THE JOURNAL OF The New York Society of Security Analysts
THE INVESTMENT PROFESSIONAL

One Big Happy Family

THE GLOBAL CRISIS TESTS POSTWAR ALIGNMENTS

THE EXPERTS | REGIONAL FOCUS

MARK ANDRESEN

by Amy E. Buttell

If the global institutions and alignments created after World War II were looking a bit long in the tooth at the dawn of the 21st century, the economic crisis has pushed them one step closer toward irrelevance, if not extinction. Up-and-coming powers like China and India, no longer content with a subsidiary role on the global stage, are clamoring for more power, and the financial crisis is giving them the opportunity to explode the political and economic status quo.

There's no doubt changes were afoot long before the crisis manifested. The post-World War II power elite has been unable to ignore the growing economic clout of these upstarts, which are flexing their economic muscles by aggressively investing in everything from commodities to financial institutions in both the developed and developing worlds. With developed economies in trouble in the wake of the meltdown, and with the old order in flux, the stepchildren of the globe are grabbing the chance to accelerate the pace of change.

Nowhere is this more evident than within the global financial institutions that were founded during and after the postwar period—the IMF (International Monetary Fund), the World Bank, and the World Trade Organization (the successor to GATT, the General Agreement on Trade and Tariffs), as well as less formal organizations such as the G-7 (Group of 7), G-8 (Group of 8), and G-20 (Group of 20). The developing world has long been dissatisfied with its inability to participate in the governance of these bodies or in the execution of policies and agendas. It wants increased representation in return for larger financial contributions. In addition, the US dollar's role as the reserve currency of the world is now in question. Based on these and other factors, the US National Intelligence Council issued a report in November 2008 entitled **"Global Trends 2025: A Transformed World,"** which heralds an "unprecedented" shift in the world order and foresees "an historic transfer of relative wealth and economic power from West to East" occurring by 2025.

Recent agreements among G-20 nations will reform international organizations and set up a framework for a more democratic decision-making model for international economic policies. For Peter Drysdale, emeritus professor of economics at the Crawford School of Business, Australian National University, the changes announced at the April 2009 G-20 summit in London create, at the very least, the potential for a new world order in which governments and peoples living in the southern and eastern hemispheres might have the opportunity to shape these international organizations and their objectives.

"The Bretton Woods agreement ensured that organizations such as the IMF be dominated by the big Allied powers," Drysdale says. "Over time, that structure will have to change. Otherwise, you have participation by major players without effective representation: a principle on which the United States was not built." As old alliances break up and new players come to the table, the great powers of the postwar period aren't going to be able to control the agenda as effectively as they have in the past.

This may lead to a series of shifting national alliances that will hinge more on specific issues and interests than on an overall philosophy of government and economics. "I think that the US will have to learn to make coalitions with countries other than the other G-7 countries," says Joseph Joyce, an economics professor at Wellesley College. "These coalitions will be changing all the time and there will be times, for example, when the US and China will be in agreement and times when they are not. It shows that you need a crisis sometimes to force change. Inertia is a powerful force, and countries don't give up power voluntarily."

The credit crisis has undermined global financial institutions and economic and political practices to the point at which real change has suddenly become possible. The massive overleveraging of countries, companies, and individuals is redirecting government and corporate

attention inward in an effort to shore up balance sheets and to deleverage. To correct the course will take longer than most people anticipate.

In that kind of new world order, the biggest and fastest-growing emerging market countries would play a larger role, potentially muscling out slower-growing, developed economies, explains Arnold Brown, chairman of the consulting firm Weiner, Edrich, Brown. "What we see happening is that China, increasingly India, and, ultimately, if they can get their act together, Russia and Brazil are in effect setting up another system, a parallel system," he says. "We'll see more direct trade between East Asia and Africa and Latin America. Those newer powers will not put civil rights and environmental demands on the countries with which they trade. That is going to be very attractive to countries that have felt themselves to be victimized by the dominance of the West."

PLAYING OUT THE CRISIS

The credit crisis has undermined global financial institutions and economic and political practices to the point at which real change has suddenly become possible. The massive overleveraging of countries, companies, and individuals is redirecting government and corporate attention inward in an effort to shore up balance sheets and to deleverage. This deleveraging process is the legacy not only of the financial crisis but also of the past few economic expansions, stretching back to the 1990s. To correct the course will take longer than most people anticipate, says David Levy, director and chairman at Levy Forecasting Center.

