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Geo-economic competition: global disruptions from the new frontline

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Geo-economic competition: global disruptions from the new frontline

2014 was filled with geopolitical turmoil that played out across the globe.

We witnessed the emergence of a number of old-fashioned military threats, as well as a notable development. We saw a new frontline emerge between major actors - the global economy, a trend that has been occurring over recent years, but affirmed in 2014. The return of realpolitik and the emergence of the global economy as a platform for competition pose risks that threaten to change global trade dynamics, integration and development, the international rules-based system and business climate.

This shift has been enabled by global economic interdependence, the dominant paradigm for the past 20 years. Economic interdependence has meant that economically powerful actors have the ability to exercise power through various financial means. States are now incentivised to employ economic tools, including sanctions and other punitive measures that can be effective as a means of coercion or punishment. This also includes circumventing the international trade process and creating smaller trading blocks to try and increase their relative power.

KEY POINTS

- Today states are relying less on traditional means of achieving power through weapons build-up and military conflict. They are instead relying more on economic means, where sanctions have become a tool of first resort, together with the increased use of punitive economic measures, the establishment of competing trade regimes and the manipulation of prices.
- The interconnectedness of the global economy means that particular countries have the ability and willingness to implement economic instruments, which in many cases are becoming important functions of foreign and security policy.
- Many political leaders have moved from seeing the opportunities of interdependence to focusing on risks, as they look to protect national producers and supply chains. As risk aversion leads trade and capital to become more regionally-constrained, this could translate into lower equity prices and higher bond spreads.
- We are seeing a trend to a more fragmented international trading system. So called "smaller clubs of trade" are becoming common in the formation of trade agreements. However, given that regionalism leads to a "patchwork effect" across the globe, as well as within some regions - between members and non-members of trade alliances - this can hinder investments and integration, and lead to increased strategic competition.
- As countries increasingly revert to economic measures to reassert their geopolitical power, we witness the rise of global risks associated with geo-economics that influence the way countries interact and businesses operate, affecting both global trade and political cooperation. Ultimately, the effects of geo-economics may undermine key governing institutions inhibiting their ability to deal and address future global challenges.

1 Disrupting the tune: the instruments of geo-economics

Geo-economics is not a new phenomenon. The idea of nation-states deploying economic weapons in international political power games can be traced back through the Cold War's spheres of influence to the era of colonialism and beyond. However, throughout the twentieth century the balance of power among nations was typically viewed through the lens of geopolitics, and it is only recently that geo-economics has become a key paradigm. The difference is that geopolitics focuses on military power, natural resources and demographics as measures of national influence, while geo-economics emphasises factors such as productivity, trade balances and foreign investment.

In recent years, regional or preferential economic integration was the more popular geo-economic strategy. It will not come as a surprise that one of the goals countries have sought to achieve through economic integration was a geopolitical one - to gain relative power by joining forces with others to increase their collective market size and economic opportunities. This is one part of the defining logic of the European Union (EU); and the Pacific Alliance, it is why the ASEAN countries are also seeking to create a unified market by 2015; and it is one of the drivers for current efforts of the United States to pursue discussions on two major free trade and investment agreements – the Transatlantic Trade and Investment Partnership (TTIP) and the Trans-Pacific Partnership (TPP).

Among other geo-economic tools are strategic investments through foreign direct investments in other countries, as well as governments purchasing other governments' debts. Such strategies enable countries to exert geopolitical influence through economic dependency. We have also seen countries revert to measures to control access to economically important national resources in order to strengthen their geopolitical position. These potential ways to leverage power over other countries through economic linkages are increasingly becoming an explicit part of foreign policy thinking.

2 Slowing appetite for a global village

The frame of geo-economics is sometimes used to describe a retreat from the prevailing logic of globalization that characterized the two decades following the fall of the iron curtain: the widespread belief that increasing economic integration would translate into more democracy and stability around the world. Today's unstable geopolitical and conflict strewn environment has raised the risk of maintaining such open economies, which can leave industries and supply chains vulnerable.

During the global financial crisis many countries implemented protectionist policies, predominately in the form of import tariff barriers to protect domestic economic markets and local producers. In the wake of the global financial crisis, despite promises from countries to reduce the number of protective measures, tariffs continue to thwart trade efforts and the integration of the global economy.

