

Global Economic Landscape: From 5 'G' To Polycrisis, and the Outlook Scenarios

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Capital Flows, Excess Savings, Polycrisis, Risk-taking Behavior, Muslim Countries.

Abstract

Learning from 'Great Moderation' to the ongoing 'Goeconomic Fragmentation', past episodes of capital flows explain the evolution of global economy and the associated vulnerabilities. The events in all episodes are related to one another, and the corresponding vulnerabilities are not entirely inseparable. Together with the expected and unexpected contemporary shocks (pandemic, wars, geopolitical tensions) the built-up vulnerabilities contribute indirectly to the current sorry-state of global economy. As uncertainties abound, and the world is facing a 'polycrisis', it is difficult to forecast what is going to happen. Any estimate, including those made by the international organizations are subject to change. The outlook scenarios mapped out in this paper is intended to help us just to frame thinking about the potential paths ahead.

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1. Introduction

After decades of deepening global economic integration, forces of deglobalisation and slowbalisation have gained strength. As the growth momentum in advanced economies (AE) weakens, and economic power gradually shifts towards emerging market (EM), the global economic landscape has gradually changed. The process, however, has been 'interrupted' by some expected and unexpected shocks associated with contemporary events, ranging from the COVID-19 pandemic, wars, and geopolitical tensions, that led to the current sorry-state of global economy. While reasons behind such a state vary, a common thread abound: heightened vulnerabilities associated with fluctuating capital flows.

It is argued in the paper that the conditions we are experiencing now can be better understood if viewed from the perspective of accumulated series of vulnerabilities emanating from the past events of capital flows. By highlighting the five episodes during the last four decades (termed 5'G'), beginning with Great Moderation (GM) of the 1980s until the ongoing Geoeconomic Fragmentation (GF), it is shown that they and the corresponding vulnerabilities were not stand-alone affairs. Instead, they were interconnected, and some of their effects were amplified. The built-up vulnerabilities lingered and played a role in shaping some of the contemporary events leading towards the current state of global economy.

The organization of the paper is as follows. In the next section I begin with reviewing the relevant literature. After laying out the analytical framework in section III by focusing on the link between flows of FDI, portfolios, and trade in each episode, I discuss each event in greater details in section IV. The specific episodes are: the Great Moderation (GM) of the 1980s, the Global Imbalances (GI) in the mid-2000, the Global Financial Crisis (GFC) in 2008, the Great Divergence (GD) in monetary policies as a response to the GFC, and the ongoing Geoeconomic Fragmentation (GF) following the COVID-19 shock and the escalated geopolitical conflicts. In each episode, the role of capital flows and the corresponding vulnerabilities are highlighted. In section V before 'Final Notes,' I discuss the recent trends and the IMF forecast before presenting the outlook scenarios and the risks of the outlook.

2. Literature Review

Based on the experience of a wide range of financial crises in different countries at different periods, Reinhart and Rogoff (2009) showed that those crises shared a

number of common features. Here, I focus on one of those features, namely capital flows. The rationale is built upon my previous works which essentially showed that vulnerabilities in AE & emerging market and developing economies (EMDE) had actually been growing since before the onset of the 2008 Global Financial Crisis (Azis & Shin, 2015; Azis, 2016; and Azis, 2018). They were largely driven by a combination of factors, including complacency, a false assessment that markets will correct imbalances, persistently low interest rates, a lack of proper oversight, and a perception that housing prices will always move north. In this paper, my conjecture is, while the current turmoil and sorry state of global economy are triggered by contemporary events (geopolitical conflicts, the COVID-19 shock, and the wars), impacts of past events have formed ingredients of vulnerabilities that contribute to the current crisis.

From the late 1980s until 2008, the global economy enjoyed a period of low volatility in terms of growth and inflation. The causes and mechanisms of that episode have been discussed by many scholars, among others Blanchard et.al (2000, 2005). There was, however, an interruption in Asia when the region suffered from a major crisis (The Asian Financial Crisis) driven by capital flows that led to a 'double mismatch'. Lured by the region's good economic prospect at the time, the demand for borrowing to finance rapid growth of investment was high. Confidence among foreign lenders was equally strong. Large firms rushed to borrow short-term from the international market. The first mismatch was a maturity mismatch (short-term borrowing financed long-term projects), the second was a currency mismatch (foreign currency borrowing to finance local currency projects). When the region's currencies fell, these firms went into trouble, causing a major financial crisis in 1997 (Azis, 2022).

The impact of capital flows on global liquidity became prominent again in early 2000s. Elaborated in Azis & Shin (2015), the dynamics of global liquidity since then has had ramifications worldwide. Capital flows to EM surged in response to low interest rates in AE. So did the EM liquidity. First, the inflows came through banks, raising banks' non-core liabilities (CIEPR, 2012). Following the quantitative easing (QE) policy in AE in 2009, the second round of capital inflows flocked into EM. This time, the flows went through the capital markets. While both rounds of inflows boosted EM investment and growth, they also elevated the risk of financial instability, worsened income inequality, and reduced the effectiveness of monetary policy (Azis & Shin, 2015).

