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Risky Business: Emerging Risks for Cross-border Business

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Risky business:

Emerging risks for cross-border business[1]

Mark Thirlwell

Introduction

Cross-border businesses, Multinational Corporations (MNCs) or Transnational Corporations (TNCs) have long played an important role in the world economy.[2] Their importance can be traced back to at least the Hanseatic League and Italian banking houses of the fourteenth century, along with the East India, Muscovy and Hudson Bay Companies of the seventeenth and eighteenth centuries. Granted this long history, however, it's also clear that TNCs are an extremely important part of the international economic landscape in the modern period. In particular, the development of TNCs and of the current era of globalisation have been closely connected, as the past two decades have seen TNCs expand their overseas activities faster than their domestic ones and play a driving role in the expansion of the international production networks that now span the globe.

As the global economy has evolved, so too have TNCs. So, for example, from an initial concentration in manufacturing, foreign direct investment (FDI) by TNCs has expanded to include infrastructure, resources and services. The nature of TNC ownership has altered too, with a recent increase in the importance of state-owned enterprises (SOEs).[3]

[1] This *Perspectives* is based on a presentation delivered to the FT-Chartis meeting *Risks for Cross-Border Business: Strategies for Evolving Multinational Liabilities* held in Sydney at the Wentworth Sofitel on 1 February 2011.

[2] According to the methodological note attached to UNCTAD's World Investment Reports (WIRs), TNCs are defined as incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. A parent enterprise is defined as an enterprise that controls assets of other entities in countries other than its home country, usually by owning an equity capital stake, with a stake of 10% or more of ordinary shares or voting rights (or the equivalent for an unincorporated enterprise) treated as a controlling share. Similarly, foreign affiliates are incorporated or unincorporated enterprises in which an investor who is resident in another economy owns a controlling share. Subsidiary enterprises, associate enterprises and branches are all defined as affiliates in the WIR.

[3] See for example the discussion in United Nations Conference on Trade and Investment (UNCTAD), *World Investment Report 2010: Investing in a low-carbon economy*. Geneva, United Nations Conference on Trade and Investment, 2010. Particularly the Epilogue.

Another trend that's worth highlighting is the growing role played by TNCs headquartered in emerging markets:[4]

- On UNCTAD's count, TNCs based in emerging markets and transition economies account for seven of the top 100 TNCs. But other sources report larger numbers: the *Financial Times* has 18 emerging market and transition economy TNCs in its list of the top 100 firms, and 124 in its list of the top 500; *Forbes* has 15 emerging market and transition economy firms in its top 100 global corporations, and 85 in its top 500.

- TNCs based in developing and transition economies now account for nearly 10 per cent of the foreign sales and foreign assets of the top 5,000 TNCs in the world, compared to only one or two per cent in 1995.

- A majority of foreign affiliate employment is now located in emerging markets. China has been a particular beneficiary of this shift, by 2008 accounting for 16 million workers, or about 20 per cent of total employees in all foreign affiliates. By way of comparison, employment by foreign affiliates in the United States has declined by some half a million between 2001 and 2008.

Not surprisingly, the global financial crisis (GFC) has also had significant implications for TNCs.[5] According to UNCTAD's 2010 World Investment Report (WIR), for example, the crisis took a significant toll on the overseas operations of TNCs: in 2008 and then again in 2009 both sales and value added by foreign affiliates declined by between six per cent and eight per cent.[6] That said, because this pace of contraction was actually less than the rate of decline in overall global economic activity, the net effect was an *increase* in the share of foreign affiliates' gross value-added to a new historic high of 11 per cent of world GDP.

The GFC triggered a major shock to global trade and capital flows. The IMF reckons that world trade volumes for goods and services plummeted by almost 11 per cent in 2009, before growing by 12 per cent last year.[7] Similarly, after shrinking by almost 16 per cent in 2008, the value of global FDI inflows collapsed by more than 37 per cent in 2009, while last year

[4] Ibid.

[5] Although GFC remains the standard term, it is increasingly common to note that the crisis was concentrated in the developed economies of the United States and Europe, suggesting an alternative description along the lines of North Atlantic Financial Crisis or NAFC.

[6] United Nations Conference on Trade and Investment (UNCTAD), *World Investment Report 2010: Investing in a low-carbon economy.*

[7] Table 1 in International Monetary Fund (IMF), *World Economic Outlook update: Global recovery advances but remains uneven.* Washington DC, International Monetary Fund, January, 2011.

