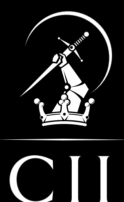
Future risk

Social and economic challenges for tomorrow

Centenary Future Risk Series: Report 2

100
1912–2012
A CENTURY OF PROFESSIONALISM



CII

Contents

contents

3 **Foreword**

4 **1. Introduction**

- 4 About this report

5 **2. Executive summary**

6 **3. Past trends and possible futures**

- 6 The global economy
- 9 Patterns of conflict

10 **4. Future socioeconomic risks: what the experts say**

- 10 **Living with a shift in global economic power**
  David Smith, Economics Editor, The Sunday Times
- 15 **Global longevity trends and their potential economic and social implications**
  George Magnus, Senior Economic Adviser, UBS
- 20 **The Long-term economic outlook for the US and its international implications**
  Dr Uri Dadush, Director, Carnegie Endowment for International Peace
- 26 **Is the Renminbi the new Dollar? Chinese monetary policy and the global reserve currency system**
  Andrew Leung, Independent Consultant and China Specialist
- 33 **The shifting balance between "risk" and "uncertainty" in a globalised world system**
  Laurence Whitehead, adviser on macro risk at Oxford Analytica

40 **5. The three scenarios**

- 41 Upside: dynamic Asia and a rebounding west
- 42 Cental: western stagflation
- 43 Downside: 1930s style depression

45 **6. The importance of insurance**

48 **7. Conclusion**

Foreword

This year the Chartered Insurance Institute celebrates its centenary year as a chartered professional body. To mark this achievement, we are publishing a series of reports, each of which explores some of the risks and opportunities that might face us in the decades to come, drawing on the assessment of commentators across various fields of expertise.

Whilst 'future gazing' doesn't always lead to accurate predictions, it is an important exercise for the insurance industry to undertake as understanding and assessing potential risks is at the heart of what we do. Indeed, central to the role of insurance is the ability to make informed, professional judgments about the relative risks of various hazards occurring over a particular period of time. By planning for the long-term and challenging assumptions about what the future might look like, the profession will be well placed to provide expertise and insight on the risks that lie ahead.

This report is the second in our centenary series and focuses on possible socioeconomic futures. Within the report, five leading experts provide their views about future risks in this area. Using the expert analysis, the report seeks to outline three possible socioeconomic scenarios and their potential implications for the insurance sector.

Stuart Reid
Chair, CII Insurance Broking Faculty

1. Introduction

The world faces a vast array of global economic and political challenges. The financial crisis and eurozone sovereign debt problems, as well as the political paralysis over the US debt ceiling, suggest we are on the verge of a seismic change in the nature of the global economy and international relations. Similarly, continuing increases in population size and life expectancy, and changes in patterns of migration throw up their own vast array of political headaches and economic trade-offs which need careful management and strong collaborative leadership. Each presents their own set of opportunities and threats, some of which are familiar and some of which are not.

Crucially, the insurance and financial services industry must be one step ahead in order to provide comprehensive insight into the changing nature of these challenges, and to recommend credible courses of action in the face of them. With this in mind and to coincide with our centenary year, over the course of 2012 we are publishing a series of reports which reflect on the great challenges of the past and explore what the future might hold.

About this report

In early February we published the first in the centenary series – ***Future Risk: Learning from history***. It set the scene for the CII Future Risk series by reflecting on some of the most dynamic trends of the past and their potential implications as well as discussing some initial findings from a global survey into the risk perceptions of members of the public from across the globe.

A central point made by the report was that in such a rapidly changing international environment, it is vitally important to question underlying assumptions about the world around us and re-evaluate prevailing wisdom. We qualified this statement by noting that whilst a healthy level of scepticism about prevailing wisdom and future forecasting is a good thing, it should not prevent us from developing some scenarios on the long-term to help us prepare for some of the opportunities and risks that lie ahead. Rather, it should ensure that we do not become overly confident and dependent upon any single story. In this context, the second in our series of reports looks at some possible socioeconomic futures and their implications for the insurance sector and society as a whole. Crucially it also seeks to identify what role the industry can play in delivering a more prosperous world.

2. Executive summary

The report begins by presenting a number of **specially commissioned essays** on future socioeconomic risks from leading experts in the field. The authors and their topics include:

- **David Smith** of the Sunday Times considers how the UK can maintain a comparative advantage in a shifting global economic order.
- **George Magnus** of UBS focuses on the economic implications of global longevity trends at a time of continuing economic strife.
- **Dr Uri Dadush** of the Carnegie Endowment for International Peace discusses the long-term economic outlook for the US and its international implications.
- **Andrew Leung**, Independent Consultant and China Specialist looks at the future direction of Chinese monetary policy and the possibility of continuing exchange rate interventions.
- **Laurence Whitehead** of Oxford Analytica considers how to cope with uncertainty in an increasingly globalised and risk averse world.

Taken together these essays represent compellingly argued visions of the future which can provide the basis for the construction of three illustrative scenarios – all of which have important **implications for the insurance sector.**

In our **upside scenario** the world is characterised by a resurgent West and a thriving East where countries act collaboratively in order to solve some of the world's biggest socioeconomic problems. In this environment, Western insurers are likely to remain highly competitive though there will be increasing pressure from Asian providers.

In our **central scenario** the world is characterised by robust Asian growth set against Western stagflation. As the US retreats from its position as global hegemon, countries increasingly act as isolated regional blocks in order to solve global socioeconomic problems. In this environment, the insurers most likely to prosper will be the ones that are able to tap into emerging markets though they may face a tough and relatively ineffective global regulatory environment.

In the **downside scenario** the West is plunged into a 1930s style depression following an ugly eurozone implosion and a failure to rebalance the global economy. Severe currency wars and 'beggar thy neighbour' economic policies return to provide the subtext for heightened geopolitical tension and civil unrest.

Crucially, the insurance sector can play a key role in determining which future it faces. **Historically the sector has helped drive economic growth, ensure sustainable public finances and mitigate political risks in emerging markets.** To maximise its effectiveness in the years ahead, the sector must continue to do the things it has done well in the past, even better in the future.

Being part of a profession will be important in this regard. In the new world, likely to be rife with uncertainties and complex, interlinked risks, a commitment to high levels of competence and ethical practice will be vital – not just for providing appropriate advice and adequately underwriting risks – but also, and perhaps most importantly, for maintaining the trust and confidence of the consumers and societies it will serve.

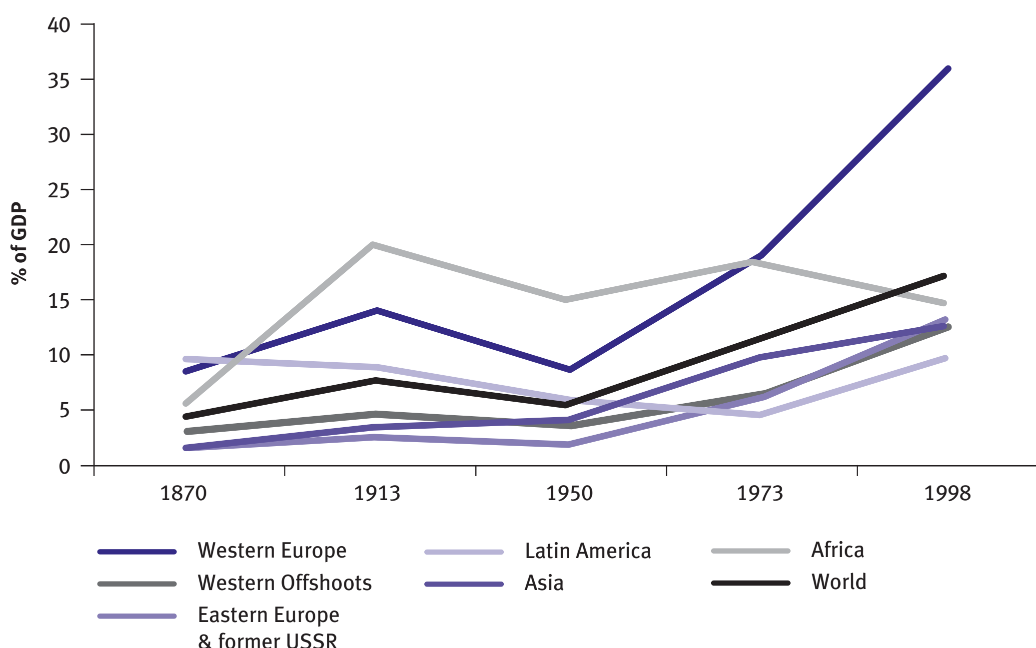
3. Past trends and possible futures

Our analysis of socioeconomic trends from the first report within our centenary series identified a number of key lessons from the past with potential implications for future risks related to the global economy, international conflict and politics.[1] In this opening section, we briefly revisit some of these lessons whilst outlining the kinds of insights that our expert authors provide. This analysis and the essays that follow, act as the building blocks for some simple socioeconomic scenarios set out later in this report.

The global economy

One key conclusion drawn from our first report was that, whilst increasing rates of growth and economic integration may be familiar, they are by no means the only important economic narratives from recent history. Prosperity has often ebbed and flowed, permeated by some of the great political and social events of our time. Indeed we argued that whilst 'beggar thy neighbour' economic policies are generally thought to be a relic of the pre-WWII era, a key risk is that they could return, particularly at times of significant economic and political stress.

Figure 1. Levels of integration: Merchandise exports as proportion of GDP



Source: OECD (2006), ***The World Economy: A Millennial Perspective***

The possibility of a return to protectionist economic policies is considered by **Dr Uri Dadush, Senior Associate and Director at the Carnegie Endowment for International Peace**. Dr Dadush's essay outlines two future scenarios for the US economy and their potential global implications. In the bad scenario, progress on trade reform, financial and monetary system reform, and global governance grinds to a halt following US withdrawal from the world stage after a prolonged recession. Even in the good scenario, US power is substantially diminished though it is still able to help lead international efforts on trade, governance and climate change.

---

1 For an in depth analysis of past socioeconomic trends please read our first centenary report, ***Future Risk: Learning from history,*** Centenary future risk series: report 1 (Feb 2012)

In Dadush's view, policy makers in Washington and Brussels must take robust action now in order to avoid the worst case. However, even if the downside scenario is avoided, and levels of economic integration increase, this still may not ensure growth and prosperity. As highlighted in our last report, the recent financial crisis showed that an important risk associated with high levels of integration is that it actually increases the chances and severity of crises which could in turn reduce long-term prospects for growth. Similarly, the recent financial crisis as well as the Asian crisis of the mid to late 1990s, highlight the possibility that the risks associated with deeply integrated and complicated global economic systems may be impossible to adequately manage or understand.