Despite the fact that contagion and externalities of the QE were felt around the world, the international financial institutions (IFIs) including the IMF were curiously

silent. It was for this reason some analysts and policy makers began to highlight the importance for EM to consider adopting policies to defend themselves by putting a damper on the dangerous component of capital inflows. This proposed measure is equivalent to discouraging risky behaviour. Imposing a levy on non-core liabilities, as implemented in Korea, is one example of such a defense measure. By providing more justifications and showing the stylistic model of putting a damper on capital flows, Azis (2018) showed that financial instability can be averted if some restrictions on capital flows are imposed. Such a measure is part of the macro-prudential policy. Bruno and Shin (2014) argued that the measure also provides domestic financial safety nets to mitigate the spillovers of financial contagion. It is further suggested that a regional financial arrangement can and should play a complementary role since efforts by individual countries alone may not be sufficient. The regional arrangement can improve the policy effectiveness (Kawai and Houser, 2007; Azis, 2022).

It has been known that the risk of massive inflows into the banking sector takes the form of pro-cyclicality, where financial variables fluctuate with broader amplitude during the economic cycle (Allen and Gale, 1994). In a downturn cycle, borrowers' cash flows and net worth decline, elevating their probability of default and raising the premium of external finance. In such a condition, their access to credit could be severely constrained, lowering spending, investment and output. This loop is known as 'financial accelerator' (Bernanke *et al.* 1989), where a relatively small shock to the economy can be amplified by endogenous changes in credit market conditions associated with market frictions. The phenomenon is related to the concepts of asymmetric information and principal-agent theory. It also involves 'agency costs' or the costs associated with imperfect and asymmetric information between lenders (principals) and borrowers (agents), where the former cannot fully access the information on investment characteristics. As a result, external finance (debt) gets more costly (higher premium) than internal finance, and borrower's net worth falls, lowering the base for internal finance and raises the need for more external finance that is costly. Thus, the effect of the initial shock is amplified, propagating the business cycle (Kiyotaki and Moore, 1997).

Unlike procyclicality in the banking sector, the risk of massive inflows going into the capital market is related to the concept of 'sudden stops', i.e., financial whiplash that creates instability and crises through current account reversals (for the case of net capital flows where countries can no longer finance current account deficits) and capital account reversals due to financial instability (for the case of gross capital flows). While the current account reversals assume an elastic supply

of foreign financing responding to financing needs of the current account, Calvo (1998) argued that in capital account reversals a gross shock affecting the supply of foreign financing can cause an adjustment to the current account balance; hence the mechanism is the reverse of that in current account reversals.

Sudden stops could lead to currency and banking crises, and output losses (Cavallo, 2006). When foreign financing dries up, debtor countries are forced to go through a resource transfer to creditor countries. As a result, foreign reserves dwindle, and the debtor countries can end up in financial crisis.

To sum up, it is conjectured that a series of massive capital flows can cause an increase in a country's financial vulnerability. The evidence had shown that most crises were preceded by rising capital inflows, and the impact of the ensuing crisis following the inflows can be economy-wide. I use this conjecture to argue that the past episodes of capital flows have indeed produced a series of vulnerabilities. These vulnerabilities are inseparable and indirectly contribute to the current sorry state of global economy.

3. Analytical Framework

Despite efforts made by individual countries and International Financial Institutions (IFIs) to, respectively, dampen the fluctuations of capital flows and stabilize global liquidity, flows volatility persisted and vulnerabilities continued. In this paper, the analytical framework rests upon the mechanisms of how the vulnerabilities during different capital flows episodes since the 1980s were built up. Such mechanisms play a role in shaping the current global economy.

The different episodes of capital flows and their repercussions to the economy are shown in Figures 1a to 1d. Three different arrows are specifically displayed, one captures the trade flows, the other financial flows, and the third captures the foreign direct investment (FDI) flows.

During 1980s to 2000, the global economy was in a relatively good shape, where the three types of flows were more or less in sync. The global current and capital account deficit was at a relatively normal level, in which trade balance in EMDE (mostly deficit) and China (mostly surplus) was sufficiently matched by a balance in portfolio and FDI flows (mostly inflows to EMDE). This was the episode of 'Great Moderation' or GM (Figure 1a).

As soon as China joined the World Trade Organization (WTO) in 2001, its exports surged particularly to AE. On the one hand, this put a downward pressure on inflation in AE, on the other hand, this boosted China's growth. Many investors in AE took advantage of the good prospect of, and the growing confidence over,

the economies of China and other EM. This led to a surge in FDI inflows. The rapid increase of China’s exports magnified the size of the country’s foreign reserves. A similar trend occurred in other EM, especially those in Asia. Most of the reserves were invested in the US Treasury. Hence, a round-tripping of flows occurred (Figure 1b). This was partly due to a shift in the thinking among policy makers in the region, i.e., from relying on external funding to accumulating foreign reserves as a ‘self defense’ mechanism. The painful lesson from the Asian crisis in 1997 had a lot to do with such a shift. The flows of FDI into China and EM also surged as the global supply chain gained a momentum. So did the massive flows of fund into the EM banking sector. While AE and EM experienced a strong growth with benign inflation, imbalances in the global economy became huge. By the mid-2000, the US current account deficits (CAD) represented 70 percent of the entire global deficits. The world had clearly entered a stage of ‘Global Imbalance’ (GI), a time bomb in the system.

