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The Global Economic Crisis

Some Strategic Implications

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1 The Nature of the Crisis

We are in the midst of a global economic crisis, of a magnitude unprecedented in recent history. There are bound to be gainers and losers due to this and the shifts in economic equations that are likely to result will also have some strategic implications. The situation is, however, still evolving and comments on these implications at this stage are at best informed speculation. Our effort here is to look at the nature of the crisis, the outcomes of similar economic events in the past, and the possible strategic implications as a result of this crisis.

The current economic situation started developing a year ago. The first symptoms surfaced innocuously in the US housing market. US lenders were said to be having problems with defaults on sub-prime mortgages. The situation rapidly escalated into a financial crisis within the United States (US), which led to a global financial crisis, and eventually metamorphosed into the global economic crisis that is today being seen as the worst economic crisis since the Great Depression of the 1930s.

What led to this drastic situation? In the US, the crisis seems to have been the culmination of a two-decade period of consumerism, easy availability of credit, increasing national indebtedness and speculative investments in housing stocks amongst other things by financial institutions. Increasing national indebtedness and deficits were financed by the rest of the world, most notably financially surplus countries like China, Singapore and oil producers of the Persian Gulf, who built up huge foreign exchange balances, and parked their reserves in US dollars. A fall in housing prices started unravelling this unsustainable position, leading to large-scale individual defaults and institutional losses, steep falls in the stock markets, collapse of a major investment bank, loss of consumer confidence, and then huge government bailouts to prevent more banks and financial institutions from collapsing.

In the last two quarters, the US Gross Domestic Product (GDP) has declined at an average rate of 6 per cent per annum, with unemployment rising steadily. The official unemployment figure for March 2009 was 8.5 per cent. Informal unemployment estimates including "discouraged workers" (permanently unemployed, and unemployed part-time workers) put unemployment figures at about 14 per cent. In the coming financial year, the US Government proposes to run a budget deficit of US $ 1.75 trillion. This is largely on account of expenditures to provide a fiscal stimulus to revive economic activity, create jobs and thereby tackle the situation. The numbers are a clear indication of a crisis in the US economy.

Why should a US financial crisis lead to a global economic crisis? It is because of the sheer scale and importance of the US economy in the world economy. The US GDP is nearly a quarter of the entire world's GDP[1], and the economies of most countries today are highly interconnected and globalised. So, if the US catches a cold, the world sneezes! For example, while the US stock market has crashed and lost value, global equity markets have lost about US $ 32 trillion[2] since the crisis broke out, an amount that is more than the combined GDP of the G7 countries in 2008.

The US is also the largest market for consumer goods and services. Most of these goods and services are produced in other countries and exported to the US. The American consumer has been the main driver of economic expansion in Europe, China, Southeast Asia, Japan, Russia, etc. A crisis leading to reduced consumption and demand in the US means reduced exports for the suppliers, leading to slowing of economic activity and job losses in these countries as well.

As a result, the world economy is expected to contract by 1.4 per cent in 2009.[3] Apart from the US, there has been a contraction of economic

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1 US GDP in 2008 was 23.44 per cent of world GDP, as per IMF *World Economic Outlook* Database.

2 New Europe, *The European Weekly*, February 17, 2009.

3 According to the IMF's latest forecast (*World Economic Outlook* Update) released on July 8, 2009.

activity in the Euro zone with an expectation of a further 4.8 per cent decline in 2009, and the GDP of Japan, which contracted in 2008 as well, is expected to shrink further by 6.0 per cent in the current year.[4] Some smaller countries like Iceland and Latvia have virtually become bankrupt, needing substantial infusion of external loans to save their economies from collapse.

In India the relatively lower level of economic linkages with the world economy had led to an initial exposition of the theory of "decoupling" i.e., the country would remain unaffected by the crisis affecting the rest of the world. This did not turn out to be so. India also finds itself in the midst of a relative downturn, with GDP growth projected to be nearer 5.4 per cent[5] as against the 7–8 per cent of the last few years.

Countries relying largely on export-led growth have in general been harder hit, just as they benefitted most from globalisation during the boom period. Some countries like China and Singapore have, however, built up large foreign exchange reserves during the boom period, and this presents them with opportunities as well.

Another parallel development has been the decline in commodity prices including the price of oil (which has fallen from its 2008 peak of US $ 150 per barrel to about US $ 40-60 in the last few months). This situation is expected to continue for a while in the face of weak global demand due to the crisis. This has adversely impacted oil and primary commodity producers such as the oil producing Persian Gulf countries, Russia, Latin America, Africa, etc.

