The Twilight of Soft Mercantilism: Europe and Foreign Economic Power

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Introduction

This paper is primarily concerned with foreign economic power. The purpose is to give perspectives on the structure and institutions of Europe's foreign economic power – how it practices its economic statecraft on the global scene – and the effect the economic crisis might have on Europe's capabilities to influence economic policy in countries outside the European Union.

The economic crisis is deep. The free fall is over, but recovery will be slow in Europe and the United States, the two main markets in the world. Yet of the profound economic problems facing the world economy, the crisis is only one. The measures governments have devised in response to the crisis will soon likely become a serious problem – inflationary monetary policy, fiscal deterioration, and the decline in competition on many markets will make themselves felt. Yet the many predictions of a collapse of the global economy, or of a profoundly changed policy-texture of economic globalization, have been vastly exaggerated. The crisis is far from as catastrophic as the newspaper commentaries and the glitterati of the economics profession have professed.

The world economy is not experiencing a replay of the 1930s, when economic isolationism followed hard on the heels of a Wall Street crash. Nor are we at a 1944 moment in world economic history – a point in time when the leading economies of yesterday formed new economic and political institutions to govern international relations and limit the raw use of economic power, then primarily embodied in the use of beggar-thy-neighbor policies such as competitive devaluations.

Governments today are not succumbing to economic nationalism as a response to the crisis. Current protectionism is real, and problematic, but it is low-intense and has so far not triggered tit-for-tat patterns or retaliatory action. Equally important, much of recent protectionism was already

underway before the start of the crisis and largely reflects two major trends in the global economy. Firstly, the rising competition to the West from new economic powers in the East, and exaggerated fears in Europe and in the United States that their economies soon will be run from Beijing. Secondly, there has been a sharp slowdown in the climate for economic liberalization of the kind that fosters growth and cross-border economic integration. This shift in mentalities and policies can be seen across the world, in developed and developing countries alike. They profoundly affect the global climate for open trade, especially the desire to keep markets open for goods, people and capital from fast-growing countries in Asia.

Starting in the 1980s, many countries shifted track in economic policy, left the "dirigisme dogma" of the past, and moved towards economic liberalism. In Asia, China started its great opening to the world in the late 1970s, and this opening has been the most important development for cross-border commerce and rising affluence in the past three decades. Southeast Asia started to integrate economically with the outside world well before China's first steps toward the modern world economy. India followed in the late 1980s, when the "License Raj" of post-colonial India was scuppered and modern, post-Keynesian economics was introduced to Delhi. In various forms, and to various degrees, all rising economies in Asia have grown fast after they introduced outward-oriented economic reforms boosting trade and investment. In the West, the rise of politicians like Ronald Reagan and Margaret Thatcher in the 1980s triggered a wave of economic reforms that liberalized economies, internally and externally.

Broad economic liberalization steered the world economy toward a new structure – a structure in which trade and cross-border investments has grown exponentially. The global volume of trade has consistently grown much faster than output in the postwar era, but from the late 1980s to recently, global trade has grown at unprecedented levels. From 1950 to 2005, global trade grew from US$400 billion to US$24 trillion – a 60-fold increase. Global investment increased by almost a ten-fold between 1990 and 2007.

The profile of trade has also changed. Fifty years ago trade was the export of a finished good to another country where it was consumed. Today trade is an integral part of the production chain. Big multinationals have led this trend. Now they operate dense production networks. Supply chains have been fragmented to such a degree it is impossible to give a meaningful

nationality to a good. A mobile phone, for example, is typically assembled in China, but the components of the phone have crossed borders 50–100 times before the actual phone is finally assembled. That is the story of modern globalization. That is also the story of China as an exporting powerhouse. Furthermore, the trade-supply-chain structure of the world economy is also the main reason why governments today have restrained protectionist instincts amidst the crisis. The allure of easing the conditions for domestic firms by raising border barriers is big, but most countries today are too dependent on import for their export – and they are also too dependent on foreign consumers – in order to benefit from short-term protectionism. China, where processing trade accounting for at least 50 percent (two-thirds is probably more accurate) of all trade, is a good example.

This is a long introduction to two simple observations. But nothing goes without saying, and they both merit acknowledgement.

