MARITIME AFFAIRS Copyright © National Maritime Foundation
Vol. 7 No. 1 Summer 2011, pp. 17–27
Print ISSN: 0973-3159, Online ISSN: 1946-6609, DOI: 10.1080/09733159.2011.601054

Geopolitical Consequences of the Global Financial and Economic Crisis: Emerging Contours

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I will start by saying that only terms borrowed from the maritime domain appear equal to the task of describing what confronts us in our troubled world today. We are, most certainly, sailing into "uncharted seas". Some of us would like to "batten the hatches" until the storm passes. Others will wish to "drop anchor" in the face of turbulent waves but the more bold among us may wish to "tack our sails" to the rising wind and endeavour to sail into a more distant but hopefully more agreeable port.

Today, we have multiple crises affecting international politics and the global economy. There is an ongoing political turmoil in North Africa and West Asia, a region we refer to as WANA, which has taken an unpredictable and possibly violent turn with Saudi Arabia's armed intervention in Bahrain and now the military operations of the United States and its allies in Libya.

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Excerpts of talk delivered under auspices of NMF Eminent Persons Lecture Series at the India Habitat Centre, New Delhi on March 23, 2011.

At the other end of the world, Japan, the third largest economy in the world, has suffered an unprecedented and devastating earthquake, compounded by a gigantic tsunami that has left death and destruction over a vast swathe of Japan's Pacific coast. And as if that was not enough, we have a full-blown crisis at the Fukushima nuclear power plant that is still not under control. Civilian nuclear energy expansion plans are being put on hold across the world as the full implications of Fukushima are debated and scrutinised in minute detail. These two crises are geographically distant but intersect compellingly in a densely interconnected global economy, in particular, its energy component. Both oil, as the fuel of global growth today and nuclear, the energy source for the future, have been impacted. And energy could become the transmission belt through which both politics and economics across the world will be changed in ways that are not at all clear.

But before analysing the impact of these latest crises, let me go back to the world as we entered a new decade in January 2011. Neither the WANA crisis nor Japan's natural disaster were on our radar screens. In fact, one could have said with some degree of confidence that WANA would remain stable, that oil would continue to flow from the key producers uninterrupted, that the region's durable autocracies would endure and the Israel–Palestine conflict would fester on as it has for so many years. In short, more of the same, hence not much to worry about; at least that seemed to be the perception until the latest events. The sources of instability were seen to lie elsewhere.

In the United States, polarisation in domestic politics has led to a paralysis in decision-making, with little readiness to commit to fiscal consolidation measures and deficit reduction without which the largest economy in world remains vulnerable and unstable. Having failed to convince its largest trade partner and creditor, China, to revalue the Yuan, the United States has embarked on a risky gamble of depreciating the dollar through "quantitative easing" or, basically, flooding the global market with newly printed dollars. Its assumption is that, in the short run, there is no alternative to the US dollar as a reserve currency, as a convenient medium in trade settlement, and hence the dollar's international role will remain unaffected. The troubles through which the euro has been passing, with the threat of default among some of its members, has rendered it a less attractive alternative. It is difficult to say at what threshold world markets will begin to lose confidence in the dollar or at what point the holders of US dollar assets, including China, will no longer be ready to absorb the devaluation of their holdings. That may come suddenly and unexpectedly and cause a global financial collapse. For the present, however, the US gamble appears to be working, especially since the latest crises are reinforcing the dollar's role as a haven currency.

The impact of high oil prices resulting from prolonged political and economic disruption in the Gulf, may lead to inflationary pressures in the US economy and cause a setback to its still fragile recovery. Each major spike in oil prices in the past has been followed by a prolonged recession in Western economies. If this happens now then, thanks to the 2008 crisis, neither the United States nor most of the Western economies have any weapons left in their monetary or fiscal armoury to deal with a fresh crisis. The fears of a double dip recession could come frighteningly true.

While the US recovery has been modest, it is relatively better off than the European Union (EU). The euro zone remains unstable with sovereign defaults still lurking round the corner for Greece, Ireland, Portugal and Spain. There is growing political opposition to a fully effective bail-out mechanism among creditor countries, in particular Germany. While differences have been papered over, the underlying structural weakness of the European Monetary System remains. There is a common currency and a European Central Bank, but no coordinated fiscal policy. This is unlikely to change and, therefore, the euro will continue to remain under threat.

