

Emerging Risks

Icebergs in the Global Socio-Economic Ocean

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The article attempts to describe the emerging risks witnessed in the late 20th century under three broad categories – economic growth, technological advances and social changes. The inversion of the demographic pyramid and its' consequences on the dependant population as well as the potential threat to the “bottom of the pyramid” market are discussed with current examples. The economic growth faces risk of the dollar bubble and lack of consensus on successor to Kyoto protocol. Political risks in the Arab countries threatening energy security as well as China's State Capitalism favoring unrealistic expectations are some of the risks discussed that could entail the global economy today and change the future.

The word “Risk” fetches 1.02 billion hits on Google while the word “Opportunity” fetches 1.2 billion. This observation is symbolic of the equity of the two constructs of human behaviour.

“If you don't risk anything you risk even more”

This quote by Erica Jong perhaps explains the behaviour of a risk taker like China, which still relies on United States Treasury Bonds for its surplus reserves despite the latter's poor fiscal position. Already into the second decade of the 21st century, the world economy, after an initial boom period, has gone into a recession and a sovereign debt crisis. A global slowdown looms ahead. This is but one example of the many emerging risks that seem poised to confront the world in the coming decades.

EMERGING RISKS OF THE EARLY 21ST CENTURY

The “Emerging Risks Survey 2010” [1] published by the Canadian Institute of Actuaries defines emerging risks as those with little or no historical precedent. The late 20th century was characterized by unprecedented technological advances such as the digital revolution and socio-demographic changes that led to higher economic growth rates. However, this also crystallized certain inherent risks which now lie ahead of the current working generation.

EMERGING SOCIETAL RISKS

Demographics

According to the US Census Bureau [2], the world's median age is around 29 and is projected to rise to over 37 by 2050. Germany and Japan already have median ages in the range of 45, while Hong Kong is projected to

have a median age of 60 by 2050!

Inversion of the demographic pyramid

Demographic risk may lead to reversal of the demographic dividend which could worsen the fiscal position of countries due to reduced tax revenues and a slowdown in Gross Domestic Product (GDP) growth. The rising working population of the late 20th century would now become the rising dependent population to be supported by fewer working people. This inversion of the demographic pyramid would put an increasing burden on inclusive governments that support welfare programmes, such as those in Western Europe where the spending on welfare is around 15% of GDP. This ratio is expected to rise to an unsustainable level of 40% by 2040 [2]. According to the Organization for Economic Cooperation and Development (OECD [2]), the gross public pension replacement rate is over 50% for most of the developed European countries which are already burdened with over or around 100% debt.

Social Inequity – “Failure of the Bottom of the Pyramid”

Although emerging economies, predominantly in Africa, appear to be sizeable potential markets, socio-economic inequity would render this class of consumers powerless resulting in a zero-sum game. Inequity is mainly due to poor infrastructure, unemployment and volatile oil prices. This benefits neither the global industry nor the people of these countries. However, short-sightedness and excessive emphasis on bottom-lines has rendered the global industry oblivious to this fact, when actually it should be developing these markets. For example, when millions of people are succumbing to preventable and curable diseases and to malnutrition, it makes one wonder whether actions like exorbitant prices for patent-protected drugs and speculation on food grains in the commodity markets are ethical.

EMERGING ECONOMIC RISKS

The Dollar Bubble

The Real Estate bubble that triggered the 2008 recession has demonstrated not only the fragility of the US Economy but also the dependence of the global economies on the US. This is just a prelude to the dollar bubble which has the potential to unleash economic devastation upon anyone with exposure to US Treasury Bills and other dollar denominated assets. Mounting public debt & the recent downgrading of the sovereign credit rating of the US serve as a clear indication of the most significant emerging economic risk: the world has taken the US' solvency for granted, for far too long.

The Sino-US Stalemate

US Treasury bills, apparently the most secure investment, have historically attracted the bulk of excess Chinese reserves, creating a debt fuelled economy in the US. As of November 2011, China's holdings of US Treasury Bills were valued at \$1.13 trillion [3]. With the US federal debt forecast at around 105% [4] of GDP in 2012 and the US federal budget deficit around 8% [5] of GDP, there is a great risk that the dollar and the US economy may not be able to support the weight of value placed on them by China & the rest of the world anymore. China, being the biggest external creditor to the US Treasury, stands to lose if it starts pulling out of its investments, since the loss of confidence would erode the value of the dollar and hence all dollar-denominated assets. On the other hand, if China continues to step up its investment, it risks increasing its dollar-exposure even more. It's indeed a catch-22 situation- like riding a tiger but not knowing how to get off without being eaten [6]. The interdependence of China and the US has fueled the dollar bubble and a lot depends on how these two economic partners take this relationship forward.

The Euro Zone Crisis

The sovereign debt crisis in the European Currency Union countries has led to a loss of confidence in the Euro as the alternate reserve currency to the dollar. In fact, it is a supplementary cause of increased dollar-demand in spite of the weak structural position of the US economy. The likelihood of Euro mitigating the risk of excess dollar-exposure now looks bleak.

The Dollar Hegemony

The US Dollar is the world reserve currency, simply because there is no other alternative. Dollar hegemony has become the US' biggest disincentive to maintain its fiscal and monetary discipline. The power of the dollar has become a double-edged sword that has the potential to cut through both the US and the global economy. The dollar bubble is perhaps the greatest emerging

economic risk the world would have to deal with in the future because the scariest part is that nobody knows how to react to a possible US default.