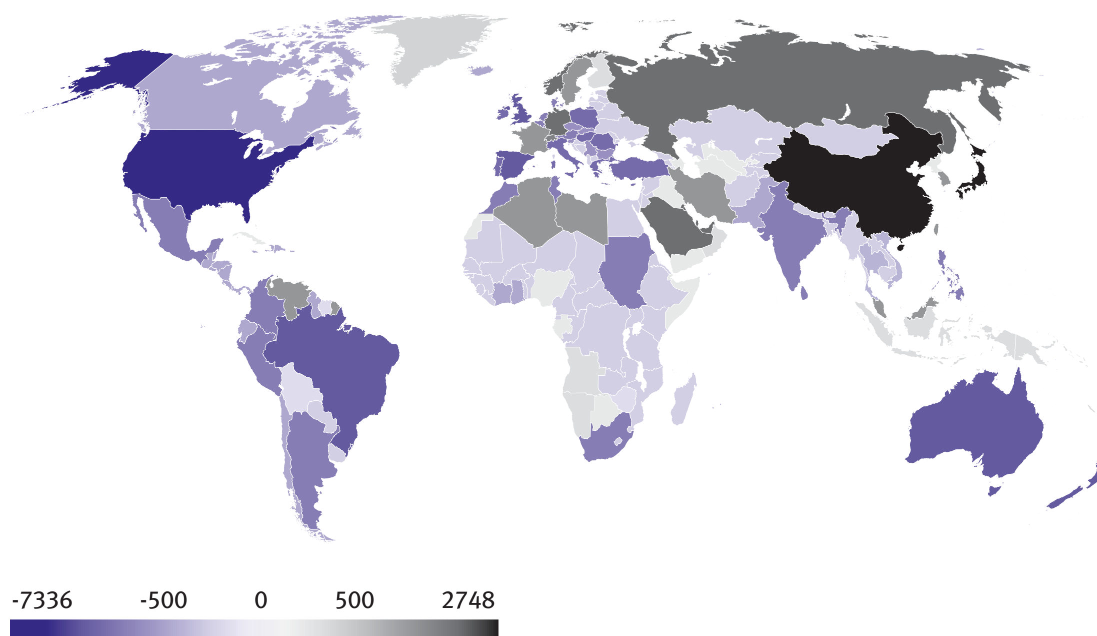
Laurence Whitehead, Adviser on macro risk at Oxford Analytica and Official Fellow in Politics at Nuffield College, Oxford, describes the current retreat from measuring risk in the prevailing financial environment. He makes the observation that the acute financial uncertainties of the 1930s that were relegated to the margins of risk analysis before 2008, have returned in the eurozone and potentially more widely. To support his argument, Whitehead provides the examples of Italy – a leading capitalist country which may ultimately prove unable to pay back its debts, and the dollar, which until the financial crisis was considered a virtually risk free currency. In response to such uncertainties which threaten to cause paralysis in decision making, Whitehead recommends going back to basic risk management principles and ensuring strong mechanisms for transparency and public accountability. Without such mechanisms, public trust in key decision makers and institutions could be undermined when mistakes are made.

George Magnus, Senior Economic Adviser at UBS Bank, is also concerned with the challenges posed by the financial and sovereign debt crises. His essay, however, is more focused on the risks posed by the combined effect of increasing international longevity against the backdrop of macroeconomic turmoil. In this context, Magnus notes the worrying way in which increasing life expectancy is 'colluding' with the crisis over economic growth to create serious shortcomings in the adequacy of retirement incomes, and how growing fiscal deficits make solving the challenge of age related spending even more pertinent. In response, Magnus outlines some actions that financial services and governments might take to minimise the risk of poor returns in old age and rising public spending.

As highlighted by both Whitehead's and Magnus's essays, the sustainability of Western economies has recently come into question, as debt (both private and public) as a proportion of GDP has substantially risen across Europe and North America. In contrast to the West's indebtedness and persistent current account deficits, a number of middle income developing countries[2] like China, continue to run large current account surpluses whilst experiencing breakneck economic growth. As a result of these contrasting trends, many agree that the global economy has been, and indeed remains, dangerously unbalanced, with a consumer driven indebted West on the one hand, and an overly export intensive high savings East on the other. Some fear this will result in a lasting decline in competitiveness for the West.

2 In terms of Gross National Income per capita

Figure 2. Map of current account balances



Source: IMF ***World Economic Outlook Database*** 2009.

Graphical representation available from: http://en.wikipedia.org/wiki/File:Cumulative_Current_Account_Balance.png

The shifting global economic order is the focus of an essay from **David Smith – Economics Editor, Sunday Times**. His essay discusses the implications for the UK of unprecedented economic growth across the developing world and argues that the future does not have to be bleak – pointing to the absolute improvement in UK living standards since the rise of America in the 20th Century which usurped the UK as the world's dominant economic force. However, crucial to maintaining UK competitiveness, argues Smith, is for it to reconfigure trade with the East – which he admits is a big challenge. In response, Smith highlights a number of key industries that the UK could build a substantial comparative advantage in, including advanced manufacturing, pharmaceuticals, aerospace and financial services.

The continued rise of Asia is not, however, an inevitability. China, for example, which Dadush predicts will overtake the US economy in the next decade, currently faces an economic predicament of its own: "*...fast growth has fired up the country' s economic engines, but it has also led to stubbornly high inflation, which threatens to overheat the economy and undermine the long-running boom*". The key concern is that; "*soaring asset prices could eventually tumble, leading to a wave of non-performing loans at the big state owned banks*" derailing growth.[3] The implications of China, the world's leading creditor, facing its own financial crisis would be disastrous – so much so, that it is the top global risk identified by Oxford Analytica.[4]

In this context, **Andrew Leung, International and Independent China Specialist**, focuses on monetary policy in China and its potential implications. He argues that any drastic appreciation of the Renminbi (RMB) is likely to cause catastrophic job losses and social instability in the country. As a consequence, Leung argues that China must retain an independent RMB exchange rate, allowing for only gradual and measured appreciation. He also argues that China should retain the protection of a non-convertible capital account given Asia's past experience with capital flight. Leung does, however, think that China is ready to liberalise its financial services sector.

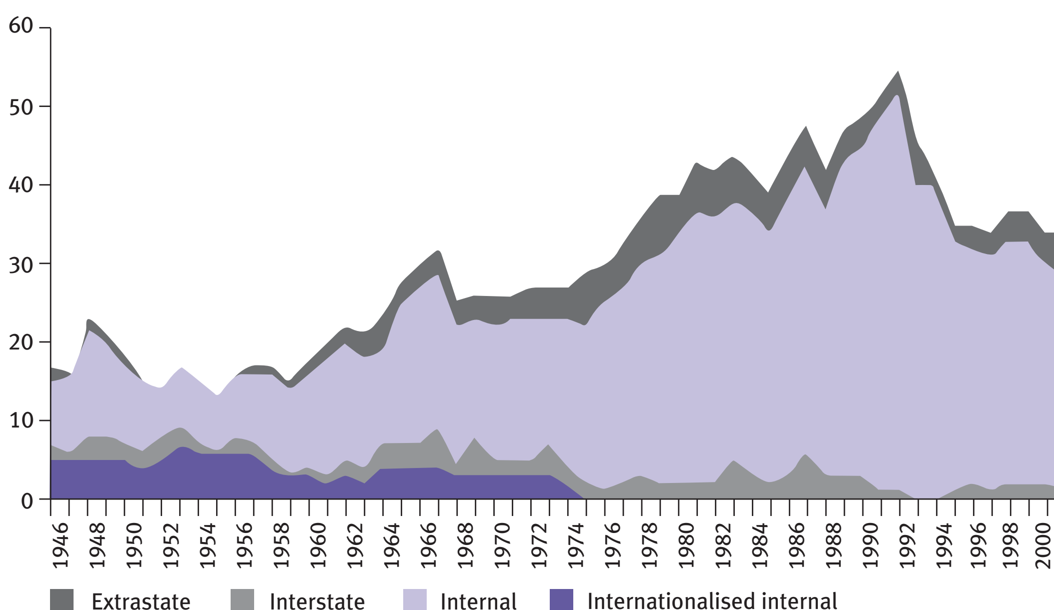
3 David Barboza (April 2011), ***Fast Growth and Inflation Threaten to Overheat Chinese Economy***, article in the New York Times

4 Oxford Analytica (Jan 2012), ***Global Risk Monitor*** http://www.oxan.com/Analysis/GlobalRiskMonitor/#risk1 (last accessed, 28 Feb 2012)

Patterns of conflict

Alongside considering global economic trends, our first report in the series also looked at international relations and patterns of conflict. In particular, it noted that since the 1960s, instances of **conflict between states** have been rare with civil war and acts of terrorism, the key security threats now facing many nations across the world today. The reasons for a decline in the frequency of so called interstate conflict, is, however, relatively unclear and much debated. The concept of nuclear deterrence is highly controversial, whilst the so called democratic peace is only relevant for explaining the lack of conflict between sets of democratic nations. We concluded that the risk of interstate conflict, particularly between democratic and non-democratic countries, is therefore, very real, particularly at a time of serious macroeconomic instability.

Figure 3. Conflict by type 1945–2000



Source: Gleditsch et al (2002) ***Armed Conflict 1946–2001: A New Dataset***, Journal of Peace Research, Vol 39, No.5 pp.615-637

In this regard, **Laurence Whitehead's** essay notes that there are substantial uncertain geopolitical implications of the 'rise of China', the resetting of US-Russian relations, and the potentially disorderly weakening of the European Union. However, for Whitehead, the greatest source of geopolitical uncertainty lies in the Middle East, where turbulence concerning countries such as Israel, Iran, Egypt and Syria, prevents the possibility of reliable long-term planning. In response to this issue, Whitehead recommends scaling back reliance on predictive models and embracing qualitative evidence, interpretive theorising and well-honed judgement.

Dr Dadush also considers geopolitical risks stemming from a substantial demise in US power. He argues that should the US retreat as a global player, a large power vacuum would materialise which would in turn lead to a weakened international community. As a result, vital aid efforts to the poorest parts of the developing world would dramatically fall increasing the chances of grievance and peripheral conflict.

