<u>Foreign Policy Implications of the Global Economic Crisis</u>

By Desmond Lachman, American Enterprise Institute

Senate Foreign Relations Committee Roundtable, February 11, 2009.

1. I very much appreciate your inviting me to participate in this roundtable on as important a topic as the foreign policy implications of the global economic crisis. Across the globe, we are already seeing untoward political consequences from the economic crisis as manifested for example by riots in Greece, xenophobic union action in the United Kingdom, social unrest in China, Russian interference in Ukraine, and the fall of the Icelandic government. There has also been a disturbing rise of protectionist tendencies and nationalistic economic and financial policies across a wide swathe of countries. These tendencies, which are likely to be fueled in the months ahead by rising unemployment, must be expected to deepen the global economic crisis.

2. Looking ahead, one has to be concerned about the likely major political fall out from what will almost certainly be the worst global economic slump in the post-war period. The International Monetary Fund now concedes that output in the world's advanced economies will contract by as much as 2 percent in 2009, while global output will increase by a scant ½ percent in 2009 or by the lowest rate in the past 60 years. This would be the first time in the post-war period that output will have contracted in a synchronized manner in all of the world's major economies. A pernicious feature of the synchronized nature of this crisis is that it precludes the possibility of any of the major industrialized countries from exporting its way out of its recession. The IMF is also now expecting only a very gradual global economic recovery in 2010, which will keep global unemployment at a high level.

3. My view is that the IMF is probably underestimating the severity of the global downturn in 2009 as it has done through the course of this crisis. In recent months, output and employment appear to have been in free fall in the United States, Europe, and Japan. Despite this freefall in output, we are yet to get a sufficiently coordinated and forceful policy response to the crisis, which might offer hope of an early end to the global economic recession.

4. I am particularly concerned about the economic outlook for Japan and Europe.

    a. In the last quarter of 2008, Japanese exports declined at a 12 month rate in excess of 30 percent, while industrial production fell by around 10 percent. These developments, coupled with the strong appreciation of the Japanese yen, raise again the specter of deflation in that country. It is particularly disturbing that Japan's compromised public finances and its lack of room for monetary policy easing will highly constrain Japan's ability to successfully combat a renewed bout of deflation.

b. In Europe, one has to be concerned about the lack of an adequate monetary and fiscal policy response to falling output across the European region. Of particular concern has to be the difficulties that the straitjacket of a single European currency is causing for Greece, Ireland, Italy, Portugal, and Spain. As an example of the social tensions that these difficulties might cause, unemployment in Spain has already risen from 8 percent to 14 percent and it appears set to rise further towards 18 percent by end-2009.The rating agencies have already begun downgrading these countries' sovereign debt, while the markets have begun speculating as to whether the Euro can survive in its present form.

5. As a barometer of the political and social tensions that this grim world economic outlook portends, one needs look no further than the recent employment forecast of the International Labor Organization. The ILO believes that the global financial crisis will wipe out 30 million jobs worldwide in 2009, while in a worst case scenario it believes that as many as 50 million jobs could be lost.

6. The major output and employment slump in the industrialized countries will have profound consequences for the world's emerging market periphery. It will do so through at least the following three channels:

a. First, through lower demand in the industrialized countries for the exports of the emerging market economies. This will be particularly painful for those Eastern European and Asian economies, particularly South Korea and China, which are highly dependent for their economic growth on exporting to the G-3 economies.

b. Second, through the reduced availability of financing to the emerging market economies as a direct consequence of the US and European credit crunch. This reduced financing is already having a particularly pronounced impact on those East European and Central European countries that have high external financing needs.

c. Third, through markedly reduced international commodity prices as a direct consequence of the synchronized global slump. This will have a particularly pronounced impact on the poorest countries in Africa and Latin America, which are highly dependent on commodity exports and which are generally not well positioned to absorb a major external shock.

7. Eastern and Central Europe stand out among the emerging markets as the region most susceptible to a full blown financial crisis. Unlike emerging markets elsewhere, Eastern European economies are heavily dependent on exports to a contracting Euro-zone area and on external financing. Any sharp drop-off in

capital inflows in 2009 as the crisis deepens will not only be a major blow to growth, but it could also potentially trigger a regional financial crisis. The Baltic countries, Bulgaria, Romania, and Hungary all stand out as particularly vulnerable. However, a crisis in any one of these countries could trigger a regional domino effect.

8. Russia is among those emerging market economies being most severely impacted by the dramatic drop in international oil prices over the past year. Russia is presently on the cusp of a currency crisis as markets focus on Russia's excessive dependence on oil export revenues as well as on the fact that Russia's corporate and financial sector debt outstrips Russia's international reserves. Similarly, Ukraine is being negatively impacted by very low international steel prices and a lack of access to global financial markets. It would seem to be only a matter of time before Ukraine experiences a wave of corporate debt defaults and a full blown financial crisis.

9. Even more disturbing from a geopolitical point of view is the virtual grinding to a halt of the Chinese economy as a result of the faltering of its export machine. The Chinese economy recorded no growth in the last quarter of 2008 and the IMF now expects that China's growth rate will approximately halve from 2008 to 6 percent in 2009. Such a growth rate would fall far short of what is needed to absorb the 20 million Chinese workers who migrate each year from the countryside to the towns in search of a better life. This could very well induce the Chinese leadership to divert domestic attention from the harsh domestic economic realities by seeking an adventure abroad.

10. As a major commodity producing region, Latin America will be very hard hit by the global economic crisis. However, among the major Latin American economies, Brazil and Mexico appear to be well placed to weather the storm. By contrast, Argentina and Venezuela both appear to be highly vulnerable to a prolonged period of low international commodity prices and of sub-par global economic performance.