
Special Report

Manning the barricades

Who's at risk as deepening economic distress foments social unrest

March 2009

Economist Intelligence Unit
26 Red Lion Square
London WC1R 4HQ
United Kingdom

The Economist Intelligence Unit

The Economist Intelligence Unit is a specialist publisher serving companies establishing and managing operations across national borders. For 60 years it has been a source of information on business developments, economic and political trends, government regulations and corporate practice worldwide.

The Economist Intelligence Unit delivers its information in four ways: through its digital portfolio, where the latest analysis is updated daily; through printed subscription products ranging from newsletters to annual reference works; through research reports; and by organising seminars and presentations. The firm is a member of The Economist Group.

London

The Economist Intelligence Unit
26 Red Lion Square
London
WC1R 4HQ
United Kingdom
Tel: (44.20) 7576 8000
Fax: (44.20) 7576 8500
E-mail: london@eiu.com

New York

The Economist Intelligence Unit
The Economist Building
111 West 57th Street
New York
NY 10019, US
Tel: (1.212) 554 0600
Fax: (1.212) 586 0248
E-mail: newyork@eiu.com

Hong Kong

The Economist Intelligence Unit
60/F, Central Plaza
18 Harbour Road
Wanchai
Hong Kong
Tel: (852) 2585 3888
Fax: (852) 2802 7638
E-mail: hongkong@eiu.com

Website: www.eiu.com

Electronic delivery

This publication can be viewed by subscribing online at www.store.eiu.com.

Reports are also available in various other electronic formats, such as CD-ROM, Lotus Notes, online databases and as direct feeds to corporate intranets. For further information, please contact your nearest Economist Intelligence Unit office.

Copyright

© 2009 The Economist Intelligence Unit Limited. All rights reserved. Neither this publication nor any part of it may be reproduced, stored in a retrieval system, or transmitted in any form or by any means, electronic, mechanical, photocopying, recording or otherwise, without the prior permission of The Economist Intelligence Unit Limited.

All information in this report is verified to the best of the author's and the publisher's ability. However, the Economist Intelligence Unit does not accept responsibility for any loss arising from reliance on it.

ISSN 0269-7106

Symbols for tables

"n/a" means not available; "--" means not applicable

Contents

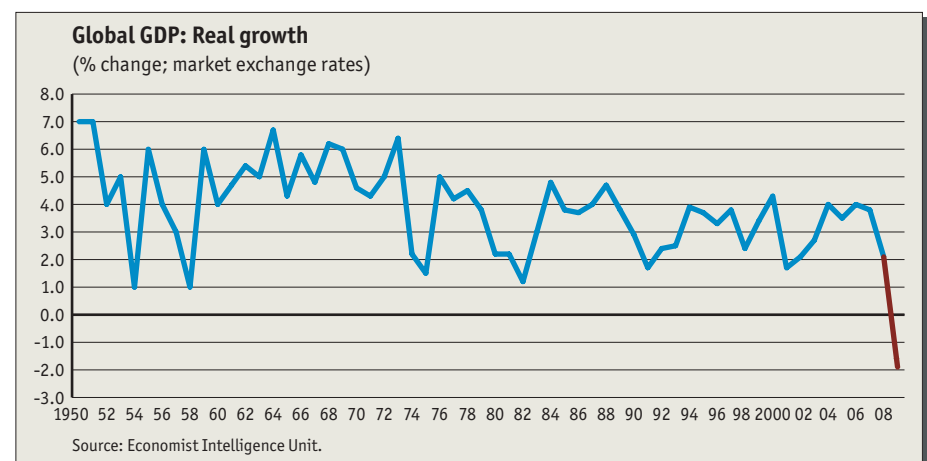
- 2 **Introduction: Banks, busts and batons**
- 5 **After the crunch: Statement of scenarios**
- 6 **Deflation and depression in the developed world**
- 10 **Submerging markets**
- 13 **Alternative risk scenario: Dollar collapse**
- 15 **Political Instability Index**
- 17 **Governments under pressure**
- 27 **Beyond unrest**

Introduction: Banks, busts and batons

The credit crunch is dragging down the global economy and raising political tensions

Collapsing credit has plunged the world economy into the deepest recession in more than 70 years. What began as a property bubble in the US has spread rapidly as troubled banks have stopped lending and consumers and businesses have stopped spending. As demand in the US and Europe evaporates, once-thriving emerging markets are losing their best customers and biggest investors. An increasingly synchronised global economy will contract in 2009 for the first time since World War II.

Eighteen months after it began, this economic chain reaction—from banks to markets to consumers to companies—is entering a new phase. Economic pain, reflected in millions of lost jobs and destroyed savings, has entered the political realm, causing some governments to collapse and threatening others. The risk of political instability is leading to a wave of trade protectionism, which is rippling across the globe. It was just such a political response in the 1930s, exemplified by America's infamous Smoot-Hawley tariffs, that deepened and prolonged the Great Depression.



Economic woe raises risk of political backlash

This special report is the third by the Economist Intelligence Unit since the credit crisis erupted in August 2007. In the first report, we looked at the implications of a financial meltdown on the global economy. In the second, we considered the wider economic effects, including the risk of a 1990s, Japan-style collapse in the US. This time we focus on the political fallout from the crisis. To sharpen that analysis, we have created a new social unrest index that identifies where the risks are greatest. We have paired that with a new set of scenarios that chart possible paths for the global economy.

The political risks from the economic crisis are increasingly dire. Dennis Blair, America's new intelligence chief, says political turmoil from the global recession has replaced terrorism as the country's biggest security threat. Ferenc

Gyurcsany, Hungary's prime minister, warns that an economic collapse in eastern Europe could tear apart the European Union and create a new Iron Curtain. Further east, the slowdown in China's economy and the lack of political freedom is creating fertile ground for social turmoil. Millions of migrant Chinese factory workers who returned to the countryside for the lunar New Year holiday earlier this year had no jobs to return to.

The political response to the crisis—economic nationalism—is taking many forms. Barack Obama's US\$787bn fiscal stimulus plan included "Buy America" provisions, though watered down from earlier versions. China has reinstated export subsidies, and countries from India and Indonesia to Ukraine and Russia have raised import restrictions in some fashion. The US bailed out its carmakers, opening the way for financial assistance to car companies in the UK, China, Brazil and in most of the major euro zone countries. As banks wobble, governments are pressing to keep bail-out funds at home, and to encourage lending only in domestic markets. Although there is a certain political logic to all this, it will deepen the already pernicious effects of the recession on trade and capital flows. We expect global trade to contract by 3.5% this year, and net private-sector capital flows to developing countries are likely to fall to US\$165bn from more than US\$900bn in 2007, according to the Institute for International Finance. Indeed, the vast interdependence of the world economy—through trade, investment, financial markets, supply chains and commodity flows—means that any protectionist shift will be particularly damaging.

The World Trade Organisation (WTO) provides some insurance against a dramatic return to trade protection; few countries will risk the opprobrium of raising their tariffs prohibitively, and most understand the dangers of doing so. But there is still much opportunity for mischief. Actual tariffs in many countries are below WTO ceilings, leaving plenty of room to increase them. Pascal Lamy, the WTO's chief, warns that if all of the organisation's members raised their tariffs to permitted levels, import duties worldwide would double. Many countries, operating loosely within international rules, will impose unjustified anti-dumping duties on imports. Exchange-rate policy will become a battleground: Timothy Geithner, the US's Treasury secretary, has already accused China of currency manipulation.

Fifty million may be thrown out of work

Job losses are at the heart of the growing political crisis. The International Labour Organisation expects global unemployment to rise by around 30m this year compared with 2007, and by as much as 50m if the world economy turns desperately downward. In the US alone, more than 2.5m jobs were lost in the four months from November 2008 to February this year. Unemployment is being driven, in part, by a collapse in industrial production, which has fallen by more than 10% year on year in most countries. Japan's exports plunged by a shocking 46% in January this year and its economy by more than 12% in the fourth quarter of 2008, at an annual rate. Service industries are shedding jobs just as quickly. Few employers, apart from government, are hiring.

Dreadful as this is, there are signs of global co-operation. Central bankers and finance ministries have worked together in recent months to co-ordinate interest rate cuts and reduce borrowing spreads in money markets. Currency

swaps have been arranged to ease liquidity strains. A meeting of the G20 leading economies is set for April 2nd, an opportunity to redouble efforts at global co-operation and reject trade protectionism. How well this works will depend largely on the example set by the US and the EU. Mr Obama's early policymaking, sadly, has had a populist tinge.

Mr Obama, in fact, should be the focal point of global efforts to confront the crisis. The US's new president pledged to restore the country's international reputation, to repair damaged friendships and to consult widely on matters of global importance. Mr Obama will have no better opportunity to prove himself than in the economic policy example he sets. He can let the sores of protectionism fester—which his own stimulus bill exposed—or he can lead an effort to co-ordinate fiscal pump-priming, encourage monetary co-operation and, most important, keep trade and investment channels open. If he chooses a more inward course, spurring a new round of beggar-thy-neighbour policies, the recession of 2009 may become the social explosion of 2010.

After the crunch

If things feel bad now, how much worse could they get?

In line with our previous risk reports (*Heading for the Rocks* and *Shooting the Rapids*), we have identified three macroeconomic scenarios for the evolution of the crisis that began in the US sub-prime mortgage market and is now reverberating throughout the world economy.

Scenario 1: Our central forecast (60% probability)

Government stimulus stabilises the global financial system and restores economic growth in leading developed markets during 2010, albeit at lower levels than in recent years. This scenario underpins our regular analysis and is not the subject of this report.

Scenario 2: The main risk scenario (30% probability)

Stimulus fails, leading to continued asset price deflation and sustained contraction in the leading economies—a depression persisting for some years. The stubborn decline in global economic activity is punctuated by occasional rallies that are taken as signs of recovery, but these quickly fade as the underlying downward trend reasserts itself. The prominent role of governments in propping up banks and reviving domestic demand leads to strong political pressure for protectionism, effectively putting the process of globalisation into reverse.