The long-term contraction in debt levels will result in what Levy describes as "a contained depression, which is what happens when you have long-term imbalances that are capable of breaking your whole system down and causing a depression, but you muddle through to a milder version of it because the government acts as a backstop on the financial sector." He believes it will take years, not months, to correct the imbalances. As this process moves forward, even countries that didn't directly participate in asset-inflating bubbles will find themselves to be vulnerable. "Even if you didn't have a bubble in your country directly, you had a bubble in the sense that you were selling into the bubble," Levy states.

And because economies are more interconnected than ever before, when gigantic bubbles burst the effects are felt viscerally throughout the world, says John Caslione, coauthor of *Chaotics: The Business of Managing and Marketing in the Age of Turbulence*. "When we are doing well, we're all riding high, because our economies are intertwined, interdependent as never before. The other aspect of this is the interlocking fragility aspect of globalization that rapidly spreads a lot of pain, a lot of damage, virally, through the bad times."

Whether the crisis worsens or stabilizes will say a lot about the rate at which changes transpire, says Simon Johnson, the Ronald A. Kurtz Professor of Entrepreneurship at the MIT Sloan School of Business. "If the crisis is more severe than it currently has been, then that would speed up the process of giving more voice to the emerging markets," he says. "If it sort of bottoms out where it is now, which is probably most likely, then what you see is what you get. The pace of change will be slower." Johnson believes that will apply especially to organizations such as the IMF.

As the economic situation stabilizes worldwide, economists are leaning toward the view that, while the crisis won't get much worse, recovery, when it comes, is likely to be anemic at best. "The US and other countries with real estate bubbles have got real structural problems that will take several years to work through," maintains John Calverley, head of North American research at Standard Chartered Bank. "It doesn't mean you can't get economic recovery, but it tends to mean that recovery is going to be on the weak side."

Calverley believes export-driven countries, including Japan, Germany, and those in East Asia and Latin America, will continue to be hit hard through 2009 and early 2010. "They've really been hit by the inventory correction and there'll be worse recessions this year," he says. "But they'll have a much stronger rebound next year." And Calverley notes that most of those countries "don't have the same structural problems" as the US and other Western countries affected by the real estate and financial bubbles.

REINVENTING GOVERNMENTS, ECONOMIES

The vast expansion of capital flow and globalization that underpinned the global economic boom is reversing itself, at least temporarily, as governments look inward in an effort to solve their own problems rather than take on the rest of the world. This will play out in interesting ways, says William Gamble, founder of Emerging Market Strategies. "We are seeing economies close up in funny ways. Governments are retaking over businesses. We are going to continue to see protectionist trends increasing," he says. Protectionism, if it drags on too long and is overly severe, could torpedo a nascent international economic recovery like few other policies. Think Smoot–Hawley redux.

The US is the perfect international whipping boy, hogging the vast majority of blame for creating the global economic crisis. The danger here is that the backlash of global opinion against the US will hurt not just capitalism, but multiparty, American-style democracy as well.

The US is the perfect international whipping boy, hogging the vast majority of blame for creating the global economic crisis. The danger here is that the backlash of global opinion against the US will hurt not just capitalism, but multiparty, American-style democracy as well. "Other governments are saying, 'It is all the United States' fault, capitalism is bad, what we have to do is go back to another model with less capitalism,'" says Gamble.

This crisis is lending credence to other forms of government and other ways of doing business. "The belief in the West has always been that democracy and capitalism have to go hand in hand. You can't have one without the other," says Arnold Brown. "The Chinese are showing a lot of people that it is possible to have a functioning capitalistic system without the trappings of democracy. That is very appealing to a lot of countries where people want to hold on to their power."

Emerging powers such as China and Russia are taking advantage of opportunities to expand their economic and political influence while the Western powers are burdened by debt and distracted by internal political debates over economic priorities. China is working to cement alliances with other developing nations through purchasing commodities and offering aid. “A lot of developing countries are looking to China because China believes it’s okay to provide them with aid and assistance without looking at what their governments are doing behind closed doors,” says Kelly-Kate Pease, an associate professor of government and international relations at Webster University.

Russia has been flexing its economic and political muscles in Eastern Europe and the Commonwealth of Independent States, where countries may have more to fear from Russia than they have to gain through alliances with the West. The Russian economy, though, is overly dependent on oil exports and is struggling with inflation and a lack of economic diversification. Like China, the Gulf Cooperation Council is busy investing in the developing world, cementing alliances and access to commodities.