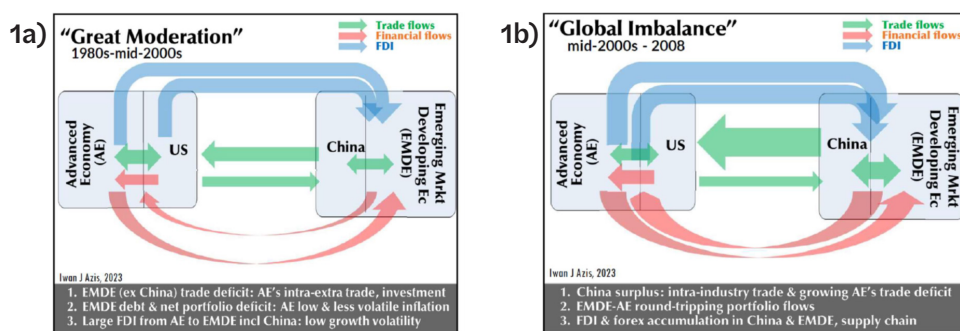


Figure 1a. and 1b. are about Framework of Analysis:
Mechanisms of Capital Flows in the Global Economy

The bomb eventually exploded in 2008 with the arrival of the GFC. The response of the AE towards the crisis, i.e., adopting a super-easy money policy including an asset purchase program known as QE, resulted in a super low interest rates. Seeking for higher returns, many FDI and portfolio investment by AE investors landed in EMDE including China (Figure 1c). As cited earlier, this time most inflows entered through the capital markets. As some countries feared of negative repercussions of the crisis, they adopted an unprecedented negative interest rates policy (NIRP). As a result, two camps emerged: some countries maintained the low but positive rates, others implemented NIRP. As the global economy entered such a stage of ‘Great Divergence’ (GD), financial market players were left to guess about the direction of monetary policy. In the meantime, geopolitical tensions started to creep up, particularly between China and the US, and subsequently the EU. The

trade volume between those countries declined as a result. At the same time, the expanding trade between China and EMDE since China’s accession to the WTO continued.

Figure 1d captures the episode of capital flows from the onset of COVID-19, the greatest global health disaster of the century. The pandemic sent shock waves through the world economy, causing the largest crisis in more than a century. The situation was further exacerbated by a worsening geopolitical conflict. This brought the world into a ‘Goeconomic Fragmentation’ (GF). Through onshoring and friend-shoring measures, trade between AE and EM was affected, while trade between China and other EMDEs continued to increase, albeit with some changes in the direction. On FDI flows, the geopolitical distance further dominated the geographic distance. A similar trend occurred in portfolio flows, albeit much less in size.

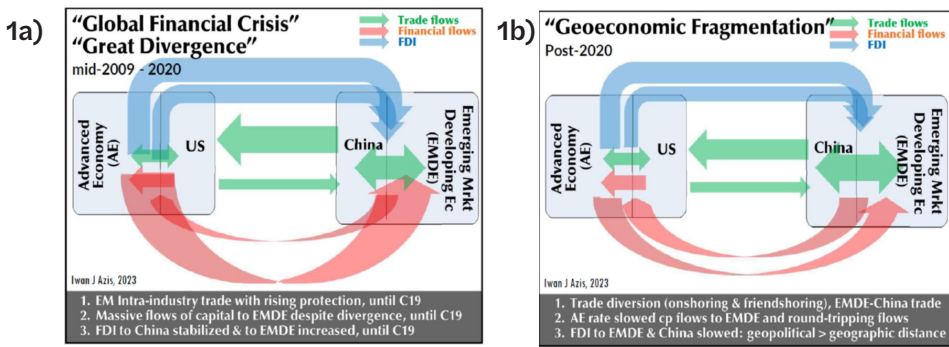


Figure 1c. and 1d. are about Framework of Analysis:
Mechanisms of Capital Flows in the Global Economy

By adopting the above framework, the discussions in the following sections elaborate further the different episodes that explain the evolution of global economy and the associated vulnerabilities since the 1980s. The covered episodes stretch back to the time when the Great Moderation (GM) began, followed by the Global Imbalances (GI) that peaked in the mid-2000s, the Global Financial Crisis (GFC) erupted in 2008, the Great Divergence (GD) in monetary policies as a response to the GFC, and the Goeconomic Fragmentation (GF) that we are experiencing today.

4. Discussion

a. From Great Moderation (GM) to Global Imbalance (GI)

From the late 1980s until the onset of the GFC in 2008, the global economy enjoyed a period of ‘Great Moderation’ (GM), the first ‘G’. The growth of aggregate

economic activity in AEs, especially G7 countries, became more stable than before, accompanied by less volatile inflation and inventories. The starting date marking the switch from high to low volatility varied, ranging from as early as 1971 in Germany to 1988 in Canada; see Azis (2016) for more details.

While country-specific factors matter, similarities in some patterns are notable: production shifts and outsourcing to low-cost countries such as China and India ('Chindia' factor), trade liberalization, lower taxes, and deregulation. They all helped stimulate growth and investment, and boosted trade with low inflation. In the US, this took place following the so-called 'Volcker recession'. To a certain degree, some developing countries also enjoyed a steady growth with narrowing fiscal deficits as a result of fiscal consolidation. Economic reforms in most of these countries began in the 1980s.