Scenario 3: The alternative risk scenario (10% probability)

Failing confidence in the dollar leads to its collapse, and the search for alternative safe-havens proves fruitless.

Economic upheaval sharply raises the risk of social unrest and violent protest. A Political Instability Index covering 165 countries, developed for this report, highlights the countries particularly vulnerable to political instability as a result of economic distress. The results of the index are displayed in map form and in a ranking table in the centre pages, along with a brief methodology.

The political implications of the economic downturn, informed by the results of the Social and Political Unrest Index, are discussed at length in the second half of the report.

The full report, in both PDF and HTML format, is available online at www.eiu.com/special. The microsite includes a full methodology for the Political Instability Index, a complete ranking of results including a comparison with the results for 2007, and a large-format version of the map.

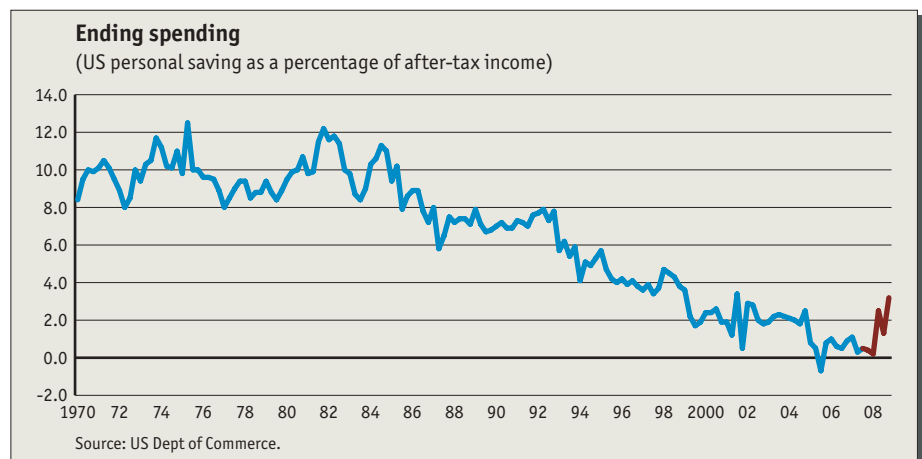
Deflation and depression in the OECD

As good assets are sold to cover losses on the bad, deflation sets in and the slump deepens

In our main risk scenario (30% probability), the global economy endures a multi-year depression characterised by bankruptcies and job losses. In a vicious cycle of debt deflation, the burden of debt rises in real terms as collateral declines in value and incomes contract. As bad debts pile up, banks' balance sheets are further weakened, resulting in forced asset sales. These drive down prices further. Like banks and financial institutions, households and companies are engaged in a process of deleveraging in which they dispose of assets in order to pay down debt.

Under this scenario we assume the major developed economies grow by just half to one percent on average over the next five years—effective stagnation. Even when growth resumes, it does so at too low a level to make inroads into high levels of unemployment.

In aggregate, non-OECD countries see growth averaging between 1% and 4% over the five years from 2009 to 2013. Export-oriented emerging markets suffer from a prolonged downturn in global trade. Even China would struggle to sustain growth rates above 5% in the period.



The rebuilding of balance sheets implies a sustained rise in savings rates, which fell to record low levels in the US and other highly indebted economies during the credit boom. The counterpart is lower consumption and investment on the part of households and firms respectively. Reduced consumption and investment entail destruction of productive capacity on a large scale.

No shortage of false dawns

Within the depression, there are episodes when economic activity shows signs of recovery, sometimes in response to stimulus measures. Equity markets and other risky asset classes rally. But these recoveries resemble the upturns in

double-dip recessions. They eventually fade and asset prices give up their gains and make new lows.

Policy initiatives prove ultimately ineffective

The depression runs its course despite the best efforts of policymakers to engineer a recovery through large fiscal stimulus packages and easy monetary policy (this scenario assumes US, euro zone and Japanese policy rates remain in effect at zero over the forecast period). The latter encompasses the adoption of heterodox measures such as quantitative easing, in which central banks purchase corporate securities, and in some cases government bonds, in order to increase the money supply, combat deflation and boost the price of risk assets. Banks are supported by continued injections of public money and by regulatory forbearance.

The ineffectiveness of policy reflects errors in both design and implementation. The task of policymakers is all the harder because they are navigating uncharted waters. Sometimes their goals are inappropriate: for example, trying to encourage overindebted consumers to borrow or to keep householders in houses that are beyond their means. Their actions are often subject to political pressures, for example in relation to state support for strategic industries, such as the automotive industry. And political pressures prevent governments from taking the bold measures needed to address the technical insolvency of large parts of the Western banking system, which would include outright nationalisation, massive injections of public funds and losses for bondholders.

The scale and duration of the credit boom that ended in August 2007 makes implementing corrective policy more difficult. The credit boom encouraged inefficient allocation of capital and left some asset prices far above long-run trends. As deflation takes hold, overvaluation is corrected by declines in nominal prices. The reduction in the value of collateral exacerbates insolvency in the household, corporate and financial sector. Eventually prices overshoot on the downside, below long-run trends, as asset valuations become downright cheap. Government attempts to support asset prices, such as through schemes to provide mortgage relief or the purchase of corporate debt, make matters worse by hindering the adjustment of prices to market-clearing levels.

Government intervention in the economy increases

As governments attempt to cushion society against the impact of recession and stimulate recovery, the role of the public sector expands at the expense of the private sector. This shift is reflected in large structural fiscal deficits and rising public debt burdens. Thus even what may have started as a well-designed fiscal stimulus has the effect of crowding out the private sector for the foreseeable future. All the more so in the case of fiscal packages poorly designed or subject to pork-barrel politics in their passage through legislatures.

Countries that have nationalised a large part of their financial system experience a particularly sharp increase in the public debt stock. Although the change in the net public debt position (taking account of the assets of banks taken into public ownership) is less marked than the change in gross debt, concerns about the creditworthiness of such sovereigns exert upward pressure

on their bond yields. This, in turn, pushes up yields on other securities such as corporate bonds, increasing the cost of borrowing for the private sector.

Shrinking finance

The financial services industry, which reached outsized proportions during the boom, shrinks. Much of the banking system operates under the control of governments, subject to political pressure in terms of lending decisions, including the prioritisation of domestic over foreign lending (financial nationalism). In response to pressure for banks to maintain high capital adequacy ratios, they scale back risky activities, such as proprietary trading. The shadow banking system—a source of the leverage and maturity mismatches that caused the crisis—withers. This is part of a broader trend of declining transactions in capital markets. Securitisation survives but volumes are much diminished compared with the boom years. This leaves a gap in credit markets that bank lending is unable to fill. Banks anyway are reluctant to lend to heavily indebted households and companies. As a greater part of banks' activities resemble those of regulated utilities, their operating profitability and return on equity declines—whether they are in public or private ownership.

Alternative asset classes such as hedge funds and private equity, which grew rapidly during the boom, struggle to adapt to the harsh economic conditions and the lack of cheap debt and leverage. Redemptions reduce assets under management by hedge funds following the industry's failure to live up to the pledge to generate absolute returns. A small number of survivors thrive amid less competition and increased volatility in financial markets. The overleveraged private equity deals undertaken at the height of the credit boom fail. Exit strategies for successful deals are hindered by low equity valuations. Faced with losses, investors lose interest in the sector. The survivors are those that truly improve their portfolio companies' operating performance, rather than depending on cheap debt and leverage to generate returns.

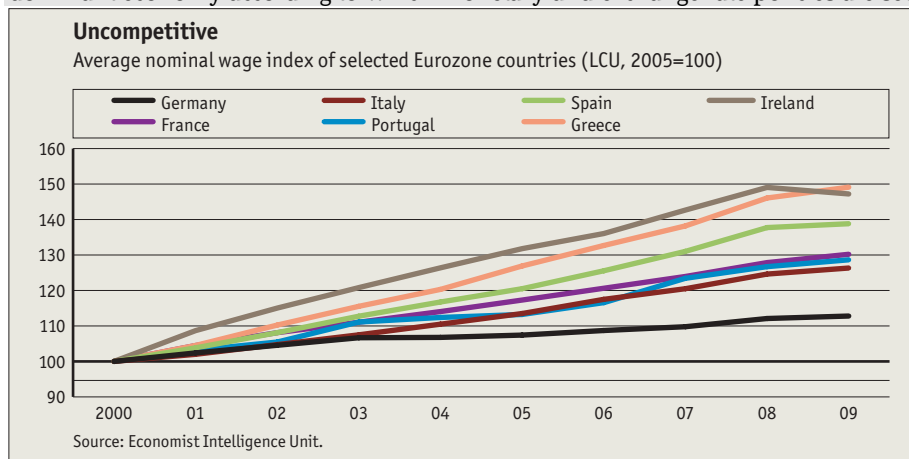
It is not only the heavily indebted who suffer

The debt deflation cycle is already a global phenomenon, encompassing most of the developed and developing world. Heavily indebted economies that experienced housing bubbles, such as the US and the UK, Spain and Ireland, are particularly vulnerable to deleveraging and asset price declines, and all the more so under our main risk scenario. But they are not alone in suffering the consequences. One lesson from the crisis is the extent to which globalisation has increased interdependency. Thus economies that at first sight may have appeared well placed owing to adequate savings rates and trade and current-account surpluses suffer most acutely from the collapse in global demand and trade. Large exporters such as Germany, Japan and China fall into this category.

The globalised nature of finance also creates problems in unexpected places. During the credit boom, banks facing subdued growth in their domestic markets had often ventured into more risky areas. Thus German and Swiss banks are being weakened by write-downs on US mortgage-backed securities, while Austrian banks are hit by high exposure to eastern Europe, and this intensifies under our main risk scenario. As such risky assets are written down, banks' capital constraints curtail the availability of credit in their domestic markets.

