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The 'Global Financial Crisis' – International Implications

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Alastair Newton, Senior Political Analyst, Nomura International plc:

"*Prediction is very difficult, especially about the future*": Neils Bohr (1885-1962)

Introduction

Thinking back even to July of this year, let alone to July 2007 when what was then known as the 'credit crunch' was first gripping us, it is doubtful that anyone would have accurately predicted at that time that we would be where we are today. So, any examination of the implications, international or otherwise, of what is now referred to as the 'global financial crisis' – and which may shortly be renamed the 'global economic crisis' – should be coupled with a warning about inherent unpredictability.[1]

With that in mind, I would prefer to stay on the relatively safe ground of considering the long-term trend, which I believe the present crisis to be accelerating, of the shift in the global economic centre of gravity back eastwards for the first time for around 200 years. For, perhaps strangely, in the context of the present crisis at least, forecasting farther out may well be easier than accurately predicting what tomorrow may bring. And I shall, indeed, touch briefly on that aspect in my oral remarks, which are elaborated somewhat in the paper I have prepared as a backdrop to this presentation.

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[1] *In its latest "World Economic Outlook" published earlier this month, the IMF is forecasting global growth for 2009 of just 3.0 percent, the lowest since 2002 and close to the IMF's marker for de facto recession globally; and that 'the anticipated recovery later in 2009 will be exceptionally gradual by past standards'. Furthermore, the IMF concedes that 'there are substantial downside risks to this baseline forecast'. See http://www.imf.org/external/pubs/ft/weo/2008/02/pdf/text.pdf.*

That said, I shall nevertheless devote the bulk of my time to the more hazardous business of taking a shot at some of the near-term implications.

First, though, the longer-term.

Watershed 2001?

"Since the industrial revolution in the 19th century, the rich countries of the 'first world' have dominated the global economy…. That era may be over":

The Economist (2006)[2]

In putting recent and ongoing events in financial markets in a broader geopolitical context, I'd like to start with what many may see as a controversial perspective.

I am confident that historians looking back on the current decade will view the second half of 2001 as something of a watershed moment in global affairs.[3] I support that view. But the date I have principally in mind as the 'moment' is not 9/11; it is 1 December 2001.[4]

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[2] "Climbing Back: The economies of what used to be called the 'Third World' are regaining their ancient pre-eminence": The Economist, 21 January 2006.

[3] See, eg, "America Between the Wars" by Derek Chollett and James Goldgeier (Council on Foreign Relations, 2008).

[4] See, eg, "Economic Factors and International Instability in the 21st Century" by Alastair Newton (Lehman Brothers International, June 2008).

That was the date when China joined the World Trade Organisation. This was an event which I believe historians will come to see as much more important in the broad than the events of 11 September 2001, as it marked a major watershed in China's ongoing quest for 'comprehensive national power' ie economic, scientific, military, cultural etc, even if the basis for now at least is 'soft' (rather than military) power.[5]

Tectonic Shifts Out Of Asia

While not really tied to a specific date, I would argue that one should put alongside China's rise that of India, seen by the Bush Administration as a 'natural ally' as, since 2001, the US has explicitly (and, historically, uniquely) sought to aid its similar emergence as a major world power.[6]

In their 2008 publication "*Power and Plenty*", Ronald Findlay and Kevin O'Rourke argue that:

> "*...the gradual rise of India and China to their natural roles as major economic and political superpowers [is] not only the best news for global human welfare in a generation, but*

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[5] China's military spending continues to cause concern in some quarters, not least because of lack of budget transparency. But figures published recently in the Economist indicate that a massive 45.7% of world defence spending is accounted for by the US alone, with China trailing in fourth place (behind Britain and France) at just 4.3%, ie around 10% of US spending; and India in eighth with 2.1% (discounting at least a significant part of its nuclear programme). See "The hobbled hegemon", The Economist, 30 June 2007 pp29-32.

[6] See, eg, "India's Role in the New World Order" by Charles Grant (Centre for European Reform, September 2008).

For more detail on India's prospects in the broad over the next decade see "India: Everything To Play For" (Lehman Brothers International, 2007).

> *[promises] to raise a variety of geopolitical challenges which as yet remain unpredictable. Indeed, history suggests that this could turn out to be the greatest geopolitical challenge facing the international system in the twenty-first century.*"[7]

I concur. And I would underline that we should keep firmly in mind that India, like China, is striving for 'comprehensive national power',

Japan – The Established Economic Power

Financial Times journalist Ed Luce wrote in 2006: *"...in many respects the world appears to be heading to a situation where relations between the three big powers [China, India and the US] will outweigh all other ties as the 21st century unfolds.*"[8] But no consideration of geopolitical shifts emanating out of Asia would be complete without reference to the established economic power in the region, ie Japan.

