Globalization in Retreat

Further Geopolitical Consequences of the Financial Crisis

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It is now clear that the global economic crisis will be deep and prolonged and that it will have far-reaching geopolitical consequences. The long movement toward market liberalization has stopped, and a new period of state intervention, reregulation, and creeping protectionism has begun.

Indeed, globalization itself is reversing. The long-standing wisdom that everyone wins in a single world market has been undermined. Global trade, capital flows, and immigration are declining. It also has not gone unnoticed that nations with insulated financial systems, such as China and India, have suffered the least economic damage.

Furthermore, there will be less global leadership and less coordination between nations. The *G-7* (the group of highly industrialized states) and the G-20 (the group of finance ministers and central-bank governors from the world's largest economies) have been unable to respond effectively to this crisis, other than by expanding the International Monetary Fund (IMF). The United States is also less capable of making these institutions work and, over the medium term, will be less dominant.

This coincides with the movement away from a unipolar world, which the downturn has accelerated. The United States will now be focused inward and constrained by unemployment and fiscal pressures. Much of the world also blames U.S. financial excesses for the global recession. This has put the U.S. model of free-market capitalism out of favor. The deserved global goodwill toward President Barack Obama mitigates some of this, but not all of it.

In addition, the crisis has exposed weaknesses within the European Union. Economic divergence is rising, as the three strongest EU nations—France, Germany, and the United Kingdom—have disagreed on a response to the crisis and refused pleas for emergency assistance from eastern Europe. The absence of a true single currency has proved inhibiting. And the European Central Bank has emerged as more cautious and less powerful than many expected.

Such lack of strength and unity in the West is untimely, because the crash will increase geopolitical instability. Certain flashpoint countries that rose with the oil and commodity boom, such as Iran and Russia, will now come under great

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economic pressure. Other, already unstable nations, such as Pakistan, could disintegrate. And poverty will rise sharply in a number of African countries. All this implies a less coherent world.

The one clear winner is China, whose unique political-economic model has come through unscathed. This will automatically enhance its global position. Yes, its growth has slowed, but to still enviable rates. And measured by financial reserves, it is the world's wealthiest country. China's astute leadership is already making strategic investments that others cannot make.

The expected prolonged severity of the global recession is central to understanding these likely geopolitical impacts. The world's three largest economies, the United States, the EU, and Japan, will not be able to generate a normal cyclical recovery. The pervasive financial damage will prevent it. As a result, nations dependent on those markets for growth, such as those in eastern Europe, will also face a long recovery. And many of the developing economies, which depend on foreign capital, have been hardest hit.

ANATOMY OF A CRISIS

Start with the United States, whose GDP is still nearly double that of any other country. Whereas most recessions follow a sequence of rising inflationary pressures, monetary tightening to counter them, and a slowdown in response to higher interest rates, this one is a balance-sheet-driven recession. It is rooted in the financial damage to households and banks from the housing- and credit-market collapse.

U.S. households lost 20 percent of their net worth in just 18 months, dropping from a peak of $64.4 trillion in mid-2007 to $51.5 billion at the end of 2008. Approximately two-thirds of this reduction involved lower financial asset values, and one-third was tied to home values. This is a big drop when juxtaposed against a median family income of $50,000 (which has been shrinking in real terms since 2000) and unprecedented household debt (which reached 130 percent of income in 2008).

That debt surged because Americans spent beyond their means. This reflected the wealth effect—households feeling wealthier on account of rising asset values and thus spending more. But consumers are now shell-shocked, and so that effect has been reversed. Household outflows are down, producing the unusual surge in personal savings rates that is now evident. This is why personal consumption expenditures fell by record rates in the last quarter of 2008. But consumer spending dominates the U.S. economy (at 70 percent of GDP). The core question is, when can spending resume growing at cyclically normal levels? With home values still falling and equity prices still 45 percent below their 2007 peak, the answer is not soon.

The other key constraint is the financial sector. Since the crisis broke, global financial institutions (mostly Western ones) have reported $1 trillion of losses on U.S.-originated assets. And the IMF recently estimated that ultimate losses will reach a staggering $2.7 trillion. These losses directly reduce banks' underlying capital and thus their capacity to lend. This explains why U.S. lending volumes have continued to decline and why the lending levels needed to support a normal cyclical recovery are not possible.

A PAINFUL RECOVERY

The recovery in Europe will be even weaker. Although the United States is expected to

register marginal growth in 2010—Goldman Sachs is forecasting 1.2 percent—the eurozone may contract again, by an estimated 0.3 percent. This reflects Europe's more exposed banking systems, historical factors, and the region's weaker policies.

Europe entered the recession later than the United States did and, logically, will emerge later. The housing and credit markets imploded in the United States, and then this implosion moved east. For example, Europe was still growing in early 2008, whereas the United States was not. Europe's banking system is proportionately larger than the United States', and its banks were more exposed to weakening emerging markets in eastern Europe and Latin America. And to date, European banks have recognized a smaller share of total likely write-downs than U.S. banks have.