Prompted by the fear of deflation after the 1997 Asian crisis, pressures for the US Federal Reserve to lower interest rates mounted. The bursting of high-tech bubbles that eventually led to a recession also forced the US Federal Reserve to adopt a more accommodative policy. As a result, investment and consumption surged and the saving rate fell, widening the country's saving-investment gap. On the trade side, the decision by China to join the WTO in 2001 led to export boom, where most products and goods landed in the US market. This helped reduce inflation, but the US current account deficit grew rapidly. By 2015, the deficit reached an all-time high, more than 7 percent of GDP. This never happened before. An uncomfortable equilibrium in the global economy emerged as a result: China-US bilateral deficits alone reached 70 percent of the entire global deficit. With such a staggering magnitude, the world entered a dangerous stage of 'Global Imbalance' (GI).

The unprecedented imbalance, however, was outshone by the favorable growth trends. Many EMDEs also enjoyed a steady growth, supported by their participation in the growing supply chains. China and other EM in Asia were particularly active in the production networks. Almost half of global surpluses originate in those economies (the remaining half come from the oil-producing and other surplus countries). As a result, the size of foreign reserves in many countries surged, in line with the 'self-defence' strategy. A major portion of these reserves was invested in the US Treasuries despite the low returns. On the one hand, this helped finance the growing US trade deficits, on the other hand, pressures on the Federal Reserve to keep the interest rates low became stronger.

In the meantime, driven by Asia's strong and steady growth, funds from AE flowed into China and EM. Amid AE's low interest rates, many EMDEs experienced large capital inflows channeled through banks (coined 'bank-led flows'; see Azis &

Shin, 2015). These flows elevated bank's noncore (as supposed to core) liabilities, raising the banks' capacity to lend. This was the phase-one of global liquidity changes, where bank lending surged (shown in Figure 2). As inflows persisted, so did currency appreciation, such that funds continued to flow in. In the process, risk-taking behaviour among investors became widespread. Hence, virtuous cycle emerged, amplifying the effect of cross border flows on the overall supply of credit, currency, and risk-taking behaviour. At the same time, there was a round-tripping of financial flows between AEs and EMDEs.

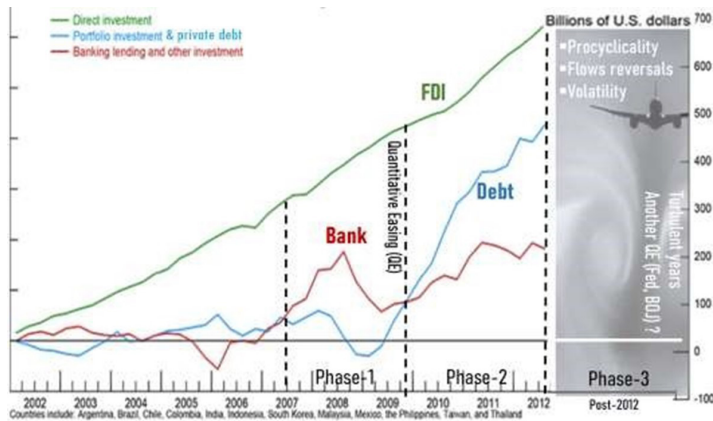


Figure 2. Three Phases of Global Liquidity in Emerging Market
 Source: Author's presentation at the 2nd International Conference Muslim World Economy and Business (ICMWEB-2023), Universitas Islam International Indonesia (UIII)

Driven by a combination of low elasticity of substitution of imports, portfolio balance, and valuation effect, a huge current account deficit in the US was accompanied by only a modest level of dollar depreciation. It was for this reason that only few saw the deficit as threatening. At that time, many believed that markets would self-correct the imbalance (Azis, 2009). Yet, by virtue of the size alone the imbalance during the GI episode made the equilibrium fragile, far from sustainable, and it created a bubble that eventually burst in 2008.

b. From Global Financial Crisis (GFC) to Great Divergence (GD)

The disaster that hit the US financial sector in 2008 was originally triggered by troubles in a relatively small part of the financial market: sub-prime mortgage market. Added by the ingredients of GI, the resulting instability brought the US economy to its knees. The event marked the beginning of the Global Financial Crisis (GFC), the third 'G', which, at the time, was considered the most dangerous crisis since the Great Depression. What is remarkable is, problems in a small (sub-prime) market could bring down the world's largest economy.

Numerous studies and reports have been written about the GFC. The episode

began with a massive amount of mortgage lending to non-prime borrowers in order to fulfill the 'American Dream' of home ownership. The initial interest rates were set to zero (teaser rates) to lure low-income households into mortgage borrowing. They failed to pay a sufficient attention to the market rates they eventually had to pay when the teaser period ended. From the lenders' side, low interest rates prompted not only private investors to gain from exercising carry trade, but also led global banks operating in the US to intensify efforts to raise funds (Azis and Shin, 2015). A large sum of acquired funds was channeled to EMDEs, another large sum was lent to US subprime borrowers. Such an arrangement was made easier by the ample liquidity including the round-tripping funds cited earlier (EMDEs' foreign reserves invested in the US market)¹.

