

The Gathering Financial Crisis: Conflict, Cooperation or Catastrophe?

By Rustom J. Modi

The world's preoccupation with the global financial crisis is understandably focused on the economic consequences. But Indian financial services and technology expert Rustom J. Modi warns that the tensions unleashed by the crisis, if not managed properly, could spill over into a host of geopolitical arenas.

A FEW WEEKS IS ALL IT TOOK. The signs that the global financial system was well past its sell-by date were there for the past three years — over-leveraged debt, exotic financial products whose underlying assets were hard to discern and belief in a never-say-never credit culture. That's all history now. The IMF has cut its global growth forecast to 3 percent, and even this looks overly optimistic. Fitch Ratings predicts that global economic growth will slow to 1 percent in 2009 from an average of 3.5 percent in the past five years as major advanced economies experience “the steepest decline in GDP since World War II.” The global economy is in recession.

The end result of a crisis unlike anything since the 1930s could be catastrophic in terms of social unrest, environmental degradation and international trade. But that plot line is not yet written. With hard work, vision and creativity, the world may come through this painful period with re-structured finances and a greater commitment to cooperation in a realigned international system. But there is much pain ahead. (See Table 1)

World markets are being re-rated — stocks are volatile and have lost 40 percent to 60 percent of their value over the past year across markets as a sample set of data from four exchanges below highlights. (See Table 2)

Over the past 18 months, speculative growth in commodities markets at first led to inflation and food shortages, but from September 2008 onwards, as the financial crisis struck, the prices of most fossil, metal and grain commodities plunged. Crude oil has seen extreme volatility, from a high of more than \$140 per barrel to around \$51 over the past

¹ IMF, *World Economic Outlook*, October 2008.

² See <http://www.oecd.org/dataoecd/6/27/41469780.pdf>

quarter. Copper currently trades around \$4,925 per metric ton, down 30 percent over the past month. This has led to dramatic changes in the economic fortunes of commodity-driven economies in Australia, the Middle East, and Venezuela.

Moreover, the world's twin economic engines, China and the US, are in dire need of government intervention to stem the damage. China's stimulus package of 4 trillion Yuan (\$586 billion), which is roughly equivalent to 15 percent of the

current year's estimated gross domestic product, neither stimulated global markets nor increased confidence. Still opaque in its governance, China remains a gamine-faced mystery and no full evaluation of the impact of the slowdown is yet available. The country is hurting, with exports slowing down, GDP growth forecast at 7.5% for 2009 and unemployment rising. Combined with this is massive social change spurred by rapid urbanization and private land ownership. In the absence of a safety net, fears are rising that massive unemployment could spur unrest.

The US economy has yet to find a bottom — the housing bubble has burst, but the retail credit shock has yet to fully hit. Markets are in a tailspin, employment, output and consumption numbers are down. Most importantly, consumer sentiment is weak with no one knowing where this will end. The US current account deficit stands at around \$800 billion, or 7 percent of GDP¹. Add to this the \$700 billion banking bailout package and you have a budget deficit that is unmanageable, with further demands from the auto sector and other industries still being made. A potential fall in tax receipts due to the recession will put additional pressure on President-elect Barack Obama's promise to increase spending on healthcare, expand social security and invest in alternative energy. All these initiatives will require cash and the government is clearly strapped for cash.

Around the world, countries are either slipping into recession or slowing down. A glance at the forecasts of macro-economic cycles below is deeply sobering. "OECD composite leading indicators (CLIs) for August 2008 indicate a continued weakening outlook for all the world's major seven economies. The latest data for major non-OECD member economies tentatively point to expansion in Brazil, a downturn in China and Russia and a slowdown in India."²

Suffice it to say that like China and the US, other OECD and BRIC nations (Brazil, Russia, and India) together with the rest of the developing world are influenced by and will influence this global crisis. We need to understand the potential ramifications of this twin shock: a world recession and the collapse of investor and consumer sentiment.