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4 Ibid

5 Ibid

Historical Experience 2

Major economic events and long-term economic growth or decline of countries have often had political fallouts which have led to significant power shifts. Sustained trends in the economic performance of a country often lead to changes in its power dynamics vis-à-vis other countries. Historical experience is especially relevant in this regard, and can be useful in speculating about the future. We have a number of examples to illustrate this:

In the aftermath of the Crimean War in the 1870s, the Ottoman Empire faced a debt crisis, where debt servicing was consuming 50 per cent of expenditure. It tackled the crisis by selling and transferring its revenue streams and assets to European creditors, the most famous being the sale of the Suez Canal to the British. Besides the obvious income losses, this also had political implications, and the empire weakened and crumbled in the years to come. Today, in an interesting regional twist, we find that as a result of the increasing indebtedness of distressed US banks and financial institutions and their need for liquidity, cash rich Chinese and Middle Eastern sovereign wealth funds are picking up stakes in these institutions at low prices.[6]

At the end of the Second World War, Britain was the second most important Western power after the US, with a huge influence in Asia and Europe. The post-War years were, however, years of consistent economic underperformance, with Britain's GDP per capita more or less stagnant for thirty years, while that of Germany and France rose in the same period by more than 50 per cent. Britain lagged in relative

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6 This case has been analyzed by Niall Ferguson in the *Financial Times* (www.ft.com), January 1, 2008.

growth of labour productivity as well as share of exports. As a result, today it finds itself no longer in a position to influence events in a way it wants. Even its special relationship with the US has been eroded because the US has forged closer links with Germany and France, who are both seen as relatively stronger, economically and politically, and the countries that matter more in Europe.[7]

Following the break-up of the Soviet Union, Russia embarked on a radical market oriented reform programme or "shock therapy", perhaps too hastily, in hindsight. As a result, the country slid into deep depression in the 1990s, a depression much more intense than the Great Depression. Russia's GDP declined by half as the economy was in free fall. Average wages declined by half. The percentage of people in poverty went up from 17 per cent to 35 per cent.[8] By the end of the period, with its economy in tatters, Russia did not command the kind of strategic influence that it should have as the successor of the Soviet Union. It was only much later that a different set of economic factors i.e., the boom in oil revenues, enabled the resurgence of the more assertive Russia that we see today.

In the four decades after the Second World War, Japan built itself up through hard work and technological excellence and recorded rapid economic growth becoming the pre-eminent power in Asia. Due to growing structural impediments in the economy and a reluctance to resolve these through needed policy reform, the 1990s became a decade of stagnation for Japan. During the decade Japan's growth rate only twice crossed 2 per cent, and was negative for a couple of years. China's growth rate, on the other hand, ranged from 8-14 per cent. Though Japan still has a much larger economy, the gap between it and China has started narrowing. Over this period, its relative standing vis-à-vis China eroded. Despite being the dominant shareholder in the Asian

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7 Case study—Britain's Decline: Its Causes and Consequences, based on the valedictory dispatch by Sir Nicholas Henderson, then British Ambassador to France, *The Economist*, London, June 2, 1979.

8 Alexander Verobyov and Stanislav Zhukow, "Russia: Globalisation, Structural Shifts & Inequality", CEPA Working Paper no. 19, Center for Economic Policy Analysis, New York.

Development Bank (ADB), it was not able to play the major role in the resolution of the Asian financial crisis of 1997–98 that it should have, weakening its influence amongst the affected countries of the region.

Conversely, cases of increased national power resulting from increased wealth abound. As a result of the prolonged boom in oil prices over the decade, the political importance of oil producing Middle Eastern states, and countries like Venezuela and Russia has increased. China's strategic strength today is significantly due to its extraordinary economic performance over the last two decades in which it has been growing steadily at over 9 per cent per annum. It has, thereby, been transformed into a political heavy weight, in a league different from what it was perceived to be in the previous decades, though even then it had nuclear weapons and the largest standing army. Similarly, India started being taken seriously on the world stage only after its economy entered a phase of rapid and sustained economic growth.

The Great Depression 3

The global economic crisis has been compared most often to the Great Depression of the 1930s. It is instructive to look at what happened to the US economy then, as well as what happened in other important countries as a consequence.

The Great Depression is acknowledged to be the longest and most severe depression ever experienced by the industrialised Western world. In the US, it began with a major stock market crash in 1929. It took 25 years for the Dow Jones industrial average to recover to its 1929 level.[9] Industrial production was down to half; median national income went down to half of what it used to be, and unemployment levels climbed to 25 per cent of the workforce. It produced poverty and hardship at a scale never previously experienced in the US.

Lack of adequate understanding of the cause and effects at that time led to an inappropriate policy response by the US authorities. Government raised interest rates, increased tariffs, and ran budget surpluses, thereby strengthening deflation and worsening the situation. Between 1929 and 1933, US GDP declined by rates between 6–13 per cent every year.[10] Recovery efforts were initiated with Roosevelt's New Deal in 1933 which focused on spending for public works and welfare schemes. The US economy did not fully recover, however, till the Second World War, when increased military spending eliminated unemployment and boosted growth. GDP growth recorded unprecedented levels of 16–18 per cent per annum during the war years.

