

# Watching the dominos fall

*Similarities between the effects of the Ukraine War and the global financial crisis*

Current geopolitical and economic conditions are remarkably similar to the situation before the 2007-2008 global financial crisis, a downturn which was foreseen as a possible scenario by Rabobank some five years before the fact. The lessons behind this classic scenario planning example are once again relevant following the Russian invasion of Ukraine.

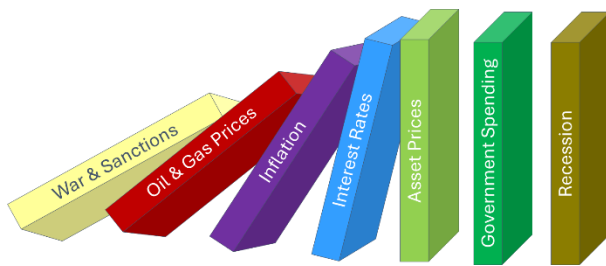


Figure 1: Domino model based on Rabobank's scenarios

## The global financial crisis as a scenario

In 2003, a large group of Rabobank employees participated in a collaborative learning network to develop and publish scenarios concerning the price of money. The resulting interest rate scenarios dealt with the core of the banking business. After all, 80% of Rabobank's turnover at the time was derived from interest revenue, and interest also accounted for as much as 60% of the bank's expenses.

The Viewing Futures Network, as the aforementioned collaborative network was known, envisioned three basic interest rate scenarios in the period up to 2010 (figure 2). First, the rate could remain low for an extended period of time and consolidate near 1%, as a result of an economic slump lasting several years. Second, it could show a volatile pattern of sharp rises and steep falls. Third, it could experience a dynamic rise throughout the rest of the decade, topping out around 8%. These scenarios were the result of deep research into 42 current trends, 8 driving forces and a

number of modelbuilding workshops. Each scenario consisted of a logical and consistent narrative, inspired by international and historical analogies, detailing imagined yet plausible timelines of economic development, interest rate mutations and financial sector reactions.

After their publication, these interest rate scenarios were widely distributed throughout Rabobank Group and shared with major clients. In hindsight, none of the scenarios exactly predicted the developments in the price of money for the next seven years, as was to be expected. Nevertheless, the organization was able to utilize the scenarios to foresee future developments and prepare accordingly. Specifically, because of these scenarios, Rabobank was able to anticipate and prepare for the housing crisis that triggered the 2007 global economic downturn and brought many financial institutions to the edge of demise – or over it.

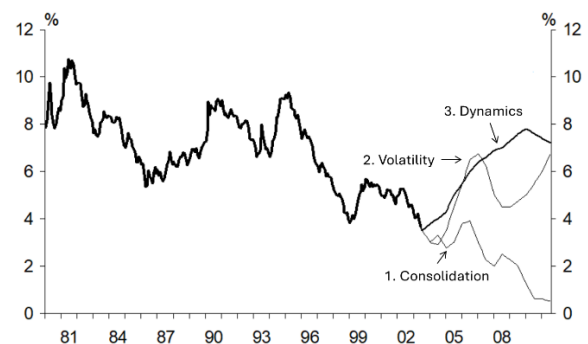


Figure 2: Rabobank's 2003 scenarios for the 10-years government bond rate (EMU)

How did Rabobank foresee the housing crash? In the narrative developed for the 'Volatility' scenario, strategists imagined a steady interest rate increase leading to a wave of mortgage defaults in 2004. This would in turn trigger a housing crash and create major problems for retail banks heavily dependent on mortgage products. Even though, in reality, the crisis occurred three years later than in

the Volatility scenario, the scenario had enabled hundreds of Rabobank employees to ‘visit’ the world of a housing crisis before it actually happened. As a result, the organization was able to identify early warning signals of a coming crisis, such as the interest rate increase leading to mortgage defaults.

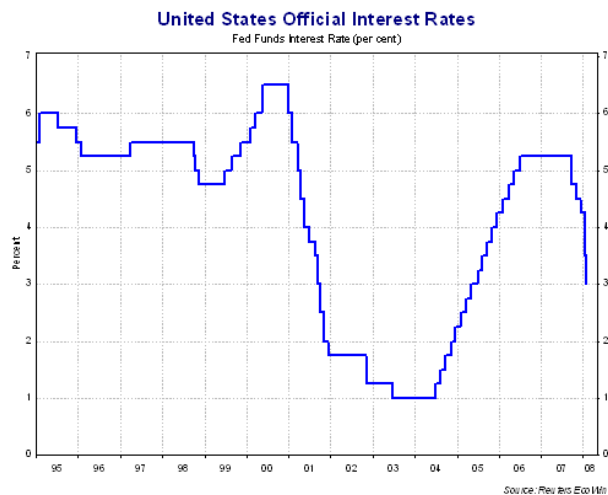


Figure 3: US Federal Reserve's interest rate, 1995-2008

As it happened, from 2003 to 2006, the American Federal Reserve increased their short-term interest rate from 1% to over 5% progressively in little over three years time (figure 3). Sensing the danger, Rabobank took precautionary measures in 2007 to secure sufficient liquidity in times of crisis and prepared \$30 billion in mortgages as security for loans with the European Central Bank in case of emergency. At the time, CFO Bert Bruggink commented: “We anticipate on a worst case scenario. I do not assume that we will need it, but at least we are ready.”