The euro zone's toughest test

In the developed world, stresses are most acute within the euro zone because of the constraints imposed on individual member states by a uniform monetary and exchange-rate policy. The stresses are twofold: doubts about the sustainability of the public finances in heavily indebted countries; and a lack of competitiveness in countries whose labour costs have outstripped those of Germany, the euro zone's dominant economy according to which monetary and exchange rate policies are set.



Depending on the depth and duration of the slump, there is a material risk of euro zone sovereign defaults and of one or more euro zone countries exiting the single currency under duress. Given the scale of financial havoc that such events would wreak and the fact that they would call into question the whole European political project, the Economist Intelligence Unit's 30% risk scenario assumes that the EU eventually takes measures that prevent these outcomes, despite their unpopularity in most member states. Such measures include joint bond issues by euro zone governments, the transfer of fiscal resources from strong to weak member states, and quantitative easing in which the European Central Bank (ECB) directly buys the sovereign bonds of financially weak member states.

Repeated cycles of competitive devaluations

While devaluation does not rescue countries from weak global demand, it does provide help at the margin, as well as alleviating deflationary pressures. Consequently, under our main risk scenario, governments are happy to see their currencies devalue provided it does not have adverse consequences for solvency of borrowers. This results in repeated cycles of competitive devaluations. There are periodic calls for co-ordinated action to stabilise foreign-exchange markets, although agreement proves elusive.

Under this scenario the US dollar proves stronger than US policymakers would like as investors continue to view the US currency as a haven of sorts.

As the process of deleveraging runs its course and flows of capital repatriation into the US wane, markets live with the risk of a collapse of the world's reserve currency in light of the combination of quantitative easing, massive fiscal deficits and a still large, albeit diminished, current-account deficit. The US authorities welcome a halt to the dollar's rally, while the lack of viable alternatives mitigates the risk of a flight from US assets.

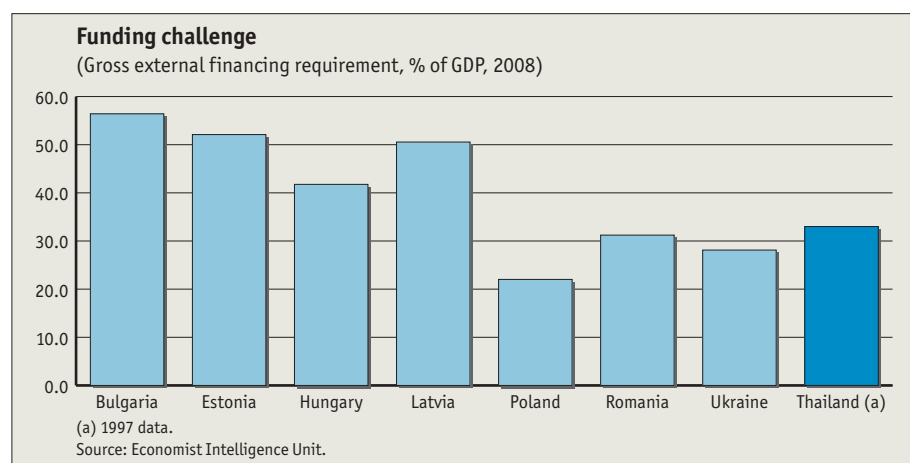
Submerging markets

There is no escape from the economic gloom—even for developing markets once vaunted as "decoupled"

Far from decoupling, emerging markets reveal how intimately they are linked to economic conditions in the developed world. The following types of vulnerability in emerging markets are exposed:

- category 1: countries where growth was driven by credit expansion and asset price appreciation;
- category 2: countries geared to global growth;
- category 3: countries with a commodity dependence.

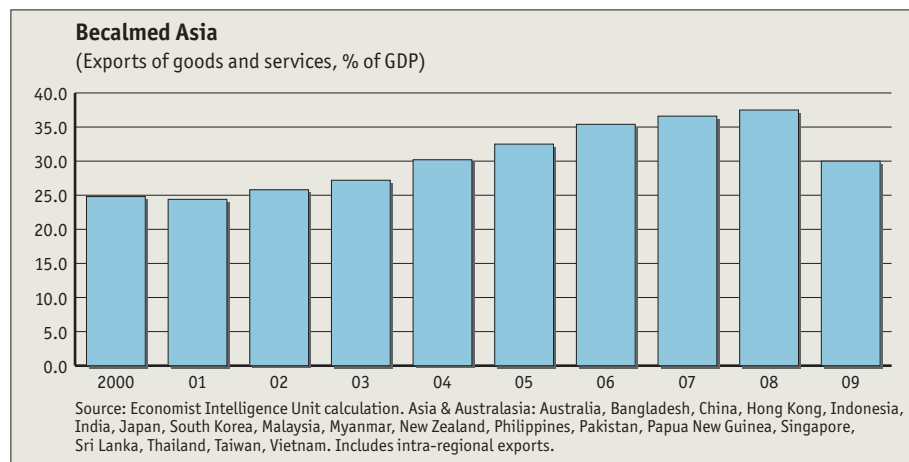
Few emerging markets do not fall into one or more of these categories. Those most acutely affected are in category 1, including many central and east European countries, which were running large current-account deficits and face large external debt repayments. Category 2 encompasses much of Asia, given its dependence upon export-led growth. Category 3 takes in Latin America, the Middle East, Africa and Russia.



The Economist Intelligence Unit's main risk scenario sees several central and east European countries (Hungary, the Baltic states, Bulgaria and Romania) receive financial assistance packages from the IMF and the EU. This assistance is necessary as west European banks, the source of much of the lending during the boom, rein in their crossborder exposure in an effort to rebuild their capital adequacy. Although large in relation to GDP, official financial assistance does not prevent downward pressure on currencies. In countries with floating exchange rates, such as Hungary, depreciation exacerbates solvency problems for borrowers with foreign-currency exposure. Countries operating currency boards (such as the Baltics and Bulgaria) face a protracted period of deflation as

a means to restore competitiveness. This creates social and political tensions which eventually result in one of the currency boards being abandoned.

Policymakers attempt to engineer a controlled devaluation but the process becomes disorderly and the currency suffers a large devaluation, leading to widespread defaults. Once this occurs, the days of the region's other currency boards are numbered.



Asia's export-led growth model comes under stress as Western consumers save more and consume less. Protectionism adds to the difficulties of Asian companies in sustaining sales in foreign markets. Over time, the decline in export markets has a severe impact on the solvency of Asian companies and banks. Asia's reputation as a safe haven because of its high saving and investment rates is reassessed. China comes under scrutiny, a country upon which much hope was invested at the onset of the crisis as a driver of recovery for the global economy.

China's aggressive stimulus measures, targeting housing and infrastructure, fail to compensate for the slump suffered by its export-oriented factories. Measures to stimulate private consumption by improving healthcare and pension provision are too timid. China's imbalances persist, a source of broader imbalances in the global economy. A surge in bank lending in response to government pressure results in inefficient capital allocation, the creation of more spare capacity and a rise in non-performing loans. Eventually China's banks, like those of their neighbours, require government support to restore capital adequacy.

Emerging-market commodity producers face a prolonged period of weak prices in response to a structural decline in global commodity demand. Oil (dated Brent) falls persistently below US\$20 per barrel. The adverse terms of trade shock leads to financial stress (devaluation, default) in commodity producers that mismanaged the bonanza, such as Venezuela and Ecuador. But even more prudently run economies, which saved part of the windfall and invested in productive capacity, have to retrench. The cushions provided by stabilisation funds are run down. Sovereign wealth funds diminish in importance as they register sustained declines in the value of their holdings.

As the developing world experiences a slump, which in some countries is even more pronounced than that in the West, the long-term emerging-market growth story, epitomised by the BRICs, is reappraised. A good deal of emerging-market outperformance during the boom is attributed to cyclical rather than structural factors. Investor sentiment sours. Net bank lending to emerging markets becomes negative and portfolio investment continues to flow out. Foreign direct investment holds up somewhat better, but even this is constrained by the overhang of excess capacity globally and by a creeping protectionism that forms part of a broader process whereby globalisation is reversed.

De-globalisation

A multi-year depression will see the frontiers of globalisation rolled back. Political leaders in most—if not all—countries will continue to pay lip service to open markets. But the market failures exposed by the financial crisis will call into question some of the tenets of the free-market capitalism underlying globalisation.

Globalisation will be blamed for job losses and falling living standards, just as it was blamed for the income and wealth disparities that opened up in the past two decades, even though the ultimate cause for these may lie more in technological advances and failures of corporate governance and regulation.

Trade, investment and labour protectionism

Governments will respond with protectionist measures in a number of forms. The destruction of excess capacity globally will encourage dumping, which will be used to justify increases in trade tariffs and quotas. In some cases, governments may find it expedient to renegotiate the terms of regional or bilateral free-trade agreements.

In a world of excess capacity where competition for new investment is intense, governments will be tempted to impose restrictions on companies planning overseas investments. High unemployment and social unrest will make labour immigration an even more contentious political issue.

The shrinkage of the financial services industry will curtail crossborder capital flows. Banks that have received public funding will be under pressure to prioritise domestic lending. More generally, the availability of crossborder capital will be constrained in a climate of risk aversion and more onerous capital adequacy requirements.

The days of the freewheeling corporation at the cutting edge of globalisation will be over. When not barred from doing so by protectionism, companies will continue to seek new markets and to achieve cost reductions from offshoring production. But a deep cyclical downturn in emerging markets will lead to a more sober reassessment of their medium- and long-term growth potential. Large emerging-market corporations will face particular challenges given the preponderance of companies in cyclical industries. Emerging-market corporate default rates are likely to exceed those of their developed counterparts. Aggressive overseas expansion plans hatched by emerging-market companies during the boom years will be scaled back.

Alternative risk scenario: Dollar collapse

What happens when the financial hurricane destroys the world's safe-haven currency?

