

## Political Insight

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# The Terrorist War in light of the Cold War

## Can it be won?

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- The Terrorist War is winnable, but it will take a decade or two.
- Ultimate victory will depend on overcoming the mass sense of impoverishment and national humiliation that provides a support base for terrorism.
- The Cold War and the co-opting of post-Cultural Revolution China show the path for accomplishing this.
- The medium-term effects of the Terrorism War on the world economy should be quite limited.
- **The real medium-term issues for investors are:**
  - If the US housing bubble has popped, the US should head into a substantial recession.
  - Japan's financial deterioration may be proceeding to a much earlier climax than previously expected.
  - China's extraordinary resilience depends on FDI flows, and it is not clear whether those will be hampered in the aftermath of 11 September.
- Commencement of US military action will, of course, cause market volatility. A short thrust into Afghanistan has been largely discounted. The effect on markets will be bigger if US forces fight in Afghanistan for a prolonged period, or if they mount a bigger attack on Iraq.

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## The Terrorist War in light of the Cold War

The free world's experience in the Cold War can shed considerable light on the prospects for the civilised<sup>1</sup> world in the Terrorist War.

### Can it be won?

*Terrorists are hard to find...*

First, can this war be won? US politicians talk with great bravado, but they initially expressed great bravado in Vietnam, too. Afghanistan's caves are pretty inaccessible, and Afghans have beaten off the British and the Russians at the height of their respective power. The terrorists have a loose, ephemeral global alliance that's hard to target.

*...but communist guerillas were harder*

In the Cold War, a lot of the communists were pretty inaccessible too. They had to be hunted in the mountains of Thailand and the Philippines, in the jungles of Malaysia, among the tribes of Bolivia and the Congo. They lost, despite support of a kind that bin Laden does not have — from a great power, the USSR, with billions of dollars to spend and the most advanced weapons on the planet. Vietnam does teach the lesson that, if we choose our battles badly, we can lose them. But the Cold War teaches that even widely dispersed forces with ephemeral links all over the world can be defeated.

*No great power backing Al Qaeda...*

The absence of great power backing is one crucial weakness of bin Laden. There are others. The US is much more united than it was during the Cold War. Killing 7,000 innocent civilians unites Americans more than Pearl Harbor did. And the civilised world is much more united against terrorism than the free world was against communism. The Cold War included vast currents of fellow travellers within Western society, including major parts of universities, cultural sectors, and the early union movements. Even though Middle Easterners are scattered all over the world, and even though fundamentalists can be found in most countries, no comparable support base aids the terrorists.

*...and few fellow travellers*

*The war is at home...*

Our weaknesses this time, of course, are that the war is being brought right home. It's the World Trade Center, not Pleiku, this time. And the level of technology is much higher. But the technology is higher on both sides, and if the terrorists continue to focus on civilians, they are likely to unify rather than divide. Having said that, we must not underestimate the horrors that may lie ahead. Poison in Washington DC's water supply, an attack on Hoover Dam to deprive California of power, a nuclear explosion in San Francisco harbor...Unfortunately, these risks are real. Even if the most horrific of them materialises, however, the position of the terrorists is strategically weak.

*...and may last decades*

Thus the main problem for the West is not that the terrorists are hard to defeat, but that it will take many years, possibly decades, to get them under control. And sporadic terrorism, with very large individual incidents, is probably with us for the foreseeable future.

### Strategies

*Hounding them works*

The strategy that worked against communist guerrillas was to hound them, to keep them on the run, to wear them down. If someone is running through the jungle, take away a bit of his food, limit his access to water, make sure he can't contact his friends, put things on the trail to trip him, make scary noises to confuse him. Eventually he becomes too weary to run. That strategy is, correctly, central to much of what the Bush administration has been saying about bin Laden. Limit his funds and his ability to transfer them, make him afraid to communicate over the phone, blow up his training camps, empower his enemies...and, eventually, he should grow weary. A crucial adjunct to this strategy has also been articulated by the Bush administration: cut bin Laden off from a supply of nasty weapons from nations like Iraq. That's where the real warfare may happen.

<sup>1</sup>By "civilised" I mean just that: all the non-terrorist parts of the world. The civilised world certainly includes most of the Middle East and most of the Muslim world. It does not include Saddam Hussein and the Taliban.



*Factionalising them works*

Another key strategy in the Cold War was welcoming China's turn against the USSR. A comparable strategy should be even easier in the Terrorist War. Arab and fundamentalist rivalries are numerous and famously bloody.