This point is well made in a recent book by American foreign policy guru, Robert Kagan, as follows:

> "*It is easy to forget, as everyone concentrates on China's rise as a great power, that Japan is a great power, too. Its economy remains the second largest in the world, a remarkable fact given its relatively small population, smaller territory, and lack of natural resources. Meanwhile, the*

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[7] *"Power and Plenty: Trade, War, and the World Economy in the Second Millennium" by Ronald Findlay and Kevin H O'Rourke (Princeton, 2008).*

[8] *"In Spite of the Gods: the Strange Rise of Modern India" by Edward Luce (Little, Brown 2006).*

> *Japanese military is one of the world's most modern. Although Japan spends barely more than 1 percent of its national wealth on defence, that amounts to $40 billion a year, among the three or four highest defence budgets in the world…. Japan is not only a genuine great power but increasingly displays great power ambitions.*"[9]

That point is at the heart of Bill Emmott's recent publication '*Rivals*' which offers an expert view on the evolving relationship between Asia's three great powers.[10] In the conclusions to that book, Mr Emmott notes that the future development individually and collectively of:

> "…*three of the world's most powerful countries sitting side by side, undergoing disruptive transformations and subject to huge domestic and international pressures, is going to be quite an adventure*."

'Uncoupling' Unravelling?

As I have already suggested, the parallel rise of China and India <u>and</u> the possible future evolution of Japan have their foundation in economic strength at a time when the global centre of economic gravity is shifting closer to Asia than at any time since the early 18th century.

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[9] "The Return of History and the End of Dreams" by Robert Kagan (Alfred A Knopf, 2008).

[10] "Rivals: How the Power Struggle between China, India and Japan will Shape the Next Decade" by Bill Emmott (Allen Lane, 2008).

Writing in the *Financial Times* last month, Gideon Rachman made the link between recent events and this longer-term trend as follows:

> "*The great Wall Street meltdown is a huge economic and financial event. But might it also signal a historic shift in global politics – a moment that marks and accelerates the decline of American power?*"[11]

Having asked the question, Mr Rachman offers a somewhat nuanced answer, with which I broadly agree, as he goes on to note that, while a psychological shift in both China and India is already under way, "*…the financial and economic troubles of the US may be no laughing matter…*" for the two emerging powers. Or, I would add, for the rest of Asia.

I have never personally bought the theory of 'decoupling' which was so popular earlier this year, at least not as a 'black and white' issue, for the very simple reason that it seems to me to be utterly incompatible with the reality of globalisation. Mr Rachman clearly agrees. He acknowledges that Asia is better able to weather an economic storm in the US than it was even a decade ago. But he offers a compelling, to my mind, case against any absolutism over decoupling.

Add to this the domestic economic – and, in some cases, political – strains wrought across Asia by the impact of higher food and fuel prices (to which I shall return), and it would be a brave individual

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[11] *"Asia rides high – for the moment" by Gideon Rachman, Financial Times, 30 September 2008.*

indeed who would argue categorically that Asia will come through the current crisis unscathed.[12]

Are Financial Markets Now Leading The Long-Term Trend?

Nevertheless, Mr Rachman's reference to an 'historic shift' remains pertinent. For the long-term trend of shifting global economic weight is clear, with all which it implies for financial markets and financial 'muscle'.

This shift in financial power has recently been highlighted by growing (if often irrational and unfounded) concerns in the West over sovereign wealth funds (SWFs) with their massive pools of liquidity.[13] Despite those concerns, surely SWFs – and the countries which possess them – should hope to profit still further now following what many see as the self-destruction of the US investment banking industry (which has disappeared in the space of just 14 month just as surely as the UK's did after the 1986 'big bang', albeit for very different reasons). But it remains to be seen whether swelling protectionist pressures (to which I shall return) will allow the so-called 'Santiago Principles', which were formally approved on 11 October 2008, to facilitate much-needed investment and liquidity flows from 'East' to 'West'.[14]

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[12] *For a more detailed commentary on food price inflation and its impact, see "The Politics of Food Price Inflation" by Alastair Newton (Lehman Brothers International, 2 June 2008).*

On Asia and 'decoupling', see, eg, "The truth behind Asia's financial fairy tale" by David Pilling, Financial Times, 16 October 2008.