FDI basically stagnated, rising by just one per cent. (Another notable feature of 2010's FDI number was that, for the first time, developing and transition economies absorbed more than half of global FDI flows, as the value of mergers and acquisitions in the developing world doubled: FDI inflows to developing economies rose some 10 per cent in 2010 to reach an estimated US$525 billion.)[8]

The return of risk

The impact of the GFC is a potent reminder of some of the risks facing TNCs. Indeed, this is a particularly interesting time to be thinking about the risks facing cross-border business, for at least a couple of reasons:

- First, the recent global financial crisis (GFC) has prompted a significant change in the way we think about risk. The period preceding the crisis was one of unusually low macroeconomic volatility – the so-called Great Moderation.[9] Central banks were thought to have tamed the business cycle, and the increasingly sophisticated tools of modern risk management were widely believed (or at least, hoped) to have contributed to a significant improvement in our ability to manage various forms of risk. The crisis has changed all of this. No less an authority than Alan Greenspan has declared that the crisis triggered the collapse of the 'whole intellectual edifice' supporting the modern risk management paradigm.[10] Likewise, the world of the Great Moderation is gone, replaced by a world of fat-tailed probability distributions and Black Swans – or known unknowns and unknown unknowns. 'Risk' has made a dramatic comeback.

- But second, and setting aside for now the recent upsurge in markets' interest in political risk as a result of events in Tunisia, Egypt and Thailand-Cambodia, the new year has brought an increase in optimism regarding the trajectory of the world economy. The latest update to the IMF's World Economic Outlook, for example, notes that the second half of last year saw a stronger recovery than the Fund had expected, and the IMF thinks that after growing by five per cent in 2010, the world

[8] United Nations Conference on Trade and Investment (UNCTAD), *Global and regional FDI trends in 2010.* UNCTAD Global Investment Trends Monitor No.5. Geneva, United Nations Conference on Trade and Investment, 17 January, 2011.
[9] See for example Ben S. Bernanke. *The Great Moderation. Remarks by Governor Ben S. Bernanke at the meetings of the Eastern Economic Association*. 20 February 2004.
[10] Alan Greenspan, *Testimony to the Committee of Government Oversight and Reform.* Washington DC, US Congress, 23 October, 2009.

economy will expand at a rate of around 4.5 per cent this year and next.[11] Not fantastic, given the depth of the previous downturn. But not too bad, either. At Davos this year, observers reported a decline in fears about the health of the world economy.[12] Apparently, even the bankers have started to feel confident enough to instruct politicians to be nicer to them![13]

Nine downside risks for cross-border businesses

So, what are the risks facing cross-border business in this new, post-crisis environment? Below I list nine risks for cross-border businesses in today's global economy.[14] These range from the possible consequences of some deep-seated structural forces to more recent developments in the international risk environment:

1. The tail end of the demographic transition;
2. The complications of the Great Convergence;
3. Resource and environmental constraints;
4. The changing trajectory of globalisation;
5. The return of the state;
6. Living with the 'new normal';
7. Overheating emerging markets;
8. Between fire and ice: a divided world economy;
9. Memo from Pyongyang, Tunis and Cairo: the 'return' of political risk.

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[11] International Monetary Fund (IMF), *World Economic Outlook update: Global recovery advances but remains uneven.* Figures are for global growth with country weights on a PPP basis. On a market exchange rate basis, the Fund thinks growth will be about 3.5 per cent in 2011 and 2012, compared to almost four per cent last year.

[12] Chris Giles, Global economy fears ease at Davos. *Financial Times*, 26 January 2011.

[13] Patrick Jenkins and Francesco Guerrera, Stop bashing the bankers, Davos meeting told. *Financial Times*, 28 January 2011.

[14] Many of these trends are issues that I have been tracking for some time. For a recent stock take, see Mark Thirlwell, *Our post-GFC world economy.* Lowy Institute Perspectives. Sydney, Lowy Institute for International Policy, December, 2010.

Note that many of the items on this list encompass upside as well as downside risks, but the following will largely concentrate on the latter.