In March 2008, Rabobank decided not to refinance \$2.5 billion in credit to Bear Stearns, one of the banks which was to topple later that year. Thanks in part to this decision, Rabobank was able to report a profit of €2.8 billion over 2008, at a time when countless other financial institutions were struggling to stay afloat.

### Ukraine war could trigger similar pattern

In our current geopolitical predicament, the Rabobank scenario study can once again prove its worth, nearly two decades after its publication. At the time, the scenario planners spent considerable effort on modelling the system dynamics behind short-term and long-term interest rates. They

created a set of eight driving forces, which, in their view, together determined the price of money. In determining these driving forces, the strategists took lessons from the 1973 oil crisis. Back then, the Yom Kippur War triggered the use of oil as a geopolitical weapon, causing inflation, rising interest rates, and falling asset prices.

The resulting model is as relevant now as it was back in 2003. After all, interest rates are on the rise again, and this development could be interpreted in multiple ways. One could consider it a short-term deviation from a long-term trend towards 0% interest (in other words, the ‘Consolidation’ scenario). However, one could just as well see it as the harbinger of a prolonged period of rising interest rates, indicating a gradual break with the trend of interest rate decline that has lasted for over a decade now.

That the latter situation is as plausible as the first – if not more plausible, at that – is evident when looking at recent events through the lens of the Rabobank interest rate model. Like in 2003, the onset of war and the introduction of sanctions have caused abrupt shifts in the geopolitical landscape, with grave consequences for global trade patterns and commodity and resource prices. Let us not forget that, following the 2003 invasion of Iraq, oil prices rose well over \$120 per barrel. Now, this sudden but prolonged increase in commodity and resource prices is pushing inflation to dazzling levels, particularly in Europe, leaving central bankers no choice but to steadily increase their base interest rate.

Thus, as long as inflation remains high, interest rates will most probably continue to rise. And while inflation is currently driven by the effects of the Russo-Ukrainian war, soaring energy prices among them, the situation could easily develop into a feedback loop known as the wage-price spiral. As higher prices are translated into higher wages, costs are driven up. In turn, this will cause prices to rise even further.

### Thinking through the consequences

Of course, the future remains inherently uncertain, and we can never know for sure. Nevertheless, thoroughly thinking through a certain scenario allows us to imagine the future more rationally, accurately, and effectively. One logical

consequence of rising interest rates, for example, would be for governments to cut spending, in order to be able to service and refinance their outstanding debts at ever-higher interest rates. Higher interest rates on government bonds would entice investors to relocate capital to these safe bets, and to steer away from riskier assets like stocks and real estate. In the Netherlands, for example, the housing market has started to cool down after almost a decade of continuous price increases. At the end of the domino file, large-scale asset devaluations and government spending cuts could very well usher in a recession (figure 1 on page 1).

Some key differences between the current situation and the build-up to the global financial crisis do exist. Since the late 2000s, central banks have kept interest rates low by adhering to a policy of unprecedented quantitative easing. Heavily indebted countries have managed to avoid default because of this, preventing the situation from escalating to something far worse. If a major economic downturn were to occur today, however, monetary authorities will no longer be able to ease even further, since they have already stretched the limits of this strategy over the past decade.

Moreover, government debt levels around the world are much higher now than they were the fifteen years ago. And since the onset of the COVID-19 pandemic in 2020 synchronized the business cycle of practically all economic and financial systems of the world, investors and financial institutions can no longer simply reduce risk by spreading their investments over different national economies. The consequences of a *synchronized global downturn* could, in short, be much worse now than in previous decades.

Fortunately, there is an upside. Fifteen years ago, there were barely any viable alternatives to fossil fuel for maintaining a secure energy supply. In the meantime, however, companies and governments around the world have invested heavily in the development of durable solutions for our increasingly urgent energy problem. In our streets, electrical cars and rooftop solar panels are no longer anomalies. The rise of sustainable energy technology has given us a way out of the recession which we did not have at our disposal during the previous global economic crisis. Decreasing our

dependency on fossil fuels through a *rapid transformation* would also serve to temper the currently rampant inflation twofold. First, commodity prices and the cost of living would be much less vulnerable to swings on the market for fossil energy. Second, energy-saving measures (which are now also money-saving measures) would lead to reduced overall demand for fossil fuels, downwardly influencing fossil energy prices.

### Complexity demands diversity

Thinking the system through in this way not only allows us to imagine the future more accurately, it also alerts us to the fact that complex problems like the Russo-Ukrainian War are not limited to any singular domain of expertise. The Russian invasion has given rise to major security and defense issues, but has also had global economic and financial ramifications. Likewise, it has triggered concerns surrounding the European energy supply, while an increase in poverty and inequality looms due to rapid inflation. In addition, Europe faces the challenge of accommodating millions of displaced persons.

Hence, consulting *just* a defense expert, *just* an economics expert, or *just* a refugee expert will not suffice for organizations to deal with this complex, multi-faceted situation adequately. As Rabobank has shown almost two decades ago, it is far more effective to bring together a host of experts from a variety of backgrounds, to navigate the future together. After all, for those who are adequately prepared, even a global economic downturn could be an opportunity rather than merely a risk.

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