Firstly, a country's conduct of its foreign economic power is today central to all foreign and security policy – to diplomacy as well as to war or threats of war. With key economies as integrated with the rest of the world as they are today, serious disruptions of trade and cross-border commerce will damage economic wealth, a central component of a nation's interest.

Secondly, for the discerning scholar of policy and power, it is not the economic crisis, or governments' responses to it, that is of prime importance when understanding trends and shifts in global economic power. Some of the intellectual fashion designers in the study of international relations and global economic policy will continue to make claims to this end.

But they are wrong. The crisis will change some countries ability to use its economic statecraft, but only at the margin. Fundamental trends before the crisis still remain valid, some of the even more so today than before the crisis.

Which trends are most relevant for Europe's foreign economic power? Let me offer three observations.

Observation 1: Europe Is a Postmodern Construct and its Institutions for Cooperation Behave as Such

Europe has a complex political structure. Europe is a continent of nation-states that at the center has the European Union and common institutions for its 27 members. But the jurisdictional competence of these institutions is

limited. Typically, policy in Europe does not gravitate from Brussels. Many policies are not decided by Brussels and remain in the confines of its member states. Over the past decades an increasing number of policy issues have been centralized to the European Union, and there are few issues without a Brussels dimension.

The European Union, however, is not the only pan-European institution for policy considerations. There is a European Court of Justice which is institutionally unrelated to the EU. There are economic co-operations that have nothing to do with Brussels. Some EU countries share a common currency, but only 15 of EU's members use it as legal tender. Some EU countries are members of NATO, others are not. Some EU members are signatories to the Western European Union, others are not. The varieties of European cooperation are significant and also affect the effectiveness of European cooperation at large. Consequently, European policymaking is a cumbersome, bureaucratic, and time-consuming process – often very difficult for outsiders to understand. Often it is little more than a mental exercise to bridge internal differences between member states rather to achieve the professed ambitions with Europe-wide policy cooperation: to increase the efficiency of European policy (individually and collectively) and enable Europe to exercise greater influence in world affairs by sharing policy and pooling resources.

Hence: any understanding of Europe must start in its institutional complexities. Its foreign economic policy offers a good example.

Foreign economic policy is the power center of Europe's global ambitions. With the size of its common market, Europe could exercise considerable influence on foreign governments by allowing or denying access to its market. From a policy perspective, commercial policy is the backbone of the cooperation in Europe that manifested itself in the European Union. It is a Customs Union and runs a Common Commercial Policy – a trade policy, in normal speak. But this does not mean unlimited power for the European Union. EU's trade policy is constitutionally limited. Issues related to services often do not fall under the power structure of Brussels – these are issues belonging to the jurisdictional sphere of the member states, and many of them have offered fierce resistance against moves of centralizing policies in the services sectors. Thus, Brussels is constrained in negotiating reduced barriers to trade in services with third countries – a constraint

which presents real difficulties in modern trade negotiations and limits Europe's capability of using its economic statecraft internationally.

Furthermore, another central element to the modern world economy – rules and policies on cross-border investment – are almost entirely an issue of the member states. Thus, if China encounters problems with investment access to Europe, there is no point calling Brussels – it must contact Berlin, London, Paris or any other European capital. Henry Kissinger's observation still holds: when you want to deal with Europe, whom do you call?

Moreover, financial issues are largely not dealt with at a European level. There is neither a pan-European bank regulator, nor a comprehensive common policy on issues of cross-border financial flows. The European Union represents Europe in the World Trade Organization (WTO); in the International Monetary Fund (IMF) countries represent themselves.

This list of limits on European internal cooperation could be made longer and comprise salient issues such as energy. The overall pattern is clear: Europe can only have clout internationally if it has opened its own markets internally and formed a joint policy and institutions to exercise it. The fragmentation of power makes Europe weak and undermines the effectiveness of its foreign economic policy and economic statecraft. Europe is the biggest trade bloc of the world, and has the biggest market when measured in aggregate purchasing power, but the fact that it has no common approach to key issues of global economic affairs weakens its hand.