[13] *See, eg, "The Politics of Sovereign Wealth: An Overview" by Alastair Newton (Lehman Brothers International, 2 June 2008).*

[14] *On 11 October 2008, the International Working Group of Sovereign Wealth Funds (IWG) formally presented its "Generally Accepted Principles and Practices" to the IMF's International Monetary and Financial Committee. The 'Santiago Principles', named after the draft principles agreed upon at the final meeting of the IWG in*

In that context, it is worth noting – as David Pilling highlighted in the *Financial Times* of 2 October - that '*...China and Japan alone boast 40 per cent of global central bank reserves...*'.[15] Based on that fact, Mr Pilling goes on to suggest that: '*By accumulating vast savings... Asians have been living below their means so that Americans could live beyond theirs*'. Indeed, savings in Japan alone are currently estimated at around $20 trillion, of which most are earning very low interest in postal savings, JGBs etc. Many experts believe that Japan's aging population will increasingly be obliged to look for better returns and therefore turn to equities in the medium term; and some add that even a 5 percent shift in that direction would amount to an infusion into equity capital markets of momentarily seemingly massive figure of $700 billion.[16]

That is not, though, to predict the demise of Wall Street *per se* – any more than the 'big bang' (or the launch of the euro) spelt the death knell of the City.[17]

But, as recent Japanese acquisition of and investment in major Wall Street banks underlines, the power of ultimate ownership in the world of finance may now be moving rapidly and irrevocably

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Santiago, include a set of 24 voluntary principles and explanatory materials which reflect SWF investment practices and objections. For additional background and a copy of the Principles, see http://www.iwg-swf.org/pr/swfpr0806.htm.

[15] "America's chance to kick its Asian addiction" by David Pilling, Financial Times, 2 October 2008.

[16] $700 billion was, of course, the US Treasury's estimation of the size of the bail-out package for the financial services sector in the US which was approved by Congress 3 October 2008. Large though that number seemed at the time, it has already been cast in a somewhat different light by subsequent events.

[17] See, eg, "Do not write off New York and London" by Michael Skapinker, Financial Times, 30 September 2008. A somewhat different perspective can be found in "The banker's fall will be fatal" by John Gapper, Financial Times, 2 October 2008.

eastwards – with all which that could imply geopolitically in the medium-term.

And In The Near Term?

But what of the near-term? What, specifically, can we expect the consequences of the crisis to be?

Among a whole range of options, I would suggest that any or all of the following five 'big issues' are distinct possibilities, if not probabilities.

1. Regulation and/or Reform

In his 13 October 2008 speech on the global economy, UK prime minister Gordon Brown stated that:

> "*It is with the same courage and foresight of [the] founders [of the Bretton Woods system] that we must now reform and renew the international financial system and we should do it around the agreed principles that are shared by every country of transparency, integrity, responsibility, good housekeeping and cooperation across borders*".[18]

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[18] *Mr Brown went on in more detail as follows: "...we must build a new Bretton Woods, a new financial architecture for the years ahead. Sometimes it does take a crisis for people to agree that what is obvious and should have been done years ago can no longer be postponed, but we must now create the right new international financial architecture for the global age. This crisis demonstrates beyond doubt that a global capital market requires much stronger global cooperation and supervision and we need to ensure that we have an effective global early warning system to alert us across continents to economic and financial risks, we need globally accepted standards of supervision that apply equally in all countries, we need stronger arrangements for a cross-border supervision of global firms, and if we have learned anything, much stronger institutions for cooperation and concerted action in a crisis. So the IMF and Financial Stability Forum should act as an early warning system, focused on crisis prevention rather than crisis resolution. We need what global companies themselves have asked for - coordinated supervision to end the mis-match between global capital flows and only national supervision, and that is why by the end of the year I believe we should implement the proposals agreed by the companies themselves for colleges of supervisors to oversee cross-border financial institutions. And action for financial stability should be accompanied by wider international cooperation on oil and energy policy and on macro-economic policy such as that which began last week with a coordinated European and American action on interest rates that should extend to Asia and to the rest of the world where it is necessary." A full transcript of the speech can be found at http://www.number10.gov.uk/Page17161.*

To give Mr Brown credit where it is due, this has been a recurrent theme of his over the past decade.[19] Indeed, in the detail of his speech (see footnote 19) there is more than an echo, to my mind, of the 30 October 1998 G7 finance ministers' declaration agreed under the then UK chancellor's chairmanship.[20]

It is perhaps instructive to look back ten years to the similar if somewhat less critical circumstances of that declaration to see how many of its solid and sensible stated aims were subsequently implemented – and how long it took for that to happen. The lesson to be drawn from that is clear, ie the political will to take tough but desirable (indeed, necessary) decisions can quickly dilute after the dust has settled. And I do wonder whether the present crisis might have been somewhat less severe, if not avoided altogether, had there been determined and timely follow-through to the October 1998 declaration.