As the financialization model that spread capital and esoteric financial products all over the world is discredited, the developed countries that fostered and lauded this approach will need to look for new solutions. In a shrunken, highly regulated investment environment, financialization can’t deliver. According to Simon Johnson, “what you may see is a return to an older American model, one based more on technological innovation outside of finance. When I say the American model is damaged, I mean the finance part of it and the idea that people should open up their capital markets and let our banks or insurance companies in. That doesn’t seem very appealing any more, but the idea that you can invent products and trade real goods is pretty compelling. And that will run up against the arrival of some more state-led models and public investment models, which is the European model, and even more state-led models, which would be China.”

Walter Schubert, professor of finance at La Salle University, agrees that the US economy needs to be more diversified and believes that it can continue to succeed in areas such as manufacturing. “If we focus on the industries that are really going to be great in the future, there’s no reason why we can’t have a fair amount of manufacturing here,” he says. “I think we’re still the second largest manufacturing economy in the world.”

While China has recorded huge growth rates in manufacturing and exporting, its economic model faces a central inherent problem, the ability of other producers to work more cheaply and undercut the Chinese. Schubert points out that “for a number of products, China is not the low-cost provider any more. Vietnam is cheaper, Indonesia is cheaper.”

William Gamble identifies another problem facing China and other developing countries. Their economies are based on relationships, rather than on the rule of law, he says, and that means that foreign companies aren’t on an equal footing with domestic operations and can’t count on the courts to enforce contracts. “These are relationship-based systems where funds flow to cronies and relatives, who want to line their own pockets, rather than to areas that make more economic sense,” Gamble asserts. “Their incentives are all wrong.”

Pease, who recently spent three months in China, concurs. “China is a very corrupt economy,” she says. “It’s very difficult to do business there. It’s so regulated. Multinational companies really struggle because they are discriminated against. Chinese companies play by a different set of rules than outside companies. And they are very dependent on the West for innovation, skills, and expertise. What would make me concerned about the rise of China is if it became the locus of innovation in the world economy.”

The most flexible economies tend to be the most innovative and entrepreneurial. Michael Szenberg, distinguished professor of economics at Pace University’s Lubin School of Business, sees innovation coming not only out of the United States but also out of small countries such as Finland, Israel, and Singapore. “Is there something about smallness that generates the desire to become more prominent, to engage in more innovative activities? It’s an interesting question,” Szenberg says.

EASTWARD POWER SHIFTS

Projections laid out in the “Global Trends 2025” report depict growth and economic and political power moving from the West toward the East. Within the next 15 years, that shift may accelerate to the point at which China and India will surpass the gross domestic product of all other world economies except the US, reclaiming the position they had in the 18th century as two of the largest contributors to economic growth. “In terms of size, speed, and directional flow, the global shift in relative wealth and economic power now under way—roughly from West to East—is without precedent in modern history,” notes the report.

Joseph Joyce calls the conclusions of the report “stunning in terms of the vision of the realignment of the planet” and “startling due to the fact that this agency thought this is a likely outcome and is willing to publish it.” He notes that the report does still project that the US will remain the world’s largest economy for a long time to come, although it also states that US power will be diminished. According to the report: “The international system—as constructed following the Second World War—will be almost unrecognizable by 2025. Indeed, ‘international system’ is a misnomer as it is likely to be more ramshackle than orderly, its composition hybrid and heterogeneous as befits a transition that will still be a work in progress by 2025.”

Arnold Brown sees the process playing out in a nonlinear fashion as countries, regions, and economies jockey for power and influence, and emerging market powers and the West take turns dominating. “In the immediate future we see the influence of the Western countries, including Japan, being diminished,” he says. “People will be looking for alternatives. They will be asking, ‘Are we better off dealing with Brazil? Are we better off setting up this relationship with China?’ There will be that kind of immediate effect. But, over time, you will see a gradual return to, if not the total dominance of the West, at least a major role for the West. Because of stability, because of security, because of the West’s tradition of functioning systems.”

