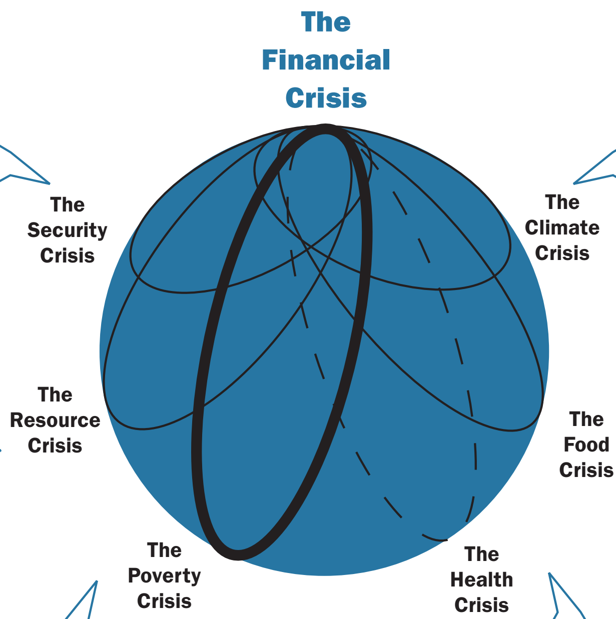
2 A New Economic World Order

The world is currently in the midst of the worst financial crisis since the depression of the 1930s. The long feared economic recession is a reality in the West and is set to continue well into 2009-2010. The stock markets swing from extreme panic to extreme euphoria, but the slump into blood red over the coming months will overshadow the positive news from the markets. The stark economic reality is that we haven't reached the bottom of the financial crisis. At the same time, it can exacerbate more of the other connected global crises, not least global poverty and the climate crisis. Monday Morning's risk analysis shows that the financial crisis is the most complex and most globally far-reaching crisis since the 1930s. It can not be solved at a national level but, at the same time, because decision makers are prepared as never before to countenance major reforms, it could open up a way forward for a global, economic paradigm shift. This is a historic chance to develop a Global New Deal: to create an environment conducive to a more sustainable form of capitalism and a new growth in the real economy. This depends, firstly, on global financial reform consisting of seven main elements to ensure greater openness; better regulation of the financial sector; tougher risk management; and new international institutions.



The finance crisis could provoke geopolitical tensions when the bill for the global economic imbalances and emergency packages have to be paid. The power game between the USA and China. The risk of more regional conflicts caused by poverty, social unrest and problems with payments in several developing countries.

The risk is that politicians will down-prioritize climate change in relation to the financial crisis. The dried up loan market could make it more difficult to secure risk-friendly capital for investment in renewable energy sources. Clean-tech businesses will feel the effect as rapid oil price-falls dampen the motivation for technology change.

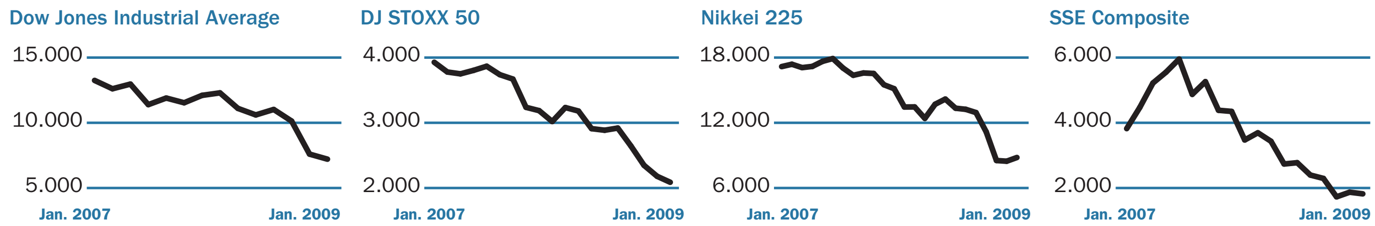
The risk of a strong increase in global unemployment and increased poverty. More debt ridden countries, such as Pakistan, could require more international help if they are to avoid a dramatic increase in social unrest and new conflicts.