1. The tail end of the demographic transition

Beginning around the start of the nineteenth century, the world economy entered a period of demographic transition.[15] First, there was a fall in the mortality rate, followed by a fall in the fertility rate. The transition that followed involved a move from high birth and death rates to low birth and death rates, and the process saw population growth first increase, and then slow again, ultimately moving the 'transitioned' economy to low fertility and an aged population. Different countries and regions are at different stages in the process: the transition began in Europe and has subsequently spread across the globe, and is projected to be completed by around the end of the current century. [16]

To be clear, the demographic transition is mostly a good news story: it's a big part of the process of shifting from circumstances where life is nasty, brutish and short, to ones where life is longer and more pleasant. An increased life expectancy is usually something to be welcomed. Still, there are also some downside risks associated with this long-term structural shift that are worth highlighting.

First, for many rich world economies the transition process is now at the mature stage, where the age of the population has increased significantly and where population growth has slowed (or even almost stabilised in some cases). All else equal, this implies lower rates of economic growth: econometric work suggests that growth in GDP per capita is positively correlated with the relative size of the working-age population and inversely correlated with the share of the elderly. There is also some evidence that savings and investment rates are inversely correlated with dependency ratios. An ageing population is likely to be associated with lower potential growth, and lower rates of saving and investment.[17] While it is the countries of the developed world that are furthest down this path, there are several major emerging markets, including China and Russia, that will also have to manage older populations.[18]

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[15] Ronald Lee, The demographic transition: Three centuries of fundamental change. *Journal of Economic Perspectives* 17 (4) 2003.
[16] Ibid.
[17] See chapter III in International Monetary Fund (IMF), *World Economic Outlook: The global demographic transition.* World Economic and Financial Surveys. Washington DC, International Monetary Fund, September, 2004.
[18] For one (optimistic) take on this as it applies to China, see Helen (Hung) Qiao, *Will China grow old before getting rich?* Goldman Sachs Global Economics Paper No. 138, 14 February, 2006.

Second, and related, ageing populations are likely to imply greater pressures on fiscal positions as demands for age-related spending increase (health spending, pensions, aged care) even as the growth in the state's revenue base slows. On one estimate, public expenditure on pensions is forecast to increase by one percentage point of GDP on average for developed economies over the two decades between 2010 and 2030. Over the same period, health spending is forecast to increase by about 3.5 percentage points of GDP, to reach 10.5 per cent of GDP on average.[19]

But what about those emerging markets where the demographic transition is producing a decline in dependency ratios and an increase in the size of the working-age population? One positive implication is an increase in the potential growth rate, savings and investment. So there is plenty of scope for good news here. But there are risks, too. Countries need to find jobs for all of these new workers joining the labour force, otherwise there is the risk of social and political unrest. More generally, some political risk experts argue that demographic factors including a high proportion of young adults (a 'youth bulge'), especially young males, and rapid increases in the urban population can be associated with social and political instability.[20] Current developments in the Middle East and North Africa may, in part, be an example of some of these forces in play.

2. The complications of the Great Convergence

The Great Convergence is the term I use to describe the onset of rapid, catch-up growth in the most populous developing economies, led by China and India.[21] Once again, this is overwhelmingly a good news story: the combination of acceleration in per capita growth rates with the large population base of the developing world offers the prospect of a much more prosperous global economy, with much lower levels of poverty, and with a significantly expanded middle class.[22] There are, however, several important risks associated with this major shift. Here I will focus on just two.[23]

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[19] But note that much of the forecast increase in health expenditure reflects technology-induced increases in prices, along with the interaction between technological change and ageing. International Monetary Fund (IMF), *From stimulus to consolidation: Revenue and expenditure policies in advanced and emerging economies.* Staff Paper. Washington DC, International Monetary Fund, 30 April, 2010.

[20] For a short overview, see Richard P Cincotta, *Demographic security comes of Age.* ECSP Report Issue 10. Washington DC, The Woodrow Wilson International Center for Scholars 2004.

[21] For a short overview of the argument, see Mark Thirlwell, *The Great Convergence.* International Economy Comments #4. Sydney, Lowy Institute for International Policy, 9 November, 2010.

[22] See for example Homi Kharas, *The emerging middle class in developing economies.* OECD Development Centre Working Paper No. 285. Paris, OECD, 2010.

[23] For a more detailed discussion behind some of the assumptions here, see Mark Thirlwell, *Our consensus future: The lay of the land in 2025.* Lowy Institute Perspectives. Sydney, Lowy Institute for International Policy, September, 2010.

