whether operating cooperatively within the existing capitalist system will remain the only acceptable way for China in future.

There is no doubt that as China has integrated into the capitalist world it has made great efforts to create a positive image of international responsibility. But the future could point in very different directions. As China's hard, military power develops, it may breed opposition from the US and other states, who could try to deny it the status in the world that its economic strength now appears to justify. Or the opportunities for peaceful change and economic prosperity will continue and China's integration into the international community will be strengthened. The rise of China is, therefore, a key component of the age of uncertainty which the new millennium has produced. Proponents of the 'peaceful rise' scenario can point to the way in which realist theories have become outmoded in the face of the evident benefits of cooperation. In the decade before 2005, US imports from East Asia increased by $263 billion, of which China contributed $200 billion. As a result, by 2012 East Asian countries were financing almost $2 trillion dollars of US debt. It is easy to portray the significance of such interdependence as removing any potential problems that might arise from foreign policy differences. The Pentagon may be suspicious of China's military strength, but potential rivalry can be mitigated, not least through the military hot lines and naval cooperation that already exist. Indeed, further 'engagement' by the West with China in military terms may be an integral part of a successful peaceful rise for China. In other words, more might be needed than economic interdependence and self-interest to accommodate China's rise. Another requirement may be the acceptance of different cultural values and approaches to such key political concepts as human rights. But it should also be borne in mind that some of the challenges for the

Hugo Chavez and Venezuela

Chavez, who became President of oil-rich Venezuela in February 1999, was a persistent thorn in the side of the US, but a charismatic leader of the underprivileged in Latin America and the representative—like China and Russia—of an alternative way forward to Western liberalism. Born in 1954, the son of two schoolteachers from a poor, rural area, he initially pursued a military career but, alienated by the corrupt political system and widespread poverty, turned to revolutionary politics and formed a secret group within the army, the Revolutionary Bolivarian Movement—named after the nineteenth-century hero of South American independence, Simon Bolivar. Chavez was imprisoned after trying to launch a military coup against the government of President Carlos Perez in early 1992, but was released in 1994 after Perez lost power. Chavez now turned to legitimate politics, proved a master of the media and secured a clear victory in presidential elections of December 1998, at the head of a coalition of small parties. He won a referendum on constitutional reform, including the creation of a one-house Parliament, the following year. Re-elected in 2000, he survived an attempted coup in April 2002, several weeks of general strike between December 2002 and February 2003, and a referendum on his rule in August 2004. He won the last with 58 per cent of the vote, largely thanks to his continuing popularity among the poor, and he was re-elected President in 2006. His policies included nationalization of certain industries and the establishment of workers cooperatives, as well as literacy, health, and social welfare programmes. Creating a Venezuelan Socialist Party in 2007, he was guided by the concept of 'socialism for the twenty-first century', a mix of Marxist economics, a gradualist approach to reform, and a belief in using referenda to decide key issues. Opponents accused him of undermining democracy, the independence of the judiciary and the freedom of the press. In contrast, supporters saw him as tackling poverty and official corruption far more successfully than previous leaders.

Initially, where foreign policy was concerned, he seemed moderate enough, going to the US soon after he took office to meet President Clinton. But he soon became a controversial critic of American foreign policy, criticizing the US interventions in Afghanistan and Iraq. His decades-old friendship with Fidel Castro, led to an exchange deal in 2004, in which Venezuela provided Cuba with oil in return for Cuban teachers and doctors being sent to work in Venezuela. He became friendly with such anti-Western figures as Colonel Gaddafi (to whom he was rumoured to offer asylum in the face of the 2011 discontent in Libya), President Ahmadinejad of Iran (with whom he exchanged several visits), and Bashir al-Assad of Syria (who he supported despite the latter's ruthless attacks on the opposition in 2011–12), all of which undermined his hopes of a rapprochement with the US after Barack Obama took power. But Chavez did not simply court controversy; he also tried to build alternatives to US and capitalist dominance of the Americas. In 2004, he was active in launching the proposal for a 'South American Community' (based on the European Union), which became the 'Union of South American Nations' three years later. Partly to undermine the US-backed 'Free Trade Area of the Americas' (which had been launched in 1994), Chavez also pushed for a 'Bolivarian Alliance for the People of Our America' which, by 2008, had hopes of creating a single currency. He increasingly won allies in the region, including Evo Morales, who became President of Bolivia in 2006, Rafael Correa, who became President of Ecuador in 2007, and Daniel Ortega, leader of the Sandinistas, who regained the presidency of Nicaragua in 2007. All of them shared Chavez's socialist outlook and joined the Bolivarian Alliance. In 2009, to escape reliance on the IMF and World Bank, Chavez also joined most other South American countries in creating a 'Bank of the South', to aid regional development. Chavez remains a fervent opponent of neo-liberalism even if his nationalizations have not proved an unqualified success. Although he has not fully defined his twenty-first-century brand of socialism, he claims it is distinguishable from old-style 'state socialism' in its emphasis on 'participatory democracy'. In June 2011 Chavez had surgery in Cuba, to remove a cancerous tumour and, despite claims of a complete recovery, he returned later for further treatment. With presidential elections scheduled for October 2012 Chavez, preparing for a third term and substantially ahead in the polls, was readmitted to a Cuban hospital in April for radiation treatment on an undisclosed cancer.

future are shared ones. The question of how to maintain an appropriate balance between the individual benefits provided by capitalism and state-influenced social obligations necessary for political stability must be successfully answered both in the liberal democratic West and communist China.

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NOTES

1. In March 2009 *The Financial Times* ran a series of articles on 'The Future of Capitalism'. The quotes are from 9 March 2009 and reproduced in David McNally, *Global Slump The Economics and Politics of Crisis and Resistance* (PM Press, Oakland, CA, 2011).
2. Joseph Stiglitz, *Freefall Free Markets and the Shrinking of the Global Economy* (W. W. Norton & Co., New York, 2009), 110. See also chapter 5.
3. Ibid., 145.
4. As put forward by Ze Zicheng, *Inside China's Grand Strategy the Perspective from the People's Republic* (University Press of Kentucky, KY, 2011), 3-–5.
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6. Ibid., 115–18.