Increased risk of bankruptcies among debt-ridden farmers and a period with lower investment could weaken supply of more foodstuffs to a growing world population. The financial crisis could delay a long lasting solution to the food crisis. There is less risk of food prices following raw materials prices down, when global population growth and a more protein-rich diet keep demand up.

Financial crisis and recession have already resulted in rapid price drops for energy and raw materials. The prices will remain low as long as the world's economies are in crisis. Increased risk for social unrest and conflicts in raw material exporting nations.

The finance crisis will hinder investment in improvement of health services in western countries which are already under great pressure due to expectations. Developing countries risk reductions in aid and help programs, and this can weaken efforts to generate clean water, sanitation and the reduction of epidemic diseases.

MM | Fourfold decline



Source: http://finance.yahoo.com

CHAPTER 2

The global financial crisis – the worst since the Great Depression of the 1930s – escalated during the fall of 2008 with a chain of bank failures, and a meltdown of stock markets worldwide. The clear-up of the financial markets, which has already cost billions of dollars, could well take many more years. And more of the largest western economies will be dragged down into an economic recession as the side effects spread quickly around the globe: growing unemployment, increasing poverty, foreclosures and significant house price falls. But the crisis also bodes ill for the beginning of a comprehensive economic paradigm shift.

This deep crisis has awakened political decision makers to the fact that there is a need for a major reform of the global financial markets. This era, which had its origins in the early 1980s with the new conservative laissez-faire ideology and the extensive liberalization of the financial markets has, for the time being, run its course. A new generation of ambitious financial and economic reforms from the USA, Europe and Asia are on the way. The world's economy must wave goodbye to the flood of cheap credit which characterized the late 1990s and the early part of the 21st century, and define a new development model founded on moderation, caution and tighter risk control. The extreme leverage of financial institutions in recent years will give way to more prudent, traditional norms. New balances need to be found between market and political regulation in order to create a new foundation for stable growth.

The market finds itself at a historic crossroads. The decisions taken in the next few years will affect economic conditions for many generations to come. The crisis contains a range of other major crises in the next few years, but it also opens up numerous new possibilities for long term renewal.

Monday Morning's risk analysis shows that:

- THE CRISIS IS GLOBAL. There has never previously been a financial crisis in which the consequences have affected all the markets so quickly and violently.

- THE CRISIS IS DIFFICULT TO SHORE UP. When the entire international financial system is hit, the problem is no longer sector-specific. The financial system binds all other sectors together across international borders.

- THE CRISIS IS OPAQUE IN NATURE. The lack of transparency has been a primary driving force behind the crisis. The global derivatives market, which has an annual turnover on paper of over 600,000 billion dollars, has been a source of intensified and increased unrest. The crisis has quite simply lacked an overview of where and with whom the ultimate liability lies.

- THE CRISIS HAS SERIOUS IMPLICATIONS FOR THE REAL ECONOMY. Increasing unemployment and falling incomes in businesses create more problems in the lending markets, losses and bankruptcies, which comes back to the banks and affects the credit market negatively.

- THE CRISIS CAN NOT BE SOLVED ON A NATIONAL LEVEL. Even the largest emergency packages in history from the governments of the USA, Great Britain, Germany and other countries, have been too small to contain the crisis. Global markets need globally coordinated measures.

Major Risks

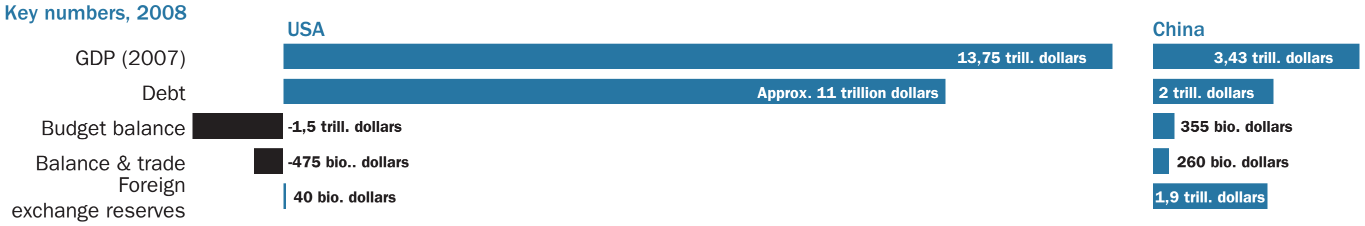
Before the crisis can be solved, the world faces a period of great economic risks. First and foremost there will be an extended period of panic swings in the stock markets and widespread fear in the money markets, where the banks won't dare to lend to each other and, in particular, will reduce loans by thousands of billions of dollars. The phasing out of a historically large debt burden in the private and businesses sectors in the USA and Europe will bring many bankruptcies in its wake. The coming year, businesses must brace themselves for markedly higher costs on the enormous amounts of debt, or crack under the weight.