In short then, our expert authors identify a number of significant and interrelated socioeconomic risks, which could have substantial implications for long-term peace and prosperity. Crucially, a number of the expert authors argue that effective action must not be deferred – what policymakers and business leaders do now will have important implications for our long-term future. In later chapters we will use this expert analysis to form the basis for some socioeconomic scenarios.

4. Future socioeconomic risks: what the experts say

Living with a shift in global economic power

David Smith, Economics Editor, The Sunday Times

In a period of economic uncertainty, it is easy to lose sight of the big picture. The big picture at the moment, if we lift our heads above the uncertainty of the global financial crisis and events in the eurozone, is a profound shift in the axis of world economic power.

In 2001 Jim O'Neill, an economist with Goldman Sachs, ensured immortality by coming up with the acronym BRICs, for Brazil, Russia, India and China. Backed up with some long-term projections of where these economies were heading, and the likely supplanting of the West as the driver of the world economy by the BRICs and other emerging countries, O'Neill and his colleagues put down a marker for the future.

Given the vagaries of economic forecasting, and changes in economic fashion, many such markers have been put down over the years. Most of them are quickly forgotten when they prove to be inaccurate.

But, more than a decade on, the BRICs have stuck and, indeed, have been joined by other groupings, including the Civets (Colombia, Indonesia, Vietnam, Egypt, Turkey and South Africa), the "7 per cent club" (economies that have consistently achieved growth rates at or above that rate) and the Next 11 (Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, Philippines, South Korea, Turkey and Vietnam).

> *"What was a pioneering idea just over a decade ago is now commonplace. Emerging economies are driving the global economy."*

What all these groupings have in common – and there is some overlap – is that they reflect the rise of emerging economies. What was a pioneering idea just over a decade ago is now commonplace. Emerging economies are driving the global economy.

The International Monetary Fund's numbers capture it well. In 2009, the worst year for the global economy since the Second World War, advanced economies shrank by 3.7 per cent, a very severe recession, while the emerging world grew by 2.8 per cent. While America suffered a 3.5 per cent fall in gross domestic product, and the European Union shrank by 4.2 per cent, China achieved 9.2 per cent growth and India 6.8 per cent.

In 2010, a year of recovery, advanced countries bounced back, growing by 3.1 per cent but the emerging world saw a 7.1 per cent boost. In 2011, according to the IMF's estimates, the contrast grew, advanced economies growing by just 1.6 per cent, compared with 6.4 per cent emerging-economy growth, a picture it expects to persist, despite all the uncertainty, in 2012.

It was not always this way. Though it was possible to point in the early 2000s to undoubted stars such as China, with an average growth rate then of nearly 9.5 per cent since 1978 (a rate that has stuck), its performance was not typical of the emerging world.

Though emerging economies have a lot of catching up to do which can only be achieved by growing more rapidly than the old, advanced countries, for a long time they failed to do so.

As recently as the late 1990s, emerging economies taken together did not outperform the advanced world. Though there were undoubted stars such as China, the average was dragged down by poor performance in Africa, Latin America and other regions.

The result was that the world was driven by advanced economies; America, Japan, Britain and the rest of Western Europe, Canada and so on. These countries accounted for two-thirds of global economic growth and pulled the emerging world along with them.

Now it is the other way around. Two-thirds of global growth is from emerging economies, while the advanced world is struggling to provide the other third. It is not hard to see why. America and Europe are suffering under the weight of their twin hangovers: the hangover of a damaged and weakened banking sector and the fiscal hangover of gaping budget deficits and rising public sector debt that have to be tackled.

> *“America and Europe are suffering under the weight of their twin hangovers: the hangover of a damaged and weakened banking sector and the fiscal hangover of gaping budget deficits and rising public sector debt that have to be tackled.”*

Emerging economies have shown themselves capable of growing even in the direst circumstances for the world economy, as we saw in 2009. Through thick and thin, good times and bad, emerging economies will outperform their advanced-country counterparts.

This is not just because they have fewer of the problems of excess which are bedevilling the West, or because they have plenty of catching-up to do, though both are important. It is also because the emerging world is increasingly trading with itself. Trade within Asia bounced back sharply after the worst phase of the global financial crisis three years ago.

Growth in some emerging economies, moreover, is generating growth in others. The emerging world is where the action is. A few years ago Africa’s best hope appeared to lie with aid and debt relief from the West. Now there is a new prosperity driven by commodity demand, particularly from China.

The other big shift is towards domestically-generated growth. Emerging economies have come to realise they cannot rely exclusively on American or European consumers. Domestically-generated growth reduced reliance on the West and is politically necessary: sharing the benefits of growth among the wider population. China’s 2011–15 five-year plan, for example, explicitly has this aim.

What does all this mean for Britain? As noted earlier, this is a period of considerable economic uncertainty. The global financial crisis which began in the summer of 2007, reached its most serious phase in the autumn of 2008 before returning with a vengeance to the eurozone during 2011, has affected us all.

It broke a long sequence of rising prosperity – the 16 years of growth that preceded the crisis broke records for the modern era – and led to an unusually sharp drop in living standards.

> *“It [the crisis] broke a long sequence of rising prosperity – the 16 years of growth [in the UK] that preceded the crisis broke records for the modern era – and led to an unusually sharp drop in living standards.”*

One easy way of thinking of the crisis's impact is by reference to the projections the Office for Budget Responsibility (OBR) presented alongside George Osborne's most recent Autumn Statement. It said that Britain's economy in 2016 will be 13 per cent smaller than it would have been had Treasury projections of the "trend" or normal rate of growth made in 2008 been achieved.

Put another way, the OBR's calculations for real household incomes suggested it will take until 2014 or 2015 to get back to 2008–9 levels. The Institute for Fiscal Studies went further, talking of a "lost decade" for median real household incomes. Not until 2016, it said, would households get back to where they were in 2006.

All this, as noted, is highly unusual. Sir Mervyn King pointed out quite early on that you have to go back to the 1920s, in other words before the Depression years, for a period of depressed real incomes as long as this. The National Institute of Economic and Social Research says that, on present evidence, this will be a longer period of "depression", which it defines as the time taken to get back to the previous peak for gross domestic product, than the 1930s.

When we look at Britain's neighbours and competitors, the picture is depressingly similar. The struggle for eurozone economies of trying to hold the single currency together is both compounded by and has contributed to their economic weakness. That weakness, given Britain's trade links with eurozone economies, transmits itself directly across the English Channel.

So should we view the rise of the emerging world with despair? Does it mark a passing of the economic baton from West to East in a way that will permanently impoverish us? Some commentators, after all, argue that the fall in living standards in Britain now is the shape of things to come. Do we have to accept the end of rising prosperity?

The answer to that is no, though I will qualify it in a moment. The biggest confusion people get into on this subject is to muddle absolute prosperity and relative prosperity. The easiest way to think of this is with the example of America's rise during the 20th century.

Did the rise of the United States make Britain relatively poorer in the last century? It most definitely did. Britain's displacement by America as an economic superpower saw US living standards catch up with then comfortably overhaul those in the UK. But did it make people in Britain absolutely poorer? It most definitely did not.

By the end of the 20th century UK living standards were far higher than at the start. In the second half of the 20th century they doubled roughly every 25 years. History tells us that it is wrong to regard the rise of new economic powers as purely a threat. They represent a considerable opportunity as well. Growth in the world, wherever it is, generates prosperity elsewhere.

"History tells us that it is wrong to regard the rise of new economic powers as purely a threat. They represent a considerable opportunity as well. Growth in the world, wherever it is, generates prosperity elsewhere."

There are, as noted above, one or two caveats. One feature of the rise of the emerging world has been much higher commodity prices. Oil prices did not break decisively above $40 a barrel until as recently as 2004. More recently, energy and commodity prices have been pushed to record levels.

This is because emerging economies are commodity-hungry. Their growth involves a lot more energy use and, as living standards rise, a big increase in commodity use, putting upward pressure on prices. So the normal post-recession experience for the West, of many years in which inflation is depressed, has not been repeated this time. Hence we have had the phenomenon of the squeeze on real incomes. It seems likely that commodity prices will be indefinitely higher than in the past although they are by their nature volatile.

The second general point is that countries like Britain have to look to their laurels. “The world does not owe us a living” is a phrase beloved of politicians but that does not mean it is not true.

In particular, the challenges that were there before the financial crisis remain and, if anything, the urgency of dealing with them has increased. There are many of these but I shall concentrate on just two.

The challenge of providing for an ageing population in a way that does not destroy the productive part of the economy is a live one. Politicians are starting to respond by increasing the state pension age and reforming public sector pensions but may only have scratched the surface and, in areas like long-term care provision, are not far beyond first base.

The issue is simply stated. The countries which will drive the global economy in the coming decades are mainly young – China is the big exception – with youthful populations. Half the population of India is under the age of 25 and three-quarters are below 35. Though Britain is relatively well-placed demographically among advanced economies, the risk of being a weak “old” economy is a real one.

> *“Though Britain is relatively well-placed demographically among advanced economies, the risk of being a weak “old” economy is a real one.”*

To take another challenge, we have to ensure that the emerging world does not decide it can do without us. Trade between China and India is increasing at a far faster rate than between either of them and the West. Britain’s share of global exports fell from 5.3 to 4.1 per cent between 2000 and 2010. The UK sells 10 times as much to the eurozone as to Brazil, Russia, India and China combined. India is only Britain’s 18th largest export market.

So there is a huge task in re-orientating Britain’s exports towards these fast-growing economies and to building up the sectors in which the economy has comparative advantage, and in goods and services that are in demand. They include, clearly, advanced manufacturing, pharmaceuticals, aerospace, and financial, business and professional services. They also include knowledge-based sectors which have so far barely made it out of the laboratory. Staying ahead in these will perhaps be the biggest challenge in this rapidly changing world.

> *“...there is a huge task in re-orientating Britain’s exports towards these fast-growing economies and to building up the sectors in which the economy has comparative advantage, and in goods and services that are in demand.”*

It is possible to be optimistic. I started this piece with Goldman Sachs and I shall end it with them. In a paper published in December 2011, the investment bank said that only the United States and Canada would have higher levels of GDP per capita than Britain in 2050.