TABLE 1 SERIOUS GLOBAL DOWNTURN

	YEAR-ON-YEAR (% CHG)		
	2007	2008	2009
	Projections		
World output	5.0	3.9	3.0
Advance economies	2.6	1.5	0.5
United States	2.0	1.6	0.1
Euro area	2.6	1.3	0.2
Germany	2.5	1.8	—
France	2.2	0.8	-0.2
Italy	1.5	-0.1	-0.2
Spain	3.7	1.4	-0.2
Japan	2.1	0.7	0.5
United Kingdom	3.0	1.0	-0.1
Canada	2.7	0.7	1.2
Emerging and developing economies	8.0	6.9	6.1
Developing Asia	10.0	8.4	7.7
China	11.9	9.7	9.3
India	9.3	7.9	6.9
Western Hemisphere	5.6	4.6	3.2
Brazil	5.4	5.2	3.5
Mexico	3.2	2.1	1.8

Source: World Economic Outlook, October 2008

(Note: Real effective exchange rates are assumed to remain constant at the levels prevailing during August 18-September 15, 2008.)

TABLE 2 WORLD MARKETS

Index	May '08	Nov 12 '08	% Decrease (May to Oct '08)
DJIA (NY)	12,800	8,693	-68
FTSE (London)	6,200	4,268	-69
Nikkei (Tokyo)	13,750	8,696	-63
Sensex (Mumbai)	17,000	9,956	-56
SSE180 (Shanghai)	8,500	4,076	-48

Source: Bloomberg & Shanghai Stock Exchange

TABLE 3 COMPOSITE LEADING INDICATORS

	Ratio to trend, amplitude adjusted (long term average = 100)				Change from previous month (points)				Year on Year chg (points)	Growth cycle outlook
	2008				2008				Latest month	
	May	Jun	Jul	Aug	May	Jun	Jul	Aug		
OECD Area	97.5	97.1	96.5	95.8	-0.4	-0.4	-0.6	-0.7	-4.9	strong slowdown
Euro Area	96.1	95.3	94.2	93.2	-0.6	-0.7	-1.1	-1.0	-6.4	strong slowdown
Major Five Asia	102.0	100.9	99.9	99.2	0.1	-1.0	-1.0	-0.7	-3.3	downturn

Source: OECD

TRADE

As the world moves into recession, shifts in trade balances and patterns are a fallout of the crisis, with an increase in protectionism and a potential change in tariffs and other mechanisms to regulate imports and exports.

Countries with strong domestic consumption, such as the BRIC nations, will focus increasingly on domestic demand and consumption. The depth and longevity of the recession will largely depend on how countries are able to dig themselves out of the trough. A case in point is the Indian software industry, within which there is a raging debate on how revenue and orders will pan out given the possible easing of demand for software services. The flip side of this scenario is the possible increase in demand for Indian software services as clients in the US and EU slash costs. A weakening of the rupee against the US dollar will also lead to increased price competitiveness for Indian software services vendors. To take another example, Australian exports are coming off the boil as commodity prices fall, and a large proportion of its exports are minerals and commodities. The same is true for OPEC nations.

The short-term imperative is an infusion of trade financing, which, at a time when global liquidity is tight, is difficult to imagine. The World Trade Organization estimates the liquidity gap in trade financing at about \$25 billion³. Multilateral agencies, together with governments, the International Finance Corporation and other institutions, will need to step in to in-

crease liquidity in the system in order to avert a trade flow crisis.

Thus, each country and industrial sector will have these pushes-and-pulls and will modify policy to achieve short-term advantages.

In summary, this is how I see the current financial crisis affecting world order:

- Economic power gradually moves to China, the BRIC countries and Japan, with these countries taking a more prominent role in driving global economic policy and governance.
- Greater multilateral voices will be heard on trade, climate change policy and governance regulations, together with a rewriting of some agreements, perhaps even WTO rules and the Kyoto Protocol. This is a result of greater relative strength in the rest of the world vis-à-vis the US, and also the Democratic victories in US elections. It is, however, much too early to say whether US hegemony over the IMF and the World Bank will decline.
- Increased protectionism — all countries will, whatever lip service they now pay to united action, try to defend and protect their own economies.
- Greater efforts at regional cooperation, for example, within the EU, ASEAN and NAFTA, despite the above caveat regarding national interests.
- A reduction in international capital flows as global liquidity dries up. This may well lead to restrictions on capital convertibility in a number of countries.
- Re-rating of global markets, with a fall in foreign direct investment, especially in emerging markets such as India, China and ASEAN countries.