The current financial and economic crisis was caused by decisions that contributed to the build-up of large economic imbalances—most importantly, in the US current account. Under our alternative risk scenario, the external imbalance is corrected through sharp currency movements; the dollar depreciates to US\$2:€1 for a sustained period, overshooting temporarily to an even weaker level. The depreciation occurs relatively quickly, in a period of less than a year.

Even under our main scenario, gross US federal government debt rises from US\$9trn (66% of GDP) in fiscal year 2006/07 (October-September) to US\$14trn (104% of GDP) in fiscal 2009/10, including the cost of support measures well beyond the US\$700bn of the Troubled Asset Relief Program. The alternative scenario sees debt surge higher still, as economic growth remains weak and financial sector rescue efforts fail.

A successive series of expensive fiscal stimulus packages scares holders of US treasuries and other assets affected by the US fiscal position. Although the US avoids default, the country's sovereign credit rating comes under increasing pressure, the more so as the administration fails to deal with long-term fiscal challenges such as Social Security and Medicare. Spooked investors leave the US for other assets, sinking the dollar on their way out.

The sharp exchange-rate depreciation finally achieves a normalisation of the current-account balance, with a move to a much lower deficit. But the process is painful. The slide in the dollar makes imports substantially more expensive, suppressing demand for foreign cars and other goods. Americans substitute domestically produced goods, reducing imports. Where there is no full domestic substitute, purchasing power suffers and consumption declines.

The increased competitiveness of US goods abroad strengthens exports, and the net effect is the desired rebalancing of the US economy away from domestic demand towards exports. But this restructuring, involving a shift from old to new industries, takes time and produces sharp friction in the labour market.

Unlike most countries, the US has few liabilities in foreign currencies, so sharp depreciation has only a modest impact on the country's ability to service its debt. Foreign holders of US liabilities, however, and the countries against whose currencies the dollar depreciates, are hit.

As the dollar collapses, safe havens are hard to find

The economic environment offers few currencies to which investors can turn when selling the US dollar; risks in most emerging markets remain much higher than in the US. Even the appeal of Switzerland as a safe haven is weakened because of the huge exposure of its banking sector to the financial crisis and the pressure on the credit rating of the Swiss federation, and because of its own

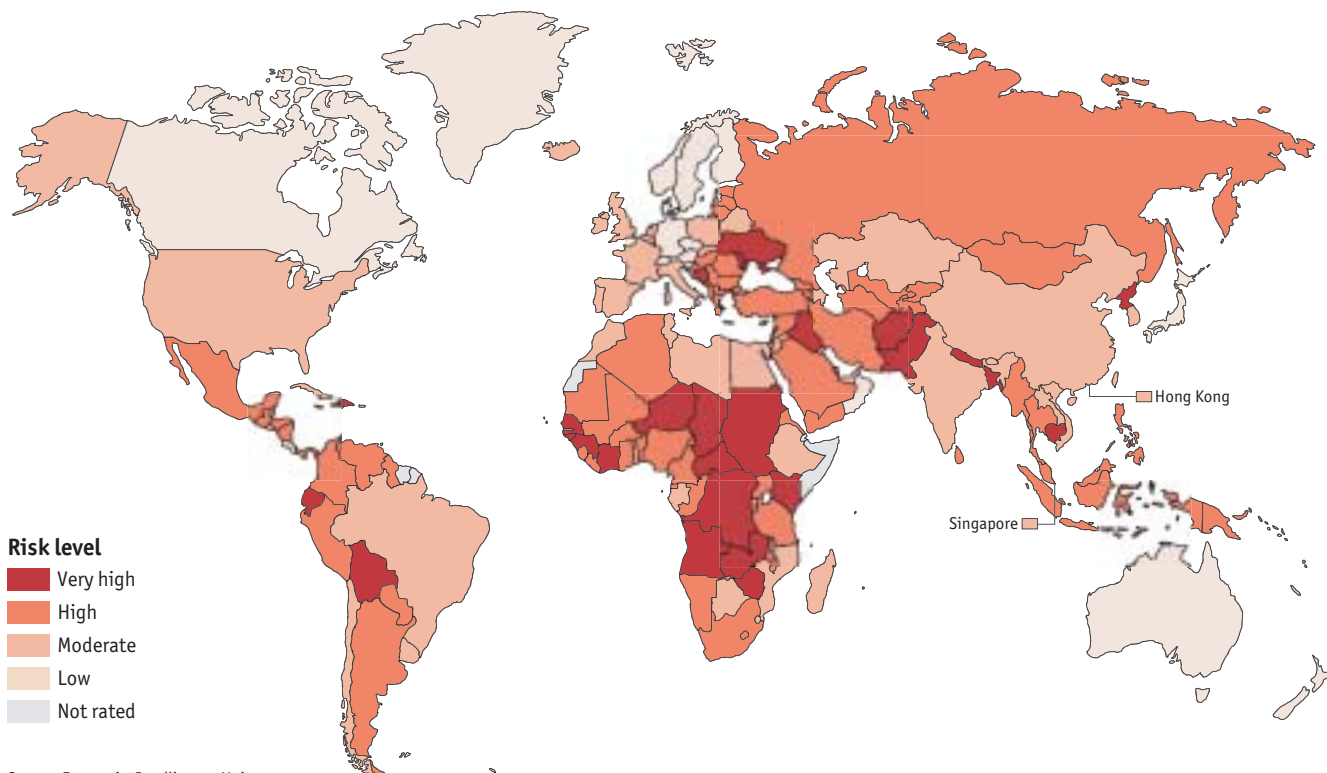
aggressive monetary easing policy. The British pound's credibility is shattered by the domestic financial crisis.

The euro area is hit by concerns about possible break-up and by the global crisis, possibly including default by a member state, such as Greece. Nevertheless, it is the most likely destination for funds flowing out of the US. (The Chinese yuan, considered an alternative in some quarters, is rejected because of China's constraints on the free movement of capital). The resulting appreciation of the euro has the opposite effect to the US depreciation: domestically produced goods are replaced by imported ones, while the competitiveness of exports shrinks.

Europe's relatively inflexible economic structure means structural adjustment involves even more problems in the labour market, and political complaints rise sharply, adding to strains on the cohesion of the single currency area.

In many emerging markets, governments intervene to dampen currency appreciation against the US dollar. This further hits the euro, forcing it up not only against the dollar but also against the main emerging-market currencies. Meanwhile, the emerging markets themselves suffer from excessively loose monetary conditions as a result of these interventions, with the resulting problems of excessive investment and inflation persisting for some years to come.

Political Instability Index



Political Instability Index: Vulnerability to social and political unrest

We define social and political unrest or upheaval as those events or developments that pose a serious extra-parliamentary or extra-institutional threat to governments or the existing political order. The events will almost invariably be accompanied by some violence as well as public disorder. These need not necessarily succeed in toppling a government or regime. Even unsuccessful episodes result in turmoil and serious disruption.

Political Instability Index

The overall index on a scale of 0 (no vulnerability) to 10 (highest vulnerability) has two component indexes—an index of underlying vulnerability and an economic distress index. The overall index is a simple average (on a 1-10 scale) of the two component indexes. There are 15 indicators in all—12 for the underlying and 3 for the economic distress index.

Underlying vulnerability indicators are: inequality; state history; corruption; ethnic fragmentation; trust in institutions; status of minorities; history of political instability; proclivity to labour unrest; level of social provision; a country's neighbourhood; regime type (full democracy, "flawed" democracy, hybrid or authoritarian); and the interaction of regime type with political factionalism.

Economic distress indicators are: growth in incomes; unemployment; and level of income per head.

A full explanation of the methodology, with sources and references, can be found at www.eiu.com/special.