Though Britain would slip to 10th place in the league of global economies by size, it would still be ahead of emerging economies in per capita income levels, as well as faring better than the rest of Europe, because immigration would continue to ease the demographic challenge of an ageing population and because of higher levels of project investment.

“Looking forward, we think the UK is capable of holding its own and in fact moving ahead of some of the other developed economies,” it said. Let us hope, as with the BRICs, Goldman Sachs is right.

Global longevity trends and their potential economic and social implications[5]

George Magnus, Senior Economic Adviser, UBS and author of the "Age of Aging" (2008)[6], and "Uprising: will emerging markets shape or shake the global economy?" (2010)

According to the Global Aging report 2010 from rating agency, Standard and Poors', "No other force is likely to shape the future of national economic health, public finances, and national policies as the irreversible rate at which the world's population is growing older".

No one disagrees global aging is having, and will continue to have profound consequences, as suggested. But 'no other force' seems a little over the top. The global system, and our societies are facing their biggest challenges in peacetime perhaps since the Industrial Revolution as a result of the rise of China and other emerging and developing countries. And the protracted and fractious consequences of the financial crisis for the economic, social and regulatory environment certainly qualify as 'game-changers'. Who knows for how long Western countries are going to have to deleverage their economies, or what the multi-year consequences will be? And how can we predict what Europe is going to look like in the next few months, let alone in the longer-term? These phenomena will shape the future too, but with even less certainty, and much less predictable consequences, than global aging, itself.

Demographic dynamics

In advanced economies, the crossover between the number of people aged over 60 and those aged under 14 as a share of the population was reached about 10 years ago. By 2050, there will be twice as many older citizens as there are children. By contrast, in emerging countries, there are still three times as many children as there are older citizens and the crossover is not predicted to happen until 2040. There are some notable exceptions, where age structure is changing extremely rapidly, almost on a par with the West, including in China, Russia and Eastern Europe.

By 2050, the number of over 60s in advanced nations is expected to rise by 2.5 times to around 418 million, and the number of over 80s will rise 6 times to over 120 million. In the emerging world, the number of over 60s will grow by more than 3 times to 1.4 billion, and this includes a 6-fold increase in the expected population of those aged over 80, to 262 million. Altogether, the over 60s will rise from 759 million to 2 billion, equivalent to a rise in their share of the population from 22 per cent to 33 per cent in advanced nations, and from 9 per cent to 20 per cent in emerging nations.

The most astounding feature of global aging nowadays is its speed. It took France over a century for the over 60s to double from 7 per cent to 14 per cent of the population. In most other developed countries it has taken or is taking between 40–80 years. But most emerging nations will accomplish this shift in roughly 20 years, with China already the fastest aging country on Earth. Its population of over 60s will grow from 144 million or 11 per cent of the population, to 438 million or 31 per cent by 2050. Some cities, for example, Shanghai, already have an age structure similar to that of Japan, which is the oldest Western country.

"The most astounding feature of global aging nowadays is its speed. It took France over a century for the over 60s to double from 7 per cent to 14 per cent of the population...but most emerging nations will accomplish this shift in roughly 20 years."

5 Based on an address to the 7th Chief Risk Officer Assembly, Swiss Re, Zurich, 16th November 2011

6 http://georgemagnus.com/books/the-age-of-aging-how-demographics-are-changing-the-global-economy-and-our-world

The problem for China and other emerging countries is that they are starting to encounter the longevity challenge at levels of per capita income and social security provision that are substantially lower than was the case for Western nations when they had a similar median age and other demographics to those of emerging markets today.

The challenge of rising longevity is a darker prospect than the traditional perspective which celebrates longer life expectancy as self-evidently good. The reason is because of the economic implications of the collapse in and sustained low levels of fertility. Put another way, there are not enough babies being born to become the workers who will support and finance the rising population of older citizens. In most advanced countries, the 3–4 working age people per older citizen will become 2 or less by the middle of the century, while in China, for example, the 10 workers who support each older citizen will become just 2.5.

It is the implied change in age structure, that is the soaring numbers of older citizens in relation to working age people, that is the root of the problem, and boils down to the fundamental economic problem of a stagnant or diminishing labour supply, and skill shortages. Boeing's senior vice-president of human resources, for example, told an audience in 2010 that by 2015, 40 per cent of the aircraft maker's workers would be eligible to retire. Recruitment and staff retention are becoming a major problem for a growing number of businesses, as evidenced in recent times by announcements at Siemens and BMW, and, therefore, for the economy. In the US, about 19 per cent of US manufacturing workers are aged 54 or more, which is roughly the same as for the workforce as a whole. But only 7 per cent of manufacturing workers are under 25, which is half that of the total workforce.

> *"With Western countries having already banked their [demographic] dividend, the headwinds to these benefits are going to gather inexorably, unless we can find new coping mechanisms to address the shortfalls in labour supply and skills."*

From an economic perspective, the significant change, then, is on the coming crunch in the working age population, and on the payback from what demographers call the 'demographic dividend'. This is the phase during which child dependency is declining, and the working age population is expanding from prior higher fertility rates, but before rising old age dependency kicks in. It is where advanced countries were for much of the post-WW2 era until a few years ago, and where most emerging countries are now. This dividend is associated with strong trends in income and consumption growth, increasing asset market development and asset returns, and economic expansion. With Western countries having already banked their dividend, the headwinds to these benefits are going to gather inexorably, unless we can find new coping mechanisms to address the shortfalls in labour supply and skills.

The collusion of rising longevity and the financial crisis

From a financial markets standpoint, the crisis has cemented a low interest rate environment, weaker equity returns, and a worrying uncertainty as to what constitutes a risk-free rate, all in the context of more stringent regulation, and increasingly of financial repression, that is, policies designed to ensure that domestic investors continue to fund government deficits.

But demographic change does some of these things too, as suggested already by Japan's experience with ageing over the last 22 years. After all, as the age structure of society rises, more and more people move out of productive work into retirement, but are not being replaced because of weak fertility rates. This tends to shift income distribution from capital to labour, underpinning weaker equity returns. Or, as now, it causes companies to continuously look for labour cost savings, which in turn, depress aggregate demand with similar consequences. In a macabre way, we could argue that rising longevity and other demographic factors are colluding with the crisis over economic growth to create serious shortcomings in the adequacy of individual retirement funding and of private pension and insurance schemes, and in sovereign solvency, given both existing budgetary conditions and the unaffordability of public age-related spending, based on existing commitments.

"In a macabre way, we could argue that rising longevity and other demographic factors are colluding with the crisis over economic growth to create serious shortcomings in the adequacy of individual retirement funding."

It is possible that financial services companies could play an important role in developing new savings and insurance products that will help the growing numbers of retirees meet their changing financial needs, and providing pension and related services as financially stretched governments pass financial provision and care responsibilities back to individuals.

Financial products and services demanded by individuals, for example, will continue to shift from those that accumulate savings during working lives to those that facilitate their draw-down during ever longer years of retirement and old age care. The longevity phenomenon is changing the standard life-cycle hypothesis that lies at the heart of things we have taken for granted in financial services for a long time, including patterns of savings behaviour and lifestyle financial products. Put another way, rising life expectancy, longer years at work, and perhaps as much as 20 years or more in retirement require people to retain at least some exposure to risk assets for longer than has been the case until recently. Evidence for the Federal Reserve's four-yearly Survey of Consumer Finances confirms that households, headed by older citizens, continue to have more conservative asset allocations than their younger peers, but retain higher levels of risk exposure than their predecessors. Asset managers will have to develop products that maintain financial exposure to equities and other risk products for longer, while controlling for the market volatility that older savers especially need to avoid.

"Asset managers will have to develop products that maintain financial exposure to equities and other risk products for longer, while controlling for the market volatility that older savers especially need to avoid."

There are ways in which governments can also mitigate the consequences of rising longevity for the economy. Immigration is an obvious example, except for the fact that for the time being, the politics are hostile – and in the case of most European countries and Japan, the scale of immigration needed to compensate for the effects of rapid ageing is unimaginable in practice. Other mechanisms are about keeping and bringing into work people whose participation rates in the work force is low, specifically older workers, and women.

Keeping older workers at work and enticing more into some form of work cannot be addressed by age discrimination legislation alone. Other than in Japan, where high older worker employment rates are the norm (but not for women), this requires governments and citizens to take a realistic view about the ability to work longer. To an extent, this is already evident in the spate of policies designed to raise the retirement age in steps or align it with longevity, or to raise other eligible ages for access to pension and healthcare benefits.

Governments are now raising retirement ages either because they are forced to do so under IMF programmes or because they are self-imposed for reasons of financial duress. But even higher retirement ages won't solve the longevity problem totally. This will require a comprehensive shift in thinking about the nature and flexibility of work and the workplace, the introduction of phased retirement schemes, new occupational and compensation structures to suit older workers, and a strong commitment to life-long skill formation and retraining.

“But even higher retirement ages won't solve the longevity problem totally. This will require a comprehensive shift in thinking about the nature and flexibility of work and the workplace.”

The position of women in ageing societies will become increasingly significant. It is worth emphasising that the demographic challenge is less in countries that have higher fertility, and it is no accident that countries, such as the US, Canada, the UK and Sweden that have higher fertility rates also have the highest proportions of women at work. This is essentially, of course, about affordable and widely available systems of child care. But higher female participation in the labour force is also about systems that better protect younger women, who head up the vast majority of single parent families, and all women to the extent that they tend to dominate part time and less well paid work, and are at risk from financial penalties associated with career breaks, having children and getting divorced.

It should be noted also that because of greater female longevity, the female proportion of the older citizen age group is going to rise, and women are typically disadvantaged compared to men, especially if they live alone, and as they grow older. In the UK, about a third of women aged over 55 have no retirement savings at all, and of those that do, over half have nowhere nearly adequate provision.

Inadequacy of retirement savings, however, is a common problem. The consequences of falling house prices, low interest rates, and weak equity markets aside, insufficient retirement savings were a cause for concern before the financial crisis. In the US just before 2008, the Federal Reserve found that 60 per cent of households in the bottom third of the income distribution had insufficient savings for retirement, and almost 50 per cent of the middle third and 42 per cent of the top third were in a similar position. These numbers are bound to have risen with higher unemployment and weaker economic and stock market conditions.