Many lenders and mortgage companies used the loans to issue asset-backed securities (ABS) and sold them to investors. The latter were attracted by the notion that the only direction of housing prices was north; that is, home prices will never fall. Numerous investors joined the party, allowing more funds to flow in and firms to use the funds to pay the existing investors. It was nothing less than a Ponzi scheme.

The subsequent entry of major investment banks into the scheme became a game changer. Their involvement set the stage for what came next. These banks and other lenders passed the rights to mortgage payments and related credit/default risk to third-party investors via mortgage-backed securities (MBS) and collateralised debt obligations (CDO), which were then insured through a financial derivative known as a credit default swap (CDS). These maneuvers managed to provide a false sense of security and stability in the market.

Pandemonium set in when the period of teaser rates ended. Many borrowers-cum-homeowners began to default, unable to repay the debt. This caused a wave of foreclosures that hit the housing market. Banks began to withhold short-term credit, investment banks enforced margin calls to protect themselves from falling loan values, and mortgage companies and hedge funds were forced to sell assets to meet margin calls. Facing an unprecedented loss due to the continuing problems in the subprime market, in the autumn of 2008, one of the oldest investment banks, Lehman Brothers, went bankrupt. Unlike in the case of Bear Stearns, another investment banks involved in sub-prime loans that narrowly avoided bankruptcy due to an 'arranged bail out' through a purchase by J.P. Morgan Chase and Co, this

¹These global banks engaged in role-reversal, i.e., from being lenders to becoming fund raisers in the US market.

time, the US authority took a hands-off stand. With no bail-out, the bankruptcy of Lehman Brothers was announced in 15 September 2008. One financial group after another followed suit, wiping out thousands of billions of dollars of investments, including those in the prime market.

What began as a crisis in the sub-prime and mortgage market had now reached the entire credit and money market. Confidence in financial markets reached an all-time low. But the saga did not end there. The contagion that followed worked rapidly and forcefully, facilitated largely by global banks who acted as carriers of transmission in cross-border spillovers. The funds they provided to finance credit in EMDEs and around the world during the good times had now dried up. The deleveraging process, which heightened the pro-cyclicality, was among the most important channels through which the crisis spread across the globe.

In response, authorities in the US and Europe injected huge amounts of liquidity by purchasing long-term government and other bonds that would lower long-term interest rates and yields. This marked the beginning of the QE policy. By way of portfolio substitution, this boosted the value of risk-assets and share prices, and also reduced market volatility. Yet, facing a super low – or virtually no – yield on low-risk assets, investors pushed the share prices so high that inevitably formed a bubble. The bubble finally burst when a sharp correction to the price/earnings ratio took place in 2015 (Feldstein, 2015). As a result, consumption and investment fell, undermining the intended ultimate effect of QE on the US recovery.

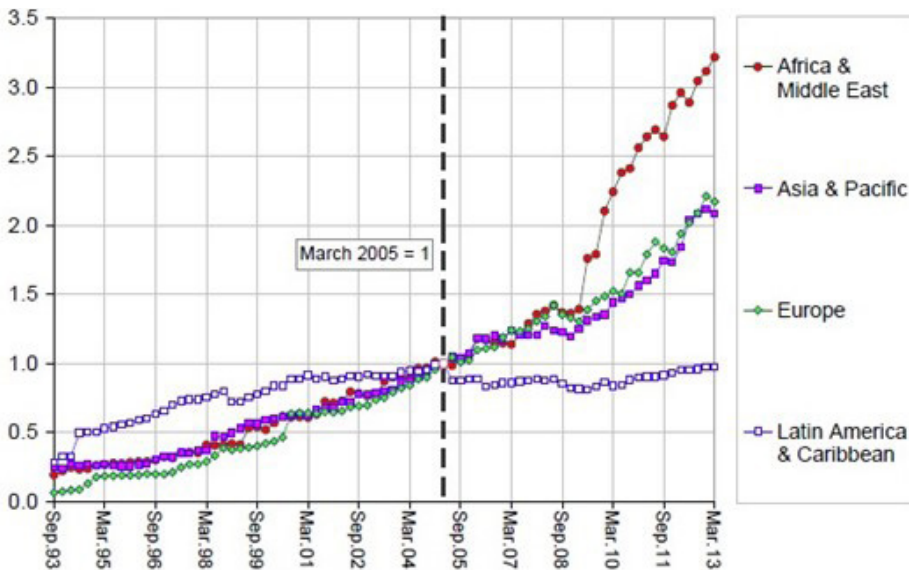


Figure 3. Government International Debt Securities Outstanding (2005Q1 = 1)

Source: Debt Securities Statistics, various volumes, Bank for International Settlements.

Global liquidity and financial conditions in EMDEs changed significantly after QE. As risks in AEs increased, and returns fell, investors voted with their feet by investing abroad, particularly in EMDEs that offered higher returns and lower risks. Many EMDEs, especially in emerging Asia, received massive amounts of inflows. This time, however, most transactions occurred through the capital markets, labeled 'portfolio investment and private debt' in Figure 2. As a result, the global liquidity entered phase-two. Unlike in phase-one, where banks were the main players, the protagonists in phase-two were fund managers. As depicted in Figure 3, the issuance of government bonds in Africa, the Middle East, and Asia Pacific, grew rapidly since 2009 to more than triple and double, respectively.