Rank	Country	Index score	Rank	Country	Index score	Rank	Country	Index score	Rank	Country	Index score	
1	Zimbabwe	8.8	38	Thailand	7	82	Lithuania	6.1	124	Belarus	4.8	
2	Chad	8.5	43	Lesotho	7	82	Saudi Arabia	6.1	124	China	4.8	
3	Congo Kinshasa	8.2	43	Nigeria	7	82	Mongolia	6.1	124	Kazakhstan	4.8	
4	Cambodia	8	43	Mali	7	86	Bulgaria	6	127	Botswana	4.7	
4	Sudan	8	46	Burkina Faso	6.9	86	Jamaica	6	127	Swaziland	4.7	
6	Iraq	7.9	46	Burundi	6.9	88	Benin	5.9	127	Trinidad and Tobago	4.7	
7	Cote d'Ivoire	7.8	46	Cameroon	6.9	88	Ghana	5.9	130	Malta	4.7	
7	Haiti	7.8	46	Papua New Guinea	6.9	88	Nicaragua	5.9	130	Singapore	4.7	
7	Pakistan	7.8	46	Mauritania	6.9	88	Tanzania	5.9	132	Ireland	4.6	
7	Zambia	7.8	51	Honduras	6.8	92	Namibia	5.8	132	UK	4.6	
7	Afghanistan	7.8	51	Indonesia	6.8	93	Armenia	5.8	134	Tunisia	4.6	
Central African												
7	Republic	7.8	53	Philippines	6.8	93	Syria	5.8	135	India	4.5	
13	North Korea	7.7	54	Turkey	6.8	95	Malawi	5.7	136	Poland	4.5	
14	Bolivia	7.7	55	Eritrea	6.7	95	Mozambique	5.7	137	Libya	4.3	
14	Ecuador	7.7	55	Estonia	6.7	97	Morocco	5.6	137	Sao Tome & Principe	4.3	
16	Angola	7.6	55	Gambia	6.7	98	Bahrain	5.5	139	Taiwan	4.3	
16	Dominican Republic	7.6	55	Latvia	6.7	98	Cape Verde	5.5	139	Vietnam	4.3	
16	Ukraine	7.6	59	Guyana	6.7	98	Israel	5.5	141	Cuba	4.2	
19	Bangladesh	7.5	60	Algeria	6.6	98	Kuwait	5.5	142	Cyprus	4.1	
19	Guinea	7.5	60	Guatemala	6.6	98	Slovakia	5.5	142	Qatar	4.1	
19	Kenya	7.5	60	Macedonia	6.6	103	Spain	5.5	142	Seychelles	4.1	
19	Moldova	7.5	63	Malaysia	6.5	104	Brazil	5.4	142	UAE	4.1	
19	Senegal	7.5	63	Uganda	6.5	105	Egypt	5.4	146	Belgium	4	
19	Guinea Bissau	7.5	65	Russia	6.5	105	Jordan	5.4	146	Hong Kong	4	
19	Nepal	7.5	66	Paraguay	6.4	107	Togo	5.3	146	Netherlands	4	
19	Niger	7.5	66	Romania	6.4	107	Bhutan	5.3	149	Oman	3.9	
Bosnia and												
27	Hercegovina	7.5	66	Serbia	6.4	109	France	5.3	150	Germany	3.8	
28	Liberia	7.4	66	Montenegro	6.4	109	Iceland	5.3	150	Japan	3.8	
29	Venezuela	7.3	70	Greece	6.3	109	USA	5.3	150	Slovenia	3.8	
29	Timor Leste	7.3	70	Uzbekistan	6.3	112	Azerbaijan	5.2	153	Czech Rep	3.7	
31	Sri Lanka	7.3	72	Congo (Brazzaville)	6.3	112	El Salvador	5.2	154	Australia	3.6	
32	Sierra Leone	7.2	72	Georgia	6.3	114	Uruguay	5.2	154	Austria	3.6	
33	Argentina	7.1	74	Albania	6.2	115	Gabon	5.1	154	Luxembourg	3.6	
33	Kyrgyz Republic	7.1	74	Belize	6.2	116	Chile	5.1	154	New Zealand	3.6	
33	Myanmar	7.1	74	Iran	6.2	116	Ethiopia	5.1	158	Costa Rica	3.5	
33	Panama	7.1	74	Turkmenistan	6.2	116	Laos	5.1	158	Mauritius	3.5	
33	Tajikistan	7.1	78	Croatia	6.1	116	South Korea	5.1	160	Switzerland	3.4	
38	Colombia	7	78	Equatorial Guinea	6.1	120	Italy	5	161	Finland	3.2	
38	Lebanon	7	78	Mexico	6.1	121	Rwanda	4.9	161	Sweden	3.2	
38	Peru	7	78	Yemen	6.1	122	Madagascar	4.9	163	Canada	2.8	
38	South Africa	7	82	Hungary	6.1	123	Portugal	4.8	164	Denmark	2.2	
										165	Norway	1.2

Governments under pressure

How sustained economic upheaval could put political regimes at risk

Popular anger around the world is growing as a result of rising unemployment, pay cuts and freezes, bail-outs for banks, and falls in house prices and the value of savings and pension funds. The extent and speed with which the global crisis has intensified, with much of the global economy slowing dramatically in the final quarter of 2008, has been a major shock.

The global economic crisis is already having a severe social impact in many countries, primarily in the form of rising unemployment. Many emerging markets are especially exposed as the crisis increases the number of people in poverty and reduces the size of the middle class. As people lose confidence in the ability of governments to restore stability, protests look increasingly likely. A spate of incidents in recent months shows that the global economic downturn is already having political repercussions. This is being seen as a harbinger of worse to come. There is growing concern about a possible global pandemic of unrest.

Warnings of dire social unrest are coming with increasing frequency from the highest sources. One of the most striking and closely argued came on February 12th in testimony before the US Senate by Admiral Dennis C. Blair, the new director of national intelligence. He declared: "The primary near-term security concern of the United States is the global economic crisis and its geopolitical implications... The longer it takes for the recovery to begin, the greater the likelihood of serious damage to US strategic interests."

Does this amount to more than political hype? International agencies and others are suspected of magnifying risks to help secure international funding for rescue efforts (and for their respective organisations). In the US, Republican critics have pointed out that Admiral Blair's warnings dovetail nicely with the Obama administration's domestic agenda of pushing through and gaining support for a massive stimulus package.

It is also true that politics today has little in common with the passions and conflicts that shaped people's commitments and hatreds in the 20th century, with the clash between ardent advocates of socialism and fervent defenders of the free market largely consigned to the past.

Some are reassured that, so far, most protest has not targeted mainstream—or even governing—parties. For example, opinion polls in Europe show little sign of voters flocking to far-left parties or the populist right. Europe's political centre has held steady, and possibly even gained in strength in some countries. However, it is early days; in the initial phase of a major crisis voters tend to rally around their existing leaders.

Threat posed by social unrest is real and substantial

The Economist Intelligence Unit believes that the threat of unrest is grave, and that the risk of complacency far outweighs any risk of exaggerating the dangers.

In this case, the implications under our different macroeconomic scenarios are only of degree. Our central forecast includes a high risk of regime-threatening social unrest; our main risk scenario more so.

Indeed, in two important respects the prevalent warnings tend, often unwittingly, to underplay the threat. First, few observers take into account the sheer number of countries that are now at a significant risk of political instability and, second, they underplay the extent to which the risk extends to rich, established democracies. Many still think that the threats are largely confined to the world's poor and "failed states". The suggestion that disturbances in the developed West could shake the foundations of these societies is broadly dismissed. Iceland is seen as an exception, and warnings of a repetition of the social pressures that transformed Western politics in the 1930s are seen as far-fetched.

There are at least four sets of factors suggesting that the threat of widespread political unrest is substantial.

- **The depth and nature of the economic crisis** Sharp income falls are expected in many countries in 2009, with all the attendant repercussions, including increased poverty and unemployment. The sheer depth of the downturn is important. Clearly, it is the most serious since the 1930s and could yet match that period. It is global and synchronised as never before. In an integrated global economy, shrinking demand in the developed world is feeding quickly through the supply chain, leading to job losses worldwide. Our Political Instability Index suggests that it is the interplay of acute economic distress with underlying—previously often dormant—structural vulnerability to instability that has pushed a large number of countries into the high risk category.
- **A very personalised crisis** This is a very specific crisis of capitalism that is linked to the avoidable near-collapse of the financial system. It is not seen as a "normal recession", a product of impersonal social forces that are difficult to identify. Instead, there are identifiable culprits. The ineptitude and greed on display are fuelling a deep anger, which in certain circumstances could lead to a popular explosion.
- **Underlying anxiety** There is a suspicion that things are even worse than officials are saying, and this may fuel unrest. The anxiety is fed by the seeming powerlessness of authorities to stem the crisis.
- **The contagion factor** Just as the economic crisis has proved to be global in ways not seen before, so local incidents have a potential to spark unrest not only in neighbouring areas but even further afield, especially in view of the almost instantaneous nature of modern communications. The riots that erupted in the first half of 2008 in response to rising food prices illustrated the power of contagion and speed with which economically related violence can spread. Riots occurred in Cameroon, Egypt, Ethiopia, Haiti, India, Indonesia, Côte d'Ivoire and Senegal. The riots only abated when falling energy costs brought food prices down as well.

Forms of unrest In many cases upheavals, even when violent, are likely to remain localised and disorganised enough that government forces will be able to bring them under control. However, unrest does not have to result in the overthrow of a government or large-scale prolonged violence to be damaging and disruptive. In Greece, a weak government managed to survive a week of violent rioting in Athens and other cities in December 2008. Nevertheless, the damage was enormous, estimated at more than US\$1bn, and this does not take into account the full impact on business confidence and possible fallout for the country's political system.

So far, only two governments have fallen as a result of the crisis and associated unrest (in Iceland and Latvia), and it can be argued that this may not even be undesirable—although bringing down governments through extra-parliamentary action is hardly consistent with a sound democracy—particularly if accompanied by violence. However, as the economic crisis worsens, some incidents will transform into far more intense and long-lasting events: armed rebellions, military coups, civil conflicts and perhaps even wars between states.

**Political Instability Index
pinpoints the most vulnerable
countries**

To assess the degree to which countries are vulnerable to unrest, we draw on our Political Instability Index, specially constructed to accompany this report. The index evaluates the vulnerability of states to social or political unrest, which we define as those events or developments that pose a serious extra-parliamentary or extra-institutional threat to governments or the existing political order. The events will almost invariably be accompanied by some violence as well as public disorder. These events need not necessarily be successful in the sense that they end up toppling a government or regime. As already argued, even unsuccessful episodes (such as recently in Greece) result in turmoil and serious disruption.

The Political Instability Index is based on 15 social, political and economic indicators. The model has two sub-indexes. The first, **underlying vulnerability**, is measured by 12 indicators. These include indicators of inequality, state strength and governance, levels of social provision, of proclivity to labour unrest, ethnic fragmentation, regime type, public trust in political institutions, neighbourhood effects and history of unrest. The second, **economic distress**, takes into account levels of development, growth in GDP per head and unemployment.

Of the 165 countries covered by the index, 95 are in the very high risk or high risk group, with 27 in the former and 68 in the latter. For 53 countries, the risk of instability is rated as moderate—which is by no means a clean bill of health—and only 17 countries, almost all highly developed states, are rated as low risk.

Because of the sharp increase in economic distress, the situation has changed fundamentally compared with the recent past. In 2007, according to the model, only 35 states (just over one-third of the current number) were rated as being at very high or high risk of instability.

Back-testing the index

The 2007 assessment can be compared to the incidence of actual outbreaks of instability around that time. To do so, we use an index of actual unrest compiled by the Banks Cross-National Political Times Series Data Archive. This is an index based on a weighted number of demonstrations, coups, assassinations, riots and government crises. The weights are determined by the perceived relative importance of these events (thus coups receive a much higher weight than, for example, the number of anti-government demonstrations). This is supplemented by data on upheavals from the Global Report on conflict and state fragility by Mason University. Of the 33 identified major instability cases, 23 were in countries that we rate as being at high or very high risk of instability in 2007—a very respectable 70% hit rate. Alternatively, of the 35 countries rated as very high or high risk, 12 did not suffer from significant instability during this period, an implied 66% success rate in identification. Ten countries that suffered instability were in our lower-risk groups, that is 10 out of 130, which is only 8% of the total number of countries.