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9 Steve Schifferes, "Financial crises: Lessons from History," BBC News Analysis, at http://news.bbc.co.uk/go/pr/fr/-/2/hi/business/6958091.stm

10 US Department of Commerce, Bureau of Economic Analysis.

Just as the effects of the US economic crisis have spread all over the world today, the Great Depression had devastating effects in virtually all major countries. International trade plunged by half. Many states underwent some sort of political upheaval, pushing them to seemingly strong nationalistic leaders. European countries, especially Germany, were hit hard by the Great Depression, which led to high rates of unemployment and poverty, and civil unrest. Against 25 per cent unemployment in the US, the unemployment rate in Germany hit 33 per cent.[11] Coming on top of the war reparations that had to be paid by Germany as a result of the First World War, the situation became desperate in the country. Severe unemployment led to a surge in membership for the nationalistic Nazi Party, which promised to restore the lost glory and prosperity of the country. Undoubtedly, the rise of the Nazi Party and Hitler, and his accelerated militarisation programme alleviated the worst of the effects of the depression, got production lines going and employment up. At the same time, his policies drew the country and the world inevitably into a confrontation that led to the Second World War.

The Great Depression did not affect Japan as strongly, though the Japanese economy shrank by 8 per cent during the three years after 1929. The civilian government of the time was the first to implement what have come to be known as Keynesian economic policies, by deficit spending to provide a fiscal stimulus, and devaluing the currency. The deficit spending went substantially into arms and munitions, strengthening the capabilities of the military. As a result, Japan was out of the woods by 1933. However, the government's move to reduce spending on arms thereafter was opposed by ultra nationalistic elements leading to the assassination of the Finance Minister, and dominance of the military in government decision-making thereafter. Again, the domestic response arising out of the Depression led to conditions conducive for conflict, and culminated in Japan's campaign in the Second World War.[12]

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11 Wikipedia, Causes of World War II.

12 Ibid

Global Strategic Implications 4

The Great Depression sparked off events and changes in many countries that increased global friction and conflict. The economic situation and the strategic shifts that resulted finally reached resolution through the Second World War.

Historical experience suggests that whenever there is an economic crisis of a global nature, or major economic changes take place over a sustained period, shifts in relative political power amongst countries also result. In addition there is the likelihood of more generalised strategic trends emerging. An attempt is made here to set out the range of such possibilities.

Most analyses suggest that the main strategic loser and gainer from the crisis is going to be the US and China respectively. We shall try to see whether the emerging trends support this view. The strategic trends and implications that we would be looking at are restricted to those directly emanating from the crisis. There may be other strategic trends emerging in the world, quite independent of the global economic crisis, which are not the subject of study here.

The crisis was caused by, and originated in the United States of America, which is also the pre-eminent military power in the world today. Accordingly, we first look at the likely strategic implications for the US. The implications for China, as the most rapidly growing major power, and the most important passive contributor to the financial crisis, deserve being looked at next.

United States

The US is facing the deepest slump in its economy since the Great Depression. Both conservative and liberal analysts believe that the magnitude of the crisis is going to have an adverse strategic impact on the US. In the short term, it is a "major geopolitical setback for the United States"[13]. Damage is being done not only to the financial systems, but also the international standing and soft power of the US. A focus on domestic recovery and a very high level of fiscal deficits will reduce the room to manoeuvre on the defence front. The drain on its financial resources is likely to limit the ability and inclination of the US to embark on new international military initiatives. Liberal commentators have gone as far as to predict that "this process (of the unraveling of the economic empire of the US) will eventually knock out the underpinnings of US military power and bring about a major reduction in overseas entanglements".[14]

That the gravity of the strategic situation is being appreciated by the US policymakers is reflected in the assessment by Dennis Blair, Director of National Intelligence in his briefing to the Senate Select Committee on Intelligence in February 2009 to the effect that the global economic crisis had replaced international terrorism as the most menacing threat to the national security of the United States.

At the same time, the US has weathered earlier crises, including the Great Depression due to its remarkable ability to reinvent itself. The Great Depression was undoubtedly a low point in US economic history, but less than two decades later after the Second World War, the US was in the midst of a phase of unprecedented prosperity. Unlike in the case of the Great Depression, the US has taken steps to stem the economic decline. The world is also more interconnected and is coordinating its efforts to deal with the situation. Ironically, despite the financial bungling by the US establishment and financial sector that led to the crisis, the US remains a safe haven for investment from all over the world, and the dollar-denominated balances of cash rich foreign countries parked in the US are unlikely to go away. The price of oil is down and likely to remain so—this will help the US, which is the world's largest consumer. In that sense, the cause and effect may

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13 Roger C. Altman, "The Great Crash 2008", *Foreign Affairs*, January/February 2009.