First, one implication of the Great Convergence is a major shift the distribution of economic weight (or economic power, if you prefer) across the global economy. This shift entails a rebalancing away from developed economies and in favour of developing ones. My base case scenario is for that transfer to take place *relatively* smoothly. But it's fairly easy to come up with other scenarios where the geopolitical and security consequences turn out to be much less benign, with significant adverse consequences for the global economy.[24]

A second implication of the Great Convergence is that these big structural shifts between the world's economies will be matched by big structural changes within them. Over time, these will include potentially large changes in income distribution and employment patterns, and – as a result – substantial societal changes. Again, it's possible that these changes can be accomplished without major dislocations. But there is clearly some risk that they will turn out to be quite disruptive and damaging to social and political stability, perhaps involving existential challenges for some existing political structures.

3. Resource and environmental constraints

The Great Convergence involves the rapid industrialisation and urbanisation of some of the world's most populous economies. You don't have to be a Neo-Malthusian to believe that this process carries with it the potential for some significant short-term disruption, as a rapid increase in the demand for resources bumps into supply constraints that will take time and investment to loosen, and which will require the incentive of higher (relative) prices.[25] There are also likely to be significant environmental costs involved as part of the development process including, but not limited to, climate change.

While there are some upsides here too (particularly if you are a commodity exporter / owner), there are a series of risks worth considering:

- Fears about resource security are an important source of political risk. Back in 2008, when food prices surged more than thirty countries had to deal with food riots and

[24] Mark Thirlwell, *The return of geo-economics: Globalisation and national security.* Lowy Institute Perspectives. Sydney, Lowy Institute for International Policy, September, 2010.
[25] On the revival of Malthusian fears, see Justin Lahart, Patrick Barta and Andrew Batson, New limits to growth revive Malthusian fears. *The Wall Street Journal*, 24 March 2008. For a discussion on the impactions of the rise of China and India for resources and the environment, see Alan L Winters and Sahid Yusuf, eds., *Dancing with giants: China, India and the global economy.* Washington DC, World Bank and Institute of Policy Studies, 2007. Also Shane Streifel, *Impact of China and India on global commodity markets: focus on metals and minerals and petroleum. Background paper for Dancing with Giants: China, India and the global economy.* Washington DC, World Bank, 2006.

other forms of unrest.[26] At one stage, the head of the IMF was warning that some developing countries faced a choice between feeding their people and maintaining macroeconomic stability.[27] Food prices today are now above the levels they reached in 2008, and some observers are linking them to the current unrest in Egypt and Tunisia.

- Resource security concerns also lend themselves to increases in resource nationalism (and the associated risks of nationalisation and expropriation) and to increased government intervention. The global oil market, for example, has long been subject to intense state intervention of various forms, and as a consequence more than 90 per cent of oil reserves are now estimated to be in the hands of state-owned oil companies.[28] The 2008 food crisis also prompted an increase in government intervention, as some exporting countries turned to export bans, a reaction that has been repeated during the current bout of high prices.[29] Recent fears about investment in agricultural land are another symptom of this development.

- Mercantilist-like responses to resource security concerns also run the risk of feeding geostrategic competition as countries compete for control over what they consider to be key assets, with negative consequences for the general business climate.

- There are also issues related to macroeconomic instability. Higher food and energy prices show signs of spilling over into higher general inflation, particularly in those emerging markets where there are other signs of overheating. Commodity exporters also have to manage the challenges of success, including structural change in their economies and the temptations provided by swollen government coffers, while simultaneously striving to remain aware of the downside risk that a commodity boom can be followed by a commodity slump – a regularly recurring historical pattern.

- An era of significantly higher oil prices could have important implications for globalisation. Alongside falling communication costs, lower transportation costs have contributed to the growth in cross-border trade. Higher prices could potentially

[26] Carolin Hoyos and Javier Blas, West rethinks strategic threats. *Financial Times*, 20 June 2008.
[27] IMF, Price surge driving some countries close to tipping point - IMF. *IMF Survey Magazine* 2008.
[28] The Economist, Oil's dark secret. *The Economist*, 10 August 2006.
[29] Keith Bradsher and Andrew Martin, Hoarding nations drive food costs ever higher. *The New York Times*, 30 June 2008. Andrew E. Kramer, Russia, crippled by drought, bans grain exports. *The New York Times*, 5 August 2010.

reverse some of that process, and perhaps also raise questions over the relative attractiveness of some international production networks.[30]

- Finally, climate change obviously represents a range of risks across a variable timeline. One set of risks would involve the increased chance of extreme weather events, which in turn can have consequences ranging from damage to people and property through disruption to key production sites or commodities such as energy and food. Another set of risks arises in terms of the policy response: given the difficulties experienced to date in reaching any kind of globally agreed solution, as evidenced by the lack of progress in Copenhagen, national approaches look more likely. This raises concerns about political risk, inconsistent regulations and the spread of so-called green protectionism via the introduction or carbon tariffs or other border adjustments.