If we assume the same hit rates apply for 2009, some 65 countries out of the 95 identified as being at significant risk will experience serious instability (neglecting in this crude calculation the difference between the very high risk and high risk countries). In other words, there is a two-thirds chance that a country in this group will suffer unrest. Out of the 67 countries not in our high risk groups, only five (8%) are likely to suffer unrest. That is, there is a less than 10% chance that a country in this group could have serious political instability (this is an average for the whole group, with the moderate risk countries having an appreciably higher chance of unrest than the low risk countries, although still far lower than the countries in the high risk groups).

Many of the members of the group seen as being the highest risk in 2009-10 will not surprise. These include countries like Afghanistan, Zimbabwe, Chad, Sudan and Pakistan, which are in a state of almost permanent conflict or upheaval. Other members of the group may be less obvious. Of the 27, 13 are from Sub-Saharan Africa—historically, Sub-Saharan African countries make up about one-half of the number of instances of serious political instability.

There are six Asian countries, four from Latin America and three from eastern Europe. There is only one Middle Eastern country in the very high risk group (Iraq). This is only surprising until one remembers that authoritarian states, which proliferate in the Middle East, are historically even less at risk of instability than fully democratic states (as noted, the intermediate regimes are most at risk). Among developed states, a fairly large number are rated as having a moderate risk of unrest, whereas until recently almost all would have been rated as low risk. The US is not considered free of risk. It has significant problems with minorities and social provision is low relative to levels of development.

China and Iran, two countries often singled out as being at considerable risk of social unrest, are not in the high risk category. Poor countries feature prominently among the countries at the highest risk, although this category also includes some medium-income countries. There is little doubt that poverty contributes to upheaval and violence; for example, researchers at the University

of California have calculated that a 5% decline in national income in African countries increases the risk of civil conflict in the following year by 30%.

China's legacy of protest

China does not figure prominently on our social unrest index, yet the risk of widespread political protest is a hot topic. This is true for foreign investors and political analysts, but particularly so for the Chinese authorities themselves.

The Communist leadership's success in abiding by a long-standing compact with the citizenry, who pledge quiescence as long as living standards continue to rise, has replaced ideology as the main pillar of the administration's legitimacy. Economic backsliding might see China's masses withdraw their support and challenge the leadership in the streets.

The chaos engulfing the former Soviet Union after the fall of the Berlin Wall in 1989 was a stark lesson to China's Communists, and one they will take any steps to avoid—as the killing of political protestors in Beijing's Tiananmen Square the same year demonstrated.

But the government does not need to look so far afield for examples of people power. Chinese history is dotted with popular uprisings that forced leaders to change course or leave office.

It was popular protest that, in 1912, brought centuries of imperial rule to a sudden end, forcing the last Qing emperor, Pu Yi, to abdicate, and leading to China's first republic. This dictatorial successor, in turn, came under attack from popular forces in a second revolution two years later. Although the regime prevailed, and subsequently assumed the imperial form it had overthrown, it was short-lived: in 1916 rebellion once again forced an emperor—this time both the first and last of his dynasty—to step down.

Events on May 4th 1919, in which riots broke out against officials' acceptance of clauses in the Treaty of Versailles granting former German-occupied territories in China to Japan, marked a decisive shift in power away from the traditional elites that achieved its starkest expression with the victory of Mao Tse Tung's Communist rebels in 1949.

China has been the domain of the Communist party ever since, but social forces have played a leading role in the direction of government nonetheless. Sometimes, the leadership has sought to shape and channel popular energy, as with the Great Leap Forward and the Cultural Revolution; sometimes it has used its overwhelming strength and influence to crush nascent popular movements, as in Tiananmen Square.

Ultimately, having established itself as a government of the people, it is reliant on popular acceptance to wield power, garnered through the promise of economic betterment once ideology had lost its charm. Although a collapse in Chinese economic activity of the extent and duration needed to foment irresistible public opposition remains unlikely even under our main risk scenario, the prospect cannot be ignored when popular discontent can be expressed to the power of 1.3bn.

Mature democracies of western Europe, and even EU cohesion, may be threatened

In western Europe, there have been strikes or large-scale protests in Greece, Iceland, Ireland, France, Germany and the UK. So far, only one of the region's governments has fallen: that of Iceland. The prime minister, Geir Haarde, resigned on January 26th after protests, some of which had turned violent. He was the first leader anywhere to fall as a direct result of the crisis. There is a fear

that Europe may be only at the beginning of a far more serious cycle of instability. The region's democracies, as well as the institutions of the EU itself, could come under threat.

In Greece, there was a week of heavy rioting in December 2008, initially sparked by the police killing of a youth in Athens. The government has so far hung on. In France, which has a tradition of unrest, up to 2.5m protesters took to the streets on January 29th, but the strike failed to paralyse the country and support from private-sector workers was limited. Guadeloupe, a region of France and part of the EU, was brought to a standstill in February by a general strike over high prices for food. France's union federations were set to hold a day of action on March 19th.

The UK has been among the worst-hit developed countries by the global downturn and the majority of the population fears a deep and long recession and the onset of mass unemployment. Popular discontent and anger are likely to rise, and populist sentiments to strengthen. The news of big personal payouts to bankers who have failed spectacularly has incensed public opinion.

Somewhat surprisingly given the UK's traditions, according to a February 2009 poll for *Prospect* magazine, 37% of respondents (more than 50% among older age groups) predicted that "there will be serious social unrest in British cities" requiring the army to restore order. As in other countries, anti-immigrant sentiment could also intensify. In early 2009, British workers held a series of protests against the employment of foreign workers on critical energy sites. The mood of the country is also revealed by the results of a recent FT/Harris survey that showed that almost 80% of British adults believe that immigrants should be asked to leave the country if they do not have a job. A majority also oppose the right of other EU citizens to work in the UK.

In southern Europe, Greece, Cyprus and Turkey are rated as high risk. Turkey looks vulnerable as a flawed democracy, with substantial ethnic fragmentation and an unstable neighbourhood.

Most west European countries are at low risk (although France, Belgium, the Netherlands, Malta, Ireland, Italy, Spain and UK are assessed as being at moderate risk). Spain has received several million immigrants in the last 15 years. Unemployment is rising more rapidly than in any other large EU country, particular among immigrants. There are now signs that this is causing racial tensions to intensify.

Initially, there was hope that the crisis would result in deeper EU integration rather than pose a threat of disintegration. However, the crisis is not only straining political structures within European countries, but also relations among them and their shared institutions. The EU's main pillars and achievements are all under strain—the single market, the common currency, and enlargement and convergence between west and east. There have been protectionist measures and strains on the euro system. The EU could become a target now of resentment in some countries, as it is viewed as an overweening bureaucratic structure that pressures countries to agree to policies not in the nation's best interests.

Eastern Europe's infant democracies are vulnerable in the downturn

There are three east European countries among the 27 that are at very high risk: Ukraine, Moldova, and Bosnia and Hercegovina. Their inclusion in the very high risk cluster is unsurprising. Another 18 countries are in the high risk group—all the Balkans (apart from Bosnia, which is very high risk), the Baltic states and several other Commonwealth of Independent States (CIS) countries. Only seven countries from the region are in the moderate or low risk groups.

Many countries in eastern Europe have characteristics that are associated with vulnerability to political upheaval: new and inexperienced states and bureaucracies; a history of unrest; regimes that are neither full democracies nor autocracies—the most prone to unrest; very high levels of popular dissatisfaction; and low levels of trust in political institutions. Some suffer from ethnic fragmentation (this feature does not, of course, make unrest certain, but indicates a proclivity—especially if accompanied by other factors) and discrimination against minorities; and factional politics (one of the main predictors of unrest according to the political science literature).

And just about all countries in the region have been hit hard by the economic crisis. Unemployment is rising in many countries that already have chronically high levels and most countries in the region are likely to experience a reduction—in some cases, severe—in GDP per head this year.

Ukraine is rated as most at risk in the region. The country has been hit extremely hard by the crisis. Its real GDP is set to plummet by more than 10% this year. The metal and chemical industries that drive the country's economy have stalled; unemployment is on the rise. In recent weeks, a variety of groups have come out in protest. The largest was a crowd of 10,000 demonstrating against the Kiev local authorities. A recent survey revealed that 41% of Ukrainians are ready to go to the streets.

Cities have had days without heat or water because they cannot pay their bills. The currency has been under extreme pressure and a debt default seems possible. The sudden, violent protests that have erupted elsewhere in eastern Europe seem imminent here now, too. There is rising popular anger about the crisis and resentment towards a government that is preoccupied with internal squabbling. Instability in a small country like Latvia is one thing, but a collapse in a large and strategically located country like Ukraine, neighbouring Russia, could have seismic repercussions.

In the CIS, Tajikistan and the Kyrgyz Republic are under serious threat. The sharp fall in remittances is causing severe economic distress in Tajikistan. Such funds account for almost one-half of the country's income. The president, Emomali Rakhmon, may be facing his greatest challenge since the civil war of 1992-97.

Russia is experiencing a severe downturn and the country has attributes that characterise high-risk countries (inequality, low public trust in institutions, high corruption and past history of instability). If the crisis intensifies, serious disturbances cannot be ruled out. The growing dissatisfaction with the economy and the government's response to the crisis does not appear yet to

have affected significantly the popular standing of the prime minister, Vladimir Putin, or the president, Dmitry Medvedev. Given the lack of a credible opposition, it seems doubtful that the rise in social discontent could threaten the leadership—Boris Yeltsin managed to survive politically through the crisis in 1998 despite a much weaker position. The liberal opposition in Russia is in disarray and the Communists are a declining force.