Down the road, the emerging powerhouses may begin to act in concert, vastly increasing their power and influence worldwide, Brown says. “We have seen for several years now that the so-called BRICs (Brazil, Russia, India, China) are becoming increasingly important and I think increasingly moving toward being a bloc, which is really significant,” he contends. “Rather than see them operating independently, I think we are going to see them understanding more and more that by collectively setting an agenda they have the potential to at least counterbalance, if not actually displace, the US, Europe, and Japan.”

Russia has been flexing its economic and political muscles in Eastern Europe and the Commonwealth of Independent States, where countries may have more to fear from Russia than they have to gain

through alliances with the West. The Russian economy, though, is overly dependent on oil exports and is struggling with inflation and a lack of economic diversification. Like China, the Gulf Cooperation Council is busy investing in the developing world, cementing alliances and access to commodities.

Simon Johnson sees that potential too, but isn't sure these four countries are ready to act together. "They are not entirely in leadership mode, but they will increasingly seek recognition of their voices and they will tend to work separately more than together. But they might start coordinating a bit more and that would make them even more important and up-and-coming than they are now," he speculates.

DOLLAR AS RESERVE CURRENCY

While the dollar is far from being deposed as the world's reserve currency, the Chinese certainly made some waves when the governor of the People's Bank of China, Zhou Xiaochuan, suggested that IMF SDRs (Special Drawing Rights) should eventually supplant the dollar as a sort of supersovereign reserve currency.

The SDR was created in 1969 to supplement countries' official reserves. Currently, its value is based on a basket of international currencies that include the dollar, euro, yen, and pound sterling. That basket is reevaluated every five years and is up for review again in 2010. The value of the SDR fluctuates daily and can be found at **http://www.imf.org/external/np/fin/data/rms_five.aspx**. On May 19, 2009, each SDR was worth 0.6532 dollars. Rates on regular IMF loans use the SDR interest rate, which is determined weekly and available at **www.imf.org/external/np/fin/data/sdr_ir.aspx**. Currently, the IMF mainly employs SDRs to account for its transactions with member nations.

A more powerful SDR, Zhou asserted, could aid the global economy in a number of ways. It could eliminate the risks involved in a credit-based currency, improve the management of international liquidity, and enhance individual countries' opportunities to manage their own economies. Russia has also endorsed the idea of an alternative reserve currency to the dollar. China currently holds $1.95 billion in reserves, mostly in the dollar.

Although experts don't expect the dollar to go anywhere anytime soon, even the suggestion that it might be supplanted as the reserve currency is significant. It's one more sign that developing nations are asserting economic power. "This is obviously not a course that would be sensible in the immediate term; it is important as a longer-term issue," says Drysdale. "It's an expression of Chinese interest and anxiety about their reliance on the dollar and in particular about what American policies might do to the value of the dollar and therefore to the returns on those reserves."

Eventually, some movement away from the dollar is inevitable, he believes. "By 2025 or 2030, three of the four biggest economies in the world will be in Asia and everything cannot focus then so much on the West," he notes. Drysdale adds that a movement away from the dollar would ultimately benefit the US as much as the rest of the world. The United States' incentive to keep its economic house in order would increase if it were unable to place as many dollars into circulation and had to reign in its budget deficits.

However, in the short run, as the holder of the most dollars in the world, China must be careful when it rocks the boat. "It's not really in their interest to talk the dollar down too much because they are the ones who are going to lose," says Johnson. "The US is more or less indifferent to this effort and I wouldn't put too much weight on it. Over time, if the Chinese want to diversify their holdings, what else are they going to hold?"

John Calverley believes it could take another 50 years for the dollar to be replaced as the reserve currency and that the Chinese currency, the renminbi, may be more likely than the SDR to take the dollar's place. At one point, the euro was considered a viable alternative to the dollar, but worries about the stability of the European Monetary Union have made that less likely.

At the very least, the renminbi could become part of the SDR's currency basket sooner rather than later. As China's influence in Southeast Asia expands, the renminbi is becoming a sort of quasi currency there, according to John Caslione. "China has its own strategies in place and is already encouraging countries in Southeast Asia as well as Australia, because they are strong in commodities, to hold the renminbi," Caslione explains.

The fact that the dollar weakened before the financial crisis and strengthened during it speaks volumes about the dollar's current standing in the world economy, says Kelly-Kate Pease. "In terms of currency, it's all about confidence. Liquidity is important, but confidence, a psychological thing, is everything. The strange thing, if you noticed, was that the dollar was really weak the last couple of years," she continues. "When the crisis hits, the dollar strengthens, right? Why would the dollar strengthen? It's because people know we are the last bastion, the safest country in which to have your assets."