Nor are European member states eager to centralize more economic policies to Brussels. The Lisbon Treaty will add some extra clout, but only at the margins. When Europe is divided, or at least lack a common approach, it also undermines the effectiveness of international economic institutions and make them anachronistic. Take the IMF as an example. Europe is vastly overrepresented in this organization as the quota of votes is based on the relative economic size of countries far back in time. A small country like Belgium, for example, has formally a greater say than China. A common European approach in a reformed membership structure would lead to lower aggregate formal influence in the IMF for European members – but its effective power would increase as the block could exercise an influence not possible today. However, almost all EU countries have so far rejected reforms that would seriously dilute their own formal status in the IMF.

Security policy is another example of the fluid and fragmentary structure of European cooperation. Europe has a common foreign policy, but the power of Brussels is weak. Many issues have to be decided on the basis of unanimity, which clearly weakens effectiveness and makes Europe look like an academic sociology seminar rather than a forum for decision making. Security policy and military policy have even weaker positions. Many EU states, but not all, are members of NATO. NATO, however, is an organization many Europeans have a difficult relationship with – for its own strengths or weaknesses, for substantive or procedural reasons, or for the fluid relation between United States and some European members. France left NATO's military structure in 1966 but has recently returned. Most countries, even non-members, cherish the security offered by the United States, but few are willing to pay substantially to a collective security approach. Most EU governments have cut down considerably on its military spending. While based in Brussels, NATO headquarters appear to be perpetually disenfranchised from the other political scene in Brussels: the EU. There are many turf fights, and often they are about defining the limits of EU cooperation. Symbolism also matters – such as in the rivalries over the accession of Cyprus to the EU. The processes of closer integration with the EU and NATO for countries like Ukraine and Georgia are other sources of conflict. These types of conflicts often pop up in surprising places – such as in EU internal dialogues over a telecommunication chapter in the initial examination of Turkey's policy that is done as part of the process laid down for a potential accession of Turkey to the EU.

In what way can this be described as a postmodern construct? It is quite clear, as Robert Cooper describes in his book *The Breaking of Nations*, that countries, not only in Europe, has evolved away from the classic definition of a state and the security-policy discourse that were closely attached to it.[1] As Leslie Gelb puts it in his recent book *Power Rules:*

> The classical masters of power and warfare would be startled at the shifting importance of military and economic power. [...] But the keen eyes of Machiavelli and Clausewitz would

[1] Robert Cooper, *The Breaking of Nations: Order and Chaos in the Twenty-first Century* (London: Atlantic Books, 2006).

> be quick to perceive that finance and commerce now occupy a special and unprecedented perch in foreign policy.[2]

There are many factors at play. Lately, economic globalization has tied countries as close to each other that it is difficult to separate states from each other, or defining broader national interests in a fashion that contradicts general ambition of increased economic wealth and the supply-chain structure of the big multinational enterprises. In some economic respects, but far from all, borders have been rendered meaningless. Yet there is arguably something more to the term postmodern than the mere instrumental aspects covered by foreign policy thinkers. In philosophy, postmodern not only represents a taxonomic position, it sets out a discourse with its own conceptual views, often defined in opposition to views underpinning the era of the modern state. In difference to the United States and China, the European Union – and, by extension, Europe – is increasingly embodying the values of philosophical postmodernism and pays homage to its spatial norms.

How can we translate such a fancy conjecture into intelligible analysis?

Firstly, the fluid concept of the political personality. As previously discussed there is in the new European policy discourse no fundamental concept of the state, let alone a state that is equipped with appropriate institutions for domestic policy as well as to exercise international power. The postmodern state is one in which territory, the core theme in the political personality of the modern state, is secondary to a more fundamental guide for policy. In this case it is transnational cooperation between European nation-states – a cooperation that involves devolution and transfer of power, a deliberate move to weaken your own autonomous authority. This transfer of power is done to gain something else: more efficient governance, a secure Europe, and greater international power. These aims, however, are not always the result of European cooperation. In fact, the fits and starts of European cooperation often weaken national authority without improving policy efficiency or the international power status. European policymaking is no different from national policymaking; people in the process of policy-

[2] Leslie H. Gelb, *Power Rules: How Common Sense can Rescue American Foreign Policy* (New York: Harper, 2009), p. 206.

making gets so bogged down by details and conflicts among key interests that the end result is difficult to link to the initial ambitions.

Nor are these aims often the guiding ambitions of European policymaking. The key ideology of European institutions is "an ever closer union." One can share this ideology or not, but one cannot escape the fact this has little to do with the appraised efficiency of closer cooperation. Nor can it conceptually be integrated with a notion of strategic national (regional) interest.