Borrowing through international securities by non-financial firms also surged, from less than US\$200 billion in the aftermath of Lehman Brothers crisis to US\$450 billion in March 2013. Interestingly, a significant portion of flows went to assets denominated in local currency (LCY) boosting the region's LCY bond market. In countries like Indonesia and Malaysia, the share of foreign ownership in LCY bond market reached as high as 40 percent and 30 percent, respectively. To the extent Malaysia's market was deeper than Indonesia's, the degree of vulnerability also differed (Azis and Yarcia, 2015). The taper tantrum episode in 2013 provided the evidence. As signals to end the QE in the US at the time caused a change in investors' perception, resulting in capital outflows, the bond yields in Indonesia fluctuated more than in Malaysia.

Since 2013, financial markets in emerging Asia and EMDEs entered the turbulent years where uncertainties and volatility reached higher than during the period before it. This was phase-three of the global liquidity change (see again Figure 2). A series of external shocks worked through cross-asset market spillovers, as risks increased and capital flows reversed (Azis, et.al, 2021). In 2015 alone, EMDEs faced a whopping US\$735 billion of net outflows. Adding to uncertainty was a divergence in the direction of monetary policy: some countries adopted NIRP, others opted to keep interest rates in the positive territory. The market had no choice but to face such a 'Great Divergence' (GD), the fourth 'G.'

Amid confusing signals, borrowers in EMDEs continued to raise foreign currency debt. In 2013, for the first time the ratio of households and non-corporate debt over GDP in EMDEs was higher than in AEs. This occurred while firms' profitability declined; see Azis (2016). By 2016, the total debt of EMDEs was four times higher than in 2008. Under such circumstances, and given the volatility of capital flows, through the balance sheet effect any large changes in the exchange rates could spell trouble for borrowers in EMDEs (Azis, 2018).

c. COVID-19 Pandemic, Goeconomic Fragmentation (GF), and Polycrisis

It is clear from the preceding discussions that, prior to 2020, the global economic landscape was already clouded by increased uncertainties and vulnerabilities. The emergence of the COVID-19 pandemic in early 2020 deepened the vulnerabilities. It sent shockwaves throughout the world. On the government finance side, increased spending for virus containment and other health-related measures had to be made while tax revenues fell. Increased spending to support businesses and workers to mitigate the negative impacts of lockdowns added to the pressure. On the trade front, the global value chains were severely impacted, causing serious shortages in supplies of goods including medical equipment and pharmaceutical drugs. Together with growing trade protection, this caused the growth of global trade to level off. Furthermore, the restrictions and lockdowns imposed by many governments put severe constraints on the movements of people and goods.

Many efforts that had been taken to mitigate the negative impacts of the shock on financial stability. Yet, financial sector was not spared. During the early stage of the pandemic, growing uncertainties led to increased volatility. The unknown nature of the virus end-game and its contagion force, combined with the uncertainty in vaccine development, deepened the turmoil. Outflows from EM accelerated despite their better economic performance compared to many AEs especially Europe. Combined with the rising interest rates in the US, pressures on EM exchange rate mounted. The so-called “global dollar cycle” driven by global financial risks, has negative spillovers on EM, especially on those facing high inflation expectation and less flexible exchange rate (Obstfeld, Maurice and Haonan Zhou, 2023)

Although gradually markets became more rational and less responsive to the crisis, and volatility declined, vulnerabilities built up during the period prior to COVID-19 remained intact. If anything, they became more exposed. Then the rest is history: the world had finally suffered from the largest global economic crisis in more than a century.

In the meantime, the world is also facing another serious problem of ‘Goeconomic Fragmentation’ (GF), the fifth ‘G.’ This problem is undoubtedly related to the growing geopolitical tensions. The accumulated vulnerabilities associated with events of the 4 ‘G’ described in the preceding sections set the stage for this fifth ‘G.’ The emergence of GI, where China’s surplus and US’ deficit grew rapidly, followed by the subsequent GFC that hit the US economy hard, was a perfect condition for exacerbating the geopolitical tensions, especially between China and the US. Conflicts happened almost everywhere: in Europe following

Brexit and war between Ukraine and Russia, in the Middle East following the war between Israel and Hamas in Palestine, and in Asia prompted by the unrelenting concerns over the South China Sea². In no small measure, China’s attainment of world power to challenge the US’ position is also interconnected with the events leading to GI, GFC, and GF. By implication, this explains why the world is now splintering into distinct geopolitical blocs with limited economic engagement between them.

The geopolitical rivalries fueled cross-border restrictions (protection) on national security grounds. Since the GFC, the global cross-border flows of goods and services had actually already decelerated. The rate of deceleration increased after the COVID-19 and the war in Ukraine (Figure 4). Even the usually resilient FDI flows suffered from a marked slowdown as geopolitical preferences trounced geographic closeness. FDI flows have been increasingly concentrated among geopolitically aligned countries. As shown in Figure 5, the share of FDI flows among geopolitically aligned economies became even greater than those between geographically closer economies.