A massive issue arising from rising longevity in current circumstances is precisely how older workers can save for retirement, especially if they are struggling with too much debt or unaffordable mortgages, but generally when interest rates are at generational lows and equity returns are meagre and volatile. This applies in particular to those not covered by private pension plans, or relying on pay-as-you-go pension systems. Only 6 countries accounted for the vast majority of the $31 trillion in pension assets at the end of 2010. They were the US with a 63 per cent share, the UK (9 per cent), and Canada, Japan, the Netherlands and Australia (17 per cent). Some countries, such as Denmark, Switzerland and Finland, had high pension assets as a share of their own GDP, as did Chile and Korea. But in much of Europe, including Spain and France, as indeed in much of the emerging country universe, pension assets are small by comparison.

Public sector savings, or the lack of them, are now the focus of attention on an unprecedented scale in Western countries. The rise in the ratio of public debt to GDP to well over 100 per cent that we have seen since 2008 is indeed unprecedented in peacetime. Most governments face many years of deleveraging, or restructuring their fiscal balances and policies, so as to stabilise and then lower the public debt burden. Some, such as Greece, Ireland and Portugal face insolvency risks that have shut down their access to private markets, and forced them into IMF programmes. We cannot know how this sovereign crisis is going to end up, especially in the eurozone, not least because solutions are heavily dependent on the political willingness and capacity of governments and citizens to deal with the consequences. Suffice to say, that the scale of the task is enormous. The net present value of age-related spending over the next 40 years in advanced nations is roughly 5 times their 2010 GDP.

“Suffice to say, that the scale of the task is enormous. The net present value of age-related spending over the next 40 years in advanced nations is roughly 5 times their 2010 GDP.”

Conclusion

Rising longevity conveys a standard fayre for actuaries, demographers and pension fund consultants. It only sounds threatening in a financial sense for pension plan providers and beneficiaries. In a wider context, though, it is also about broad-based financial security in societies experiencing an unprecedented rise in age structure. It is about fault lines in the way our economies work. And it is, pressingly, about the financial viability and possible solvency of governments, entailing a politically fractious debate about the redrawing of entitlement rights and responsibilities of citizens and the state. And these are just some of the economic consequences. There are social implications too for public policy as it applies, for example, to immigration, education, and care in the community, and for families, as yesterday’s two generation family structures with siblings and cousins become multiple so-called ‘beanpole’ families.

“After a period in which banks and financial service providers, among others, have been pilloried for their role in creating the crisis, it would be fitting indeed if the industry played a strong role in devising at least some of the answers to the challenges posed by rising longevity.”

We have to find new coping mechanisms in the creation of jobs, especially for women and older workers, in the way we think about the nature of work, the workplace and retirement, and in the systems that encourage people to save more for retirement and allow them to manage their savings for the decade or two in which they spend their twilight years. The financial crisis has certainly retarded the process, and aggravated the economic consequences of rapid societal ageing. After a period in which banks and financial service providers, among others, have been pilloried for their role in creating the crisis, it would be fitting indeed if the industry played a strong role in devising at least some of the answers to the challenges posed by rising longevity.

The Long-term economic outlook for the United States and its international implications

Dr Uri Dadush, Senior Associate and Director International Economics Program, Carnegie Endowment for International Peace

The long run economic success of the United States will determine its ability to continue to provide economic and political leadership to the order it created in the aftermath of World War II. Though the US economy exhibits some salient areas of strength, there are also areas of vulnerability. The future is uncertain, but how the US economy evolves will certainly have implications for the rest of the world.

A National scorecard

The United States is potentially among the best-placed economies to benefit from the twin modern-day trends of globalisation and technology. Typically ranking in the top five of the World Bank's Doing Business Indicators and the World Economic Forum's Global Competitiveness Index, the United States remains not only the largest economy in the world by a factor of three in current dollar terms but also among its most open, innovative, and flexible. Its high per capita income reflects high productivity – the broadest and single best measure of competitiveness. Despite being home to less than 5 per cent of the world's population, the United States accounted for 28 per cent of global patent applications in 2008 and is home to nearly 40 per cent of the world's best universities. Furthermore, US demographic trends are favourable compared to those in other advanced countries. Over the next twenty years, the UN expects the United States' population to grow by 17 per cent, while projecting that of the rest of the developed world will grow by only 1 per cent. Part of this strength comes from high immigrant inflows and the country's unusual ability to integrate migrants.

“The United States is potentially among the best-placed economies to benefit from the twin modern-day trends of globalisation and technology.”

Nevertheless, the United States is also plagued by serious and growing weaknesses. Health care is expensive and inefficient: public and private health spending is 50 per cent higher per capita than that of the next highest Organization for Economic Cooperation and Development (OECD) country, but the US infant mortality rate, at 6.7 deaths per 1,000 births, is higher than in all OECD countries except Turkey and Mexico. Moreover, as the population ages, health care costs, which already account for about 17 per cent of US GDP, are expected to rise rapidly. Secondary education is weak, with fifteen-year-old American students ranking only 31st of 65 countries in mathematics tests and 22nd in science tests in a survey that includes many developing countries. This could mean that while future US workers will lay claim to the world's highest wages, many will bring only mediocre skills. Some also believe that the United States has a large infrastructure deficit relative to other countries, though hard evidence on this is difficult to come by.

The US income distribution is considerably more unequal than other advanced countries, and that divide is growing. While incomes of the top 1 per cent of Americans have soared, median household incomes have declined since 1999. Moreover, the American Dream has become a myth for many people: social mobility is lower and relative poverty rates are higher in the United States than in most other advanced countries.

Despite its high productivity and competitiveness, the US cumulative current account deficit over the last thirty years is $8.5 trillion, a reflection of extremely low household savings rates and government deficits. Dysfunctional tax policies are partly to blame for the indebtedness of both households and the federal government. The US tax system – complex and rife with distortions – overly encourages borrowing, including for housing. It is also an outlier among advanced countries in numerous other ways – for example, in its very low effective corporate tax rate (though high nominal rate), low effective income taxes on the richest Americans, tax breaks on large mortgages which are regressive, and low gasoline tax.

The United States retains a dominant military apparatus. For example, the United States owns 11 of the world's 20 aircraft carriers – and Italy's fleet of two is the second largest. But this does not come cheap. US defence spending accounts for nearly 5 per cent of its GDP – a share about twice that of other developed countries – and for 40 per cent of global defence spending.

Last but not least, an increasingly polarized and even dysfunctional political system is contributing to the fiscal mess, as evidenced by the brinkmanship surrounding the debt ceiling and the failure of the congressional "supercommittee." Political immobility has also often prevented the United States from leading on the big international issues – from climate change and trade negotiations to IMF replenishment, for example. The United States provides less foreign aid, proportional to its GDP, than any other advanced economy.

Some important trends

In *Juggernaut: How Emerging Markets are Reshaping Globalisation*, William Shaw and I estimate that, by 2030, the rise of emerging markets will add approximately a billion people to the world middle class. These newly empowered consumers will demand education, entertainment, and products and services driven by information technology – all goods the United States excels at producing. At the same time, trade barriers – which include logistical costs – have come down in recent decades and, despite the protectionist sentiment stirred by the Great Recession, world trade continues to far outpace GDP. Moreover, as a global technological leader, the United States could in the future be propelled by innovations in medicine, biotechnology, communications, transportation, or energy. For example, developments that improve the efficiency or extraction of shale natural gas and oil – of which the United States possesses large reserves – will provide disproportionate benefits to the United States.

"...by 2030, the rise of emerging markets will add approximately a billion people to the world middle class. These newly empowered consumers will demand education, entertainment, and products and services driven by information technology."

However, these favourable trends must be weighed against looming dangers. A fiscal disaster – caused by unchecked health care spending, unwillingness to raise taxes, and rising debt in the United States in the coming years – could lead to a sharp economic contraction and depressed demand for a prolonged period. Such a process could be accelerated by the collapse of the eurozone, which could trigger another world recession and more intense scrutiny of sovereign debt levels. The last financial crisis exposed profound institutional vulnerabilities in the US financial system. But the economy's continued "financialization" and a failure to adequately tackle the root causes of the 2008 crisis and excessive risk taking in banks may leave the United States vulnerable to another financial crisis. If left unaddressed, poverty and income inequality, both at their highest level in decades, could undermine social cohesion and further polarize national politics.

“...the economy’ s continued “financialization” and a failure to adequately tackle the root causes of the 2008 crisis and excessive risk taking in banks may leave the United States vulnerable to another financial crisis.”

Some international trends are potentially adverse as well. While the rise of China and other emerging markets presents great opportunities, it also erodes the United States’ relative economic weight and that of its traditional allies. The ability of the United States to manage and indeed accept the rapid rise of new global economic powers – in other words, to work with the trend rather than against it – is unclear. Their rise is bound to cause numerous frictions, many of which are already visible today – from global imbalances and currencies, to aid policies, to negotiations over trade and financial regulation. How this power shift is managed is of utmost importance.

In few areas is the potential for conflict more evident than in the mitigation of climate change, where China and India and many other relatively poor and fast-growing countries are very wary of committing to emission targets that could constrain their development. Even though the worst effects of climate change are unlikely to materialise within the twenty-year horizon of the projection, its early manifestations may intensify as may awareness of its dangers. This will raise the stakes in climate change negotiations, and the United States is ill-equipped to handle them given its lack of internal consensus on the issue.

Two stories

In the good scenario, most of these threats are avoided. Relations with key international actors remain cautious but generally peaceful. Markets stay open and trade continues to grow rapidly. The United States addresses its fiscal deficit and succeeds in stabilising its debt/GDP ratio over the next decade. The eurozone remains intact and no new major financial crises erupt. And the worst effects of climate change are avoided.

In this case, the US economy grows steadily at about 2.7 per cent a year (see Juggernaut for a more detailed discussion). This compares with 2.5 per cent over the last twenty years, which includes the Great Recession. US growth reflects both solid labor force growth and technological advance, while capital deepening plays a relatively small role. Average living standards continue to rise, as real US per capita GDP increases by nearly 40 per cent and the fruits of economic progress are more equally distributed, relieving social tensions and attenuating political divisions.

Though the relative size of the US economy declines – from about a third of G20 GDP in 2010 to about a quarter in 2030 in real US dollars – it remains the largest in the world at market exchange rates. In purchasing power parity (PPP) terms, however, the US economy is eclipsed by China, by around 2016, and China is 70 per cent larger than the United States in 2030. Trade also shifts East: the US share of world trade dips from around 12 to 10 per cent, while East Asia’s share is expected to double from 10 to 20 per cent. Though its growth slows quite sharply by the end of the forecast horizon, China becomes the central player in world trade and the largest trading partner of most countries.