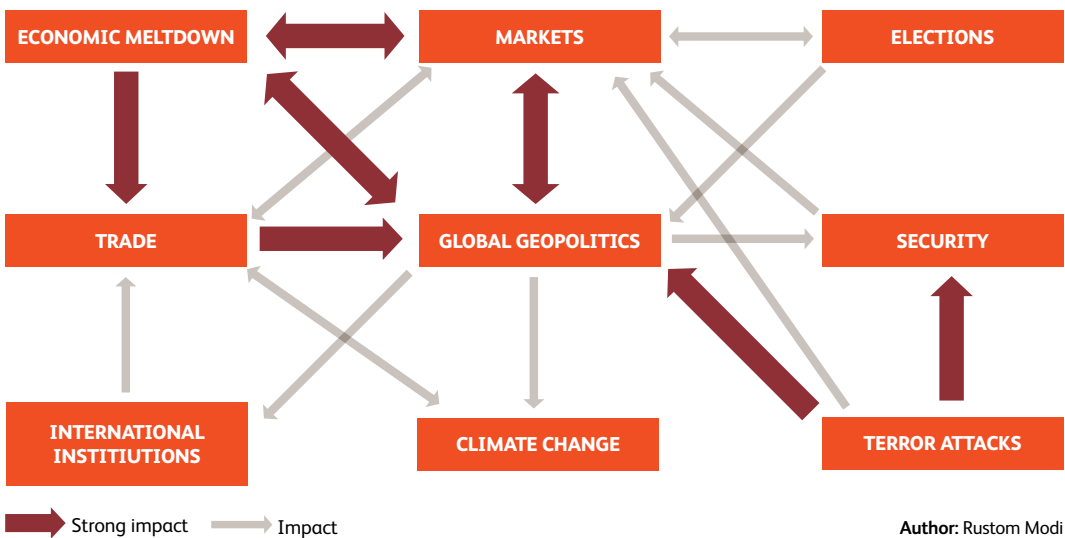
- A serious questioning of whether liberal democracy and free trade are the utopian end-states of civilization (apologies to Francis Fukuyama). I see glimmerings of this with China moving towards a welfare state by 2030, India perhaps re-looking at how to mesh free-trade capitalism with its old socialist democracy, the US looking at creating more social safety nets and the EU certainly not doing away with any of the welfare schemes it currently has in place.
- Greater international oversight of the international financial system, and consequently, greater controls over alternative investment vehicles and regulations over tax havens.
- Re-rating of global currencies, and a potential rethink of the US dollar as the world's reserve currency. Many who predict this happening by 2010 are wrong, though. History shows that predicting the death of the Bretton Woods system has been premature.

We will potentially see a world where economic power gradually moves to China, the BRIC countries and Japan, with these countries taking a more prominent role in driving global economic policy and governance.

- Political ideology will change as the clarion call to free trade and free markets dies down and the world reconsiders laissez-faire economic orthodoxy. Right-wing politics, though, may increase as countries look inward, and nationalism grows. Sovereign wealth funds and other investment arms will increasingly be used as tools of state policy — an economic carrot and stick.
- Global power will tend to be vested in a multi-polar world. There will be tremendous jockey-

GEOPOLITICAL ANGST — THE IMPLICATIONS
 Geopolitical lines also will be redrawn in a complex dance between countries and regions. Key issues are:

GRAPHIC 1 THE KNOCK-ON EFFECT OF THE ECONOMIC CRISIS



4 See <http://www.migrationinformation.org/Feature/display.cfm?id=577>

5 See www.electionguide.org

ing for power as China, Russia, India and others force their way onto the world stage, and the US comes to terms with the fact that it no longer has absolute power. This will make the world much more uncertain and dangerous.

