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Some reflections on 'Global Risks 2011'

Five thoughts prompted by the World Economic Forum (WEF)'s sixth annual report on global risks.[1]

In 'Global Risks 2011', the WEF highlights two 'cross-cutting global risks' for the coming decade: (i) economic disparity – wealth and income disparities both within and between countries and (ii) global governance failures – weak or inadequate global institutions, agreements or networks. The same report also emphasises three risk 'clusters': (i) macroeconomic imbalances; (ii) the illegal economy; and (iii) the water-food-energy nexus. Finally, it also highlights 'five risks to watch': (i) cyber-security issues; (ii) demographic challenges; (iii) resource security issues; (iv) retrenchment from globalisation; and (v) weapons of mass destruction. Here are five thoughts prompted by reading the report.

1. *Managing the consequences of the Great Convergence*

A key theme of the report is the connectivity of the various risks discussed. One way to think about this is to identify common risk drivers, including major structural changes currently underway in the world economy. Arguably, the single most important of these is the onset of rapid catch-up growth across some of the most populous developing economies – a trend I have described as the Great Convergence.[2] The most dramatic example is of course China, which has enjoyed roughly three decades of annual GDP growth averaging almost 10 per cent, but other emerging economies, including India, have also upped their relative growth performance.

This shift in the geography of economic growth is a big deal. The fact that some countries enjoyed a take-off into modern economic growth in the nineteenth century while others didn't resulted in a Great Divergence in economic performance that went on to shape much of the economic *and* political landscape of the next two centuries. In my view, it's hard to see how the unwinding of that Great Divergence and its replacement with a Great Convergence can fail to be similarly transformative. Importantly, a great many of the outcomes of this process will be positive ones – not least, the prospect of a more prosperous planet with a healthier, longer-living population. But there are some major risks here as well.

The Great Convergence implies a substantial redistribution of global economic weight and hence (albeit with a lag) of political power. These relative shifts will involve and are now creating international stresses and strains. This process is, in my view, one crucial contributor to the global governance failures highlighted by the report. For example, the shift to a world economy where economic power is not only more widely distributed, but is also distributed across a much more diverse set of economies requires at least two big things of global governance. <u>First</u>, building

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institutions that take the new balance of economic power into account. This involves, for example, the recent downgrade of the G7/G8 and the increased prominence of the G-20, as well as reforming the governance of the IMF.[3] Second, developing new rules of the game that keep existing stakeholders happy *and* engage the support of new players. This ranges from developing rules for SWFs and other state-controlled investments through to forging a new consensus on the role of capital controls and all the way up to the workings of the international monetary system and the status of the global reserve currency. All of which meanwhile implies a large degree of systemic uncertainty.

Moreover, as well as big shifts *between* countries, the Great Convergence also involves big shifts *within* countries. For both developed and developing economies, these include changes in national comparative advantage, industrial structure, and income distribution. Adjustment to these changes can involve large economic and social dislocations, contributing to the 'economic disparity' risks highlighted by the report and to the developed world's declining appetite for globalisation and liberalisation more generally.

2. Dealing with the Spectre of Malthus

Another critical consequence of the Great Convergence has been a dramatic shift in relative prices across the world economy. One manifestation of this was the 2003-2008 commodities boom – the longest, broadest and biggest boom of the post-World War II period, and one which signalled an abrupt reversal of almost three decades of low and declining commodity prices.[4] In 2008, when the boom was at its height, the world economy was facing two 'other' GFCs: a global food crisis and a global fuel crisis. The onset of the third GFC – the global financial crisis – did trigger an abrupt fall in commodity prices, but it's notable that oil prices are now back above US$100/barrel (with political risk obviously playing an important role), while the January 2011 FAO food price index reached its highest level in both real and nominal terms since the index started.

The rapid industrialisation and urbanisation of the developing world is one critical factor contributing to the water-food-energy risk nexus identified by the report. It has contributed to environmental stress, helped stoke neo-Malthusian fears about resource scarcity, encouraged an increase in resource nationalism, including some incidents of expropriation and nationalisation, and prompted a range of state economic interventions, including the use of export bans. Higher commodity prices are also prompting concerns about inflation in some developing economies and fears of stagflation in some developed ones. Meanwhile, resource-rich economies (including Australia) have to manage the problems of success while still preparing for the possibility that this all turns out to be just another, albeit somewhat longer, commodity boom-and-bust cycle after all.