4. The changing trajectory of globalisation

The next two risks I want to highlight – the changing trajectory of globalisation and the return of the state – are quite closely linked.

The changing trajectory of globalisation is to a large extent a product of one of the trends I have already discussed – the onset of the Great Convergence. As the global economy encompasses a greater role for emerging markets like China, India, and Brazil, it seems inevitable that the policy preferences of these new players will have a greater influence on both the speed and the form of global economic integration. This prospect is often captured in shorthand form in terms such as the 'end of the Washington Consensus' or the 'rise of the Beijing Consensus'. One relatively recent example of the consequences of this shift is a change in attitudes towards the use of capital controls. Until relatively recently, official opinion as captured by, for example, the statements of the IMF on the subject, was either dismissive or actively hostile towards the use of capital controls as a tool of macroeconomic policy. That is no longer the case, as a growing number of emerging markets have decided to turn to controls as a response to large capital inflows, and are doing so with a degree of IMF approval.[31]

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[30] Such fears were on the rise in 2008, when oil prices reached US$147/barrel. See for example Jeff Rubin and Benjamin Tal, *Will soaring transport costs reverse globalization?* StrategEcon, CIBC World Markets Inc, 27 May, 2008 and Mark Levinson, Freight Pain. *Foreign Affairs* 87 (6) 2008.

[31] Stephen Fidler and Jon Hilsenrath, Countries' rising use of capital controls stirs debate. *The Wall Street Journal*, 29 January 2011. For the IMF's new view, see Jonathan D Ostry, Atish R Ghosh, Karl

Moreover, there is also the reaction of the developed world to take into account. Here, I think it's plausible to argue that there has been a declining appetite on the part of voters – and hence of many politicians – for continued liberalisation and deregulation that is in part a response to the adjustment pressures created by the Great Convergence.[32] This shift has been reinforced by the global financial crisis, with its implicit lessons about the dangers of financial deregulation and innovation, and which has pushed the change beyond a loss of appetite for more deregulation and towards an appetite for more regulation (or re-regulation).

For cross-border businesses, then, these developments risk at best a marked decline in the rate of expansion of some of the forces that have helped drive their explosive growth over the past couple of decades, and – less likely but still possible – a significant reversal of those same forces.

5. The return of the state

One particularly important way in which these changes to globalisation have manifested themselves is in the return of the state to a more prominent economic role. So, for example, the rise of emerging markets that is a product of the Great Convergence has seen a relative international shift towards economies which typically give the state a greater role in their economies than do developed economies.[33] State-owned enterprises (SOEs), state-owned banks (SOBs), and sovereign wealth funds (SWFs) have become increasingly important players in the global economy, and the rise of so-called 'state capitalism' is now a popular theme.[34] The increasing attention paid to resource security issues has also prompted an increased role for government, as discussed above.

In the developed world, the reaction to the rise of this bunch of SOBs, SOEs and SWFs has also contributed to the return of the state, as governments have been tempted to tighten up

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Habermeier, Marcos Chamon, Mahvash S Qureshi and Dennis B S Reinhardt, *Capital inflows: The role of controls.* IMF Staff Position Note. Washington DC, International Monetary Fund, 19 February, 2010.

[32] I make this case in Mark Thirlwell, *Second thoughts on globalisation: Can the developed world cope with the rise of China and India?* Lowy Institute Paper 18. Sydney, Lowy Institute for International Policy, 2007. See also Mark Thirlwell, *Second thoughts on globalisation: an update.* Lowy Institute Analysis. Sydney, Lowy Institute for International Policy, September, 2007.

[33] This is a point about comparisons across countries: that is, it argues that (say) China or India give a relatively higher role to the state in their economies than does Australia. This is not to deny that many emerging markets have reduced the role of government in their own economies over time. Although on this last point, it's worth noting that many observers argue that as a consequence of the crisis this process has halted, and perhaps gone into reverse, in the case of China. See for example Michael Wines, China fortifies state businesses to fuel growth. *The New York Times*, 29 August 2010.

