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World stability hangs by a thread as economies continue to unravel

The political bubble is bursting. Spreads on geo-strategic risk are now widening as dramatically as the spreads on financial risk at the onset of the credit crunch.

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Whether it is the Indian rupee, the Shanghai bourse, or Kremlin debt, the stars of the credit boom have fallen to earth. Investors are retreating into 3-month US Treasury bills – the ultimate safe-haven. The yield has fallen to 0.02pc, less than zero after costs. You pay Washington to guard your money.

The working assumption of the "Great Boom" is – or was – that we live in a benign era where most societies are converging towards some form of market liberalism; where trade and capital flows are unrestricted; where governments have enough legitimacy to keep order by light touch; where a major war is unthinkable.

This illusion is now being tested.

We should not to read too much into the Bombay carnage. It may or may not be significant that the Deccan Mujahideen – whoever they are – picked India's financial hub to launch their spectacular.

Even so, the love affair with Bombay's bourse was cooling anyway. The Sensex index is down almost 60pc from its peak.

The exodus of foreign capital may now quicken, laying bare the horrors of Indian public finance. The combined federal and state deficit is 8pc of GDP. Plainly, spending will have to be slashed.

If the atrocity now propels the Hindu nationalist leader Narendra Modi into office at the head of a revived Bharatiya Janata Party (BJP), south Asia will once again face a nuclear showdown between India and Pakistan.

Events are moving briskly in China too. Wudu was torched by rioters this month in a pitched battle with police. Violence has spread to the export hub of Guangdong as workers protest at the mass closure of toy, textile, and furniture factories.

"The global financial crisis has not bottomed yet. The impact is spreading globally and deepening," said Zhang Pin, head of the national development commission. "Excessive bankruptcies and business closures will cause massive unemployment and stir social unrest".

We are about to find out whether China has made the wrong bet with a development strategy of vast investment in manufacturing plant for mass export at thin margins to the US and Europe.

The shocking detail in the World Bank's latest report on China is that wages have fallen from 52pc to 40pc of GDP since 1999. This is evidence of an economic model that is disastrously out of kilter, and unlikely to retain popular support.

The Communist Party lost its ideological mission long ago. The regime depends on perpetual boom to stay in power. As the economy sours, there must be a high risk that it will resort to the nationalist card instead.

Tokyo certainly thinks so. When I visited Japan's Defence Ministry last year the deputy minister showed me charts detailing the intrusion of China's fast-growing fleet of attack submarines into Japanese waters. "We see its warships in the Sea of Japan all the time," he said.

Shoichi Nakagawa, the head of the ruling LDP party, was even more explicit. "What happens when China attacks Japan? Will the US retaliate on our behalf?" he said.

As for Europe, it is already fragile. Iceland, Hungary, Ukraine, Belarus, Latvia, and Serbia have turned to the IMF. Russia is a hostage to oil prices. If Urals oil stays below $50 a barrel for long, we are going to see an earthquake of one kind or another.

It is too early in this crisis to conclude whether Europe's monetary union is a source stability, or is itself a doomsday machine. The rift between North and South is growing. The spreads on Greek, Irish, Italian, Austrian, and Belgian debt remain stubbornly high. The lack of a unified EU treasury has become glaringly clear. Germany has refused to underpin the system with a fiscal blitz.

In the 1930s, it was not obvious to people living through debt deflation that their world was coming apart. The crisis came in pulses, each followed by months of apparent normality – like today.

The global system did not snap until September 1931. The trigger was a mutiny by Royal Navy ratings at Invergordon over pay cuts. Sailors on four battleships refused to put out to sea. They sang the Red Flag.

News that the British Empire could not uphold military discipline set off capital flight. Britain was forced off the gold standard within five days. A chunk of the world followed suit.

Nor was it obvious that Germany would go mad. Bruning persisted with deflation, blind to the danger. The result was the election of July 1932 when two parties committed to the destruction of Weimar – the KPD Communists and the Nazis – won over the half the seats in Reichstag.

We can hope that governments have acted fast enough this time – with rate cuts and a fiscal firewall – to head off such disasters. But then again, the debt excesses are much greater today. If in doubt, cleave to those countries with a deeply-rooted democracy, a strong sense of national solidarity, a tested rule of law – and aircraft carriers. The US and Britain do not look so bad after all.

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