Protests have thus far been limited in scope and are likely to remain isolated and localised. So far, the only significant mass protests—against an increase in tariffs on imported used cars—have been reported in Vladivostok. The use of riot police to break up these protests suggests that the government is ready to use force should such unrest occur in other areas. The authorities can use a mix of repression and conciliation to ward off protests. Despite the weak threat to the government, the crisis could nevertheless lead to a further strengthening of authoritarian tendencies.

Fiscal stimulus options are not possible in most east European countries, as many are struggling with huge funding needs owing to large current-account deficits and, in some, large budget deficits. Those with imbalances and IMF programmes are having to engage in fiscal austerity. This is certainly not popular in these countries. The recent violent protests that have erupted in Latvia and Lithuania were against the governments' austerity measures that included tax hikes, cuts in wages and curbs on social spending.

Romania and Hungary could be flashpoints for political destabilisation. The deteriorating economic situation and rising unemployment raise the spectre of social unrest in Romania. Romania, whose break with communism was the most violent in eastern Europe with the exception of the former Yugoslav republics, experienced episodes of violent political upheaval in the 1990s, with outbreaks of inter-ethnic conflict, violent demonstrations in the capital and trade union protests including forceful blockades of roads and railways. Public unrest was most notable during periods of declining economic output in 1990-92 and 1996-99.

In Hungary, falling real wages, a sharp recession and growing unemployment are affecting the government's popularity. The country is highly indebted (the public debt stood at around 70% of GDP in 2008, and is rising) and the government has no cash to spend. A tighter fiscal policy is part of an IMF rescue package, and this could fuel unrest.

**Depth of crisis may overcome
Latin American reluctance to
return to the streets**

Many countries in Latin America have politics marred by extreme factionalism—the most powerful single predictor of political instability. A prevalence of low trust, past history, extreme inequality and exposure to contagion all underscore the region's fragility. Memories of widespread unrest are still fresh in the region, and there may be less propensity than elsewhere to take to the streets. But under our main risk scenario, where economic distress is particularly deep and prolonged, protest and rebellion may once again come to appear attractive.

Sharp falls in commodity prices will have political repercussions in some countries in the region. No longer can such states use the commodities windfall

to buy off dissident groups or finance powerful security forces. Bolivia is an example of an energy producer that is at a very high risk of a political crisis. A majority of the population, many of Indian descent, supports the president, Evo Morales. But the eastern part of the country, largely controlled by a European-descended elite, resents this support. Efforts to achieve greater autonomy have led to repeated clashes with government troops and, in deteriorating times, could set the stage for a civil war.

Falling living standards could fuel protests against incumbent administrations, particularly in countries that have witnessed extremely strong economic growth in recent years, reflecting resentment that administrations did not do more during boom years to address the structural causes of poverty and income inequalities. Argentina, one of the region's largest economies, is a case in point.

Against this backdrop, an upsurge in crime levels and drug-trafficking is also likely, in the context of woefully inadequate state security institutions in many countries. The combination of deteriorating domestic security conditions and rising frustrations with incumbent governments could well combine to cause a fall in support for democracy, as larger numbers of people become frustrated by the failure of national leaders to respond to the financial crisis and its effects.

Economic failure could fuel support for extremists in Asia

In Asia, there are six countries in the very high risk group, including Bangladesh, Pakistan and North Korea, where turmoil could have major global spillover effects. Elsewhere in the region, extremist groups in the Philippines, Thailand and Indonesia could attempt to ride on social discontent spawned by the crisis. Indonesia, with the world's fourth-largest population, will be vulnerable to social unrest ahead of and during the parliamentary election in April and the presidential poll in July.

In China, the crisis has left at least 20m migrant workers jobless so far. Rising unemployment is likely to bring more local riots, protests and strikes—what officials call "mass incidents". There were over 80,000 such incidents in 2007, up from over 60,000 in 2006. However, disturbances tend to be localised and are unlikely to present a broader challenge to the government. The ability of migrant workers to organise is in doubt. China weathered the last wave of unemployment, when 35m were without work in the late 1990s, with little difficulty. And the government had less money then.

The number of unemployed migrant workers could rise to 30m and more in 2009. College graduates unable to get jobs will add several million to the tally, raising the total closer to the levels of the late 1990s. However, it has been estimated that even if the number of unemployed reached 50m, the Chinese government could cap discontent with social support payments of some US\$60bn in total. Although this is a substantial sum, China can afford it. Unlike the unemployment in the 1990s, which mostly affected older workers in the state enterprise sector, the current wave affects a young cohort more capable of engaging in violent protests. An increase in the incidence of riots and demonstrations would require the mobilisation of special police and perhaps army units. In most scenarios, however, the regime would still survive even large-scale disturbances.

Many Sub-Saharan African countries are in the high risk categories

Sub-Saharan African countries are unsurprisingly well represented in the high risk categories, but not all countries in the region are affected.

In the early stages of the economic slowdown many predicted that Sub-Saharan Africa would escape the worst of the crisis because its economies are less integrated into the international financial system and rely less on global capital markets to finance investment. It is increasingly apparent, however, that Africa will be affected by reduced demand for its exports, lower capital inflows and-crucially-falling remittances from Africans working abroad. This last will have a particularly serious impact on Africa's poor, and will serve to increase income inequality, which is one of the key indicators of underlying vulnerability.

By and large, the risk in Sub-Saharan Africa is that tensions arising from the economic crisis will exacerbate existing problems, whether political weaknesses (as in Côte d'Ivoire, Guinea and Guinea-Bissau), fragile institutional frameworks (as in the Democratic Republic of Congo), or income inequalities associated with the so-called resource curse (Chad and Angola). However, there is more of a questionmark over the most obvious high-risk state: Zimbabwe. Given that the government has survived the almost-complete implosion of the economy, the rigging of numerous elections and the oppression of large sections of the population, it may yet be able to ride out the latest threat. That said, if declining commodity prices lessens its ability to buy off the military and security forces, the Mugabe government may finally fall.

The main threat to sociopolitical stability in the medium term is the return of civil unrest on a scale witnessed after the disputed election in December 2007: more than a thousand people were killed and 350,000 made homeless after the country split on ethnic and party lines, bringing Kenya to the brink of civil war. The formation of a grand coalition government stemmed the crisis, but to prevent a repeat (or worse) in future requires the settlement of long-term grievances, including over land and the constitutional dispensation, and an end to the culture of impunity. Positive steps are being taken, but progress is likely to be slow and could be derailed by in-fighting. As a result, medium-term risks remain significant.

Beyond unrest

Social discontent is far from being the only source of risk to governments

Beyond the immediate risks of political instability, the current crisis also points to other, in part related, forms of political risk. Three stand out:

- threats to democracy over and above outbreaks of political unrest;
- a negative impact on economic policies and longer-term potential growth rates—in particular, there is a risk of a descent into protectionism;
- a host of geopolitical risks, including ultimately the outbreak of large-scale international conflicts

The threats to democracy

The last few years of the global economic boom that ended in 2008 saw a disconnect between strong economic performance and weak politics in many countries. In particular, a decades-long spread of democratisation has come to a halt in recent years. There are problems across many of the world's regions. In the developed West, a precipitous decline in political participation, weaknesses in the functioning of government and security-related curbs on civil liberties are having a corrosive effect on some long-established democracies. There has been a very weak response in the Middle East to pressures for democratisation. The promise of "colour revolutions" in the CIS has remained unfulfilled and authoritarian trends in Russia have continued. Political crises and malaise in east-central Europe have led to disappointment and a questioning of the strength of the region's democratic transition. Media freedoms are being eroded across Latin America and populist forces with dubious democratic credentials have come to the fore.

Economic growth prior to the outbreak of the crisis masked the negative implications of weak politics (including an associated lack of progress on economic reforms in many countries). However, the economic crisis is now exposing countries' flawed politics, and also threatens to lead to more pronounced political fallout than has so far occurred. In present circumstances, democracy may suffer from the failings of US foreign policy and from democracy's association with free-market capitalism.

The risks are compounded by weak support for democracy. Most people in most places still seem to want democracy, but support is hardly robust in many areas. A survey by the European Bank for Reconstruction and Development (EBRD) and World Bank in 2006 found support for democracy to be only just above 50% in the CIS and below 60% even in east-central Europe. Latinobarometro polls for Latin America show that support for democracy across the region was on average only just above 50% in September-October 2008—significantly, support was lower than in the mid-1990s following a large dip, to only just above 40%, during the economic downturn of 2001. Trust in

key institutions of democracy, including political parties and legislatures, tends to be particularly low.

Political regression could take a number of forms. In developed economies, economic recession could feed anti-immigrant sentiment and interact with existing concerns about terrorism to result in a further erosion of civil liberties. In emerging markets, however, the risks are greater. Many democracies are very fragile and backsliding on democracy, even into authoritarianism in some cases, is possible if they are subjected to intense socioeconomic stress. This is especially the case in Latin America (which has a history of democracy reversals), eastern Europe (where democracy is only weakly consolidated) and Africa. Across the globe, moreover, nationalism and support for extremists is likely to rise.

The policy impact

Political and economic freedom are often closely associated, and a rollback of democracy could have negative implications for economic policy. This is particularly the case as the financial and economic crisis is likely to decrease the attractiveness of free-market capitalism for many emerging markets and strengthen the appeal of "state capitalism" on the Chinese model. A broad backlash against free markets and neo-liberal ideology may develop in some countries as economic conditions deteriorate. The crisis in the international financial system is likely to have some knock-on effect on faith in the market in other sectors.

Fears are mounting that the global economic crisis will prompt a serious increase in protectionism, as recession-hit countries try to boost domestic jobs at the expense of free trade. Although a wholesale retreat into 1930s-style protectionism may still look unlikely, there seems little doubt that the incidence of trade restrictions of various kinds will increase. This will exacerbate a contraction in world trade.