The USA, which next year will have a national debt of over 11,000 billion dollars and a public budget deficit that will soon hit 12 per cent of GDP, has ceded a large part of its independence to China and the oil producing states, which have surpluses and lending capital. The crisis can pave the way for a change in the global balance of power.

The major national emergency packages create in themselves new risks in the form of increased public borrowing which, ultimately, can spread doubt about the creditworthiness of entire nations.

In the long term there is a major risk of a massive fall in the value of the dollar; currency unrest; and increased political tension

MM | The economic shift in power accelerates



Source: IMF World Economic Outlook 2008, www.Safe.gov.cn, www.ustreas.gov/.

A NEW ECONOMIC WORLD ORDER

concerning trade.

The economic recession in western countries could extend in to 2010 if the financial system is not brought under control early in 2009 and investors aren't prepared once again to back businesses and new projects. If the economic downturn goes on longer, it will create increased pressure on unemployment in many countries. This could lead to social unrest in both rich and poor countries. History has shown that crises can provoke powerful political frustrations. It will take a great deal of skill for political leaders to navigate a course through the many pitfalls of the financial crisis. Politically, the greatest risk would be a return to 1930s-style trade protectionism; state interventionism at the highest level; economic nationalism and authoritarian ideologies.

The financial crisis can also exacerbate more of the other connected global crises. If politicians and businesses avoid the necessary investments in energy saving and clean technologies in order to address the short term economic pressures it could worsen the climate crisis. It could make it difficult for the world's poorest countries to attract foreign investment and donor money and so generate new poverty in Africa. It has already lead to marked falls in energy and raw material costs, and not least the food exporters from developing countries will find it difficult to deal with the sudden change. This can prompt new political and social conflicts.

Thorough Reform

The financial crisis has been caused by a number of fundamental imbalances in the world economy, as well as catastrophically bad risk management and warning systems. This has also placed a question mark besides a long list of the fundamental elements of global financial capitalism which were let loose on the markets in the early 1980s. With sophisticated financial instruments and new derivatives the financial institutions found themselves operating with very high gearing, and private householders in Western countries were tempted to convert equity into overspending, while the debt grew and grew. Bank directors received lucrative stock options which encouraged them to take even greater risks, and a wave of greed undermined social morality. More wanted more, but it was also too much. Historically high overspending and the debt-financed growth model in some countries, such as the USA, Great Britain and Denmark, resulted in private debt increasing to over 100 per cent of GDP. The business world's debt burden exploded too, as many felt that the era of cheap credit would go on forever. The financial crisis is testimony to the fact that the bubble could not last forever, and that the classic economic truth – that the bill will have to be paid – had returned with some force.

Monday Morning's risk assessment indicates at least seven areas in which there clearly is a need for change.

- TIGHT MONETARY POLICY. The central banks and finance industries, particularly in the USA, Japan and Europe, have increased the money supply considerably. Combined with interest rates below underlying inflation rates, this created asset bubbles which can set off financial recklessness and breakdown. A marked relaxation of monetary policy is a short term crisis measure that increases the risk of an inflation spiral. Therefore, monetary policy must be gradually tightened at the same pace as the crisis subsides.

- CURRENCY BALANCE. The global imbalances were stoked by American overspending and dramatically undervalued Asian currencies. All major export nations have a balance of trade surplus with America, which could in time undermine the dollar's position. There is a need for a new balance betweeen major currencies.