INTERNATIONAL INSTITUTIONS ADAPT

The transition to a new economic and political era is taking its toll on international financial institutions. Recent events have spotlighted the G-20 and the IMF, but questions also dog the World Bank, the World Trade Organization and the G-7 and G-8.

The April 2009 G-20 meeting in London was seen as advancing the cause of the developing world, giving it more of a say in global economic policy and the policies of the IMF. Some viewed the meeting as displacing the G-7 and G-8 in favor of a more representative group. "London was an important step away from the G-7 and G-8 arrangements in terms of bargaining between economic leaders on the issues that confront the global economy, in that it included a representative range of newly emerging economies and Australia," says Drysdale.

"That's an important change in the system, if it becomes entrenched, because then we've got a different kind of dialogue among world leaders," he continues. "The big adjustments in the international economy, including the crisis we are going through now, have to be managed in partnership with the big emerging economies, including China, India, and other participants that were previously peripheral to discussions of economic policy direction."

As the financialization model that spread capital and esoteric financial

products all over the world is discredited, the developed countries that fostered and lauded this approach will need to look for new solutions. In a shrunken, highly regulated investment environment, financialization can't deliver.

Uri Dadush, senior associate and director of the International Economics Program at the Carnegie Endowment for International Peace, believes that one reason the G-20 is in the process of becoming a more powerful force in the global economy is its incorporation of more countries and a larger portion of the world's population. "It isn't just a question of the efficacy of decision making, it is also a question of whether you are legitimate, and whether you have the authority and mandate," he says. "It has become evident in the last few years that the G-7 and the G-8 do not have a mandate or legitimacy."

While Dadush is optimistic about the prospects for the G-20, he is less so about the resumption of international trade talks, in which he was involved at the World Bank. "I am generally pessimistic about the chances of reviving the Doha trade talks—given the current crisis, it is not seen as an urgent priority," he says. "Unfortunately, the content of the Doha round and the negotiations have become more and more diluted, so that it is very difficult to say it is important."

The potential for the IMF to snag a larger role got a shot in the arm at the G-20, where participants agreed to triple international commitments to the fund, in an effort to boost its ability to respond to countries hit by the financial crisis. But in return for increasing their contributions, developing countries at the G-20 meeting extracted several important concessions that will initiate reform at the IMF.

Not only will the voting representation of developing countries increase, but the G-20 agreed that in the future the leaders of the IMF and the World Bank will be chosen by merit, rather than tradition, which had placed a US pick at the head of the IMF and a European pick at the head of the World Bank. "These developments are a healthy thing," says Johnson. "While I don't think that voting at the IMF should be like the United Nations, I do think the legitimacy of the IMF in particular will be strengthened by giving the emerging markets more votes and more voices."

As a former chief economist and visiting scholar at the IMF and the author of a forthcoming book about the organization, Johnson sees legitimacy as a key issue. A disgruntled, underrepresented developing world is likely to see the IMF as illegitimate and to believe that the fund is there to "punish them more then help them." He believes that with more legitimacy and more funding the IMF may be able to fulfill its role as "promoting international financial stability." Joyce contends, "I think the fund wants to be more active in crisis prevention and wants to be able to literally say to countries that it is concerned about some aspect of their policies that may lead to some sort of international crisis. The IMF has been somewhat stymied by being pushed into a much more narrow role."

ENSEMBLE ACTING

Regardless of how the current economic situation plays out, big change is coming. The only question is how rapidly that change will occur, and whether the Western powers will accede gracefully or get dragged kicking and screaming into the new world order. The US will continue to be the largest economy and political force for the foreseeable future, but, increasingly, it will have to share the stage with the up-and-coming emerging market powers, those with the fastest growing economies.

"Where does the money really lie?" asks Caslione. "It lies in Asia, largely China, and in the Middle East. Now we will start to see more of a balancing out of power. We just had the G-20, which was reported in many papers essentially as the G-2: the US and China. It's interesting because the Chinese and other emerging powers believe they have earned the right to sit at the big table, at the decision-making table that the Europeans, the Americans, the Canadians, and the traditional Western economic powers have been sitting at. They have an opinion, and now they have the money to back it up."

__Amy E. Buttell__ is a journalist working in Erie, Pennsylvania.