“[In the good scenario] in purchasing power parity (PPP) terms the US economy is eclipsed by China, by around 2016, and China is 70 per cent larger than the United States in 2030. Trade also shifts East: the US share of world trade dips from around 12 to 10 per cent, while East Asia’s share is expected to double from 10 to 20 per cent.”

The G20 in 2030

	Billion 2005 US dollars, market exchange rates	Billion PPP dollars	Average annual real growth rate, 2010–2030
Argentina	527	1,174	4.3
Australia	1,501	1,442	3.2
Brazil	2,440	4,217	4.3
Canada	2,083	2,087	2.8
China	21,479	37,644	9.3
France	3,323	3,025	2.0
Germany	3,593	3,360	1.2
India	5,328	13,321	8.0
Indonesia	1,073	2,446	5.5
Italy	2,197	2,102	1.2
Japan	5,786	5,170	1.2
Korea	2,122	2,510	3.9
Mexico	2,397	3,449	5.1
Russia	2,487	4,611	5.3
Saudi Arabia	896	1,401	4.6
South Africa	791	1,150	5.4
Turkey	1,437	2,054	5.1
United Kingdom	3,597	3,134	2.2
United States	22,258	22,258	2.7

In the bad scenario, the US economy slows sharply. The breakup of the eurozone leads to a massive financial crisis in Europe, causing US unemployment and fiscal deficits to rise further. With little countercyclical policy space left in the United States, a slow recovery follows after two to three years of deep recession. In the longer run, health care costs continue to rise rapidly and a failure to bridge ideological divisions over tax increases and cuts in social spending causes the debt/GDP ratio to continue its steep ascent. Investor confidence becomes severely eroded, eventually leading to a fiscal crisis and a deep recession. Meanwhile, US foreign policy is handcuffed by fiscal constraints – as is already evident in the US response to the Arab Spring and the eurozone crisis – and China and others are increasingly called on to help.

Concerns about its waning influence deter the United States from reducing its defense spending, causing defense spending to accelerate in China and, in response, among its Asian rivals. US and foreign companies shun the fiscally and growth-challenged United States as an investment destination. Outsourcing intensifies and good jobs in the United States are scarce; social cohesion is undermined by rising inequality and downward pressure on government spending on education, infrastructure, and social services.

Distracted by its domestic problems and internal divisions, a paralysed United States accelerates its withdrawal from the international stage. The multilateral trading system is stalled, and trading partners eschew bilateral negotiations with the United States as they cannot rely on it to deliver on the deals it negotiates. The United States' influence in the IMF, World Bank, and WTO declines in proportion to its economic and financial weight.

> *Distracted by its domestic problems and internal divisions, a paralysed United States accelerates its withdrawal from the international stage. The multilateral trading system is stalled, and trading partners eschew bilateral negotiations.*

In this bad story, growth in the United States slows to a snail's pace: an average of 1.5 per cent a year through 2030. Weaker international trade and finance arrangements, as well as spillovers from US and European domestic crises, will slow growth in other countries by about 0.5 per cent a year. Slower growth holds down US living standards: US per capita GDP rises by only 18 per cent over twenty years, half as much as forecast in our baseline. The US role is considerably diminished internationally – the US share of G20 GDP (measured in real dollars) falls to just under 25 per cent by 2030, while China's economy passes that of the United States in dollar terms and is 85 per cent larger in PPP terms. Seen as a country on a downslide, the United States is both incapable of leading and disinclined to lead, and other countries look to align themselves with ascendant powers.

Global implications

Even in the good scenario, the United States will be a less dominant economic player on the international stage. That scenario, however, is unambiguously better not only for Washington but also for the international community, which the United States continues to lead on the strength of its institutions and values. A reinvigorated United States participates in the conclusion of a watered-down Doha Round and then leads a process of WTO reform that streamlines new negotiations and strengthens the rules governing the international trading system. An ambitious Trans-Pacific Partnership including Japan and China is concluded, as is an important bilateral agreement on reducing behind-the-border barriers with the European Union. IMF resources are greatly expanded. As it rebalances its own books, the United States steps up its contributions to the World Bank and embarks on an ambitious development initiative in support of a more democratic Middle East. Working closely with China and India and leading by example, the United States guides the G20 as it tackles the most difficult challenges, from climate change through agricultural and energy subsidies to financial regulations.

In the bad scenario, the eurozone unravels. The European Union still exists, but as an empty shell around a fragmented continent mired in a prolonged depression. Suffering from another global crisis, Japan remains ensnared in its decades-long slump. With the United States increasingly withdrawn, and few countries willing to follow an authoritarian and mercantilist China (assuming it does not adapt quickly to playing a more prominent global role), a large and dangerous global power vacuum is created. There is also a dearth of values and ideas, as the Washington Consensus becomes discredited and the world's most successful economy, China, is built on a one-party, state-driven system.

> *With the United States increasingly withdrawn, and few countries willing to follow an authoritarian and mercantilist China (assuming it does not adapt quickly to playing a more prominent global role), a large and dangerous global power vacuum is created.*

Progress on climate change, trade reform, financial and monetary system reform, and global governance grinds to a halt, and the trading system may be thrown into reverse by a revival of protectionism. A weaker and less secure international community reduces its aid effort, leaving impoverished or crisis-stricken countries to fend for themselves and, therefore, multiplying the chances of grievance and peripheral conflicts. The United States loses its proportionally greatest influence to regional hegemons – China in Asia and Russia in Eastern Europe and Central Asia – while Western Europe would remain divided and rudderless. The Middle East finds itself riven by numerous rivalries that occasionally erupt into open conflict and oil price shocks. More generally, the absence of leadership and confusion on values makes the reconciliation of disputes more difficult and tempts the strongest to take risks they would not otherwise take.

Conclusion

> *"The overriding lesson of these two futures is that there is more at stake in current economic policy debates in Washington and Brussels than most people realise."*

Which of the stories is more likely to be realised? I believe the good scenario is the more likely, though many would disagree. What is clear is that the outcome will depend crucially on today's decisions, and, if mistakes are made, the bad scenario may well materialise. The overriding lesson of these two futures is that there is more at stake in current economic policy debates in Washington and Brussels than most people realise. A return of the United States and European economies to health over a reasonable time frame is vital for preserving the current international order and re-establishing a sound base for continued prosperity and peace.

Is the Renminbi the new Dollar? Chinese monetary policy and the global reserve currency system

Andrew Leung, International and Independent China Specialist

Introduction

Amidst global economic uncertainties, the perceived problem of an undervaluation of the RMB is a perennial refrain. A trade war loomed with the US threatening to impose punitive tariff mechanisms which threatened to trigger a global currency war. Meanwhile, China's current resource-intensive manufacturers are already trading at wafer-thin margins and any drastic RMB appreciation is likely to cause catastrophic job losses and social instability. The RMB has in fact appreciated by some 55 per cent since China's first currency reform in 1994. Like the experience of appreciation of the Japanese yen following the Plaza Accord, this magnitude of appreciation has not reversed China's exports or Western imports. Goldstein and Lardy of the Petersen Institute have suggested a three-stage approach of how China could move to a market-determined exchange rate and an open capital account. However, as China is a very large country in rapid transition, an independent RMB exchange rate policy is important to grapple with the multi-faced challenges of social dynamics and geopolitics. In any case, with rising social tensions, China is changing course in the 12 Five Year Plan (2011–15), towards a higher-quality, more balanced and more sustainable growth model geared to much higher domestic consumption. This promises to diminish her current account surplus and foreign currency reserve over time. While China is ready to liberalise her financial services and to seek a role for the RMB as it becomes more internationalised, she is likely to allow only gradual and measured currency appreciation in tune with the changing times. China, however, would remain extremely cautious in giving up too soon the protection of a non-convertible capital account in an uncertain world, if past traumatic experience is any guide.

The dynamics of a currency war

Following similar legislation introduced during the Bush Administration,[7] a Currency Manipulation Bill with threatening punitive tariffs was passed on Capitol Hill in September 2010 with a large majority. With a record-high unemployment rate, depressed wages, and struggling exports, President Obama continued to appeal to China-bashing emotions in his State of the Union address on 24 January, 2012. His senior officials have also been keeping up the pressure on the Chinese currency in the run-up to the presidential election.

Meanwhile, rounds of quantitative easing (QEs) have been dragging down the value of the RMB which is indirectly linked to the dollar, making the Chinese currency seem even more undervalued.

To safeguard competitiveness, other exporting countries such as Japan and Brazil have intervened to keep their currencies from rising too much against a depreciating dollar. Along with the European Central Bank and the International Monetary Fund, India has joined in the chorus for a stronger RMB. 'Beggar-thy-neighbour' policies are in vogue.

> *"China's response is that it would not be fair for the RMB to appreciate alone while the US is allowing the greenback to plummet."*

7 ***"The Future of China's Exchange Rate Policy"***, Petersen Institute for International Economics, Washington D.C, July 2009, Congressional Currency Bills pp.77–81

China's response is that it would not be fair for the RMB to appreciate alone while the US is allowing the greenback to plummet. Moreover, China and the US are essentially not competing in the same kinds of goods and services. Even if Chinese products were entirely priced out of the American market, not many American jobs would be saved as US consumers are prone to buying low-priced substitutes from other developing countries.[8]

The RMB has appreciated by some 55 per cent since China's first currency reform in 1994. This has not helped US exports or reduced Chinese imports. There is a similar story in the appreciation of the Japanese yen under the Plaza Accord in 1985.

Additionally, a great deal of China's exports has imbedded imported foreign parts, components, materials, proprietary technologies or services. RMB appreciation will lower the costs of such imports. So the RMB would have to appreciate even more drastically to have the intended effect.

Moreover, ever-lower 'China prices' demanded by global merchandisers like Walmart have depressed profit margins of Chinese products to wafer-thin levels, often well below 5 per cent. Drastic RMB appreciation will drive many Chinese manufacturers out of business, resulting in massive unemployment and social instability. This will be a catastrophe not only for China, but also for the world's consumers, suppliers and distributors.

The workings of China's currency and monetary regime

Prior to China's open-door policy in 1978, the RMB was kept extremely high, at RMB1.86 to the dollar, designed to support 'import-substitution'. After China switched to an export-oriented economy, the exchange rate dropped to RMB5.8 to the dollar by 5 July 1986.