Furthermore, the European policy response has been much weaker. Washington adopted a $787 billion fiscal stimulus program (involving tax cuts and spending increases), representing five percent of GDP. This is expected to raise 2009 GDP (over four quarters) by two percent above the level that would otherwise have prevailed. By contrast, the European Economic Recovery Plan is targeted to provide a stimulus equal to only about 1.5 percent of the EU'S GDP. The resulting boost will be smaller.

When it comes to monetary policy, there has been a similar disparity. The U.S. Federal Reserve lowered the federal funds target interest rate—the rate at which banks lend to one another overnight—to zero percent six months ago. Together with the U.S. Treasury and the FDIC, the Federal Reserve has provided an astonishing $13 trillion of support to the financial system. This includes guarantees of commercial paper, money-market-fund investments, specific groups of bank assets, and the like. In contrast, however, the European Central Bank has lowered its rates more slowly, only reaching 1.25 percent in April 2009. The comparable figure for overall credit support is 115 billion euros of capital injection for banks and 217 billion euros of funding guarantees—a fraction of what Washington has spent.

There are numerous reasons for this weaker European response. Some have to do with the stronger social security nets across much of Europe and the lesser need for special protection now. Others involve a historical aversion to steps with potentially inflationary consequences. And there is also the inherent difficulty of reaching agreement among multiple nations. The overall implication is that Europe's recovery will be even slower than the United States'.

Japan's will be even weaker. Japan remains the world's third-largest economy, but its GDP is expected to fall 6.6 percent this year and to decline again in 2010. This ties directly into Japan's decreasing, but disproportionately important, export sector. Japan also has a limited capacity for fiscal or monetary stimulus, as its national debt is extremely high and its monetary policy has been accommodative—allowing easy access to credit—for years.

The developing world has been hit hardest. Inflows of investment and financing have plunged, exports are very weak, and commodity prices are way down. The countries of central and eastern Europe are particular victims, as they ran large balance-of-payments deficits and depended on external borrowing to finance them. Several of them, including Hungary and Poland, have resorted to emergency loans from the IMF. Meanwhile, Africa has seen capital inflows nearly come to a halt.

The overall picture is a grim one: a deep, truly global, and destabilizing downturn, with world GDP falling for the first time in the postwar period. Given rising populations, such an outright contraction is stunning. As of this writing, it may have bottomed out, but the next three years will be painfully slow. The geopolitical consequences are now coming into view, and they will be profound.

AFTER GLOBALIZATION

First, the era of laissez-faire economics has ended. For 30 years, the Anglo-Saxon model of free-market capitalism spread across the globe. The role of the state was diminishing, and deregulation, privatization, and the openness of borders to capital and trade were rising. Much of central and eastern Europe adopted this model, as did swaths of East Asia and diverse nations from Ireland to Mexico.

This movement reflected the economic primacy of the United States. Its growth, soaring standards of living, and conservative economic policies were widely admired. Countless societies preferred this model and supported governments that espoused it. The state-centered models, such as the French and German ones, were in retreat.

Now, a page has been turned. The Anglo-Saxon financial system is seen as having failed. The global downturn, and all its human devastation, is being attributed to that failure. Throughout the world, including in the United States, this has turned the political tide in a new direction. The role of the state is expanding again, together with a reregulation of markets. This is evident in the United States, where President Obama has moved toward more activist and bigger government. The quasi nationalization of the banking and automotive industries, as well as the pending reform of the financial system, makes this clear. It is also clear in Ireland, the United Kingdom, and elsewhere, where nationalizations have gone even further. And it is clear in statements made by such leaders as French President Nicolas Sarkozy, who recently celebrated "the return of the state" and "the end of the ideology of public powerlessness."

Second, globalization is in retreat, both in concept and in practice. Much of the world now sees it as harmful. Those nations, especially developing ones, that embraced increased capital flows and open trade have been particularly injured. Those that insulated themselves, such as India, have been less scarred. The global spread of goods, capital, and jobs is reversing. Global exports are falling sharply. The World Bank reports that exports from China, Japan, Mexico, Russia, and the United States fell by 25 percent or more in the year leading up to February 2009. Capital flows are plunging, too. Emerging markets are projected to receive only $165 billion in net positive capital inflows this year, down from $461 billion in 2008. Furthermore, financial and trade protectionism are spreading. Both the World Bank and the World Trade Organization recently reported a movement toward higher tariffs, higher nontariff barriers, and an increase in antidumping actions, designed to protect domestic jobs. Brazil, India, Russia, and numerous other states were cited. Moreover, various states' fiscal stimulus plans include subsidies for exporters and "buy domestic" provisions. And discriminatory actions against foreign workers are spreading. Immigrant workers, who are particular victims of this crisis, are returning home in waves. Japan and Spain are

offering them cash to leave, and Malaysia is forcing them out.

Third, the world may be entering a new global phase marked by less leadership, less coordination, and less coherence. The world was already moving away from its post-Berlin Wall, unipolar condition, but this crisis has accelerated that process. The United States has turned inward, preoccupied with severe unemployment and fiscal pressures. Its economic model also is now out of favor. President Obama has made a triumphant overseas tour and is hugely popular everywhere. But his attention and political capital must be reserved for domestic issues, such as stabilizing the banking industry, handling the budget, and reforming health care.