*Economic strategy is missing*

Having said all this, there is still something missing. The Cold War was ultimately won on economics. Massive US aid to Europe consolidated the positions of allies and tilted wavering countries such as Greece and Turkey into the alliances. From Japan to Indonesia, the same thing happened in Asia. Eventually the Soviet Union collapsed economically. Military power provided a vital shield enabling this to happen, but behind that shield the winning forces were economic.

*Cultural Revolution in China had a similar base...*

The closest Cold War analogue to the Terrorist War was China in the 1960s. China had been poor and divided, and internationally abused, for two centuries. Its leaders had tried many strategies to restore prosperity and national greatness, but all had failed. The strategies became increasingly radical with the Great Leap Forward and the Cultural Revolution, and still the primary result was that many Chinese died. The Great Leap was a terrific effort to jump into the modern economy, but instead 30m people starved. That is analogous to several Islamic efforts to restore dignity and prosperity by returning to (perverted versions of) the tested methods of the seventh century.

Such failures set China up for the Cultural Revolution, an outburst of chiliarism that revolted against everything in the established order. Mao led it for his own political reasons, but Chinese society was vulnerable to a call to destroy everything in the established order: kill the rich people, destroy the "Four Olds" (everything representing traditional culture), send the intellectuals to the countryside, humiliate and emasculate the bureaucrats, smash the capitalist-imperialist international system led by the US, and everything will come right. Mao was bin Laden with a base of 800m people. Maoist operatives caused disruption from Dar es Salaam to Calcutta to Berkeley. Ultimately the Red Guards did tear down the system, and the damage they did at home far exceeded any damage Chinese policies did overseas.

*...that disappeared when a path to dignity and prosperity opened*

That is precisely the situation of the Islamic fundamentalists. Descendants of a once-great civilisation, they have now spent several centuries in poverty. Like their Chinese counterparts in 1966, their primary emotion is despair; their language of despair comes from the Koran, as the Chinese language of despair came from Lenin and Mao, and as the Western despair often comes from the Bible. (Jerry Falwell's blaming the World Trade Center bombing on secularism jumps to mind.) But the substance is despair. Deal with the underlying despair and the language will be used to express more conservative thoughts.

What weaned China from despair and disruptive ideology was the discovery of a path to recovery of prosperity and pride through economic reform. Deng Xiaoping and others noticed how well their counterparts in Hong Kong, Taiwan, and Korea were doing and courageously set out to emulate them. It helped that China's old enemy, Japan, was doing much better and Beijing felt it had to do whatever was necessary to keep up. Their new strategy won support from the international community. Some 20 years later, China still has a long way to go, but its people are basically at peace with themselves and China is basically at peace with the world. (Those who don't understand that just haven't been paying attention to what has happened since Mao.) Indeed, it actively seeks to join the system it once despised, for instance by pursuing WTO membership.

*The US needs to do the same in the Middle East*

The counterpart strategy in the Terrorist War would be to find a way to bring the principal Middle Eastern countries into the modern world, a world where prosperity and pride seem attainable. Doing so may seem improbable, and might seem to fail to address vital ideological issues, but finding the path to placidity for China seemed even more improbable in 1975.

*Turkey, Iran and Egypt must be courted*

The counterpart of seducing China to join the system is more complicated in the Middle East. It probably requires the Europeans to be much more supportive of Turkey, the US to be much more enticing toward Iran, and the world to organise a huge package of tough love for Egypt. Such a programme, gradually extending to key countries in Africa, will gradually reduce the base of potential support for terrorism. Such a programme will require something the Bush administration doesn't find attractive, namely a major aid programme, but aid programmes with the right conditions helped win the Cold War and unwillingness to consider them would be plain foolish given the alternative cost of paying for expensive weapons, not to speak of the pain of clearing rubble from our major cities.

*Indonesia and Africa are the risk areas for spreading despair*

In addition to the Middle East, the civilised world has to worry even more about Indonesia than it has been, and it has to return to concern about Africa. Indonesia was rescued from its culture of despair three decades ago, when it had the third-largest communist party in the world and one of the largest peacetime massacres in history. Its situation then was much worse than today. But the situation today is very grave, and a combination of economic neglect and treating Indonesia policy as an appendage to Timor policy could easily spread the terrorist war to Asia. In Africa, the spread of fundamentalist terror to sub-Saharan Africa has been limited by antagonism between North African Arabs and sub-Saharan black Africans, but the firebreak is very permeable. How to start rescuing Africa, and hardening the firebreak in other ways, requires strategic imagination of the first order, but that is now a necessity.