From 1994 to 2001, the RMB ***appreciated*** against the dollar by a total of 18 per cent at an average of 3 per cent annually, without undermining export competitiveness. On July 21, 2005 China ended the fixed RMB-dollar peg, switching to linkage with a basket of currencies, including the US dollar (mainly), the Euro, the Japanese yen, and the Korean won.

Between July 2005 to the end of 2008, the RMB was allowed to ***appreciate*** again by 21 per cent against the dollar. However, during this period, China's current account surplus continued to surge.

On June 19, 2010, the RMB reverted to a managed floating exchange rate regime with reference to a basket of currencies. Under this regime, the RMB spot exchange rate can move intra-day +/- 0.5 per cent from central parity.

Theoretically, an undervalued currency leads to an ever-increasing current account surplus and foreign exchange reserve. The excess liquidity requires regular sterilization via the sale of central bank bills and increases in commercial banks' reserve ratio requirements. This acts as a tax on these banks. To prop up their commercial viability, the margin above the deposit rate has to be kept wide. As low lending rates are needed to spur economic growth, the deposit rate has to be kept even lower under a mandated interest rate regime. As speculation on upward adjustment of the RMB became a one-way bet, there is a great deal of caution in raising interest rates as it often attracts difficult-to-sterilize disguised speculative capital inflows.

8 ***China's exchange rate policy: a yuan-sided argument***, The Economist, 19 November, 2009, at http://www.economist.com/node/14921327 (accessed on 26 February, 2011)

> *“…when China’s global current account surplus stood at 3 per cent of GDP, the estimated RMB undervaluation was 15–20 per cent. By 2007, when China’s global current account surplus reached 11 per cent of GDP, the undervaluation was ‘conservatively’ estimated at 30–40 per cent.”*

An analysis by Morris Goldstein and Nicholas Lardy of the Petersen Institute for International Economics[9] finds that in 2003, when China’s global current account surplus stood at 3 per cent of GDP, the estimated RMB undervaluation was 15–20 per cent. By 2007, when China’s global current account surplus reached 11 per cent of GDP, the undervaluation was ‘conservatively’ estimated at 30–40 per cent.

According to Goldstein and Lardy, the existing currency regime has a number of economic disadvantages, such as:

(a) monetary policy inflexibility;

(b) eschewed investment decisions towards manufacturing at the expense of services;

(c) hindered transition to a more consumption-driven economy;

(d) reduced household income (of which interest receipts are an important component in China), impeding progress towards a truly commercial banking system; and

(e) monetary disequilibrium, perpetuating China’s external imbalance.

The two authors recommend a gradual three-stage approach to move to a free-floating exchange rate system – during a global recession; following global recovery; and after China’s current account surplus has drastically shrunk.

Initially, during a global recession, China should avoid competitive devaluation and any tax rebates for resource-intensive exports; increase expenditure on physical infrastructure; and expand social outlays in education, health and pensions. The RMB should continue to appreciate by 4–5 per cent a year while the daily exchange rate fluctuation limit should be raised to 1 or 1.5 per cent.

During the subsequent stages, the RMB should appreciate sufficiently rapidly to eliminate large current account surpluses in 3–4 years. The government should reduce exchange intervention and sterilization; gradually allow dual capital flows; initiate interest rate liberalisation; and support central bank independence with an inflation targeting mandate.

It is evident that China’s own approach so far has already embodied virtually all the ingredients of the first stage of the Goldstein-Lardy recipe. However, it is by no means certain that China will necessarily follow the other more drastic prescriptions in the way recommended for the subsequent stages.

> *“China jealously guards her monetary and exchange-rate flexibility as a powerful tool for social stability.”*

First, China jealously guards her monetary and exchange-rate flexibility as a powerful tool for social stability. Second, while an inflation-targeting monetary policy may serve to counteract boom-and-bust cycles[10], a rigid inflation targeting approach is now subject to serious debate following Europe’s mounting sovereign debt crisis. Third, learning from bitter domestic and international experience, China remains sceptical about any one-size-fits-all recipe for problem solving. As a market economy in rapid transition, China is more wedded to ‘*groping for stepping stones in crossing a river*’.

---

9 ***“The Future of China’s Exchange Rate Policy”***, Morris Goldstein and Nicholas Lardy, Petersen Institute for International Economics, Washington D.C, July 2009, pp. 87–96

10 ***“What Monetary Policy Does China Need?”***, Marvin Goodfriend, Professor at the Tepper School of Business at Carnegie-Mellon University and Eswar Prasad, and Chief of the Financial Studies Division in the IMF’s Research Department, posted on Global Vision, a global markets and poverty alleviation website run by Mercy Corps, 19 July, 2007, at http://www.globalenvision.org/library/3/1692 (accessed on 27 February, 2011)

The economy is more than economics

In the November 2010 issue of China Analysis, a publication of the European Council on Foreign Relations, Francois Godement *et al.*[11] revealed a panoply of geopolitical considerations advanced by leading Chinese academics. While there is agreement on the need for RMB internationalisation, some view this as a means to escape perceived currency manipulation by the United States as the issuer of the world's most preferred international reserve currency.

For background, an April, 2005 article *Our Currency, Your Problem* for the Hoover Institution penned by Niall Ferguson[12] is instructive. He reckoned that the Bush administration's tax cuts and a global war on terror were financed by a multibillion-dollar overdraft facility at the People's Bank of China (through China's massive purchase of Treasury bills), which he called "a Chinese tribute to the American Empire'. In April, 2009, Paul Krugman, a New York Times Op-ed columnist and Novel Prize laureate, called this China's '*Dollar Trap*'.[13]

As Godement points out, 'since 1944, the dollar has lost 97 per cent of its value against gold… in the service of its own economic interests'. No wonder on 13 March, 2009, Premier Wen Jiabao openly aired his worries about China's trillion-dollar investment in US Treasuries.[14]

> *"The idea that the RMB exchange rate, a vital tool for economic and social stability, should be left entirely to a Western-dominated global marketplace in accordance with some academic criteria is regarded by some in China as a Western myth of quantitative economics."*

It may be a sign of China's rising economic nationalism but US monetary policy is seen by some in China as '*a mechanism for plunder*' under a US '*economic hegemony*'.[15] The idea that the RMB exchange rate, a vital tool for economic and social stability, should be left entirely to a Western-dominated global marketplace in accordance with some academic criteria is regarded by some in China as a Western myth of quantitative economics.

RMB internationalisation barring immediate capital account convertibility

Against this background, it makes perfect strategic sense for China to internationalise the RMB. The following regional and international developments are beginning to unfold:

(a) With China as the centre of Asia's regional production and supply chain, the use of RMB for international settlements with China's trade partners worldwide is gathering pace as China's economy is growing to become the world's largest, probably by the end of this decade.

(b) As of 13 March 2012, Japan announced a plan to acquire US$10.3 billion worth of China's treasury bonds as part of its foreign currency reserve, following Malaysia and Chile. As the greenback is perceived to continue to lose value, the trend of including RMB-denominated Chinese treasuries in foreign currency reserves will probably accelerate. This option may become increasingly attractive to energy exporting countries such as Russia and the Middle East.

---

11 ***"Redbacks for Greenbacks: The Internationalization of the renminbi"***, Francois Godement et al., China Analysis, European Council on Foreign Relations and Asia Centre, November 2010

12 ***"Our currency, Your Problem"***, Niall Ferguson, Hoover Institution, Standford University, 30 April, 2005 at http://www.hoover.org/publications/hoover-digest/article/6386 (accessed on 27 April, 2011)

13 ***"China's Dollar Trap"***, Paul Krugman, New York Times, 2 April, 2009 at http://www.nytimes.com/2009/04/03/opinion/03krugman.html?_r=1&em (accessed on 27 February, 2011)

14 ***"China's Leader Says he is 'Worried' Over US Treasuries"***, New York Times, 13 March 2009, at http://www.nytimes.com/2009/03/14/business/worldbusiness/14china.html (accessed on 27 February, 2011)

15 See Michael Hudson's controversial book, ***"Super Imperialism - The Economic Strategy of American Empire"***, Pluto Press, New Edition March 2003, which offers a no-holds-barred elucidation of a plausible "American Grand Design" to rule the world through calculated "Monetary Imperialism"

(c) With support from Beijing, Hong Kong is being developed as the premier offshore financial centre for RMB internationalisation, including the issuance of “dim sum” bonds and other RMB-denominated financial instruments. RMB bank deposits in Hong Kong have been rising rapidly to RMB 627 billion in March 2012. It is expected to jump to six trillion by 2020, much more than the deposit base of the Hong Kong Dollar, with implications for Hong Kong’s current US dollar peg.

(d) Singapore is positioning itself as a regional offshore financial centre for the RMB. So is London. This would further support the internationalisation of the Chinese currency.

(e) Continuous diversification of China’s outbound surplus capital is leading to more Chinese mergers and acquisitions of assets across the globe, expanding RMB commercial relationships internationally.

(f) China is on track to continue to liberalise her financial sector, such as the qualified foreign institutional investor (QFII) and the qualified domestic institutional investor (QDII) schemes,[16] allowing for a freer inflow and outflow of RMB funds for investment purposes.

“*...China is quietly extracting herself from the ‘Dollar Trap’ by creating an international monetary zone of her own.*”

This way, China is quietly extracting herself from the ‘Dollar Trap’ by creating an international monetary zone of her own.

However, China’s capital account non-convertibility has proved its usefulness during recent global financial crises when it shielded China from much of the cross-border financial tsunami. In the light of increasing international financial uncertainty, China is unlikely to be in a hurry to discard this protection.

Global reserve currency system

On the other hand, China is becoming anxious for a more stable international currency system. The clarion call was first sounded by Zhou Xiaochuan, the Governor of the People’s Bank of China on 23 March, 2009,[17] referring to the need to address the so-called ‘Triffin Dilemma’.[18] Zhou proposed using Special Drawing Rights (SDR) of the IMF to replace the US dollar as a primary reserve currency.

While it is debatable whether the SDR is the ideal solution, the historic American credit-rating downgrade and the doubtful future of the dollar as a stable long-term storage of value are likely to revive this debate. As China’s economy is slated to overtake the US economy by 2018 (The Economist) or 2027 (Goldman Sachs),[19] the day when the RMB emerges as at least one of the world’s reserve currencies no longer seems too far away.