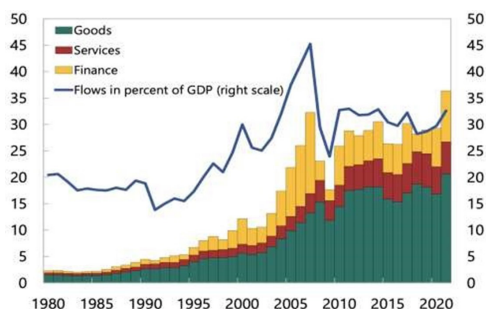


Figure 4. Global Flows of Goods (Exports only), Services, and Finance (\$ trillion, unless indicated otherwise)
Source: IMF Balance of Payments, World Bank and IMF staff calculations

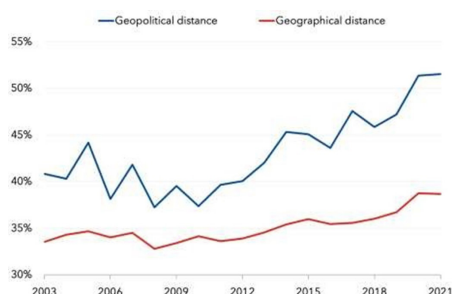


Figure 5. Share of FDI Flows Between Geopolitically and Geographically Close Countries
Source: JaeBin Ahn *et.al* (2023)

²The selected are considered apropos to the 5 ‘G’ discussed in the paper. A more complete list would include conflicts in Africa, where historical reality, impacts of colonisation, comparative under-development, and shortcomings in governance limit the effectiveness of some resolution efforts.

The growing GF carries significant risks and costs that work through multiple channels. The interconnections between emerging risks evolved into a cluster of related global risks and disparate but interacting crises, causing what is known as the ‘polycrisis.’ The compounding effects of such a crisis is hard to predict. What is certain is, the overall effects exceed the sum of each part. Central to the mayhem are the shortages in natural resources (food, water, minerals, metals, and energy). Driven by the interrelated environmental, geopolitical and socioeconomic risks, the effects of the gap between demand for and supply of those resources have widened. Conflicts and war in the Middle East could exacerbate those effects. Although the overall repercussions on the already gloomy economy remain uncertain, the risk of polycrisis is bound to accelerate when it is combined with the accumulated vulnerabilities during the 5 ‘G’ episodes

5. Outlook

While the world has become more interconnected and interdependent, it has also turned more diverse and multi-polar. Multiple shocks and worsening geopolitical climate make things difficult to predict, let alone the impact of climate change. Under such circumstances, and given the interrelated risks discussed in the paper, producing a global economic outlook is extremely challenging. The goal posts are constantly moving. Hence, one can only develop scenarios.

An optimistic scenario can be constructed on the basis of the following positive trends. First of all, despite all the predicaments, no recessions have occurred in major economies thus far. According to the IMF’s World Economic Outlook (IMF, 2023), the global growth is expected to fall from 3.4 percent in 2022 to 3.0 percent in 2023 and 2024, a slight improvement from the previous estimates of 2.7 percent (Figure 6). Much of the progress is expected to come from growth in emerging Asia, while growth in AE is expected to suffer from a pronounced slowdown, falling from 2.7 percent in 2022 to 1.3 percent in 2023³. China’s recovery from severe downturn caused by the country’s strict zero-COVID policy also plays a major role in the no-recession outlook.

The easing of supply chain disruptions and the resumption of strong labor markets after COVID, along with the solid wage growth that could bolster production and consumer demand respectively, are also encouraging trends. Softening inflation (see the world inflation in Figure 7) and falling oil prices and gas (compared to the level at the start of this year) will lower the costs of production in

³ Based on the data up to the third quarter of 2023, about two-third of the world growth has come from Asia.

many sectors. Although financial conditions have tightened due to rising interest rates, the stock market is surprisingly resilient: at the time of writing, Nasdaq had jumped 16 percent year-to-date and the S&P 500 surged by 7.8 percent (the two are the most prominent equity indices in the US). All these provide reasons not to be gloomy.

Looking at Muslim countries (the interest of today’s conference), the growth trend seems to follow a U-shape pattern, similar to the global trend: decelerating growth in 2023 before recovering in 2024. ⁴ For oil-producing countries, including OPEC+, the growth fall in 2023 reflected the lower oil production in line with the agreement made in 2022 to anticipate possible downturns in the demand because of a slowing global economy. Non-oil growth, however, is expected to remain robust. High oil prices and steady growth in partner countries will offset the impact of high food prices. The growth deviation between countries or group of countries as listed in Figure 6 is not too large (between 3 and 4 percent).

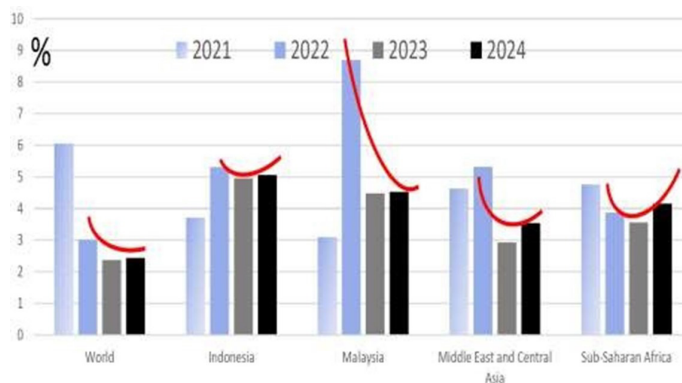


Figure 6. Growth Outlook: World and Muslim Countries
 Source: Processed by the author based on IMF (2023)

On the other hand, the gap in terms of inflation is quite significant, where the rate in the Middle East-Central Asia and sub-Saharan Africa is a lot higher than in Indonesia and Malaysia (Figure 7). While domestic and external factors play roughly equal roles in Indonesia and Malaysia, inflation in sub-Saharan Africa has been driven much less by domestic activity (with the exception of natural disasters). The sharp increase in global commodity prices, swings in the exchange rates, and the global supply chain disruptions have contributed more significantly to the high rates of inflation. Tightening monetary policy may work to soften price increases, but its overall impact on businesses, especially small ones, could be devastating.