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3. *Navigating the shoals of a post-crisis world economy*

The risk outlook is also being shaped by the nature of our divided, post-crisis economy.[5] Three features of this landscape deserve special mention, as all three contribute to the macro imbalances nexus identified by the report.

First, the ongoing deterioration in sovereign risk across the developed world, but particularly on the Eurozone periphery. The GFC has been followed by an almost 30 percentage point increase in the ratio of gross general government debt to GDP. According to the IMF, the average ratio for advanced economies has risen from 73 per cent in 2007 to an estimated 101 per cent this year. (For emerging economies the comparable increase is about one percentage point, to a forecast 37 per cent).

Second, the potentially destabilising consequences of large capital inflows to developing countries. While both the Great Convergence and the difference in cyclical positions between developed and developing economies indicate a re-allocation of capital from the former to the latter, past experience shows that developing economies often struggle to manage large-scale capital inflows, with the risk of overheating, asset price bubbles, and exchange rate crises all significantly higher under such circumstances.

Third, the problems posed by a divided economy where some parts are too hot, others are too cold, and where connections between the two parts are tighter than ever. Not only is this a recipe for exchange rate and other financial volatility, but the divided policy priorities of a too hot / too cold world further complicate the global governance challenge.

4. *Context: speed, complexity and contagion*

The previous three points were about risks and risk drivers. It's also worth highlighting three general features that characterise the current risk environment: speed, contagion and complexity.

The *speed* at which the modern economy moves and at which economic adjustment now takes place has increased significantly. Take, for example, the pace of economic growth. In the early part of the nineteenth century, in the aftermath of the world's first industrial revolution, British annual GDP growth was perhaps around two per cent, at which rate it takes roughly 35 years to double the size of the economy. US economic take-off later in that same century saw real GDP growth rates of about 4 per cent, giving a doubling time of about 18 years. At an annual rate of ten per cent, China's economy currently doubles in size every seven years.

Contagion used to be a term associated almost entirely with infectious diseases. In the aftermath of the Asian financial crisis, it became clear that the increasingly inter-linked nature of our economic and financial systems means that national financial

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accidents and other economic problems will now spill rapidly across borders. With an increase in the number and range of economies which have a significant weight in the global economy, and with continued economic integration, contagious crises have become an important feature of our environment. Current events in the Middle East and North Africa suggest that political contagion may also merit closer attention.

Then there is the *complexity* of modern economic and (especially) financial systems. The GFC has just reminded us of some of the crucial features of complex systems. One of these is the 'robust-yet-fragile' property, whereby highly connected systems typically demonstrate a tipping point property: up to a certain point, all of the connections serve as shock-absorbers by working to disperse an adverse shock across the system. Unfortunately, beyond that point they switch roles and turn into shock-amplifiers. Worryingly, it turns out that it may take only a relatively modest event to push the system over this tipping point.[6]

5. The CYA clause: beware the 'unknown unknowns'

'Global risks 2011' provides a comprehensive snapshot of the kind of risks that are currently front of mind for risk experts across a range of corporations, governments and international organisations. That is, it does a great job of cataloguing what we might call the 'known unknowns,' to borrow from a now famous typology. But that thought prompts one final warning, or the CYA clause. History suggests that it's often precisely the risks that you don't see coming – the 'unknown unknowns' – that really bite you.

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[1] This IEC is based on presentations delivered at two breakfast roundtables organized by Marsh & McLennan Companies on 23 February 2011 in Sydney and on 25 February in Melbourne. The *Global Risk Report 2011* is available for download at http://riskreport.weforum.org/. Marsh is a corporate member of the Lowy Institute.
[2] See IEC #4.
[3] See IEC #10.
[4] John Baffes and Tassos Haniotis, *Placing the 2006/08 commodity price boom into perspective.* Policy Research Working Paper 5371. Washington DC, The World Bank, July, 2010.
[5] See IEC #5.
[6] See Andrew G Haldane, *Rethinking the financial network.* Speech by Mr Andrew G Haldane, Executive Director, Financial Stability, Bank of England, at the Financial Student Association, Amsterdam 28 April, 2009. Haldane also discusses two other important 'robustness' results: the 'long-tailed distribution' of connected networks and the 'small world' property of the same.

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