Certainly, in the context of an already sharp decline in world trade, few measures could be as damaging as a proliferation in trade barriers. The implementation of low-key protectionist measures can be expected, including subsidies and limited tariff hikes (within the ranges permitted by the WTO). Populist appeals to protectionist sentiment will be persistent. The political imperative to protect domestic jobs will force governments to listen sympathetically to protectionist lobbies. Politicians struggling to develop a coherent policy response to the crisis, and in many cases also struggling with falling popularity ratings because of the worsening economic climate, can exploit the fact that foreign trading partners are an easy target.

At various summits, world leaders regularly promise to resist siren calls for more protectionism. But these promises ring increasingly hollow as the politicians that make them sign off on restrictive measures at home. For example, at a G20 meeting in November 2008, politicians were quick to pledge that they would not allow the economic crisis to undermine their support for free trade. Yet, almost immediately after the summit ended Russia and India raised tariffs on cars and steel, respectively.

Talk is cheap and there has been no strong commitment (including at the recent G20 meeting) to refrain from protectionism. Western fiscal and other support packages have clear protectionist elements (informal restrictions on parent banks' activities abroad and stipulations on where assistance can be spent). According to the World Bank, 47 new trade restrictions have been introduced globally since late 2008. More than one-third of these were put in place by the G20 countries. There is talk of a risk of what has been called "murky protectionism": industrial subsidies, requests that banks lend to only local companies, or the use of environmental arguments to discriminate against foreign goods and services. Examples abound, such as the "buy American" provisions in the US stimulus programme or Nicolas Sarkozy's idea that French car companies should make cars only in France. In these cases, the governments in question appear to have backtracked. But it is very unlikely that this is the end of the story, and the risks remain high. It is likely that other such actions will be repeated as politicians come under enormous pressure from domestic voters to limit job losses.

Governments in both the developed and developing world are likely to strengthen non-tariff barriers to trade, and to raise retaliatory measures for trade-distorting measures by other countries. The US government's bail-out of General Motors and Chrysler constitutes a subsidy that amounts to a trade barrier for foreign carmakers. At the same time, the US itself is on the lookout for trade-rule violations by other countries. Anti-dumping cases have been rising, and more cases are likely in 2009. There is much room within the WTO framework to increase protection without overtly violating the agreement.

Is Doha dead?

The only way to head off global protectionism is a global response. That would provide some political cover at home for governments that keep their markets open. For years, political leaders have been urging the completion of the tottering Doha global trade talks, although they have not made enough concessions to seal a deal even during the boom. While a pact would be useful, it would take years to complete and would not close many WTO loopholes.

Furthermore, the US seems unenthusiastic. Forthcoming political elections in India and Europe reduce further the likelihood of progress on the Doha round. India, now one of the most vocal developing-country players in international trade negotiations, will be distracted by a general election. The European Commission is due to reach the end of its current term in late 2009. History suggests that there is little hope to advance free-trade agendas during economic downturns.

A return to the 1930s

The severity of the financial crisis and downturn in the real economy has inspired comparisons to the Great Depression of the 1930s. One policy of that era, the US's Smoot-Hawley tariff act, raised trade barriers dramatically and is widely seen as having contributed to the severity of the Depression. Could something similar happen now?

Until very recently, little credence was given to the possibility of a serious descent into protectionism. The world had, it was argued, changed irrevocably; it had benefited too much from globalisation; the lessons of the 1930s beggar-

thy-neighbour policies had been well learnt; criticisms of globalisation had very weak intellectual underpinnings; and post-war institutions, from the EU to the WTO, were too strong and influential to permit serious backsliding.

Few are any longer so confident that the 1930s will not be repeated. In some respects, the current situation is even worse: it is a truly global crisis, to which practically no country can claim to be immune. Important regions of the world were economically isolated in the 1930s. Serious crises before 1913 (when globalisation also reigned) carried no risk of rapid contagion because of a lack of international financial market integration.

Wheelbarrow time?

The onset of an economic crisis that exceeds anything in recent memory has sparked a flurry of interest in historical episodes of extreme economic stress. One that has attracted more than passing attention is hyperinflation in Weimar Germany in 1923, when the Reichsbank issued a Mark100trn note and a wheelbarrow of money was needed to buy a loaf of bread. Savings carefully accumulated over a lifetime's work were wiped out, and the debacle contributed to the rise to power of National Socialism.

Hyperinflation (classically defined as inflation of over 50% a month) is less unusual than commonly supposed. Argentina, Brazil and Peru (1989-90), Ukraine (1991-94) and, at present, Zimbabwe are among the recent victims. But since the 1950s the phenomenon has been limited to developing and transition economies.

So could it happen again in the developed world? Morgan Stanley rated the possibility high enough in January 2009 to recommend that companies buy insurance. Concerns have been raised by massive fiscal stimulus measures (such as the Obama administration's US\$787bn package) and liquidity injections (with the Bank of England in March following its US counterpart, the Federal Reserve, in announcing "quantitative easing"). Policymakers might even be tempted to induce inflation to erode large debt burdens. But hyperinflation, strictly defined, remains unlikely.

First, the high demand for liquidity that prompted the cash injections is not the result of higher demand for goods and services. Banks will be using the money to shore up their own balance sheets rather than reinjecting it into the real economy. And quantitative easing is designed not to send the money supply into orbit but to stop it from crashing—in other words, to ward off deflation.

Second, policymakers are still going to be on their guard against renewed inflationary pressures (at least in developed economies). Hyperinflation occurs when deliberate attempts to stimulate inflation get out of hand. In Weimar Germany, the major concern for the government and the big industrial combines was unemployment, which they feared could lead to a Communist takeover. A cheaper currency was seen as useful to boost exports and keep people in work.

The costs of excessive inflation are now more clearly understood. Indeed, there is a widespread feeling that loose monetary policy earlier this decade was an important cause of the financial bubble that has now burst.

The greater risk, rather than a renewed surge in inflation as a result of the current massive monetary stimulus, is that the first signs of an upturn prompt an unduly rapid tightening of monetary policy that chokes off the nascent recovery.

"De-globalisation" scenarios Even before the current crisis, globalisation was under threat from a variety of sources. The Economist Intelligence Unit's baseline longer-term forecasts assume what is called a *controlled globalisation*. This implies a significantly less open world than seemed possible before the bursting of the dotcom bubble, September 11th, corporate scandals and the EU's malaise. The rise of China and India have already strengthened protectionist forces and there are also growing signs of an emergent backlash against liberalising trends towards foreign direct investment.

The danger to globalisation has now increased many times over. The process could be stopped entirely just as previous eras of globalisation were reversed. Alternative scenarios are possible, based on a partial reversal of globalisation (*globalisation in retreat*) or its unwinding (*globalisation sunk*). We have used our model to trace through the likely quantitative effects of the various scenarios, by making assumptions about changes in key growth drivers such as the extent of trade integration, regulatory institutional and technological change, which are also influenced by the degree of openness. We assume that the alternative trajectories start from 2010.

Globalisation in retreat: The most likely scenario, this sees protectionist sentiment thriving in a climate of insecurity. Throughout much of the developed world, economic weakness and high unemployment breed angst and fuel rising protectionism in various forms. This is likely to shave a percentage point off annual global growth in 2011-20, relative to a forecast of controlled globalisation under our previous baseline forecast—cumulatively, a large amount of lost world output.

Globalisation sunk: Historians have observed some uncanny parallels between the world today and on the eve of the first world war and the end of the golden first age of globalisation that lasted from 1870 to 1914. That era was marked by a high degree of international mobility of goods, capital and labour and the dominance of a free-trade orthodoxy that was periodically challenged by protectionist sentiment. There was relatively free trade, hardly any limits on capital movements and freer immigration than today. The first world war wrecked all this. Global markets were disrupted, technical advances petered out and stagnant consumption discouraged innovation. By the end of the 1940s most states in the world had imposed restrictions on trade, migration and investment. Were this to be repeated, the consequences for growth would be disastrous. Global growth in 2011-20 would drop to about 1% per year, implying a fall in world income per head. The hardest hit would be the emerging markets, especially the poorest ones.

The US holds the key US policy will be the main determinant of which model emerges. However, the US can no longer be viewed as an unambiguous champion of unfettered globalisation and associated international political processes. For one thing, there has been a marked worldwide decline in respect for the US—unlikely to be reversed simply by the arrival of a new administration in Washington—that constrains US influence. For another, aside from the impact of domestic politics in the US, there is also what might be called the “paradox of globalisation”: the fact that the US benefits from globalisation comparatively less than others,

which (especially Europe and Asia) stand to gain far more. It is unclear to what extent such considerations influence US strategic thinking.

Geopolitical risks

Finally, geopolitical risk will also rise as the economic downturn tests international co-operation and leads to increased tensions between states. Overall, these trends will feed off each other: there is a danger of a negative spiral as economic dislocation leads to political regression, the negative policy implications of which in turn compound the economic downturn. An associated risk is that of a spike in the activities and power of organised crime groups controlling parallel economies that tend to flourish with rising unemployment.

The crisis also presents some geopolitical opportunities for the US. The sharp decline in oil prices has hit states such as Iran, Venezuela and Russia. However, the dominant trend may be that of a threat to continued US global primacy. Emerging powers such as China or India could take the opportunity presented by US economic weakness to extend their own influence. China, in particular, has already established itself as a major player in Latin America and Africa, and it is investing heavily in extractive industries across the globe, procuring energy supplies in new oil deals with Russia, Venezuela and Brazil—and other natural resources for its industrial economy.

The greatest danger, dwarfing all other risks, is the possibility of an outbreak of major inter-state conflict, an all-too-common feature of past episodes of extreme economic distress. The British historian, Niall Ferguson, has recently talked of an imminent "age of upheaval". Looking at the causes of 20th century upheavals, he concludes that just three factors made the location and timing of large-scale conflict more or less predictable: ethnic disintegration, extreme economic volatility and the decline of empires. All three are very much present today. Before such theses are just dismissed as scaremongering, two things should be remembered: first, very few in the pre-1914 world predicted the disaster ahead; and second, in our own times very few predicted the depth of the financial and economic meltdown now afflicting the world.