14 Thomas R. Cusack quoted by Thomas B. Edsall in the *Huffington Post* at www.huffingtonpost.com/2008/10/13

not be in tandem. Although the US is the prime culprit in triggering the crisis, it is likely that countries heavily dependent on US markets may end up being more adversely affected than the US itself.

The US remains in a league of its own. With all these factors at play, and with the size of the US economy being nearly a quarter of the world economy, and US annual military spending being nearly half of world military spending, US strategic domination will remain for quite some time yet, regardless of the crisis, though one would expect that the gap between it and others may narrow over a period of time.

China

China has been perhaps the greatest beneficiary of globalisation, growing on the back of an export-led strategy. Accordingly, a crisis of globalisation would reasonably be expected to hurt China. Nevertheless, official numbers seem to indicate that the Chinese economy is equipped to weather the storm. The economy is continuing to grow at a relatively rapid pace[15], at a time when most large Western economies are shrinking. While constrained budgets and lack of growth will at some stage affect the strategic ambitions of the US, an expanding economic cake (even after the crisis) enables China to continue strengthening its military and projecting its great power ambitions. It has a budget surplus, a current account surplus and US $ 2 trillion in reserves[16], of which about US $ 1 trillion is said to be in US government-backed securities. This liquidity affords it opportunities to expand its global influence, and acquire assets necessary to protect its strategic interests. It is useful to be in such a position at a time when Western countries and their assets are under financial pressure.

Having benefited from the global status quo so far, China is unlikely to radically disturb it. In recently articulating the need for a new global reserve currency, China expressed its unease with the present dispensation. However, presently there appears to be no realistic safe

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15 As per the latest World Bank estimates, the Chinese economy is expected to grow at 6.5 per cent in 2009.

16 Matthew J. Burrows and Jennifer Harris, "Revisiting the future: Geopolitical Effects of the Financial Crisis," *The Washington Quarterly*, April 2009.

alternative. As long as the US continues to be perceived as a safe haven, China's reserves will continue to be invested in the US. As a result, America and China are locked together, financially. In the present situation, where a possible sudden switch of such a large amount of reserves from dollars to another currency could trigger a fresh crisis in the United States, preserving the status quo gives China economic leverage over the US, and it is likely to make full use of this leverage in advancing its strategic interests. The US and the Western world will be more willing to accommodate China's interests. Already, the nomenclature G-2—to denote that in today's world the US and China are the pre-eminent powers—is being used by the media. This denotes the implicit recognition that any global financial arrangements decided upon would need the agreement of China apart from the US to work.

There is a downside. The crisis is estimated to have left at least 20 million people jobless.[17] This could rise to more than 30 million in 2009. Local riots, protests and strikes are said to be on the rise. The internal stability of the country has so far been ensured by rapid growth of income and employment, based on an export-led strategy that has taken a hit. Some analysts believe that, if adjustments are made due to different accounting standards followed in China, the current rate of growth in China is probably nearer zero, not around 7 per cent as is being projected.[18] There has been a huge step up in bank lending (US $ 670 billion in new loans in the first quarter of 2009) to help export industries and enable companies to retain employment levels. This poses a risk to the stability of the banking system, already carrying the overhang of past bad debts, and is not sustainable in the long term.

At the same time, the paramount objective of the government in China has always been to ensure the supremacy of the Party's power. Social stability is of the utmost importance for this, and given that resources are not really a problem at present, it can be expected that whatever economic and political measures are needed to deal with the unrest would be taken. It would require a prolonged downturn, and a fall in the growth rate over a period of time to create a situation that may

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17 Economist Intelligence Unit Special Report "Manning the Barricades," March 2009.

18 *Stratfor*, "The Recession in China", May 7, 2009.

have major internal repercussions for the government. In such an eventuality, Chinese internal stability may be at risk.

Meanwhile, as commodity prices fall, China has been busy buying up control over energy and natural resources across the globe. Billions of dollars have been spent in recent months on such deals that include an Australian iron ore and zinc companies Fortescue Metals and Oz Minerals respectively[19], stakes in one of the world's largest mining companies Rio Tinto, Brazilian oil company Petrobas and Calgary-based oil company Verenex Energy.[20] Along with such investments, its diplomatic influence in the developing world in particular will grow.

Energy efficiency is being taken seriously domestically as well, probably with a view to reduce eventual dependence on imported energy. It is reported that China will spend about 40 per cent of the fiscal stimulus package of US $ 516 billion on green projects.[21]

For China, it's the growth performance that matters in the end. As long as it can keep up the rate of growth, its strategic influence will continue to grow. At a time when most major powers are in the economic doldrums, this means a relative strengthening of China's position in the world. The atmospherics in the April summit of the G20 seemed to acknowledge this changing reality. If the growth performance is overstated and the economy is actually stagnating as is being speculated, China will face serious medium-term challenges. However, even then, the huge reserves of liquidity will keep China going in the short term.