MIGRATION AND IMMIGRATION POLICIES

The economic downturn will also lead to a rethink by countries that have traditionally relied on the Diaspora of their citizens abroad. Indians, Poles,

remittances, increased domestic unemployment as workers return home and, in the most extreme scenario, social unrest.

DOMESTIC POLITICS AND THE GLOBAL SLOWDOWN

A number of important countries have elections scheduled in the next few years, meaning domestic political reactions to the global slowdown will play out at that level too — Japan and Germany

One fact remains: governments and the private sector in all parts of the world are complicit in allowing the rape of our natural resources — even encouraging it.

and Filipinos are now increasingly looking at opportunities back home as the US and Europe grapple with recession and a shrinking labor market.

New restrictive immigration policies have already been announced by the UK and Australia. The number of Poles migrating to the UK has declined as employment and wages fall in the UK, with Poles reckoning that it is probably better to weather the economic storm at home where growth is a comparatively robust 4 percent a year. However, there is a detrimental economic impact on countries exporting labor. For example, India has thousands of workers remitting funds from the Middle East to India. India’s largest source of such inflows is the US, with the Reserve Bank of India (RBI) estimating that 44 percent of the total remittances of \$24.6 billion in 2006 came from America. “Globally, the World Bank estimates for 2005 put India in the lead at \$23.5 billion, with China and Mexico close behind at \$22.4 billion and \$21.7 billion, respectively.”⁴

If the job market for foreign workers shrinks rapidly, the impact for home countries will be significant, with a fall in inward foreign exchange

in 2009, the UK and Brazil in 2010, South Korea, France and Russia in 2012.⁵ The localized geopolitical whirlwinds of these elections will ripple across the world. Take India, for example. With elections looming next year, the maelstrom of Indian politics will inevitably twist economic reality to suit domestic posturing. Indeed, this has already begun, with the opposition attacking the current government’s policies. Never mind that the whole world is in an economic crisis, if the Indian opposition were to be believed, it is all the fault of the incumbent government. Such domestic political pressures in various forms will be experienced in countries across the world.

ENERGY AND NATURAL RESOURCES

Unfortunately, with less money available to spend on a good cause in hard times, one of the near-term victims of the crisis may be the battle against climate change. Trading in carbon credits has already fallen dramatically. There is a flip side, of course, with green technology advocates arguing that investment in this area has the potential to stimulate national economies. The United Nations

6 "A Green New Deal," *Newsweek*, Nov. 3, 2008.

Environment Program has gotten into the act, saying that the crisis should be used as an opportunity to push green technologies. It remains to be seen whether these initiatives will overcome the powerful short-term survival gene that operates so strongly in most national economies.

Supporters of investment in green technology argue for the equivalent of a "Green New Deal" with its potential to pump-prime the global economy much as the New Deal helped to revive the US economy during the Great Depression of the 1930s. "You are not just putting money into hot paper or into a financial-services sector that destroys itself," says Oliver Schäfer, policy director of the European Renewable Energy Council. "You are investing in clean technology, which is real business." His argument is intellectually persuasive, with one potentially fatal problem: lack of investment resources.

Investment must drive this transformation, but in a recession, money is hard to come by, even from governments eager to stimulate their economies. The stumbling block is that falling consumption during a recession, and the subsequent drop in the price of most commodities, including fossil fuels, reduces the urgency to switch to alternative energy sources. We have already seen crude oil prices plummet due to the global decline in demand.

Put succinctly, this is the problem: "To push ahead, governments have to provide incentives and regulations, and a whole lot of money up front. If global warming is to be confined to about 2 degrees Celsius by 2050 — instead of rising by an apocalyptic 6 or 7 degrees — carbon-dioxide emissions will have to be 50 percent lower in 2050 than they are today. And according to the International Energy Agency, that will require investment of about \$45 trillion by 2050. Such expenditures could well be offset by energy cost savings, but that would happen later, and the enormous layouts have to happen now. This is not a problem that unregulated free markets and private capital are going to solve short of a Malthusian meltdown."⁶

The first issue is the difficulty of implementing climate change legislation that increases energy costs. The EU is scheduled to adopt a climate change plan by December 2008, with the goal of cutting emis-

sions by 20 percent by 2020. But several European Union countries have argued the plan imposes too high a cost in the current economic environment. Echoing this sentiment, Ernest-Antoine Seilliere, president of Business Europe, which represents 20 million companies, says, "Competitiveness is an important subject that has to be taken into account when any European package is implemented to reduce CO2 emissions."