## **The imperative of globalisation**

*Continued globalisation is the pre-requisite of victory*

These necessities remind us of a prerequisite to all that was achieved in the Cold War. Globalisation provided the conditions where Europe and Japan could revive, where the poorer Asian countries from South Korea to Indonesia could find prosperity, and where China could be seduced into joining our system. We easily forget that in 1960 Japan was seen as condemned to an indefinite future as an impoverished semi-agrarian economy that made cheap toys and ridiculously low quality cars. Taiwan and South Korea were among the world's poorest countries and were dominated intellectually by socialism. It was globalisation that made possible a world where Taiwan companies make most of our scanners, South Koreans make a plurality of our computer chips, and coastal China has the fastest-rising wages in world history.

It is partly globalisation that bin Laden protests, as the Maoists did a generation ago, even though the phrase hadn't then been invented. But it is globalisation that offers a framework within which big chunks of the Middle East and Africa could one day begin to enjoy the prosperity and stability that Asia has achieved (and still has, despite recent problems).

*Two risks to globalisation*

There are two risks to globalisation. The lesser risk is an excessive tightening of controls on trade and travel in response to terrorism. The greater one is the spreading anti-globalisation movement that now disrupts every major meeting of the institutions that symbolise globalisation. Although their motivations, social backgrounds, and methods are totally different from those of the terrorists, the anti-globalisation movement, if it were to spread and gain much greater influence, is the one thing that could cripple the civilised world's ability to co-opt the social base of the terrorists. A measure of how close the alliance of anti-globalisers and protectionists has come is the battle over Fast Track trade negotiating authority for the US President. Clinton was denied Fast Track Authority. President Bush is fighting a close battle for it as these words are being written, and it may come only with crippling restrictions that virtually no other country in the world will accept. Without Fast Track authority, the US cannot negotiate trade, and without US leadership the progress of globalisation stalls.

If one had made the same argument regarding China in 1966, the link would have been rejected as ludicrous. But the results speak for themselves.



## Key issues

*Co-opting China required a Taiwan deal. The Middle-East requires Palestinian and Saudi deals*

The other key to bringing China into the system was cutting a deal on the most troubling issue, Taiwan. The compromise reached in the 1970s has its ambiguities and its detractors on both sides, but it has basically held for a quarter century. The counterpart of the deal with China over Taiwan is deals over the Israeli-Palestinian conflict and the presence of US troops in Saudi Arabia. As with Taiwan, the key criterion is that the deals must be reasonably fair to all the principal parties. Israel's position has been strengthened by Arab terrorism. The Palestinians have been offered re-assurance by Colin Powell's endorsement of a Palestinian state. The need for a settlement is now urgent.

*Criteria of success*

The Bush administration will stand or fall by: a) its ability to sustain a broad international coalition over an extended period of time; b) its ability to keep the pressure on the terrorists without getting bogged down in an extended Vietnam-style land war in Afghanistan or elsewhere; c) its ability to face politically difficult decisions regarding Saudi Arabia and Israel-Palestine; and d) its ability to build a broader political-economic strategy on top of its current police-military moves. These are formidable challenges, and there is as yet no substantial evidence as to how it will fare. Its initial instincts in each area other than "b" have been inauspicious, but it has shown substantial ability to learn and develop.

## Consequences

*This war won't drive the global economy*

Wars usually either devastate economies or rescue them. The world wars devastated many economies. World War II also rescued the US and others from the Great Depression. The Korean War revived Japan's economy after World War II, and the Vietnam War financed the Southeast Asian economic miracle and built much of the infrastructure of roads and communications that underlay the miracle. The Terrorist War will neither devastate economies nor rescue them. On both sides, it will be sporadic. Exciting but sporadic. Other World Trade Center-type incidents and much worse are quite possible. An allied attack on Iraq is quite possible. But incidents of this scale, repeated periodically over a decade or two, are unlikely to move the major economies one way or another. The best analogy for the economy of the civilised world during the Terrorist War is probably the City of London under sporadic IRA terrorism. The human consequences are terrible, but the economic consequences are limited.

*Energy is the only sector that could be greatly affected*

Nor will they likely move sectors. The battles will use oil and steel, but not enough to raise the price of oil or steel substantially. They may help individual companies such as Boeing (BA US, US\$36.59, not covered) or Airbus, or firms that make helicopters or guns, but not whole sectors unless one considers those few companies a sector. The principal risk of large economic moves will come if Saudi Arabia is attacked or if the royal family falls. Then there could be a rise in the price of energy that could greatly affect the whole world.