[34] Ian Bremmer, *The end of the free market: Who wins the war between states and corporations?* New York, Portfolio, 2010.

investment controls and other regulations in response. At the same time, globalisation has also prompted demands for increased regulation in areas such as product safety.

A further push to the return of the state has been delivered by the global financial crisis, albeit with a catch. The crisis triggered a massive amount of direct intervention in the financial sector, including huge bailouts, as well as increased government support to other sectors (particularly autos).[35] It has also prompted a wave of new financial sector regulation and the creation of a series of new regulatory bodies, including a set of new pan-European regulators. The lessons of the financial crisis are producing some significant changes to regulatory frameworks, and it seems likely that the new consensus for more capital, more liquidity and more regulatory oversight will work to wind back some of the ease with which cross-border business could access finance for international expansion.[36]

The important qualification here is that the state's return is constrained in many developed countries by fiscally straitened circumstances.

What about the risk of trade and investment protectionism more generally? Thanks to the combination of the new trajectory for globalisation and the return of the state, my view is that this risk is on the rise. The fallout from the global financial crisis and in particular, high rates of unemployment in the developed world, likewise contribute to a greater risk of governments turning to trade and investment barriers.

While the risk has increased, however, the good news is that to date there has been no major switch to protectionism. Useful monitoring exercises carried out both by the WTO and by independent observers have detected no dramatic retreat from open markets.[37] Instead, there has been a sort of slow, piecemeal and fairly modest backsliding, including some flirtation with soft or murky protectionism. Mind you, this is still enough to warrant concern: after promising at their November 2008 summit to avoid turning to protectionism, G-20 members

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[35] On government support to the financials sector see Stephanie Marie Stolz and Michael Wedow, *Extraordinary measures in extraordinary times: Public measures in support of the financial sector in the EU and the United States.* Occasional Paper Series No. 177. Frankfurt, European Central Bank, July, 2010.

[36] Work by the BIS finds that the higher capital requirements currently envisaged would have a relatively modest impact on economic growth. Bank for International Settlements (BIS), *Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements. Final Report.* Macroeconomic Assessment Group, established by the Financial Supervisory Board and the Basel Committee on Banking Supervision. Basel, Bank for International Settlements, December, 2010.

[37] For the official sector, see WTO and UNCTAD OECD, *Reports on G20 trade and investment measures (Mid-May to Mid-October 2010).* 4 November, 2010. For another view, see Simon J Evenett, ed., *Tensions contained . . . for now: The 8th GTA report.*2010.

have since between them introduced more than 500 measures likely to have a protectionist effect.[38]

In my view, *the key point here is that the long shift towards privatisation, deregulation, and liberalisation that began in the 1980s and then intensified in the 1990s, and which has been a crucial contributor to the rapid expansion of cross-border business, looks to have peaked for now. As a result, the overall regulatory environment for cross-border business is unlikely to be as supportive in the near future. In addition, private sector TNCs are set to faced increased competition from state-controlled players that may well have an extra comparative advantage in playing in this new environment.*

6. Living with the 'new normal'

Most of the preceding risks predate the global financial crisis, although the latter has subsequently had a further role to play in amplifying or accelerating some existing trends.[39] A more direct risk associated with the crisis is the adverse economic consequences for much of the developed world outside of Australia.[40] Past experience with major financial crises and other downturns confirms that the recent crisis had some particularly unfortunate features:[41]

- The trigger for the current downturn was a series of major financial accidents, and history shows that recoveries from downturns associated with financial crises tend to be slower and shallower than recoveries on average;

- The crisis occurred across a large number of developed economies, and the evidence suggests that recoveries from synchronised recessions (when ten or more advanced economies are in recession at the same time) likewise tend to be slower and shallower on average; and

- Large financial crises are often followed by sovereign debt crises.

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[38] Evenett, ed., *Tensions contained . . . for now: The 8th GTA report.*
[39] This is one of the points made in Thirlwell, *Our post-GFC world economy.*
[40] This section draws on two short papers from late last year: Mark Thirlwell, *'New normal' or just the same old nasty?* International Economy Comments #2. Sydney, Lowy Institute for International Policy, 4 November, 2010.
[41] See for example International Monetary Fund (IMF), From recession to recovery: How soon and how strong?, in *World Economic Outlook: Crisis and recovery.* Washington DC, International Monetary Fund, 2009 and Carmen M Reinhart and Kenneth S Rogoff, *This time is different: Eight centuries of financial folly.* Princeton, Princeton University Press, 2009.