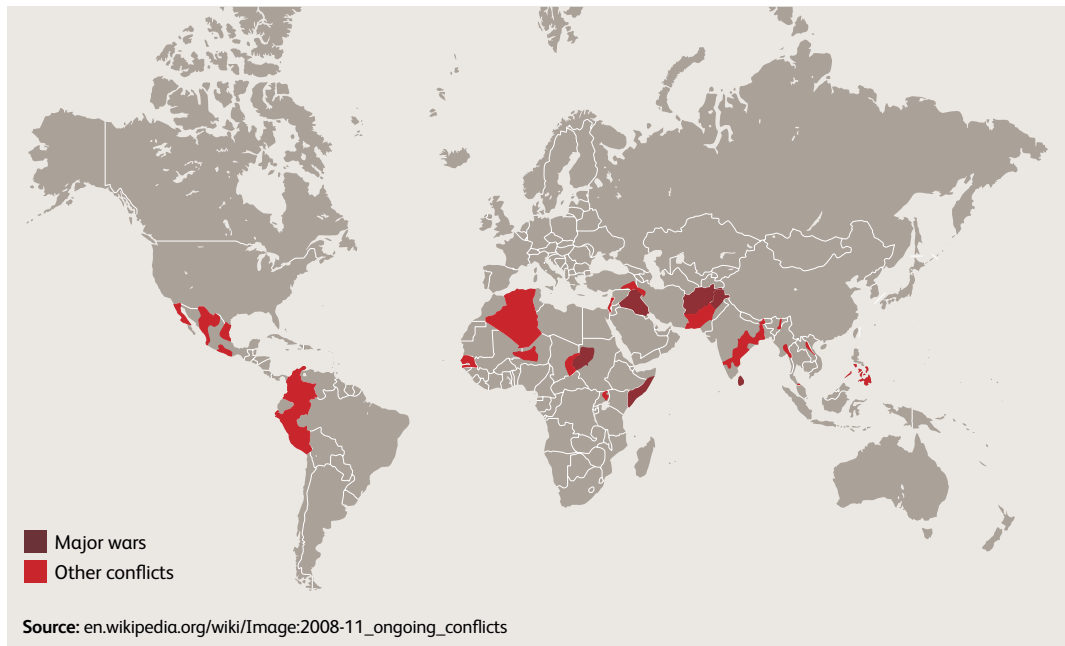
The second key issue is the difficulty of creating new structured commodity products that can be traded globally based on carbon emissions, at a time when the world is aghast at the poor regulatory framework and market meltdown affecting structured financial products, such as the sub-prime mortgages that triggered the current crisis. In short, any new financial products, even those that aim to achieve green climate effects, are likely to be greeted with skepticism.

One fact remains: governments and the private sector in all parts of the world are complicit in allowing the rape of our natural resources — even encouraging it. The current debate on China's aid to Africa typifies this. Chinese aid is nothing if not self-serving, aiming to capture the natural resources of the continent for itself. Not that China is alone in doing so. Countries the world over, including the US, India and Russia, have played this game. The UK, France, Belgium and Holland did much the same in Africa throughout the 18th and 19th centuries.

And then, there is domestic environmental rape. Look at just two examples, India and Brazil. For the moment, India is so taken with industrial development that it can hardly spare a fleeting glance at environmental issues, whether this involves the building of port infrastructure that ruins a fragile ecosystem in places such as Orissa, or cuts through national parks in Uttar Pradesh, Rajasthan and Maharashtra, or involves the import of hazardous materials such as asbestos. India voted, together with Russia and Canada, to block the inclusion of chrysotile asbestos as a hazardous material at a UN conference in Rome in October 2008. India currently imports over a quarter million tons of the material per year.