Europe

In terms of military power, the European Union was always far behind the US or Russia. In the wake of the global economic crisis, its economic power may also decline. The European economy, like the US, is expected to contract. In any case, growth trends have been

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19 A realisation of the strategic implications of these deals seem to have motivated the decision of the Australian government to block the Oz Minerals deal, and put the Rio Tinto deal under scrutiny; despite the excellent trade relations between the two countries.

20 *Time*, March 16, 2009.

21 *Down to Earth*, Centre for Science & Environment Newsletter, March 24, 2009.

sluggish for the major European countries for some time. The crisis has demonstrated the inability of the Europeans to act as a unit, even in a matter as important as this. As job losses mount, increased nationalism and anti-immigrant sentiments may become more evident. The already low appetite of European countries for overseas entanglements (e.g., in Iraq, Afghanistan) in support of the US is likely to be further reduced. In the NATO summit in April 2009, Europeans agreed to send only 5,000 troops to Afghanistan, against the more substantial commitment that the US was lobbying for.[22] European Union countries will have to choose between reduced influence on the world stage, or exercising influence through common security policies.

The Balkans and Eastern European countries are likely to be more susceptible to distress and social unrest arising out of the crisis. Ukraine, Moldova and Bosnia have been identified as "at high risk" for social unrest and political upheaval in *The Economist's* Political Instability Index.[23] Latvia and Iceland virtually went bankrupt due to the crisis, and their governments collapsed, serving as a grim warning to others struggling to manage the fallout of the crisis. Georgia remains under pressure due to the territorial claims of Russia. Less affected by the crisis, Turkey is lobbying for inclusion in the European Union, apparently with the support of the US. The attention of the Europeans, when they are able to look beyond their own internal difficulties, is likely to be focused on managing the strategic fallout of the situation in these areas.

Within Europe, Germany is in a class of its own. Germany is the largest European economy, and the world's largest exporter (ahead of China and the US). Inevitably, the crisis of globalisation has severely affected the German economy, which has contracted, and is expected to contract further by 6.2 per cent in 2009.[24] Interestingly, Germany seems to have charted out policies divergent from that of the US, perhaps due to domestic pressures brought upon by the crisis. Germany has not put in place any substantial fiscal stimulus plan of its own, and seems to

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22 "Obama's Strategy and the Summits", *Stratfor Geopolitical Weekly*, April 6, 2009.

23 Economist Intelligence Unit, no.17.

24 IMF *World Economic Outlook* Update, no.3.

be awaiting the picking up of demand in the US and other markets to expand its exports and pull out of the downturn. This would enable it to benefit from the US fiscal stimulus without running up huge deficits of its own. Germany appears to have resisted pressure from the US during summit meetings in April to start its own domestic stimulus plan.[25] It was also lukewarm, along with the other European powers, to send a substantial force to Afghanistan.

On the other front, Germany is acutely aware of its energy dependence on Russia, and is unlikely to come in the way of Russian expansionism, especially during a critical economic phase such as the present one. All these trends suggest potential strategic shifts. These shifts, and the preoccupation of European powers with their domestic economies, perhaps would make the political situation more difficult for the countries on the periphery of Europe, which may need to balance the competing interests of Russia and the US, without expecting too much support from the EU.

Russia

Over the last decade, Russian influence and ambitions have been growing on the back of its economic strength, fuelled largely by windfall revenues due to the high price of oil. The global economic crisis and the concomitant plunge in oil and commodity prices has been bad news for Russia, which has been especially hard hit. Foreign capital inflows, which touched US $ 28 billion in 2007, have dried up. The rouble is falling against the dollar. Energy revenues have come down. Foreign exchange reserves have declined from US $ 750 billion in August 2008 to about US $ 400 billion. The economy is expected to contract by 6.5 per cent in 2009. As in the 1990s, the decline in Russia's economic strength may again tend to reduce Russia's ability to exercise strategic influence. It will make Russia's geopolitical ambitions harder to achieve.

However, as has been pointed out, Russia remains politically and economically strong because the Russian government can count on its people to support the state and keep the country going with little

25 "Obama's Strategy and the Summits", no.22.

protest over the conditions.[26] Further, Russia exports massive amounts of natural gas and metals, which gives it additional income streams that other oil exporters do not. Exports of vital natural gas to Europe in particular gives Russia strategic leverage that it has used in the past; this becomes even more important when the Continent is going through a recession. The real issue for Russia has been the achieving of financial and strategic independence, perceived to have been temporarily lost following the breakup of the Soviet Union. The government will hold on to that independence at all costs, regardless of the status of the economy.

Thus, Russia has been quick to seize opportunities afforded by the crisis in other countries and still has substantial reserves to expand its sphere of influence. It was Russia, not one of its NATO allies that initially offered a US $ 5 billion bailout package to Iceland to prevent the collapse of its economy. Nearer home, it provided a US $ 2 billion loan to Kyrgyzstan.