These unfortunate historical precedents imply that much of the developed world now faces a 'new normal' of slower growth, higher unemployment, higher debt, and less wealth.[42] That also makes for unhappy voters, so alongside this greater macroeconomic risk, it makes sense to add in heightened political risk, as well.

Another consequence is an increase in sovereign risk. Traditionally, sovereign risk has been associated with investment in emerging markets: the last sovereign defaults by developed economies came in the wake of the Second World War. But a critical legacy of the financial crisis has been a big deterioration in sovereign balance sheets across the developed world. According to the latest IMF Fiscal Monitor, for example, this year will see advanced economies on average run a fiscal deficit of about seven per cent of GDP. At the same time, the stock of advanced economy public debt is expected to exceed 100 per cent of GDP. By way of contrast, in developing and emerging economies the fiscal gap is expected to be just over three per cent of GDP while the ratio of public debt to GDP is forecast to be just 37 per cent.[43] In other words, there has been a notable shift in sovereign risk towards the developed world.[44]

A further complication to bear in mind is that this crisis-induced deterioration in public balance sheets is taking place on top of the long-term fiscal pressures caused by demographic change, as discussed above. *With developed country governments facing the possibility of a sustained fiscal squeeze, the future likely holds some combination of tax hikes and spending cuts, or higher inflation, or a fiscal crisis . . . or even a combination of all three!* For now, these pressures are most apparent on the periphery of the eurozone, where it seems almost inevitable that one or more countries will have to undergo some form of debt restructuring – effectively ushering in that first developed country default in decades.

7. Overheating emerging markets

While much of the developed world is facing a near-term future of slow growth, high debt, and stubborn unemployment, policymakers in many developing countries are contemplating a quite different set of challenges. Here the issues are inflation, rising asset prices, and large-scale capital inflows.

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[42] The term 'new normal' is associated with Mohamed El-Erian. See Mohamed A. El-Erian, *A new normal.* Secular Outlook, PIMCO, May, 2009. Note that there is also a question about how 'normal' pre-crisis conditions really were.

[43] International Monetary Fund (IMF), *Fiscal monitor update: Strengthening fiscal credibility.* Washington DC, International Monetary Fund, January, 2011.

[44] Mark Thirlwell, *The great sovereign risk shift.* International Economy Comments #1. Sydney, Lowy Institute for International Policy, 3 November, 2010.

According to the Institute of International Finance (IIF), for example, net private capital inflows to emerging economies were US$908 billion in 2010, up an impressive 50 per cent on a weak 2009 performance, with flows to China reaching an all-time high of US$227 billion.[45] This year the IIF reckons inflows will be up again, to US$960 billion, before going on to breach the US$1 trillion mark in 2012.

An upsurge in capital flows to the developing world should not be a surprise: it represents a sensible adjustment to the new geography of economic growth, and to the shift in sovereign risk. But it is not without its dangers.[46] In particular, *a key risk is that a familiar pattern now repeats itself: low interest rates and growth prospects in the developed spark a search for yield, prompting investors to turn to emerging markets. For a while, large net capital inflows encourage a self-reinforcing boom in the recipient economies. But then appetites change, capital flows reverse (sometimes in the form of a 'sudden stop'), and the borrowers face a process of painful adjustment.* Empirical work by Carmen and Vincent Reinhart shows that capital inflow 'bonanza' periods in emerging markets are usually associated with a higher incidence of banking, currency, and inflation crises, and that they systematically precede sovereign defaults.[47] Similar work by the IMF finds that more than one-third of episodes of large net private capital inflows ended with a sudden stop or currency crisis.[48]

Will we see a re-run of a 'typical' emerging market crisis? It's certainly possible. Sure, it's true that there are several important features distinguishing this boom from its predecessors. But then, there always are. And betting on 'this time is different' typically hasn't been the best long-term strategy.

[45] Institute of International Finance (IIF), *Capital flows to emerging market economies.* IIF Research Note. Washington DC, Institute of International Finance, 24 January, 2011.

[46] See Mark Thirlwell, *Here we go again . . .?* International Economy Comments #6. Sydney, Lowy Institute for International Policy, 18 November, 2010 and Mark Thirlwell, *Meet the trilemma.* International Economy Comments #7. Sydney, Lowy Institute for International Policy, 19 November, 2010.