Rising protectionism and the failure to remove existing barriers between countries in the ASEAN regional bloc is currently putting the formation of the ASEAN Economic Community (AEC) in danger. Both government and business officials have cautioned that the 2015 deadline may not be reached if countries, cannot commit to this agreement. Indonesia, for instance, has introduced measures to restrict the hiring of foreign workers and foreign investment into the country, going against efforts from other countries in the bloc to deepen economic and political ties.[1]

A recent report from the World Trade Organisation claims this is a similar story in other regions as well. The report found that the number of restrictive trade measures implemented by G-20 economies since 2008 in fact continues to rise. According to the same report, G-20 economies introduced up to 93 trade-restrictive measures between May and October of 2014. The report cites enduring geopolitical tensions, in particular the conflict in Ukraine, as adding to the gloomy outlook for global trade.[2]

Public support for free trade and foreign direct investment has waned across advanced

1 "Asean chiefs fear rising protectionism", Jeremy Grant, September 8, 2014, *Financial Times*

2 "Report on G-20 Trade Measures", November 5, 2014, *WTO*

economies since the financial crisis.[3] Although growing again, global flows of foreign direct investment remain down by more than a quarter on their 2007 peak.[4] This data suggests that many political leaders have moved from seeing the opportunities of inter-dependence to seeing the risks, as they look to protect national producers and supply chains. However, as risk aversion leads trade and capital to become more regionally-constrained, this could translate into lower equity prices and higher bond spreads. Such a trend has alarmed transnational corporations who ranked the rise of trade protectionism among their top concerns in the United Nations' World Investment Prospects Survey 2013-2015.[5]

While globalisation is unlikely to slow down due to continued advancements in technology which continue to bring us closer together, we may experience some degree of turbulence or enter a new phase. However, importantly, in an era when nation states are increasingly preoccupied with their relative power and security, the challenge is to reassert the logic of global economic cooperation: that trade and investment has the ability to draw cultures and politics together, helping to establish conditions for peace and security.

3 The patchwork effect: fragmentation of global trade

There is a growing chorus of concern at other threats to multilateralism. While the General Agreement on Tariffs and Trade (GATT) was one of the most successful instruments in fostering international collaboration, more recently we have seen a trend to a more fragmented international trading system. So called "smaller clubs of trade" are becoming common in the formation of trade agreements.

Countries are bypassing the World Trade Organisation (WTO), where one of its primary functions is to limit national protectionism, and instead trade deals are increasingly being done directly between national governments and involving the private sector. The reason why - countries find directly working with like-minded nations a much quicker process, and at the same time they can create trade rules to best serve their interests.[6] The most extensive of these trade negotiations are the Transatlantic Trade and Investment Partnership (TTIP) and the Trans-Pacific Partnership (TPP).

The proposed TPP region – the US, Canada, Mexico, Australia, Japan, Vietnam and Brunei – would account for about one third of world trade.[7] The TTIP is intended to make it easier for the US and EU to trade goods and services. Significantly, neither includes the BRICS economies — Brazil, Russia, India, China and South Africa.

The AEC, as mentioned above, is also due to come to fruition later this year to create a unified market. This will follow a number of other trade clubs in this region; such as the above mentioned US guided TPP, the ASEAN led Regional Comprehensive Economic Partnership (RCEP). Asia is not the only region fragmented by different trade associations; we also see competing trading groups in Latin America, through the Pacific Alliance, Mercosur and the Andean Community, as well as in Europe; the EU and the Eurasian Economic Union.