- OPENNESS AND CONFIDENCE. Today the banks are not obliged to make their risk profiles public or account for their exposure in high risk derivatives, which breeds uncertainty in a crisis-hit market. The international bank and finance sector must be reformed so that uniform and shared rules are agreed upon to ensure openness regarding bookkeeping values. Knowledge about who has debt liability must be publicly available. These are the preconditions for increased confidence in the market.

- THE SPREAD OF RISK. High risk loans and investments must be separated from traditional banking business. The banks that handle systematic and important functions in the ordinary economy – house loans, business loans, export credit guarantees etc. – must demand tighter capital guarantees, so that they do not allow too hard loan gearing. Anti-trust legislation which breaks some of the largest banks up into smaller units could be necessary in order to spread the systemat-

THE THREE DILEMMAS OF BAILOUTS

- **Large debt burden.** Together with unlimited loan facilities to financial institutions, the bank rescue plans create pressure on national budgets. Guaranteeing the institutions' debt is problematic because several of the largest institutions in many countries bear greater liabilities than the GDP of the countries that are guaranteeing them. In the worst scenario countries such as Iceland are, in this instance, completely unable to guarantee the debt. From Eastern Europe to Argentina and Pakistan, countries risk ending up in the same situation. The negative consequences of taking over the loan commitments will be serious – for overseas creditors as well. Both the USA's rescue of Long Term Capital Management in the 1980s, and the Swedish banking sector's reconstruction in the 1990s demonstrated this. The problem is simply that, this time, there is no talk about one off or regional bank crises, but a global systemic crisis involving banks around the world.

ic risk in case of new bank failures.

- RISK ANALYSIS. The risk analyses of the dominant credit rating agencies have shown themselves to be wholly inadequate. They don't just have the economic incentive to price the risk too low, but in some instances are themselves participants in the market. The system must be reformed, and the authorities must at the same time ensure reliable and independent advice is given to private investors.

- REGULATION OF STRUCTURED PRODUCTS. The surreally vast market for derivatives and other structured investment products is almost completely unregulated. In theory, derivatives are considered to be a kind of insurance instrument. But as major US investor, Warren Buffett, has said, it is also a kind of 'weapon of mass destruction' with the potential to bring about worldwide financial meltdown. Derivatives must be supported by better regulation and an open clearing house for derivative trading must be established.

- NEW GLOBAL LEADERSHIP. Neither the G7/G8 nor the UN Security Council are representative of the global economy or balance of power any more. These bodies have little if any legitimacy beyond the West, and new economic powers, such as China, India and Russia, should be invited as permanent members. The World Bank and the International Monetary Fund (IMF) have been discredited having played anonymous or secondary roles during the financial crisis. There is a need for a rethink of the Bretton-Woods system, which had its origins in the aftermath of WWII. The International Monetary Fund and World Bank must be reformed so that they can contribute to ensuring global financial and economic stability. Permanent solutions require new institutions with wide ranging legitimacy.

Global New Deal

It may well take many years to reform the financial system. The process towards a new system of regulation will be gradual, and it takes time to formulate rules that can apply across international borders. The Basel II agreements alone, which on paper placed high demands on the finance sector, took nine years to negotiate and implement – and it was already apparent by the autumn of 2008 that the rules were simply insufficient. This time there is no time to wait nine years. Reform must happen much more quickly if confidence in the global banking system is to be re-established. There is much to indicate that it is not enough merely to regulate the financial market more and stuff more taxpayers' money in the banks. There is also a real need to ward off the real economic consequences of the financial crisis, which spread with great speed to businesses, households and supermarkets, and will affect other global crises concerning poverty, food, health, safety and climate.

During a period of transition there will be a need to increase public investment in infrastructure, and pump demand out into society to get the economy back on its feet again. This can help counter the risk of a marked increase in unemployment on a global level. But there are different ways to spend the money. The world's decision makers must make a fundamental choice between an 'Old Deal' and a global 'New Deal'.

The classic Keynesian solution, the national 'Old Deal', relies on major investment in infrastructure and state-lead stimulus plans to maintain growth for growth's sake. The more visionary alternative is a Global New Deal, which doesn't just generate more growth, but more intelligent growth. Such an alternative paves the way for an economic paradigm shift toward more sustainable capitalism.