Unsustainable Economic Growth

With the Kyoto Protocol set to expire in 2013, and no sight of a global consensus on the road ahead concerning environmental protection, the risk of unsustainable growth looms ahead. Global oil consumption is set to cross the 100 million barrels per day (bpd) mark and at 2010 production levels, the global oil reserves will reportedly [7] last for about 131 years. With absence of formal sustainability agreements, there is an impending risk of energy shocks, price volatility and reckless growth, particularly by former non-signatories to the Kyoto Protocol such as the US.

EMERGING POLITICAL RISKS

India – Emerging Governance Deficit Risk

In India, the ruling government has come under heavy fire in the current term for a multitude of scams, some of which are to the tune of trillions of Indian Rupees (or a few tens of billion dollars). The prominent ones are the “2G Spectrum Scam” and the “Commonwealth Games Scam”. The former relates to the auctioning of 2G mobile telephony spectrum licenses at prices below market standards. The Comptroller and Auditor General of India (CAG) estimated the losses to the exchequer at 1.76 lakh crore Indian Rupees or US\$ 33.56 billion [8]. The latter scam concerns a variety of matters including over-priced contracts, infrastructural compromises, delays etc. on account of serious corruption by officials of the Games' Organizing Committee. The Commonwealth Games Scam became a national shame and faced boycott calls & withdrawal from a few countries, drawing global media attention. These scams have scarred the “India Shining” image and are becoming major hindrances in India's growth objectives.

The Jasmine Revolution – Political Instability and Oil Shocks

2011 was marked with political upheaval and regime changes in the Arab world. Till date, governments of 3 countries have fallen and many more are on the brink. While this appears to be in favour of the oppressed masses, the lack of political stability & credible democracy is a big risk to these countries. Fragmented political factions and armed militia make matters worse, potentially leading to anarchy and governance problems. The uncertain geopolitical outlook has raised concerns about the potential re-pricing of risk and the impact on international oil and gas markets, not

to mention bubble creation in other assets like gold. It is estimated that for every \$20 price increase per crude oil barrel, the world would have to forego 1% of GDP [9]. This translation of political risk into economic risk is a deadly consequence especially in times that lie ahead.

Dark Clouds over China's State Capitalism

China's state capitalism model [10] has helped it groom global corporations that have thrived and turned into big businesses churning out money for the state, increasing Chinese footprint in global markets. Yet, for all its upsides, state capitalism has inherent flaws such as conflict of interest in regulation, political interference in business and lack of innovation. Moreover with rising per capita income in China and emergence of educated youth, the next generation is all set to demand more freedom, rights and liberty. This is already visible in the form of protests against the government when the latter introduced internet access restrictions. It is likely that imminent risks would be soon evident, should the ruling class in China fail to address this issue. The credibility of the business environment in China would be at stake with serious political & economic consequences.

TRANSFORMING EMERGING RISKS INTO OPPORTUNITIES

As expressed earlier, every risk comes with an opportunity. The key lies in transforming the risks into opportunities.

To counter the demographic risk, countries experiencing the inversion of the demographic pyramid need to encourage immigration of skilled & semi-skilled labour. This may result in cultural assimilation problems in the short term, but would prevent the country from going into a phase of slowdown in the long-term. Policies to boost demographic figures, such as tax-breaks to couples bearing children could be implemented along the lines of policies in Germany. To foster social equity, public-private partnerships could be undertaken in emerging economies to develop infrastructure. Global corporations could chip in to aid this inclusive growth by bringing in technology at affordable prices, since they too stand to gain in the long run.

Capitalizing on dollar bubble risk would require bold moves from both the US and the rest of the world. China being a major global trade partner could open currency swap lines with other large economies to reduce dependence on the dollar as the trading currency. The US could swing into savings mode while China could focus on domestic consumption to tame its

surplus reserves. This would potentially restore the global trade balance. Sustainable growth, however, would require a major commitment from developed countries. To counter the implications of a deadlock over environmental agreement by the US, the European Union could set stringent import regulations linked with environmental policies, besides the imposition of carbon tax which would incentivize the move towards sustainable growth.

Transforming political risk into opportunity is the toughest. Nevertheless, measures such as the “Lokpal Bill”, a bill to bring accountability to politicians and bureaucrats, are being proposed and debated in the Indian Parliament. This is the right time (just after the scams) to channelize public opinion towards bringing about an anti-corruption bill. The Arab countries on the other hand, could be assisted in bringing in a democratic and politically stable regime through economic aid and other forms of support from developed economies which could imply oil price stability. China, on the other hand, could capitalize on the success of state owned enterprises (SOEs) by disinvesting and strengthening regulation at the same time to ensure that a free market capitalist disaster such as the 2008 recession is avoided.

SUMMARY

The world, with its emerging risks, may not be the world that the current generation would have wished for. Nevertheless, that's what it will inherit. Will the demographic risk weigh down on the current generation & will social inequity hamper balanced growth? Will the dollar bubble burst & will the world make a transition to a green economy? Will the corruption in India, the political turmoil in the Arab world and the changing socio-political environment in China impact the regional and global economic growth? Only time can tell.

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