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[19] *Given the credit which Mr Brown has been receiving from many quarters over the past few days (see, eg, "The crisis is redefining our leaders" by Gideon Rachman, Financial Times, 14 October 2008) it is hard to believe the criticism which the government in general and the prime minister in particular was coming in for just 12 months ago over, inter alia, Northern Rock.*

[20] *There may be some parallels between the current crisis and the 1998 global economic crisis (which was sparked by Russia's August 1998, default following a period of over 12 months of market turmoil during the so-called 'Asian financial crisis'). For over two months a range of measures and statements, including agreement on 'intensified cooperation' among G7 partners at their meeting in the margins of the IMF annual meeting in Washington on 3 October, had failed to shore up market confidence after the default. However, the 'Declaration of G7 Finance Ministers and Central Bank Governors' – issued on 30 October 1998 and setting out a wide-ranging menu of reforms to the international financial system – seemed to do the trick almost immediately despite the fact that the vast majority of its prescriptions were medium-term. Despite the bounce in markets on 13 October in response to concerted 'rescue package' action globally, it is still not entirely clear that we have reached the 2008 equivalent of that '30 October 1998' moment. But IMF Managing Director Dominique Strauss-Kahn was brave enough on the 13th to offer publicly that: 'The peak of the crisis is perhaps behind us'.*

The October 1998 declaration can be found in full at http://www.g8.utoronto.ca/finance/fm103098.htm.

That said, pressure for real change is certainly significantly greater than it was in 1998.

First, greater regulation of financial markets looked to be very much on the cards even before the crisis became as serious as it is now and turned a probability into a certainty.[21] For example, it has seemed likely for some time in the wake of food and fuel price inflation that there will be a concerted push by at least some G7 members next year for global regulation of some sort to govern so-called ‘speculation’. And, in the light of recent events, one might already reasonably add short-selling with, I suspect, a host of other perceived ‘evils’ to follow.[22]

Second – and more fundamentally – debate over reform of the International Financial Institutions (IFIs) has been ongoing more or less continuously since 1998, albeit with little progress to show for it to date. On the back of the current crisis, China in particular is already making it clear privately that, in return for underwriting the additional government debt arising from rescues packages across the OECD area, it expects to see some real and rapid progress on IFI reform. Should that not be forthcoming – and, to be clear, it would involve ‘losers’ (in the EU in particular) as well as ‘winners’ – there is, in my view, a real risk that the emerging economic powers will increasingly turn away from the established international institutions, thereby undermining the latter’s ability to deal with the next crisis.

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[21] *See, eg, “Irresponsibility ushers in the age of control” by Philip Stephens, Financial Times, 14 October 2008.*

[22] *For example, the Italian finance minister, Giulio Tremonti, has committed to put the abolition of hedge funds on the G7/8 agenda next year (when Italy holds the presidency).*

However, I would offer a word of caution. Maintaining momentum for necessary reforms is vital. But it is equally the case that regulation rushed out during a crisis often has unwanted perverse impacts and sometimes even fails to achieve its stated objectives. In that respect, *Sarbanes Oxley* (SOX) offers, in my view, a salutary warning.[23]

2. Rising Protectionist Sentiment

Most economists now agree that we are in for a significant global slowdown, certainly through 2009 and possibly beyond. It is therefore not unreasonable to assume that, across the OECD area, some of the 'lagging indicators' of a slowdown will continue to rise for some months to come yet, notably unemployment.

This is only likely, in my view, further to fuel protectionist pressures on both sides of the Atlantic but perhaps especially in the US where a Democrat-controlled Congress has already shown some antipathy towards free trade – and where the Democratic Party candidate for the presidency, Barack Obama, has committed to renegotiate elements of NAFTA and to sign off any Congress-approved bill on China's alleged 'currency manipulation'.