The industrialised world is also experiencing what is being called "multi-speed recovery". Some economies are recovering faster than others. Germany is an outstanding example. It has emerged as the strongest economy in Europe and is undoubtedly the continent's prime engine of growth. It is no longer willing to play second fiddle to the other European powers like France and the United Kingdom, and is displaying a greater degree of independence from the United States. It has developed an unusually close energy partnership with Russia and its fastest growing export markets are outside the EU, most prominently in China. This is leading to a perceptible change in the balance of power and influence with the EU and a loosening of the erstwhile strong political, economic and security links across the Atlantic.

It is significant, for example, that Germany abstained on the UN Security Council vote on Libya, along with China, Russia, India and Brazil. It is not taking part in the military operations that have been launched against Libya by the United States, France and the United Kingdom.

Germany will be impacted by high oil prices and its decision to close down seven of its 17 nuclear reactors will mean a significant energy challenge. However, this is where the energy partnership and close political relations with Russia will come in handy. This will only reinforce Germany's drift away from its European Union and transatlantic moorings.

What about China? There is no doubt that at the beginning of 2011, China was looking the indisputable winner, emerging relatively unscathed from the global financial and economic crisis. The growth of its gross domestic product (GDP) had regained the double digit range; its export machine appeared to be in excellent health and it was using its deep pockets to acquire resource assets across the world. While there have been concerns about over-heating and inflationary pressures, China appears to have managed its economy with skill and finesse and graduated to becoming the world's second largest economy. With this increase in economic capabilities have come political influence and the resources to expand and upgrade its military, in particular naval assets.

In sustaining a high rate of GDP growth, the Chinese economy has accumulated significant imbalances which could result in an asset-bubble and a painful collapse thereafter. The growth drivers continue to be high investment and high exports, both of which are very susceptible to changes in the external economic environment. In the latest Five Year Plan announced by Premier Wen Jiabao, the targeted growth rate has been brought down to 7.5% per annum, with far more significant spending on social welfare, the service industry and on defence and internal security. The less developed Western interior of China will now be the focus of infrastructure investment, away from the coastal provinces. All this adds up to a very deliberate and planned effort to move progressively to a more domestic demand driven, consumption oriented pattern of growth to address the imbalances that might impact China's growth story. However, this assumes that the external environment will remain, by and large, conducive to China's developmental goals.

This is where the uncertainties spawned by the WANA and Japanese crises may change the assumptions behind China's strategy. China is heavily dependent upon oil from the Gulf region and this dependence has been growing year by year. A sustained hike in oil prices, as a result of political turmoil in WANA, will add to the already rising inflationary pressures in the Chinese economy. At the same time, a significant downturn in global demand, as a result of multiple crises, will impact severely on

China's export economy with few alternatives in sight. We may see a cumulatively reinforcing spiral of lower global demand leading to the slowing down of the Chinese economy, which in turn will cut back its demand for goods from markets around the world. We are now in a world where disruptions in the Chinese economy will have almost as much adverse impact as a decline in US consumption demand.

China has also been affected by the Fukushima nuclear disaster. Its ambitious nuclear expansion plans have been put hold pending a comprehensive review. Considering the fact that China has been planning to use nuclear energy to enhance its energy security and reduce its dependence on imported energy, the decision to review proposed nuclear power plants is unusual, but may reflect a greater sensitivity to domestic and international public opinion than one had realised.

What is the outlook for Japan? At the beginning of the year, Japan appeared headed for a modest economic recovery, but was still unable to engage in any significant reform as a result of continued political instability and frequent changes in political leadership. Japan's long-term prospects appeared to be bleak, given its aging and declining population and its unwillingness to consider any significant immigration. The latest crises could impact Japan in two contrary directions. They may reinforce the passivity and lack of dynamisms that has characterised the "prolonged slumber" that Japan appeared to have fallen into after the real estate bubble burst in 1990. Or the crises may shake Japan into forging a new political consensus, willingness to accept thoroughgoing reforms and put the Japanese economy on a higher growth trajectory, driven by innovation and efficiency. While nuclear energy is currently under a cloud in Japan, I suspect that the compulsions of energy security will ensure that this source of energy will remain an important industry in Japan, while safety and security procedures are reinforced. Having served in Japan, my sense is that the people of this remarkable country have the reserves of innate strength, resilience and commitment to excellence which are necessary ingredients for its much anticipated renewal. There will be many cheerleaders for Japan's strong revival.

