The Case *for* Reviving *a* Rules-Based Multilateralism

By Mansoor Dailami

But what will be America's role?

The reaction of global financial markets to the heightened geopolitical tensions of recent years is paradoxical. Prior to the rout caused by Covid-19, global equity markets were riding high, witnessing a decade-long bull run. Capping the decade, markets rallied to all-time highs, with the U.S. S&P 500 index delivering an annual return of 32 percent, while Germany's Dax and France's CAC both rose 25 percent and Japan's Nikkei gained 18 percent. Emerging market equities racked up gains of around 15 percent. China's CSI 300 index romped ahead by 36 percent.

Several factors were behind the market gains—most notably, extended monetary policy easing after the global financial crisis, and in more recent years, U.S. tax and regulatory reforms that helped boost investor sentiment and spur corporate earnings. Equity markets are also known to trade on behavioral biases that temporarily drive stock prices away from their economic and corporate fundamentals, due to investor overconfidence or other human foibles. But the anomalous relationship between geopolitics and equity markets is worth pausing over. In particular, the degree to which capital markets have been able in recent years to shrug off worries about geopolitical tensions and political conflicts is

Mansoor Dailami is Senior Advisor for the Rock Creek Group, and formerly was Manager of the Emerging Global Trends Team at the World Bank Group. The views expressed herein are the author's and do not necessarily reflect the views of the Rock Creek Group.

not explained by familiar market anomalies or mainstream theories of asset valuation and pricing.

Geopolitical portents, as played out in theaters from international trade to global security, have been sufficiently alarming and broadly reported in media in recent years to potentially move markets. Recent events suggest that the world is entering a period of intensified great power competition against a backdrop of changing American domestic and international politics. The worldview that is gaining traction, regardless of what school of international relations one adheres to, is that a new era of geopolitics now beckons. This is often referred to as the "geopolitics of the twenty-first century," or simply "the new geopolitics."

In relation to capital markets, this era of geopolitics is fundamentally distinct from that of the twentieth century in that the primary venue of competition between major powers is in the realm of economic affairs. Much of the focus is on the nexus between national security and international economic relations, throwing aside the past consensus of economic liberalism and open-door policies. A rising China is shifting the balance of global growth toward a multipolar order. A reviving Russia is challenging America's strategic interests in the Middle East through its active role in OPEC+ and its military intervention in Syria. The United States' reluctant internationalism has led allies and adversaries to re-evaluate their economic and security ties with it and encouraged a re-ordering of international relations toward regional spheres of influence.

In the contemporary landscape of great power competition, the key question is no longer whether China and Russia will be revisionist powers, but rather what stance the United States will take in redefining its national economic and security interests at a time when the country's political establishment is reshaping America's role and responsibility in the international system. The forces that have brought these changes to the fore have been in the making for some time, dating back at least to President Obama's strategy of "graduated escalation." The Trump administration has raised the stakes. In questioning U.S. involvement in the world from the prism of national security, rather than the traditional lens of maintaining the global order, the Trump administration has shaken the post-Cold War liberal vision of politics and the economy that had been the frame of reference for policymakers and financial markets alike.

Without the anchor of a multilateral rules-based global order, market sentiment is much more likely to rapidly toggle between euphoria and panic.

For investors conditioned by the traditional liberal vision of economic policy and politics, the geopolitics of the twenty-first century have increased uncertainty. Broadly, this uncertainty is of two types: impact and contextual. Impact uncertainty relates to the unpredictability of the impact of coercive tools, such as economic or financial sanctions imposed on target countries and their retaliation. Contextual uncertainty is a larger phenomenon, relating to the transformation in the global order and associated great power transition and contestation over the basic tenets and terms of the new geopolitics.

Investors are relatively well-versed in dealing with impact uncertainty, including through portfolio diversification and factor investing, drawing on efforts made by researchers and major financial houses to measure and monitor

What Role Will Washington Play?

In the contemporary landscape of great power competition, the key question is no longer whether China and Russia will be revisionist powers, but rather what stance the United States will take in redefining its national economic and security interests at a time when the country's political establishment is reshaping America's role and responsibility in the international system. The forces that have brought these changes to the fore have been in the making for some time, dating back at least to President Obama's strategy of "graduated escalation." The Trump administration has raised the stakes. In questioning U.S. involvement in the world from the prism of national security, rather than the traditional lens of maintaining the global order, the Trump administration has shaken the post-Cold War liberal vision of politics and the economy that had been the frame of reference for policymakers and financial markets alike.

—M. Dailami

geopolitical risk in a systematic manner. They are not, however, well-equipped to assess the impacts of contextual uncertainty. Such risks are notoriously difficult to model and factor into investment decisions, as they relate to uncertainty over the political policymaking process and rules. Whereas the liberal interdependency paradigm of the post-Cold War era had provided the framework that anchored investors' worldviews, interdependence has now become a tool of strategic competition among major powers.

Much has been made of the Trump administration's use of economic and diplomatic coercion in shaping geopolitical outcomes, whether in the context of China, Russia, or Iran. Less attention has been paid to the degree that economic liberalism has been sacrificed in the process. Governments are applying greater scrutiny to foreign direct investment, cross-border stock market listings, technology transfer, and immigration on the grounds of national security.

In the United States, scrutiny of foreign investment in the infrastructure and technology sectors has deepened under the Foreign Investment Risk Review Modernization Act of 2018. In 2019, the European Union adopted a regulation that will set up an EU-wide mechanism to strengthen foreign investment screening processes on national security grounds, while South Korea has tightened protection of national core technology by amending the Act on Prevention of Leakage and Protection of Industrial Technology. Canada, Germany, and the United Kingdom have also applied stricter national security considerations to foreign direct investment.

The reaction of global financial markets to the heightened geopolitical tensions of recent years is paradoxical.

Like all humans, investors look for established patterns and familiar grounds to inform their capital allocation and investment decisions. Without the anchor of a multilateral rules-based global order, market sentiment is much more likely to rapidly toggle between euphoria and panic. This has been abundantly clear in recent weeks, when markets suddenly capitulated to Covid-19 after responding with cheers in recent years to increasingly ominous geopolitical showdowns. As global policymakers deploy their fiscal and monetary arsenals to address the economic fallout from Covid-19, there is also the imperative of reviving the rule-based multilateralism of the post-Cold War era. ◆