Hence, in Europe's process of forming a common political personality, the modern, or classic, concept of the state has lost traction in European considerations of policy and power.

Secondly, with mixed jurisdictional competencies, overlapping institutions, and a generous amount of internal rivalry, there is a constant exercise in Europe, in its execution of policy and power, that involves invariable reflection and debates of the authority of institutions – what they can do and what they cannot do. This process of reflection takes primacy over the fundamental principles of a state: protecting the territory and pursuing a policy in the national interest. Often, process becomes as important as substance and outcome – indeed, often it becomes the dominant, let alone only, aspect of policy in Europe.

Thirdly, the concept of power gets transformed in a political and institutional atmosphere such as the described. More than anything, the concept of international power has changed. Europe, today, largely embodies a postmodern concept (in a taxonomic sense) of international power – a concept that emphasizes the role of "soft" power over "hard" power, to use Harvard scholar Joseph Nye's terminology. Process takes primacy over outcome also in Europe's international relations. There is an inability in this postmodern discourse to gauge power in terms of military capacity. The emphasis is rather on perennial negotiations in international organizations and the multitask capabilities of countries to be hyperactive in all sorts of negotiations and organizations.

At the core of the postmodern concept of power is a refusal to accept genuine power. Power is not hard or soft. It is neither smart nor dumb. Power is power. It is the capacity to get countries to do what they don't want to do. The postmodern concept of power does not accept this view. It does not understand what Leslie Gelb calls the soul and music of power: defining

and pursuing a national interest. Europe's idea of power is, for good and ill, in a rival business: to weaken national interests in order to build a pan-European interest.

This is not a critique of European cooperation. Europe is what it is – a continent of nation-states that has been plagued by wars. To weaken past concepts about national interest and power has been a survival necessity. But the move of authority from nation-states to pan-European institutions has not enabled Europe to become the sort of international power that corresponds with its economic size and wealth. European power is now living in between the concept of national interest, on the one hand, and pan-European institutions to exercise international power, on the other hand. Member states often pursue interests inside Europe but they cannot do it effectively on the international scene, neither individually nor collectively.

This is not likely to change in the near and medium-term future. In fact, the crisis has amplified the institutional confusion in Europe – conceptually, institutionally and intellectually. Especially in the field of finance and financial regulation. Europe, collectively, is now pursuing regulatory ambitions on three different levels: multilaterally, in the IMF and the Bank of International Settlements; regionally in the European Union; and domestically in each and every member state. It is messy and complicated. Seldom has it been asked: what would be most efficient from a regulatory point of view, and what is Europe's strategic interest? Many member states have strategic interests, and pursue them vigorously. Some also act on ideological pretexts. Even if they know some of their core interests are likely to be trampled on in the process of forming a common policy, many member states cannot refuse to participate in the process. However, no one expects the end result to have sufficient coverage and make it unnecessary for EU countries also to have individual policies and individual authorities to execute these policies. On the contrary, it is widely accepted that Europe cannot form a complete policy. Regulatory ambitions, collectively and for many individual countries, are also as unconnected to strategic foreign policy as it is forgotten that Europe is about to start doing the same things that it wants other countries to do away with.

Observation 2: Europe Is a "Diminishing Giant"

Europe has grown to be the biggest economy in the world. But it has achieved this by expanding the membership of the EU club, not by fast economic growth or a dynamic economy. Despite its ascending size, its relative share of the world economy, or of world trade and investment, has declined as other parts of the world, primarily Asia, have grown much faster. This is a fate that Europe shares with the United States; their relative economic clout is diminishing. In contrast to the United States, which can still claim global leadership because of its military superiority, Europe's main source of international power has been its economic size. Thus, a shrinking economy is perceived as a threat to foreign economic power and the execution of this power.

From the vantage point of economics, this view merits nothing but ridicule. Economic wealth, which is the sole purpose of production, is not about size. The richest countries on earth are typically small countries, like Norway and Switzerland. The fact that other economies grow bigger is not a threat; it is a development that should be applauded as it offers new opportunities for companies to export more goods and services.