There is not just a need for a well functioning and more open financial market, financial institutions should also contribute to promoting investment in the development of a more sustainable capitalism, which specifically aims to promote growth in businesses, technologies and solutions which, again, can reduce the effect of the seven connected crises. One example is investment in energy saving, new energy-efficient technologies and renewable energy sources. This is one of the world's major potential high growth areas. In the USA alone millions of new jobs could be created while at the same time reducing energy waste, pollution and dependence on fossil fuels. As well as this, in the building industry, which will otherwise have to brace itself for the most extreme difficulties in the coming year, there are enormous earnings opportunities and a large number of jobs to be created in optimizing the energy usage of existing buildings.

In the USA and Europe a proportion of the transport infrastructure is suffering from years of wear and delayed investment. Essential public investments have to be considered from an en-

- **Moral hazard.** The concept of “moral hazard” implies that governmental help creates expectations that similar assistance will be forthcoming in the future. This stimulates the finance sector to take risks. Similarly, the ‘too big to fail’ argument encourages financial institutions to generate such large claims that their bankruptcy will have too dramatic consequences for the government to allow them to collapse. In the same way aggressive interest cuts, such as the wholesale ones undertaken by the US Federal Reserve at the end of the 1990s and after the dot-com-crash, led to a property bubble on the back of cheap credit.
- **Lacking justice.** Ordinary people don’t get a bail-out when they declare bankruptcy. Banks and investors earned spectacularly during the bubble period and their losses which occurred as a result of their own flawed characters, esoteric products and apparent irresponsible dealings is now underwritten by the tax payers. There is, therefore, a risk of a social and political backlash if the rescue package is not understood as ‘just’.

vironmental perspective at an earlier juncture. If increasing public investments do not contribute to minimizing the climate crisis, there is the risk that we will experience new and stronger economic crises in the future.

Innovation More Important Than Ever

Innovation and new thinking are vital to ensure new growth. Western economies can no longer be sustained by loan financed consumption which, at the end of the day, people do not have the means for. And the developing countries will find that for some time access to both investment capital and markets will fall.

The winners in this period of change will be the businesses and countries which focus on innovation and investment in intelligent growth at an early point. In the process it is important to rebuild a well functioning financial market and find capital-rich participants who can play a lead role in a new partnership to realize the goals of a Global New Deal. The potential candidates include investment funds, state funds and pension funds which have been sidelined in the capital markets for some time. Therefore they have large sums of money to invest at the first sign of stability. It is important to get these money reserves activated in solving the financial crisis and the other connected global crises.

The problems in the finance sector can, at best, inspire new solutions and systems. Several experts have, for example, emphasized the need for more stable markets for house loans, and here the Danish mortgage credit system has been praised internationally as a best practice model that other countries could follow. As a result, the phenomenon of interest free loans would gradually be phased out as products of the era of cheap credit.

In the coming year, debt ridden businesses will look to consolidate, and more will consider financial restructuring and mergers in order to put the crises behind them. It is to be expected that new financial institutions will gradually emerge in the wake of the crisis. Major banks will meet competition from new, small and innovative players, who will be able to offer micro-loans via the Internet thanks to vastly reduced administration costs.

Banks, such as Grameen Bank, that offer cheaper loans to those as the bottom of the global economic pyramid, will find new markets opening up, including in the USA and Western Europe.

One of the most important conditions for the creation of new growth from below is the development of a new class of entrepreneurs, innovative talents and smart leaders. Developing countries – in particular in Asia – will be a powerful driving force, and the demand for know-how, technology and management tools will be enormous in both China and India. It is not unthinkable that Western countries have reached their limits in terms of their domestic service economies’ expansion and will experience generally lower growth rates in the coming years. Therefore there is great potential in increasing investment in populous countries and regions which, with minimal investment, have a greater scope for growth from a lower start point. Ensuring a quicker transformation towards moderate wealth in the developing countries, along with more investment in climate solutions in the West, could be the quickest and most reliable way to sustainable growth on a global level.