This paper is not suggesting that regional trade agreements (RTAs) boost barriers to trade. Despite some skirmishes overall there is more fluid trade, and in many cases, some aspects of RTAs can accompany and complement multilateral rules and agreements. However, given that regionalism leads to a "patchwork effect" across the globe, as well as within some regions - between members and non-members of trade alliances - this can hinder investments, and integration, and lead to increased strategic competition.[8]

A prime example of this is Ukraine. Last year we witnessed Ukraine being torn over its decision to join the EU and the Eurasian Economic Union. In early 2014 President Yanukovych accepted a $15bn lifeline from Vladimir Putin, after abandoning a trade deal with the EU in

3 "Advanced economies take a dim view of globalization, survey finds", September 16, 2014, *Financial Times*

4 "Globalization Is in Retreat? Not So Fast", Eduardo Porter, September 16, 2014, *The New York Times*

5 United Nations World Investment Prospects Survey 2013 -2015, 2013, *United Nations*

6 "WTO failure points to fragmented future for global trade", Tom Miles, August 4, 2014, *Reuters*

7 "Welcome to the geopolitics of trade, where Dr Pangloss meets Machiavelli", Timothy Garton Ash, 10 July 2013, *The Guardian*

8 Regional Trade Agreements, OECD

late 2013.[9] This move sparked the EuroMaidan protests leading to his Governments demise, and prompted clashes that continue to embroil eastern Ukraine between Ukrainian forces and pro-Russian separatists.

This illustrates how the fragmentation of global trade can also have the effect of forcing a country to make a strategic decision with regards to which trade alliance it should join. Considerations can be made along a mixture of ideological, historical, economic and political lines. All of which can further complicate a country's geopolitical surroundings.

4 Playing by the rules

The current geo-economic environment threatens to undermine not only the future prospects of global agreements on trade and investment, but also the international rule-based system. One aspect of both the TPP and TTIP is essentially about trying to balance political relations and in turn alleviate any geopolitical and security dilemmas. The second characteristic concerns the creation of a market that's big enough to be able to continue to set the rules in the global economy.

It is important to mention at this point that both the TPP and TTIP don't include the BRICS economies in their negotiations. While their economies may be currently suffering some setbacks, as a result of the fast-shifting international order and the growing collaboration between these countries, the BRICS are fast becoming an organised political body. One such political entity that many observers believe should be better integrated into current international frameworks.

Given that the trade deals together would cover approximately 75% of the world´s GDP[10] - operating under the current liberal economic order - the US and major Western economies could maintain the ability to control influence over these emerging economies and others. According to this viewpoint, the intention is that China and other developing economies will ultimately have to decide whether they would rather be excluded from this market or agree to meet the standards on for example, complex issues such as agriculture, intellectual property and state owned enterprises.

Perhaps in response to the threat to exclude China and other developing economies in the above trade deals, and to what many see as an outdated system, China together with a number of emerging economies are starting to establish alternatives to the Bretton Woods institutions. These countries are starting to find new ways to cooperate economically. For years they have voiced their frustration over western dominance in global financial institutions and have recently advanced their challenge. Last year, China launched the Asia Infrastructure Investment Bank and we saw the launch of the New Development Bank (NDB) that includes Brazil, Russia, India, South Africa and China. These structures signify the first challenge to the current global economic order since World War Two.

In light of the purported failure of the Bretton Woods institutions, we see countries, in particular emerging economies, disengaging from them and trying to create alternative regimes. The driving force behind this is as much geopolitical as it is economic. However, with the world facing challenges that respect no national borders and require multilateral responses, the effects of geo-economics on institutions of global governance could be to weaken our collective resilience to global risks and challenges. This could hamper the way we resolve conflict, address global terrorism and find a solution to climate change.

5 Risky business

Of course, any approach which proposes an alternative to violent conflict and avoids the spectre of traditional warfare is not wholly regressive. Geo-economics and its array of sanctions and strategic trade policies present such an alternative. Yet its harmful effects are nevertheless substantial, and the message from the business sector is simple; punitive geo-economic measures from governments hinder business significantly and in some cases make businesses impossible.