Other nations have been rising, especially China. Although the United States' capacity to lead is now diminished and will continue to be so over the medium term, none of these rising powers is capable of full leadership. The outlook for effective multilateral approaches is also cloudy. The *G-7* and the G-20 are relatively ineffective, as evidenced by the recent London summit. Yes, the IMF was expanded there, and that is important, but on the more challenging issues—a coordinated global stimulus, global financial oversight, and Afghanistan—the summit failed. Fundamentally, the *G-7* is an anachronism—China is not a member—and the G-20 is too large. On urgent political matters, such as Iran and the Arab-Israeli conflict, multilateralism is in retreat. The economic crisis is requiring most nations, including the United States, to focus inward. Also, other nations' responsiveness to U.S. initiatives has been muted. The case of Pakistan makes that clear: a failed state with nuclear weapons would threaten many nations, and yet only U.S. diplomacy is fully active there.

Fourth, this crisis likely will increase geopolitical instability. Dennis Blair, the U.S. director of national intelligence, has asserted that the downturn already has produced low-level instability in a quarter of the world. The IMF has warned that millions will be pushed into unemployment, poverty, rising social unrest, or even war.

Key commodity-centered nations, such as Iran and Russia, rose with the oil and resource boom and flexed their geopolitical muscles accordingly. But now, they are coming under severe economic pressure. This year, unemployment in Russia is projected to reach 12 percent, and five million of its people will likely fall into poverty. Nearly half of its monetary reserves, although they are still ample, have been spent to stabilize the ruble and prop up state enterprises. Iran's oil and gas revenues will fall to $33 billion this year, from a 2007 level of $82 billion. At current world oil prices, Iran is actually running a current account deficit. Inflation is at 20 percent in the country, and Iran is unlikely to grow in 2009 or 2010. How these economic pressures will affect its upcoming election and the nuclear issue is unclear.

Countries in Africa have been hardest hit of all, and instability will likely rise there. Fragile states, such as the Democratic Republic of the Congo and the Central African Republic, have seen their social problems exacerbated by the crisis. Foreign reserves in the region have dwindled. The Congolese government will soon be unable to import essentials, such as food and fuel. The Central African Republic is already unable to pay the salaries of its civil servants. In 2007, African countries raised $6.5 billion selling bonds on the international

markets. This year, the figure will be zero. Private capital inflows could fall by nearly 90 percent, and the Overseas Development Institute, a British think tank, has projected that official aid will decline by $20 billion, as donors retrench. The commodity price crash, combined with the related slowdown in growth, the cutoff of private capital inflows, and diminished official assistance, has pushed the continent's collective current account surplus of four percent to a deficit of six percent in just two years. A World Bank study estimated that 53 million people living in emerging markets will fall back into absolute poverty this year. More frightening, according to the same study, up to 400,000 more children will die each year through 2015 on account of this economic crisis.

THE CHINESE MODEL

Only China has prevailed. China's growth did diminish but now may be picking up again. Recently, electricity consumption, freight shipments, and car sales in China have all increased. Its financial system is insulated and relatively unleveraged—and has thus been largely unharmed. This has allowed China to direct a recent surge in lending for stimulus purposes. Beijing's unique capitalist-communist model appears to be helping China through this crisis effectively. And measured by its estimated $2.3 trillion in foreign exchange reserves, no nation is wealthier.

All of this is enhancing China's geopolitical standing. The West is experiencing a severe economic crisis, seen as its own making, whereas China is not. The Chinese leadership is well aware of this relative advantage, even though its priorities are always domestic. Apart from its coal supplies, China is resource poor. But it has recently been making offshore investments in natural resources of a kind that others no longer can make—such as securing future oil supplies from Russia and Venezuela.

It is increasingly clear that the U.S.-Chinese relationship will emerge as the most important bilateral one in the world. The two nations have similar geopolitical interests. Neither wants Iran to acquire nuclear weapons, North Korea to be destabilized, or Pakistan to become a failed state. There is no reason, therefore, why their relationship cannot be a cooperative and globally stabilizing one.

This economic crisis is a seismic global event. Free-market capitalism, globalization, and deregulation have been rising across the globe for 30 years; that era has now ended, and a new one is at hand. Global economic and financial integration are reversing. The role of the state, together with financial and trade protectionism, is ascending.

Pro-growth leaders who seek to limit this phase must lead by example. One key is to promote aggressive stimulus measures to shorten their own countries' recessions and restart world growth. Beijing, London, and Washington are all moving impressively in this direction. Second, financial deregulation went too far, and so moderate reform is now needed to prevent a recurrence of the abuses and regulatory failures that resulted. Washington will shortly launch such a legislative effort, and Europe is moving even faster. A third key is President Obama and the enormous global goodwill he enjoys. He has a uniquely influential podium, which he could use to espouse the benefits of globalization and market liberalization. It is too soon to know whether he will use it that way. Let us hope that he does.

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