Russia will inevitably stand to gain from any rise in energy prices, since it remains the world's largest energy producer, both oil and gas. If energy prices remain high for an extended period, the Russian economy will see strong growth and Russia will exercise greater political influence vis-à-vis Europe, China and Japan. A disruption in oil supplies from the Gulf may lead Japan to pursue a more nuanced policy towards Russia, setting aside the territorial issue over the four northern islands, while developing a new energy partnership with Russia. We may see a development similar to Germany's relationship with Russia in Europe and the consequences for the Asia-Pacific balance may be significant.

Despite the complexity we confront in WANA, it would be worthwhile to interpret, however tentatively, the swift and often dramatic chain of events unfolding in the region. In my view, the bigger story in the region is not Libya, but the Saudi armed intervention in Bahrain, which has the potential to trigger a region-wide Shia–Sunni divide. It is unlikely that Shia Iran will stand aside while this unfolds and a Shia dominated Iraq may well be drawn in as well. These sectarian fault lines, which lay dormant in the past, may well erupt into violence and turmoil across the region with unpredictable consequences. In Libya, popular protests are overlaid with inter-tribal loyalties and conflict. Western armed intervention is unlikely to resolve these domestic fissures even if Gaddafi departs from the scene. It was US military pre-eminence in the region and its network of authoritarian allies which held the pieces together, reinforced by the regional balance among the key countries: Egypt, Saudi Arabia, Iran and Iraq. Israel has been a significant factor in both. The US invasion and occupation of Iraq shattered the regional balance irretrievably, while the current wave of unrest is fragmenting the alliance network. The Egyptian revolution was acceptable since the pro-US army remains in command. In Bahrain, a risk to the US base in the kingdom could not be countenanced. Hence the deafening silence over the Saudi intervention in Bahrain and the excesses of the security forces even as a humanitarian intervention is under way in Libya. These contradictions are bound to multiply as the turmoil spreads across the region. WANA is becoming what geopolitical scientists refer to as a "shatter belt", radiating tensions in all directions.

And finally to our own country, India. There were storm clouds on the horizon already when the new year began. While the economy continued to register strong growth, shaking off the aftermath of the global financial and economic crisis, inflation became and remains a major concern. The spike in oil prices will only add to inflationary pressures and efforts to damp down prices, through higher interest rates and fiscal tightening will slow down the GDP growth rate. The prospects of the Indian economy are further undermined by non-economic factors including the spate of corruption scandals, the continuing governance deficit and a general loss of credibility of the current ruling dispensation. On the nuclear energy front, delays in rolling out the ambitions expansion plans are likely as the government undertakes comprehensive safety reviews and seeks to allay heightened public concerns. However, I believe that nuclear energy will constitute a major component of India's search for energy security, in a world of growing energy and resource constraints.

Bringing there different strands together, what is the big picture that emerges? I would venture to offer the following perspective.

At the beginning of 2011, the world was witnessing a multi-speed economic recovery from the global financial and economic crisis of 2008. In the industrialised world, the United States registered a relatively stronger recovery than Europe, but it was the emerging economies of Asia, in particular China and India, which regained accelerated rates of growth in their GDP, investment and exports, thereby becoming the engines of global recovery. This reinforced the perception that the centre of gravity of the global economy was now moving inexorably and even more rapidly than before towards Asia. There is a sense that the latest crisis will further accentuate that trend. The expectation is that in relative terms, the adverse impact on the advanced economies will be greater than on the emerging economies. However, given the web of trade and investment relations which bind the market segments of both advanced and emerging economies, it is likely that if the multiple crises cross a certain threshold, the entire global economy could go into a cumulative contraction, and all bets will be off. It may also be worthwhile to acknowledge that while the trend line is unmistakable, one should be mindful of the fact that, for the foreseeable future, the weight of the mature industrialised economies will continue to dwarf the emerging economies. The United States (with a GDP of $14 trillion), EU (with a combined GDP of US$15 trillion) and Japan (with a GDP of US$5 trillion) still outstrip, four to one the combined GDP (in purchasing power parity terms) of India and China (US$3 trillion + US$5.5 trillion)