European leaders are well aware of the benefits to European citizens from rising affluence in other parts of the world. They also know that its long-term strategic interest is in growing economic wealth in previously poor countries, like many of the Asian countries, as growth makes countries more stabile and economic ventures more profitable. Yet Europe becomes preoccupied with its diminishing foreign economic power. Why?

Firstly, many European policymakers, as policymakers from all parts of the world, suffer from what the economist Paul Krugman has called "pop internationalism," or what former OECD chief economist David Henderson has called "do-it-yourself-economics" – a home-grown idea of economics that only fragmentally correspond with actual economic knowledge of sources of affluence. These beliefs often build on a zero-sum game view of the economy: the wealth of others comes at the expense of your own wealth. Similarly, if companies in other countries perform well, it must mean that you own companies are at a disadvantage. At the center of this misunderstanding is a striking ignorance about the profile of the world economy – corporate development in many new economic powers are driven by West-

ern firms – and about the source of growth: climbing the value-added chain and how trade helps this climb.

Secondly, a falling share of world production and world trade amplifies the need to reform international economic institutions – like the IMF – to reflect the new patterns of production. Such reforms inevitably mean falling influence for individual European countries. For a continent that is perceived to be one of the parents of current international institutions for economic cooperation, such a notion invites dislike.

But there is something more to the story than these instrumental aspects.

There is a growing feeling in Europe that its own model for power and expansion is inadequate to gain, or maintain, international power in future. Europe's foreign economic power has primarily been regional in nature – it has been exercised primarily through ambitions and policies to get other countries in Europe to accede to the European Union. What is Europe's foreign economic power on the global scene has derived from the fact that some of the member states once were the biggest economies in the world and that they have jointly maintained its influence by expanding the membership of the EU club and deepened the cooperation in areas of commercial policy, which has enabled Europe to be influential globally. More than anything else, Europe's power structure has been bottom-up – when it has deregulated markets internally and deepened regional policy cooperation, then they have maintained is international economic power.

This model of maintaining power has not passed its sell date, but it is becoming more difficult to run and expand the model. Expansion of membership, for instance, is much more difficult now as (barring potential membership applications from Iceland, Norway and Switzerland) potential candidates are on the periphery of Europe, borders to troubled or troubling countries (Iraq and Russia spring to mind), are poor, and (if Turkey is excluded) will not give Europe more clout internationally. Furthermore, the more Europe expands, the more difficult it gets to deepen policy cooperation as varieties of policy and policy ambitions get more differentiated. Differently put, Europe's global economic power has had its source in expanding membership and deepened regional policy cooperation. One of these sources is now exhausted, the other is in fatigue.

It is also more complicated deepening policy cooperation today than in the past. Europe started its commercial and economic cooperation by

forming a Customs Union and, thirty years later, by eliminating internal barriers to trade in goods. The result was the single market. There are plenty of unfinished businesses: forming a single market for services and a common policy for foreign direct investment, for example. There are also many related ambitions: forming a currency union or establishing common regulations and regulatory bodies in areas of cross-border commerce. But from a political and technical point of view, such reforms and ambitions are far more difficult to achieve than the initial aim to reduce barriers to trade in goods. While barriers to trade goods typically has manifested themselves in tariffs and border barriers, barriers to trade in services is mostly embodied by behind-the border regulations, which tend to reflect political and regulatory cultures. Nor is the economic rationale of some of the ambitions as obvious and strong as it was for reducing barriers to trade. It is not necessarily the case that it is in the short or long-term interest of a country to become a member of a currency union and limit its power to run a monetary policy. It might be in the economic interest of some, but not of all.

The psychology of a "diminishing giant" is thus more complicated than just the perception of falling relative economic power internationally. It is based on the observation that its own model in the past to gain or maintain foreign economic power is no longer sufficient.

Observation 3: Shift in View of Foreign Economic Model and Ambition

There are subtle trend shifts in Europe's view of international economic cooperation and foreign economic power. These are primarily related to the issues raised above: the postmodern structure of power and the psychology of a diminishing giant. They are also manifested in economic and regulatory ambitions and models.

Hardened Mercantilism

All countries in the world (barring failed states) tend to run a mercantilist trade policy – that is, a trade policy that maximizes export, output (not necessarily GDP) and the buildup of own reserves. This is a policy in which export takes primacy over import. From the vantage point of economics, this is a flawed idea. The principle of free trade is much better than mercantilism, partly because import is the most important flow in trade. It is

through import a country gets access to goods it cannot produce at competitive prices and quality, or produce at all.