It seems that Russia may continue to try to extract strategic advantage from the crisis, despite its own difficulties. If the crisis is very prolonged, and commodity prices stay low over an extended period of time, then stresses and strains are going to show. At this juncture, Russia is relying on energy and nuclear weapons capability to project influence. Maybe energy alone cannot sustain Russia's strategic ambitions forever. But with the present resolute government, they just might be able to manage to tide over the current crisis.

Significant Regional Trends

The relatively low international price of oil is likely to continue for some time due to the global economic crisis and the resulting weak demand in major consuming markets. This is going to affect major oil consumers and producers in varying degrees. The US, Europe, India, China, Japan and East Asian countries, all heavy importers of oil, and all affected by the crisis, will get some relief. Producing countries heavily dependent on revenue streams from oil will have problems. Unlike Russia, countries

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26 "The Financial Crisis and the Six Pillars of Russian Strength", *Stratfor Geopolitical Weekly*, March 3, 2009.

like Iran and Venezuela have limited foreign exchange reserves, and will face domestic pressures. Limited direct linkages with Western markets coupled with a steady stream of high oil revenues over a long period had enabled both to become financially independent and also more assertive in their foreign policies. At the same time they had built up levels of domestic spending unsustainable at lower prices of oil. Since both are ideologically driven regimes, any sudden change in perspective appears unlikely. However, if the continuation of the crisis brings about a sharp deterioration in domestic economic conditions and social unrest, and external assistance becomes necessary for survival, possibilities of a more accommodating international profile may open up.

Arab oil producers including Saudi Arabia, although affected, are in a stronger position as they have built up large reserves. Saudi Arabia is estimated to have reserves of US $ 1 trillion, while a small country like Kuwait has a sovereign wealth fund alone worth more than US $ 250 million.[27] These reserves permit these countries to undertake, like China, strategic investments, and create possibilities for exercising leverage.

Japan is also in a difficult situation. By the 1980s, Japan had become a world power and pre-eminent in Asia by leveraging its economic might, growing rapidly, and building up a technological base that was the envy of its peers. A decade of poor economic performance has meant that its preeminence has slipped. Though Japan is still a major presence in Asia, China has become more powerful regionally not due to its military strength but due to it superior economic performance.[28] The global economic crisis may well accelerate the process. Japan's economy shrank last year by 0.7 per cent. The outlook for 2009 is for a further reduction of 6 per cent. This is a tremendous setback by any standards. In this situation, Japanese influence and prestige, and its ability to have a major say in the post-crisis world, will be diminished.

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[27] Peter Zeihan, "Falling Fortunes, Rising Hopes and the Price of Oil", *Stratfor*, December 15, 2008.

[28] William H. Overholt, "Japan's Economy, at War with Itself", *Foreign Affairs*, at http://www.foreignaffairs.com/print/57627

The sharp fall in commodity prices, and the limited likelihood of their recovery in the wake of the crisis, will affect commodity exporters in Africa and Latin America. Major exporting countries like Argentina and Bolivia stand to lose heavily. However, China's huge demand for commodities and raw materials may provide succour for some of these countries and reduce their dependence on the US market. In the last decade, Sino-Latin US trade increased tenfold to over US $ 100 billion[29], and the crisis affords a mutually beneficial opportunity to both sides to strengthen their links.

Seven out of the top 10 states assessed as highly vulnerable to social or political unrest are from Africa[30], underlining the distress likely to be caused by the crisis in the continent. Even countries like Nigeria, which had started doing relatively well due to a prolonged surge in oil revenues, and were managing to keep competing ethnic and regional tensions in check, will suffer. Most of the other African countries are already being affected by reductions in foreign capital inflows, commodity prices, demand for exports, and remittances from non-residents.

Incomes in the sub-Saharan Africa region had been growing at a healthy 5–7 per cent over the last two years, but are expected to grow by only 1.5 per cent in 2009.[31] The resultant decline in incomes may end up destabilising some regimes. In a study, it was estimated that a 5 per cent decline in national income in African countries increases the risk of civil conflict by 30 per cent.[32] An increase in the proportion of the poor can exacerbate existing political tensions. The West is likely to be too preoccupied with its own difficulties to help in any substantial way. Opportunities for trade, investment and development of greater strategic linkages are there for countries involved in the region (like India and China) which have the inclination and ability to increase their involvement.

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29 William Ratliff, "China's Latin American Tango", *The Wall Street Journal*, November 26, 2008.