Geo-economic policies often employed under the auspices of economic coercion, such as sanctions and trade suspension, affect the business and

9 "Ukraine crisis: Timeline", 13 November 2014 , *BBC*

10 Talking Trade with Congressmen Jim Costa and Erik Paulsen: Why TPP and TTIP Advance U.S. Economic and Strategic Interests, Miriam Sapiro, October 3, 2014, *Brookings*

investment climate, with potential knock-on effects on unemployment and social instability. For example, Russia, on the receiving end of EU and US sanctions, had the worst-performing stock market among big markets in 2014[11] and the net profits of Gazprom – which supplies nearly a quarter of the EU's gas – fell 41% in the first quarter.[12] Russia's failure to deal with sanctions led Alexei Kudrin, Former Finance Minister, in late December 2014 to say "we (Russia) have entered or are currently entering a full economic crisis".[13]

Businesses in the countries imposing sanctions are also at risk of detrimental spillover effects. European banks reportedly had exposure of more than €100 billion to loans in Russia and Ukraine.[14] Losses by Western-based multinational corporations exposed to Russia have been put at $35 billion.[15] And while Russia has not yet responded to sanctions by threatening to halt Europe's gas supplies via Ukraine, if it were to do so the effects would be significant, including the UK's Gross Domestic Product (GDP) taking an estimated 1% hit.[16]

So far markets have arguably been surprisingly sanguine about geo-economic risks, with most stock markets riding relatively high despite a news agenda dominated by crises in Ukraine and the Middle East. In part this can be attributed to the reasonably modest economic output of crisis hotspots – the Middle East, North Africa, Russia and Ukraine collectively account for only 7% of global GDP.[17]

In part it also reflects the efforts already taken by multinational corporations to diversify their geographic risks. Knowledge of and agility in supply chains – right back to raw materials, as a significant proportion of supply chain disruptions come from lower tiers – is more and more seen as a competitive advantage. Companies are monitoring geopolitical situations and calibrating the associated geo-economic risks to their supplies and operations.

11 "Why investors are ignoring war, terror and turmoil", Gideon Rachman, September 8, 2014, *Financial Times*

12 "E.U. ratchets up sanctions on Russia, awaits retaliation", Geoffrey Smith , September 11, 2014, *Fortune*

13 "Europe in 2015: A year of insecurity", Gavin Hewitt, 29 December 2014, *BBC*

14 "Raiffeisen Latest Bank to Be Hit by Ukraine Crisis, Shares Dive as Bank Warns on Loss", Nicole Lundeen and Ulrike Dauer, September 23, 2014, *The Wall Street Journal*

15 "Profits in a time of war", Sep 20 2014, *The Economist*

16 "Economic meltdown scenario piles pressure on Russia and the west", Larry Elliot, 22 July, 2014, *The Guardian*

17 "Profits in a time of war", Sep 20 2014, *The Economist*

Nonetheless, there is little room for complacency – especially considering the potential for resurgence in geopolitical tensions over the Diaoyu /senkaku islands in the East China Sea between China and Japan, the world's second- and third-largest economies. In 2010, Japan accused China of halting rare earth mineral exports; in 2012 Chinese protesters launched boycotts of Japanese products.[1] Furthermore, markets continue to be troubled by disputes in the South China Sea largely as a result of territorial disagreements between China and its southern neighbours.

In 2011 China blocked Philippine banana imports in response to the standoff between Manila and Beijing over the Scarborough Shoals, cutting Philippines banana exports by 30%.[2] If historical tensions and a recurrence of territorial disputes in the South China Sea and in the East China Sea were to lead to spiralling geo-economic sanctions, particularly between the two Asian powers, there would be serious implications for global business.

6 Conclusion

The current geopolitical situation is a long way from the prevailing logic of globalisation that characterized the two decades following the fall of the iron curtain. It has shifted from an approach based on the belief that increasing economic integration would ensure greater democracy and stability around the world, to an international environment characterised by the return of realpolitik.

Today states are relying more on economic means to achieve power. Sanctions have become a tool of first resort, together with the increased use of punitive economic measures, as well as the establishment of competing trade regimes and the manipulation of prices. The interconnectedness of the global economy means that particular countries have the ability and willingness to implement economic instruments, which in many cases they are becoming important functions of foreign and security policy.

As countries increasingly revert to economic measures to reassert their geopolitical power, we

1 "China´s Maritime Disputes", *Council on Foreign Relations*

2 "The China-Philippine Banana War", June 6, 2012, *Asia Sentinel*

have seen the rise of global risks associated with geo-economics that influence the way countries interact and businesses operate, effecting both global trade and political cooperation. Furthermore, the effects of geo-economics may ultimately undermine key governing institutions inhibiting their ability to deal and address future global challenges.

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