At the centre of the multiple crises we are confronted with is the energy challenge. Energy is where the different, locationally separate crises have become knotted together. If the political turmoil in the Gulf, which accounts for 40% of the world's oil reserves, spreads to the main oil producing countries like South Arabia, the United Arab Emirates and Kuwait, there will be another and quite unprecedented "oil shock" which will send the global economy into a downward spiral and probably a prolonged "stagflation" of the kind witnessed after the first oil shock of 1973. Saudi Arabia will be the pivot in this regard because it constitutes the master valve of the oil markets. It has the ability to ramp up output at short notice since it maintains a spare capacity of over two million barrels/day, which more than the total output of Libya. The Western armed intervention in Libya and the Saudi military ingress into Bahrain may trigger a wider and more damaging political turmoil in the region with consequences that may dwarf anything we have seen so far.

The other aspect of the energy crisis is what is happening to the nuclear industry world-wide in the wake of the Fukushima nuclear disaster. The immediate impact is on countries which have a high proportion of their electricity generation dependent upon nuclear power. This includes Japan itself (30%), Germany (20%), the United States (20%) and France (80%). In Germany, seven nuclear power plants have suspended operations and others are being scrutinised carefully before their future is decided. In Japan, too, there will be loss of power availability with the closing down of several reactors, including those at Fukushima. If similar action is taken in other countries, there will be need for alternate power sources, such as gas, to make up for the shortfall. This will add to the price pressure on both oil and natural gas. The longer term impact involves the future of the nuclear industry itself. Nuclear renaissance has suddenly run out of steam as country after country reviews and re-examines its plans for new nuclear power plants. And this includes China, which has planned to add nearly 5 GW of nuclear power by 2020 alone.

I believe that nuclear energy will remain a significant source of clean energy going into the future because there are simply no other credible alternatives for the foreseeable future. However, there will be a slow-down before China and India get back on track with their ambitions plans, China will be the more likely to get off the mark first than India.

Given the emergence of energy as a pivot around which geopolitical changes will tend to play themselves out, it is energy producers who will stand to gain the most from the current crises. The oil producing countries of the Gulf stand to gain, but only if they are not, in the meantime, overwhelmed by the spreading political turmoil. On balance, I would expect that any economic gain through higher oil prices may well be cancelled out due to political unrest and rising uncertainty. On the other hand, Russia, which enjoys a relatively stable polity, is likely to be a net gainer. It is the world's largest energy producer and can leverage its energy supplies to gain greater diplomatic space vis-à-vis all major powers, but in particular, Europe, Japan and China. Other energy producers will also gain both political and economic leverage, and this includes Brazil in Latin America and Indonesia in Southeast Asia. We will probably witness an even more frenzied scramble for energy resources in Africa, whose economic and political profile will finally begin to register on the international radar. One analyst has warned that we may be on the threshold of a "geopolitical Cold War centred around energy security".

The redistribution of economic and political power has not yet fallen into a neat and predictable pattern. The diffusion of power is ongoing and its nature is fragmented and lumpy. This is already having the effect of loosening existing alliances and more informal groupings. A certain fluidity is in evidence all round. The United States is reluctant to act in WANA and prefers to let France and the United Kingdom take the lead. Germany, an important NATO ally, demurs. Within the European Union, the Franco-German diarchy is now fraught with tension and the coherence of earlier years is now dissipating. In Asia, on the other hand, we are witnessing the gradual crystallisation of a loose, countervailing coalition that seeks to hedge against a more powerful and assertive China. The emerging powers, India, Brazil and South Africa, are now coordinating their political postures on key issues and this was in evidence during the early phase of the Libyan crisis.