⁴ The GDP of 57 members of the Organisation of Islamic Cooperation (OIC) represents roughly 8% of the world’s total. Note that the groupings made in Figures 5 and 6 have a caveat as they includes some non-Muslim countries in sub-Saharan Africa.

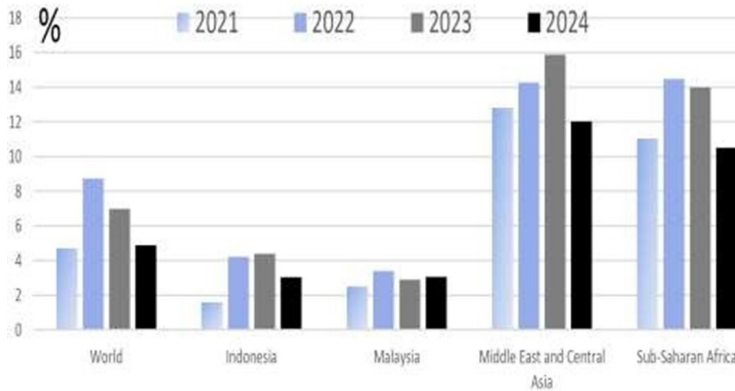


Figure 7. Inflation Outlook: World and Muslim Countries
Source: Processed by the author based on IMF (2023)

From this perspective, and given the on-going GF discussed earlier, the inflation outlook in sub-Saharan Africa is not encouraging, unless the international community help secures the availability of key commodities and energy products. The COVID-19 shock has also worsened the inflation in sub-Saharan Africa, with a rate double than that of the pre-pandemic level. In the Middle East-Central Asia, the exchange rate depreciation and commodity prices have also been the dominant factors causing the high inflation, although the impact is less severe than in sub-Saharan Africa. In most oil-producing countries, the fluctuations in oil prices do not seem to have a meaningful effect on inflation. At any rate, a positive scenario implies that there is no reason for Muslim countries not to have better growth prospects except when the war in the Middle-East is pushed into something uncontrollable.

On the other hand, it is unwise to conjecture that no-recession case, falling oil and energy prices, and subdued volatility in financial market will persist. The downside risks are not only high but also growing. When the Israel-Palestine war began, oil prices were already elevated, raising the probability of supply disruptions. If the trend continues, going beyond control, it can take a toll on the economic activity of energy-importing countries and the global economy in general. Higher energy prices will also further complicate the task of central banks around the world in trying to bring inflation down⁵. While the effects of movements to boycott, divest from, and sanction Israel (known as BDS) to pressure Israel to abide by international

⁵ Note that the tightening of the US monetary policy always raised concerns about spillover effects on EMDE. Although EMDE sometimes raised rates in response to capital outflows or a depreciation of their currency due to such a policy, in recent years the driver of rising rates in EMDE has been the domestic inflationary pressures (see Johannes, Ende-Becker, Sattiraju, 2023).

law and to end its controversial policies toward Palestine are not easy to estimate, they can substantially affect the commerce activities in many countries.

Another downside risk may also come from the financial sector. In addition to the tightening of global liquidity, wars always have negative effects on global risk sentiment. Spread will widen, and currencies are likely under pressure. Then there is a risk that the conflict will spread beyond Gaza and Israel, and the acts of terrorism increase following the war. This could lead to further human tragedy and negative impacts on the economies within and beyond the Middle East. Of course nothing more devastating than the tragic loss of human life and the immense human suffering caused by the war.

6. Final Notes

Narrow economic chains of cause-and-effect have proved difficult to forecast amid built-up vulnerabilities during the '5G' episodes. Wars are much harder to predict. There is no single and easy solution to cope with the ongoing polycrisis. Dealing with the climate change alone is already complex and difficult, even if geopolitical tensions can be softened and the effects of the GF are minimized. The scenarios mapped out in this paper should at least help to frame thinking about the potential paths ahead.

Although at the time of writing this paper the markets look relatively calm, forces behind growing polarization, increased populism, and scepticism about the benefits of globalization remain intact, if not stronger. When juxtaposed with the built-up vulnerabilities discussed in the paper, these forces make it difficult to seek cooperation and organize collective actions to avert the worst outlook scenario of global economy. Recent events including a string of bank failures, escalated tensions between China and the US and Europe, lingering effects of the war in Ukraine and the Middle East, rising number of disasters related to climate change, and a continued tightening of monetary and financial conditions have all heightened the talk of a recession. They make the current relative calmness in financial market an uneasy calm, or calm before storm.

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