7 *The Independent*, "The rape of the rainforest... and the man behind it," Michael McCarthy and Andrew Buncombe, May 20, 2005.

GRAPHIC 2 ONGOING CONFLICTS



In Brazil, soybean farming, together with the planting of crops to produce ethanol, is the single largest threat to the rain forest. In 2005, an area of more than 10,000 square miles — nearly the size of Belgium — was cleared to make way for soybean cultivation. To quote the world's largest soybean farmer, the governor of the Brazilian state of Mato Grosso, Blairo Maggi: "To me, a 40 percent increase in deforestation doesn't mean anything at all, and I don't feel the slightest guilt over what we are doing here. We are talking about an area larger than Europe that has barely been touched, so there is nothing at all to get worried about." Rape and pillage — there is no other description for this.

SECURITY AND CONFLICT

As economies weaken during the current crisis, will terrorism increase? This is possible on two counts. First, as governments shift focus to fixing the economy there is less attention devoted to combating terrorism, allowing terrorist outfits to re-group, plot and execute their plans. Second, and this is perhaps even more dangerous in the longer-term, if large numbers of people are

pushed to the brink of economic disaster, there is a greater likelihood that they will be more easily swayed by a variety of religious, political and ethnic extremism. While this threat is more likely to hit poor, densely populated and disenfranchised Third World countries hardest, other regions will not be immune.

Conflict driven by economic hardship also is likely to increase as states raise barriers to trade and employment. Jingoistic pressures are another potential source of conflict. Look at Russia and its aggressive reaction to US moves to provide a missile shield in Europe. Similar scenarios will play out across the world — India and Pakistan, India and China, Iran and the US, and so on.

SOCIAL FABRIC

The potential for the current financial crisis to tear at the fabric of social order within affected countries cannot be underestimated. Tensions between urban and rural populations, the rich and poor and conflicts based on religious, ethnic, regional and linguistic affiliations could all emerge in a prolonged tailspin.

The potential for the current financial crisis to tear at the fabric of social order within affected countries cannot be underestimated.

When will we reach the tipping point, and is the consequence armed revolution?

Will failed states fall deeper into chaos?

When will we reach the tipping point, and is the consequence armed revolution? Will failed states fall deeper into chaos? These are very real questions facing geopolitical analysts as we enter an ever more uncertain future.

In summary, the current crisis raises a number of possible scenarios:

- The emergence of a liberal post-free-trade brand of economics and a neo-modern welfare state in countries that were previously committed to the so-called Washington Consensus of free-market orthodoxy.
- Greater multilateralism across the board — whether over trade or the make-up of global institutions. Much good will come if the IMF and the World Bank are made more inclusive in their decision-making processes, and if the International Criminal Court in The Hague is finally used to redress various global injustices.
- Uncertainty in emigration patterns — both legal and unofficial — as countries tweak policies due to economic and political pressure at home.
- Domestic politics in many countries driven purely by the demands of short-term political survival.
- Energy and environmental issues pushed to the back burner as countries struggle just to survive the current crisis.

WHAT NOW?

It's not all gloom and doom. We do, indeed, stand at a point where two roads diverge. One requires short-term sacrifices to meet long-term goals; the other allows us to satisfy the demands of the mo-

ment, but at a cost to our future. This is the dilemma this crisis poses, and global collaboration has never been more vital to finding a way forward.

There is great potential for lasting benefit — reform of the financial system could result in a more benign and inclusive integration of globalization and world economics. Will we, as global citizens, make the right choices?

REFERENCES

- www.commerce.nic.in
- www.unesco.org
- www.migrationinformation.org
- www.stats.oecd.org
- www.indexmundi.com
- www.marketwatch.com
- IMF, *World Economic Outlook*, October 2008
- Shanghai Stock Exchange Indices
- Winter 2008/2009 Energy Market Assessment Item no. A-3

Rustom J. Modi is currently an advisor to KPIT Cummins India, an information technology firm, and Strategic Partners Ltd., a private equity firm based in San Francisco and India. He previously held senior positions at JP Morgan and the Tata group of companies.