Europe's view of trade policy has been mercantilist in nature – but it has been soft mercantilism, resting on the view that reciprocal opening of markets is of benefit to all parties. Furthermore, the model of regional trade liberalization and ambitions of forming common policies have pushed Europe in a free trade direction. Internal trade liberalization has strengthened Europe's interest in subsequent global liberalization as European firms have become competitive and outward-oriented in the initial phase of liberalization. This has also enabled Europe to be one of the guardians of the multilateral trading system.

Differently put, domestic economic reforms in Europe strengthened the free-trade component in its national-interest calculus. It had an economic interest to open global commerce. It also had a strategic interest as it could project its own market reforms and strategically use international economic institutions to that end. Free trade and multilateralism were handmaidens for Europe's policy ambitions.

Subtly but systematically, this model and perception of trade has changed. Europe has moved close to mercantilism in its basic outlook on global trade and commerce. Behind this move is partly a belief that the economic interest for Europe in global free trade is not as strong as before. There is also a belief that it cannot no longer project global economic liberalization to the same extent it could before. Furthermore, inside the Brussels beltway an increasing number of policymakers and intellectual fashion designers hold the view that free-trade ideology undermines foreign economic power and that only a strengthened mercantilism could help Europe leverage its economic statecraft abroad. This is the return of an age-old belief, widely discredited by noted scholars such as Eli Heckscher and Jacob Viner. It is also discredited by modern scholars. At the heart of this notion is the use of punitive measures against countries that do not behave as you wish. There are three problems to this notion.

First, if a country uses a punitive measure against, for instance, the export of another country it is likely to damage its own economy as much as the targeted country's economy. Hence: the economics and political economy of such measures do not speak in favor of them.

Second, if a country uses punitive measures against another country, it can be retaliated against with similar measures. Hence: you can only use punitive measures against countries that are substantially weaker than you.

Third, punitive economic measures are typically inefficient – they do not achieve what they intended to achieve, most often a policy change in another country. Economic sanctions are a good example. Few of them change anything. Nor are they intended to: trade sanctions are often used because a political leader feel pressured to do something but cannot come up with an alternative that is efficient and do not oppose your other interests.

EU's bilateral trade relation to China offers a good example of this shift in thinking.

For years, the EU supported and pushed China's grand opening to the world. Some Europeans believe, rightly or wrongly, that they were responsible, in a positive sense, for getting China to open up for foreign trade and to join the WTO. Now, however, Europe is deeply annoyed with its trade relation to China. It claims that China is manipulating its currency and is building up a bilateral trade surplus because of this currency manipulation. Europe runs an overall balance in its trade account, and hence do not have a general problem in its external economic relation, as the United States have had in recent years, but its bilateral trade deficit to China is annoying to the mercantilist. The purpose of trade to a mercantilist is to generate surpluses, not deficits. Because of this deficit, and a few other factors, Europe increasingly is threatening China with punitive trade measures unless it does what Europe wants it to do.

The economics of this view is flawed, but it is gaining currency in Brussels and in other corners of Europe. Some support such claims for tactical reasons – they believe China is more willing to follow dictums from Europe if Brussels wield the threat of punitive actions in front of Beijing. Others, and this group is growing, see this issue through the lenses of strategic international behavior and power. They assert that the size of Europe's markets are so big that by using trade sanctions against China, or threats thereof, Europe can motivate China to pursue the non-trade objectives it wants it to. These objectives range from signing up to a global agreement to reduce carbon emissions to a new policy on Tibet and human rights. Mercantilism and non-cooperative strategies for international relations are thus merged.

From Multilateral to Bilateral

As Europe's influence in international economic institutions has declined, and will continue to decline, its interest for them has followed suit. This is not to say that Europe rejects multilateralism in the field of commerce and economics. It does not. But it does not believe that they are to strategically benefit as much from these institutions as they did in past. It is rather pursuing a bilateral strategy, and this strategy is bound to be amplified in future. The backbone of Europe's commercial-policy strategies today is bilateral – not multilateral or unilateral. It is eyeing growing economic powers for special trade deals, and believes it has more to gain from such strategies than from other. It is also enforcing the commercial policy relation with its former colonial subjects and with other poor countries, partly to maintain its clout in these regions.