[47] Carmen M Reinhart and Vincent R Reinhart, Capital flow bonanzas: An encompassing view of the past and present, in *NBER International seminar on macroeconomics 2008*, ed. Jeffrey Frankel and Christopher Pissarides. Chicago, University of Chicago Press, 2009.

[48] See Chapter 3 in International Monetary Fund (IMF), *World Economic Outlook: Globalization and Inequality.* World Economic and Financial Surveys. Washington DC, International Monetary Fund, October, 2007.

8. Between fire and ice: a divided world economy

The last two points remind us that we now have a world economy which can be divided roughly into two parts (or in the current terminology, we have a two-speed recovery).[49] On one side, there is a rapidly growing (and in some cases possibly overheating) developing world. On the other, the crisis-hit developed world. Part of the world economy is in danger of becoming too hot, another part is too cold.

At the same time, however, this divided world economy is also more inter-connected than ever before. This combination generates several risks including:

- Potentially incompatible policies and diverging economic conditions imply an increase in exchange rate volatility and a rise in the risk of destabilising capital flows and currency crises;

- Competing policy objectives are already contributing to the emergence of policy frictions and disputes, with (for example) US policymakers unhappy with China's exchange rate policy, and Chinese policymakers similarly displeased with the US Federal Reserve's policy of quantitative easing. This makes international economic cooperation more difficult and increases the threat of economic conflict and hence of a turn to protectionism.

The crucial point here is that *the divided world both increases the case for international economic cooperation (in order to design consistent economic policies) while simultaneously making achieving that cooperation more difficult.*

9. Memo from Pyongyang, Tunis and Cairo: the 'return' of political risk

The ninth and final item on my list is the return of political risk. In November last year, North Korea provided us with a dramatic reminder of the importance of political alongside economic and financial risk. This year, events across the Middle East and North Africa (and to a lesser extent along the Thai-Cambodia border) have reinforced that message. I would make three additional points here.

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[49] See Mark Thirlwell, *Our divided global economy.* International Economy Comments #5. Sydney, Lowy Institute for International Policy, 16 November, 2010.

- First, current developments in North Africa and the Middle East may have been influenced by some of the issues already discussed. In particular, the role of high food prices and the presence of so-called 'youth bulges' have both been mentioned as potential contributory factors.

- Second, as investors are increasingly drawn to 'new' or 'frontier' markets by the presence of depressed returns in the developed world, the importance of old-fashioned political risk analysis will increase.

- Finally, as noted above, one potential implication of the great sovereign risk shift is that political risk is also likely to become a relatively more important factor in some developed markets, where fiscal austerity, high unemployment and divided political systems could all play a significant role.

In summary . . .

The rise of TNCs, like the rise of globalisation itself, can be traced to a combination of facilitating factors, including: liberalisation and deregulation in general, and in particular the opening up of new economies and industries to trade and foreign direct investment (FDI); a worldwide shift in political and economic attitudes away from nationalisation and towards privatisation; advances in international transport and telecommunications technology that have reduced the costs of cross-border communications and transactions; and increases in the availability of financial support for cross-border mergers and acquisitions and other forms of FDI.[50]

The preceding discussion suggests that there are now some significant downside risks to many of these drivers. To that extent, *the future external environment for TNCs may well turn out to be tougher in some key regards in the years ahead compared to the environment that has prevailed for the past couple of decades.*

Two final thoughts

To wrap up, here are two final thoughts on risk.

[50] United Nations Conference on Trade and Investment (UNCTAD), *World Investment Report 2010: Investing in a low-carbon economy.*

First, I began by noting that 'risk is back'. After a period when it seemed that a great many households, businesspeople, investors, and financiers either forgot about risk altogether, or priced it at very low levels, the financial crisis brought risk back to front of mind. Overall, this should be a good thing, and should help reduce the chances of financial and other accidents somewhat. Against this, however, there is the risk that in this kind of environment the probability of self-fulfilling crises increases, as market actors and others are now more sensitised to the danger of things going wrong, and more primed to act accordingly.[51]

Second, much of the preceding analysis is heavily influenced by the assumption that the world economy will continue to be shaped by the forces of the Great Convergence. I think that this is a sensible base case. But it is still an assumption, and one lesson we are supposed to have drawn from the recent financial crisis is that we shouldn't be too confident in our assumptions.[52]

[51] I make this argument in a bit more detail in Thirlwell, *Our divided global economy.*
[52] Thirlwell, *Our consensus future: The lay of the land in 2025.*

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