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[23] *The online encyclopedia Wikipedia's article on SOX opens as follows: "The Sarbanes-Oxley Act of 2002 (Pub.L. 107-204, 116 Stat. 745, enacted July 30, 2002), also known as the Public Company Accounting Reform and Investor Protection Act of 2002 and commonly called SOX or Sarbox; is a United States federal law enacted on July 30, 2002 in response to a number of major corporate and accounting scandals including those affecting Enron, Tyco International, Adelphia, Peregrine Systems and WorldCom. These scandals, which cost investors billions of dollars when the share prices of the affected companies collapsed, shook public confidence in the nation's securities markets. Named after sponsors Senator Paul Sarbanes (D-MD) and Representative Michael G. Oxley (R-OH), the Act was approved by the House by a vote of 334-90 and by the Senate 99-0. President George W. Bush signed it into law, stating it included 'the most far-reaching reforms of American business practices since the time of Franklin D. Roosevelt'."*

On the other hand, there are those who are arguing for reviving the Doha Development Round (DDR) of multilateral trade talks in response to the current crisis. But I am not alone in being sceptical that such calls will carry the day.[24]

3. Copenhagen Under Threat?

Irrespective of its outcome, the upcoming US presidential election has encouraged some optimism over prospects for a far-reaching post-Kyoto global agreement on climate change in Copenhagen in a little over 12 months time. And, certainly, it still looks to be the case that the next US Administration will be more forthcoming in the negotiations than the current one has been to date.

However, climate change is an area where Europe has set the pace to date and it remains to be seen whether, in the face of an economic slowdown, it will be prepared to continue to do so. With business and unions across Europe lobbying hard against any measures likely to impose additional costs, pressure is mounting on Europe's leaders to water down the ambitious climate change-related measures they agreed in March 2007, with at least two countries threatening at this month's European Council meeting to veto the package altogether.[25]

4. Western Aid vs Eastern Promise

There was a period in the first half of this year when the then 'credit crunch' more or less disappeared from our front pages in favour of food and fuel price inflation. Although prices have since

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[24] See, eg, "Doha Round: The saga that became a never-ending story" by Alan Beattie, Financial Times, 9 October 2008.

[25] See, eg, "German plea to halt costly laws" by Chris Bryant, Financial Times, 13 October 2008.

fallen, the UN Food and Agriculture Organisation (FAO) continues to warn that underlying drivers of food price inflation persist and that those prices are therefore set to remain at a higher plateau for some years to come.[26]

Couple this with some of the policy responses to the price hikes – which may have made some sense in the short-term but which carry longer-term negative consequences – and it is clear that, as noted previously, a large number of emerging markets will suffer economic – and, in some cases, political – stress for some time to come.[27]

It is, therefore, particularly worrying that at least some developed country aid budgets appear now to be under threat as a result of the financial crisis, as highlighted by IMF Managing Director Dominique Strauss-Kahn at the Fund's annual meeting earlier this month.[28] Furthermore, if aid budgets are cut (and, as seems likely, this is coupled with lower investment flows from the developed world), the world's poorer countries are likely to turn increasingly to potential donors and investors elsewhere which could, in turn, be detrimental to the drive to improve standards of governance in those countries.

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[26] *See, eg, "Biofuels: prospects, risks and opportunities" (Food and Agriculture Organisation, 2008), available at http://www.fao.org/sof/sofa/index_en.html.*

[27] *See "The Politics of Food Price Inflation" by Alastair Newton (Lehman Brothers International, 2 June 2008), pp5-11.*

[28] *See, eg, Mr Strauss-Kahn's remarks to the Board of Governors of 13 October 2008 at http://www.imf.org/external/np/speeches/2008/101308.htm, where he noted that: "Developing countries need help too. They face reduced export demand and reduced access to trade credit. And many are already suffering from the other crisis—the food and fuel crisis that has strained budgets and balances of payments, and raised inflation and living costs…. The rest of the world must…help. I understand that the budgets of advanced countries will be under more strain because of the financial crisis. But it is very important that donors do not respond to the crisis by cutting aid to the poorest and most vulnerable people in the world."*

5. Terrorism and the Global Economy

By design or default, few in the developed world now seem to remember that the ambitious DDR was launched on the back of the 9/11 attacks; and that the boost which it was expected to the global economy in general and emerging economies in particular was at that time widely seen in part as a means of addressing some of the underlying causes of terrorism. Seven years later, the Doha Round is, as previously noted, in the doldrums; and the global terrorist threat remains a very real one.[29] As the global financial crisis increasingly impacts on the real economy, it follows that it stands potentially – albeit indirectly – further to fuel terrorism.

And one is left to wonder – just as *al Qa'ida's* leaders may well be actively wondering – just what sort of an impact a major terrorist strike against a western target now would have on the global economy.

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[29] On 1 June 2008, the US Secretary for Homeland Security, Michael Chertoff, warned that al Qa'ida and associated groups remained intent on carrying out attacks on the US, Europe and elsewhere. Although Mr Chertoff stated that there was currently no specific intelligence to suggest an imminent attack, he warned of an evolving threat emanating principally from "the frontier areas of Pakistan" which he alleged al Qa'ida "...are using as a platform...to train operatives".