30 Economist Intelligence Unit, no. 17.

31 IMF *World Economic Outlook* Update, no. 3.

32 Ibid

Defence Expenditures

It is a global guns vs. butter scenario. With most major powers forced to run up huge budget deficits and spend on fiscal stimuli, defence budgets are bound to come under pressure. This does not necessarily translate into immediate cuts; it's just that if the crisis is prolonged, then tightening of belts will become inevitable. It also means a lean period ahead for the defence industries; we may see more procurements being deferred or orders put on hold. An early signal of these trends is in the US defence budget for 2010, which appears to aim at coming to terms with the situation and maximising the "bang for the buck". Though projecting a 4 per cent growth, the budget seeks to shift the emphasis from expensive top-end equipment to manpower and low cost but effective support to operational units.[33]

Financial constraints and tighter defence budgets would limit the capability of major powers to undertake long-term overseas operations. This does not necessarily mean lower prospects of all types of conflict. Domestic economic hardship may make localised military adventurism more attractive to distract public attention, especially for authoritarian regimes.

Another defence related trend of the crisis is the undertaking of large procurement deals by China of Western dual-use technology. In February 2009, a high level Chinese business delegation during a visit to Europe is reported[34] to have finalised deals in engineering and electronic equipment with a strong emphasis on high-end dual-use technology. Western governments strained by big domestic bailout packages seem to have toned down reservations about sale of such technologies outside countries allied to them.

Prospects of Conflict

A crisis of this magnitude is bound to increase political and economic tensions. There are crisis-driven potential security threats that may increase prospects of conflict. One such is the inevitable rising

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33 News item in the *Indian Express*, April 16, 2009.

34 News item by Pranab Dhal Samanta posted in indianexpress.com, March 15, 2009.

nationalism and protectionism, which will result from job losses all over the world. Protectionism, by limiting international trade, may delay the resolution of the economic crisis, and increased nationalist sentiment may fuel anti-immigrant violence in industrialised countries. Yet another, is the loss of confidence in the ability of the government to handle the crisis; two governments in Europe, i.e., Latvia and Iceland have already collapsed due to the crisis. Localised incidents can spark unrest, e.g., food riots in Egypt, Ethiopia, Indonesia and Senegal.

A prolonged recession coupled with preexisting domestic instability may increase the possibility of the collapse of regimes that are important in preserving the international order. For example, a collapse of the state apparatus in Pakistan could give international terrorism a fillip. Internal instability also has the potential to induce external behavior that can be geopolitically destabilising. Weak governments may be encouraged to engage in foreign policy aggression to try and bolster their domestic position.

Despite the above factors, the situation is not the same as in the 1930s, and in today's world, it is highly improbable that the global economic crisis could lead to a world war as it did then. The international order is relatively more stable, with all major powers working with greater coordination, and mostly seeking to stick to the status quo. Learning from experience, the current national economic policy responses are better formulated, and therefore the economic crisis is unlikely to reach the severity of and linger on for as long as the Great Depression. The greater role being played by fora like the G20 in seeking solutions to the crisis indicates the recognition amongst the key players from both industrialised and developing countries that a broad consensus is needed to move forward. And finally, all this is backed by the hard fact of the overwhelming military dominance of the US; this acts as a force for stability. Localised conflicts remain possible; perhaps a serious threat arising out of collapse of critical states at worst, but a world war—most unlikely.

Strategic Implications for India 5

Going by current indications, India is likely to emerge from the crisis somewhat better off than most countries. Though there has been a drop in exports of goods and services, a general slowdown in manufacturing activity, and increased unemployment in the affected sectors—it could be worse. Economic growth is not very dependent on foreign capital, and so is likely to continue, though at more modest rates than hitherto. A strong fiscal response has also been put into place. While the government now optimistically expects a growth rate of 7.7 per cent[35], even pessimistic forecasts do not go below 5 per cent.[36] That in itself is a good, in a year when the world economy is expected to record negative growth, and major industrialised countries are anticipating severe contractions in their economies. For India, economic growth has been the key to power and will remain so, hence, policies supporting economic growth remain a strategic necessity.

Multilaterism is again in fashion. The role of the rich countries club—the G7, is being replaced by the G20 in which India is represented, which is good for India. There was a general understanding at the G20 summit in April on expanding funding and broad-basing governance of the International Monetary Fund. Again, India could expect to be a beneficiary of the exercise in terms of an enhanced role.

Due to the expectation of continued economic growth, India would not face the guns vs. butter issue to the extent that many others are facing. Defence expenditure is down to a sustainable 2.5 per cent of

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35 *Economic Survey 2009*, Ministry of Finance, Government of India.

36 Economist Intelligence Unit, Country Forecast – India, May 15, 2009.

GDP.[37] There are enough funds available for defence modernisation and procurement.

Regional security challenges do exist. India lives in a tense neighbourhood, though the tensions are not necessarily due to the crisis. After a year of stagnation, the Pakistan economy is expected to grow at a modest 2 per cent in 2009–10.[38] The "Af-Pak" situation is heading in an unpredictable direction. The crisis may fuel instability in Pakistan, with economic pressures feeding unrest, and the government's ability to deliver is limited. These trends may have been contributing factors in the recent expansion of the Taliban's influence in Pakistan. This situation poses a threat to India as well. However, the historical antipathy of the Pakistan Army towards India and its continuing decisive role in the polity means that there is no scope at present for Indian assistance or intervention to alleviate the situation.