Another test of the civilised world's leadership will be whether it has the courage to diversify energy sources as rapidly as possible even though this means pushing aside opposition to nuclear power.

## Investment perspectives

Afghanistan and the Terrorist War dominate the headlines, but they should not dominate investor consciousness. The risks to investors are three.

*The real investor issues:*

### 1) The US economy

First, the US economy has been sustained by consumer confidence, and consumer confidence has been sustained by a housing bubble. Consumer confidence may now have been shaken both directly by terrorism and indirectly by puncturing the housing bubble. Evidence on the housing bubble is preliminary but unpromising. The effect of interest rate cuts is not likely to fall primarily on business investment, since business still has much overcapacity, and not directly on the stock market, but rather on the housing bubble. Alan Greenspan, whether intentionally or otherwise, has to ground his place in history on temporary reflation of the housing bubble. Watch housing prices, not Afghanistan.

### 2) Japan's finances

Second, Japan's economic malaise is terminal but has not been acute. The Japanese financial numbers are so weak, and the policy response, even under Prime Minister Koizumi, so weak, that major downturn must be judged an increasing risk. Until recently, it seemed that this could be postponed until 2004 or 2005. Now the risk of a dangerous spiral may be moving closer. If Japan takes a major dive before the US recovers, we are likely in for a serious and prolonged global recession. Only massive structural reform can save Japan. Fiscal stimulus and easy money by themselves will avail nothing. Watch Japanese banks, not Afghanistan.

### 3) Chinese FDI

Third, while the Chinese economy has been well managed and very resilient, it is highly dependent on large flows of foreign direct investment. These flows have been rising and we have forecast that they will exceed US\$50bn in 2001. However, we must now carefully monitor whether the post-11 September economic slowdown and decision-making pause will substantially affect those flows. If there is a serious deterioration over several months, we may have to re-assess Chinese growth prospects.

### Indonesia the main Pacific hotspot

In most of the rest of Asia Pacific, the direct impact of the Terrorist War is likely to be minimal. Terrorist incidents are of course possible anywhere, but outside the major capitals they don't have the impact that bin Laden wants. China is the most likely target, with its small population of disaffected Muslims in the far west, but the Chinese have tools against terrorism that many Western nations don't have. Tokyo offers some targets, but is unlikely to become involved to a degree that affects its economy. Indonesia has the largest problem. Muslim extremist demonstrations have occurred, and there will undoubtedly be more, but the world's largest Muslim nation tends toward moderation so long as its economic problems do not become much worse. The demonstrations will keep away investment, and that is regrettable, but this means the loss of a new-found opportunity rather than a new deterioration.

### Problems in the Philippines look set to continue: we don't think they will get a great deal worse

Some Philippine dissident groups have a direct connection to Al Qaeda, which has *inter alia* provided some training for the Moro Islamic Liberation Front. Osama bin Laden's Philippine disciples have been involved in plots to kill the Pope and to hijack American airliners for terrorist purposes. The kidnapping group Abu Sayyaf has connections to bin Laden. These problems will continue. They will not likely become a great deal worse, but the Philippine government may get substantially more help in coping with them.

### Malaysia and elsewhere: moderation dominant

The rest of the region should be relatively unaffected. In Malaysia, the region's other substantial Muslim nation, moderation is dominant and Prime Minister Mahathir, however much one might criticise his corporate governance ideas, is one of the great masters of political balance on the issue of relations between Muslim and non-Muslim communities. Brunei is wealthy and conservative. The rest of the region is mostly disengaged from the Terrorist War.

Aside from the major economic issues, each thrust in the war will of course cause market volatility. The first thrust should come soon after the return of Secretary of Defense Donald Rumsfeld from his current trip to the Middle East. The market has largely discounted a substantial temporary thrust into Afghanistan. The market impact will be more substantial and more enduring if: a) the US presence in Afghanistan endures more than a few weeks; or b) the thrust into Afghanistan proves to be mainly a feint presaging a larger attack on Iraq, which is the most dangerous current developer of large-scale chemical, biological and nuclear terrorist weapons.



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**Neutral** - stock expected to trade within the range set by the two actionable headings.  
**Underperform** - stock expected to underperform the local benchmark index by 10% or more over the next six months.

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