From Deregulation to Regulation of Global Markets

Another subtle shift is Europe's growing interest in establishing global regulations which basically has the effect of closing markets or imposing new barriers to trade: environmental and labor standards regulations, public health regulations, antitrust regulations, etc. Europe's regulations on chemicals, REACH, is a notorious example, demanding excessive testing and registration of all chemicals in a product before it can be sold on Europe's markets.

This interest is partly a consequence of its own domestic regulations, which tend to be more excessive and intrusive than in other parts of the world, and the interest to avoid a situation where its own firms are disadvantageously positioned to their competitors because of EU regulatory zeal. But Europe also believes it has projectionary power in the fields of regulations and that it has the foreign economic power to demand other countries to sign up to the similar policy. Furthermore, it believes that the interest for other countries to keep access to Europe's markets is so strong that they are willing to import Europe's own regulatory model.

There is a clear trend shift in European policy. For many years, its foreign economic ambition underpinned by cynical economic interests and long-term strategic considerations has been to open markets. Instrumentally, its view has been to establish rules that prohibit regulations to interfere with cross-border commerce. This is still an ambition, but it is not strategic

or principal. It is contextual and fragmentary. And it is combined with a new interest for global regulations – regulations that clearly interferes with cross-border commerce. Behind this shift lies an economic defensiveness, but also the idea that one of Europe's ways to maintain its global standing is in global governance.

The Economic Crisis and the Balance of Economic Power

Finally, how do these trends connect to short-to-medium terms aspects of the current economic crisis? Let's look at the United States, China and Europe.

The United States

America is not in terminal decline. It remains the only country which combines economic strength and military capability, and consequently its international power is by far bigger than those of Europe and China, and it is the country everyone looks to for global leadership.

The U.S. economic statecraft has diminished during the crisis. Its consumer power is not as big as before the crisis. It remains a destination for foreign investments, but risks of inflationary pressures, along with its increasing need for foreign capital to finance its vast fiscal deficit, limit its attractiveness. The financial crisis has reduced liquidity on U.S. financial markets, and its relative position has weakened as so much money has been lost in the housing bubble and the financial mania. But few countries are capable of really benefiting from the seriously declining liquidity. Other financial centers are in similar situations as the United States – and emerging financial hubs (e.g. Tokyo, Hong Kong and Shanghai) have far too low quality of its financial infrastructure, and far too illiquid markets, to offer real competition.

China

China's economy has not deteriorated as much as Western economies, but its ability to use its economic statecraft on the global scene is limited by some structural problems in its economy. Far too much of its reserves are locked in underperforming financial assets in the United States. Its growth in the past years has been driven by investment, and Beijing is tailoring its anti-crisis policy to support investment. This is not a sustainable growth model,

and the Chinese economy gets locked into underperforming investments at home (investments with low incremental capital-output ratio). Channeled through its state-owned financial sector, new policy will enforce an underperforming financial sector with low international power and create new problems of non-performing loans. A cementation of the current structure of China's financial sector will seriously block future growth potential and capability of foreign economic leadership. China will continue to increase its foreign economic power, but it will grow more slowly than before, and it needs to undertake further domestic economic reforms to maintain its ascending role on the global scene.

Europe

Europe is in deep trouble. Western European economies have dived deeper than the U.S. economy. Many Eastern European economies have been on the brink of defaults and only survived through the financial assistance of the IMF and EU partners. Fiscal policy in some big EU countries (e.g. Italy and the UK) was in bad shape already before the crisis. With big welfare states, a contracting economy sharply pushes up fiscal spending as more people claim unemployment benefits and similar support. Europe's growth trend was low before the crisis, and growth potential looks even worse now. Too little of Europe's existing growth has been driven by productivity increases and innovation, and a significant part of growth and increases in real income has come through trade (internal and external). Similarly, trade has been the main lever of structural change in the (Western) European economy, and as trade will remain in the low regions in the medium-term Europe is likely to face an increase in its already big problem of structural unemployment. Policy reforms to increase competitiveness are almost non-existent. Hence, Europe's foreign economic power will continue to decline.