This somewhat confused geopolitical backdrop is likely to deal a setback to efforts to evolve equitable and effective global regimes to deal with global and cross-cutting challenges such as piracy, international terrorism, non-proliferation, climate change, global pandemics and issues related to food, water and energy security. There may be more limited solutions, region-wise or among countries with convergent interests, such as India, Brazil and South Africa. The role of the G-20 may increase and its agenda may expand beyond the management of the global economic order. The pressure for reform of the UN Security Council may increase as its dysfunctionality becomes even more exposed in a world beset with simultaneous and multiple crises.

Let me conclude by articulating, in a broad sense, what India's strategy could be to deal with this environment of heightened uncertainty and rapid and unexpected change.

One, I would, once again repeat a mantra that I had put forward during my presentation here last year.

"Engage with all major powers, but align with none".

We need to become adept at forming and working through coalitions which are issue based and sometimes event-specific. Dealing with uncertainty demands flexibility of response. It also demands contingency planning, the working out of alternative scenarios and Indian responses that are appropriate to each. For example, a prolonged disruption in oil supplies from the Gulf is a contingency that could very well confront India and we need to explore alternative sources of supply before that happens. Is it possible to redirect some of our sources of supply to Southeast Asia and the Russian Far East? Is Latin America an option? Could some of our oil demand be converted to the use of natural gas, which may be easier to access? As we look into these alternatives, new alignments will suggest themselves; perhaps a much greater emphasis on our relations with Russia; the possibility of turning IBSA into an energy partnership or tapping into Iran's huge gas reserves if that country manages to escape the current turmoil in its Arab neighbourhood.

Two, India still remains a relatively stable political entity in an arc of instability stretching from the edge of Europe to the Western edge of the Pacific. In an atmosphere of pervasive uncertainty, this attribute of stability is a strong asset that can be leveraged to India's advantage. It can serve to attract investment, it can keep projecting India as a reliable and predictable partner. An international situation which is in flux crates the space for an emerging power like India to consolidate the geopolitical gains it has already made and expand its strategic space vis-à-vis other powers. This requires a degree of strategic boldness which is not always characteristic of the Indian temperament.

Three, for India, the geopolitical focus will be Asia and, in particular, the Asia-Pacific region. The emerging strategic order in the region is in the words of one analyst, "profoundly maritime" and "geopolitically speaking the maritime balance would appear to be the key to further stability in Asia". With its significant and steadily growing naval capabilities and its geographical location, straddling the western and eastern reaches of the Indian Ocean, India is very well placed to be a decisive element in this maritime balance. A reordering of our security priorities in favour of our naval capabilities is essential if we are to consolidate and expand our role in region. This will also enable us to help create the kind of countervailing presence that is necessary in order to ensure that Asia remains as multipolar as the world which is emerging.

Four, I will repeat what I have advocated on many occasions in the past, i.e. the need for a long term and effective neighbourhood policy. The Indian sub-continent is a single, interconnected and cohesive geopolitical and geo-economic unit, though it is divided politically. It constitutes India's strategic realm. The challenge for Indian diplomacy will be to gradually transcend the region's political divisions and enable a shared security and strategic perspective to emerge. Regional economic integration and promotion of cross-border physical and digital connectivity must become an urgent priority, because it may help foster the shared security perspective that I have referred to. Without progress in this direction, India's larger role regionally and globally will encounter a constant constraint nearer home.

Mr Chairman, ladies and gentlemen, faced with a rapidly changing international environment and persistent uncertainty, one can only sketch out some of the pointers to the future. It is like trying to link dots which are constantly moving. In my presentation on the same subject, on February 28, 2009, I had concluded by quoting a remark from the Global 2020 document:

> *"Linear analysis will get you a much changed caterpillar but it won't get you a butterfly. For that you need a leap of imagination."*

What has been happening in the world around us bears testimony to the wisdom of this cautionary advice. No matter how carefully we plot our course, the seas defeat us and push us off-course into uncharted waters. Perhaps we need a different kind of compass and a new set of charts to show us the way.

Admiral Prakash, that brings me to the end of my presentation. I wish to thank the National Maritime Foundation for once again giving me a platform to share my perspectives with such a distinguished audience. A word of thanks, too, to the India Habitat Centre for providing a prestigious venue for this interaction.