The only country with the means and leverage to influence and help Pakistan is the US, and the US seems to be making an effort, not just in providing military support, but motivating the international community to provide generous financial assistance. The IMF sanctioned a US $ 7.6 billion loan to Pakistan in November 2008, and the country has secured pledges of funding from international donors of US $ 5.3 billion at a donor conference held in April 2009.[39] Presumably, while providing Pakistan aid to meet the economic crisis and military support to tackle the Taliban threat, the US would also be concerned about the need to forestall the possibility of Pakistan's nuclear arsenal falling into fundamentalist hands.

The outcome of political turmoil in Nepal is also uncertain. Bangladesh is going to be hard hit by the crisis. It was doing well before the crisis, in areas like textile exports—the earnings and jobs of which will be affected severely. It has been reported that growth in the US $ 11 billion garment export industry has come down to near zero, down from a 72 per cent year-to-year growth in July 2008. This in turn would affect

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37 *SIPRI Yearbook*, 2008.

38 Economist Intelligence Unit, Country Forecast – Pakistan, May 26, 2009.

39 Ibid

employment in these and other interrelated sectors. Declining Western demand for exports would have similar effects. Weaker inflows of worker remittances from the Middle East are also of concern[40], and can lead to dissatisfaction with the government, which has so far been relatively positive in its strategic outlook. The government is dealing with the situation by announcing a US $ 500 million stimulus package in April 2009, and the expectation is that GDP growth in 2009–10 may touch 3.6 per cent.[41]

India has the opportunity to help, and must walk the extra mile to do so. Recently, India has concluded a free trade agreement with the Association of South East Asian Nations (ASEAN) and perhaps it is time to look at the possibilities closer home. The free trade agreement with Sri Lanka has been successful in boosting trade and business, and has contributed significantly towards the deeper economic linkages and more cordial political relationship that exists between the two countries today. These kinds of agreements may be a good objective to work towards. Even if this is not immediately possible, in this time of crisis, India can consider allowing Bangladesh (and also Nepal) greater access to its markets, even without reciprocity. This would be economically and strategically important. It would soften the impact of the global crisis on these important countries for India and build medium-term economic interlinkages and interests in the form of closer ties.

The strategic shifts in global power may not all be to India's advantage. The rise of China may also presage a rise in its aggressive posture towards India. Already, China has been pursuing initiatives at building stronger economic and military linkages with strategically important (for India) countries in the neighborhood like Myanmar and Nepal. Overtures have been made to Seychelles with a state visit of China's President, which seems to indicate strategic interest in the Indian Ocean. It was recently reported[42] that China blocked a US $ 2.9 billion India country assistance programme for financing from the Asian

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40 *AsiaOne*, "Dwindling Exports hit Bangladesh Economy," Singapore, April 13, 2009 at www.asiaone.com

41 Economist Intelligence Unit, Country Forecast – Bangladesh, May 26, 2009.

42 News item in the *Indian Express*, April 14, 2009.

Development Bank apparently because it included a component in Arunachal Pradesh—this was an unprecedented development for a multilateral project.[43] This could be an indication that increased Chinese clout in multilateral institutions like the IMF, when it materialises, may encourage similar aggressive actions in the economic arena in future. India has to be prepared to step up its own projection of power at every opportunity.

In this quest, a few things can be learnt from China itself. Acquisition of productive assets abroad, strengthening investment and trade linkages with Africa and Latin America, preparing for the next oil shock by improving energy efficiency and focusing on renewable energy are some of the economic steps that will give India more strategic room to manoeuvre in future.

On the other hand, India's soft power, culture, political values, and the example it sets to countries in the developing world are some unique strengths that China does not have. These have strategic potential as well, and should serve India well through the crisis and beyond. The crisis in the West and the anti-immigrant fallout is likely to accelerate the reverse brain drain to India, with beneficial effects on the economy.

The crisis has given India some strategic space, and an opportunity to reduce the gap with the big players. Skeptical commentators feel that India is inwardly focused and not particularly equipped to advance its geopolitical standing.[44] It is up to India to prove them wrong. India's expanding economy and greater external engagement can give it a stronger voice and stake in strategic affairs in the medium term. The way to look at the global economic crisis is as "an opportunity for any nation that lives in the future and a disaster for any nation that lives in the past".[45] That is perhaps how it will unfold eventually, and when all is said and done, there is reason to expect that India will be on the right side of history.

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[43] Despite Chinese opposition, the programme was approved by the ADB with support from all other countries including Pakistan! (G. Parthasarthy in the *Times of India*, June 29, 2009).

[44] Roger C. Altman, no.13.

[45] Chinese internet king Jack Ma, referring to the crisis, quoted in *The Hindustan Times*, March 22, 2009.

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