16 See a good description of these schemes on Wikipedia : Qualified Domestic Institutional Investor at http://en.wikipedia.org/wiki/Qualified_Domestic_Institutional_Investor and Qualified Foreign Institutional Investor at http://en.wikipedia.org/wiki/Qualified_Foreign_Institutional_Investor

17 Zhou Xiaochuan’s ***“Statement on Reforming the International Monetary System”***, Council on Foreign Relations, at http://www.cfr.org/china/zhou-xiaochuans-statement-reforming-international-monetary-system/p18916 (accessed on 27 February, 2011)

18 In the 1960s, a Belgian-American economist Robert Triffin outlined the potential conflict of interest between what is desirable for the reserve-currency issuing country and what is best for maintaining global currency stability. This is known as the “Triffin Dilemma”

19 ***“Jim O’Neill: China could overtake US economy by 2027 ”***, The Telegraph, 16 March 2012 reiterates the date of 2027 as assessed by Goldman Sachs earlier. See http://www.telegraph.co.uk/finance/economics/8901828/Jim-ONeill-China-could-overtake-US-economy-by-2027.html (accessed on 16 March, 2012)

Global economic imbalance

Underlying the above discourse is the root cause of many of the world's crises and conflicts – a systemic global economic imbalance. Well before the financial crisis, Asian exporting countries' mounting surpluses were fed into the West's financial system through investment in US Treasuries, supporting perennially low interest rates and easy credit. The latter has been exotically-leveraged under the imperative of financial innovation to feed an unbridled consumption era built on an inflated housing bubble. This in turn pushed up Asian countries' exports and surpluses, with the result that more was invested in US Treasuries to fund even more debt-driven consumption. In short, the West, particularly the US, is over-consuming while China and some other surplus countries are over-saving.

> *"...China has been rebalancing her economy towards domestic consumption. Studies ... have highlighted the burgeoning consumer market in China and how it will account for a lion's share of global consumer growth in the coming decades."*

Meanwhile, China has been rebalancing her economy towards domestic consumption. Studies by Credit Suisse and Mckinsey have highlighted the burgeoning consumer market in China and how it will account for a lion's share of global consumer growth in the coming decades.[20] By 2025, China's consumer market will be driven by 350 million more urbanites in 221 new cities, according to a McKinsey study.[21]

Concurrently, notwithstanding quantitative easing, Americans are now beginning to save more as people prefer to pay down their debt rather than burning their fingers again with reckless debt-driven consumption. So a global rebalancing may already be taking place, according to Stephen Roach, Chairman of Morgan Stanley Asia.[22]

Conclusion

According to China's Rich List 2010, there are more than 550,000 households with private wealth more than 100 million RMB. Yet, China is still a very poor country, with per capita income ranking amongst some of the poorest countries in Africa. Some 170 million Chinese people still remain at or below the poverty line of $1.25 a day.

In this economic divide, there is rising discontent due to galloping food prices, irregular land grabs, labour disputes, pollution, corruption, inequality, and social injustice. With a more educated and internet-savvy middle class, smouldering grievances may threaten to ignite a fire, as what has been happening across the Middle East.

China is beginning to switch to a more equitable and sustainable development model in the new Five Year Plan (2011–15). If realised, the transformation will diminish China's current account surplus, moderate her foreign currency reserve, and reduce incessant pressures for RMB appreciation.

> *"To promote consumption and investments of a growing middle class, China stands to benefit from gradual currency appreciation, financial system liberalisation, a more flexible interest rate regime, and freer outward and inward capital flows."*

---

20 For example: J f. Garner, ***"The Rise of the Chinese Consumer: Theory and Evidence"***, John Wiley & Sons, 2005 and " The Value of China's Emerging Middle Class" in the McKinsey Quarterly, 2006.

21 ***"Preparing for China's Urban Billion"***, McKinsey Global Institute, March, 2008

22 Stephen Roach, ***"Next Asia: Opportunities and Challenges for a New Globalisation",*** Wiley, 2010

It is no coincidence that a raft of reform measures is proposed in a recent 468 page study report jointly compiled by the World Bank and the Development Research Center (DRC) of the State Council. Many of these measures are designed to improve the efficiency, equity, and sustainability of China's system of allocation of resources, echoing the spirit if not the letter of the Goldstein and Lardy studies mentioned above. These reform measures are essential if China is to escape the "Middle Income Trap"[23] and to become a "*Modern, Harmonious, and Creative High-Income Society*" by 2030.[24]

Nevertheless, as the existing world order is now being challenged with a rising China, the waters ahead remain uncharted. Moreover, with an ageing population profile, China is likely to grow old getting rich. During the nation's challenging development trajectory, while she is set to redouble efforts to boost the RMB's status as an international currency, liberalise her financial system and redress the socio-economic and ecological imbalance of her economy, China is likely to remain extremely cautious in not giving up too soon the financial protection of a non-convertible capital account.

23 In his Opening Remarks on 3 September 2011 at the ***Conference on China's Challenges for 2030*** in Beijing, Robert B. Zoellick, World Bank Group President, wanted to understand how China could avoid the so-called "Middle Income Trap" – that stage when many countries in South East Asia and Latin America when reaching about $3,000 to $8,000 per capita income seem to stall in productivity and income growth.

24 **"China 2030 – Building a Modern, Harmonious, and Creative High-Income Society",** a study jointly undertaken by The World Bank and the Development Research Center of the State Council, the People's Republic of China. The report was released on 27 February, 2012. A conference edition may be accessed at http://www.worldbank.org/content/dam/Worldbank/document/China-2030-complete.pdf

The shifting balance between "risk" and "uncertainty" in a globalised world system

Laurence Whitehead, adviser on macro risk at Oxford Analytica, and Official Fellow in Politics at Nuffield College, Oxford.

Environmental, financial, geopolitical and security surprises of recent years all underscore the inadequacies of recently fashionable "risk metrics", which aim to tame uncertainty by attaching numerically precise statistical probabilities to contingent events. The theoretical foundations of this "bell curve" or "standard deviation" approach to risk measurement require the events in question to be separable, recurrent and reasonably homogeneous. This has proved a powerful analytical tool for the management of a wide range of insurance risks (road accidents, epidemiological incidence and so forth), and it can also be fruitfully applied to some environmental issues (for instance hurricane frequencies and intensities) and to some major aspects of financial behaviour (such as individual stock selection, asset allocation and so forth).

It has now become overextended, having been applied to macro-contingencies (such as civil wars) where cases are infrequent and far from homogenous. And it has been applied to events that are not fully separable, but that belong in longer chains of causation where the parameters of interaction are inherently unstable or uncertain (the so-called "butterfly effect" is invoked by chaos theorists to illustrate such possibilities). It also requires patterns of behaviour to be recurrent, thereby ruling out antagonistic strategic game changes, not to mention the intervention of "unknown unknowns" (or "black swans"). It works best when the causal connections under consideration are tight and linear, but most of the major issues facing contemporary policymakers require both multi-causal and non-linear forms of analysis.

For the first two decades after the end of the Cold War this confidence in the ever-wider applicability of statistically based risk management techniques was steadily extended into progressively more dubious domains. It changed behaviour, as hitherto sceptical and cautious policymakers were displaced by more confident and aggressive strategic maximisers, whose reputations for success derived from their willingness to press such risk metrics to the very limits of their plausibility – and then beyond.

"For the first two decades after the end of the Cold War this confidence in the ever-wider applicability of statistically based risk management techniques was steadily extended into progressively more dubious domains."

The 1998 collapse of long-term capital management provided an early warning of where this cycle of behavioural change was likely to lead. When this warning was not heeded the 2008 "sudden stop" to liberalised financial flows provided a starker and more severe corrective. By 2011 the lesson was more widely assimilated. The overconfidence in such risk metrics that characterised the previous decades was followed by a severe switchback towards ultra-defensive behaviour and acute risk aversion. This is especially apparent in the major liberalised international financial markets, but it is also beginning to prompt parallel defensive shifts in key geopolitical arenas. An example of this is German public aversion to bearing Southern European economic risks. Similarly, the successful al Qaida project to fly commercial planes into the Twin Towers has stimulated a chain reaction of security precautions ever since September 2001. The 2011 nuclear accident at Fukushima has produced a comparable reversal of risk appetites in the global nuclear power sector, with major consequential impact on broader global energy security concerns.

The current retreat from "risk" and rise of uncertainties financial sector

One of the most telling confirmations that the old intellectual consensus has failed concerns the edifice of numerical beliefs it constructed around the notion of a "risk free" class of financial asset. According to orthodox financial theory this was supposed to be United States Treasury bills. Neither monetary theory nor financial history actually provided much of a justification for this assumption. After all, within living memory the United States government had ended the convertibility of the dollar into gold, and throughout the first decade of the twenty-first century first the President, then the Congress, and then the Federal Reserve had dedicated their efforts to undermining the fiscal and monetary foundations of the greenback. By the time of the Lehman collapse in 2008 there was an evidently non-negligible possibility of another legally enforced suspension of normal commercial banking, and in August 2011 Standard & Poor's dropped the US government's triple A rating. In the absence of an unquestionably "risk-free" financial yardstick, all the elaborately structured hierarchy of higher risk assets lost their fundamental moorings. With the Federal Reserve currently promising negligible interest rates on treasury bills and bonds for an extended (ie, multi-year) period of time, it is offering no financial reward for holding liquidity. This can feed volatility and capital flight.

This highlights the broader process of the retreat of measurable risk and its substitution by uncertainty. The uncertainty arises from the fact that short-term money managers no longer have a highly calibrated structure of incentives to "lock-up" their cash for determinate periods of time. In the absence of such traditional constraints and incentives, they might be more prone to "herd behaviour" which could take the form of extremely rapid and massive redeployments of funds from one deposit basis to another, perhaps prompted by nothing more than false rumours or anticipatory defensive repositioning. As financial intermediation has accelerated over the past two decades of economic globalisation and financial liberalisation, the stock of liabilities accumulated within both the formal and the "shadow" banking systems has risen to an ever higher multiple of the goods and services ("real") side of world economic output. The stability of these liabilities rests on a trustworthy structure of counterparty interaction and arbitration, and in the last resort on a legally enforceable dispute resolution, liquidation, and debt settlement system. Thus, financial confidence cannot ultimately be detached from the exercise of sovereign power. But "too big to save" banks are underpinned by host governments reliant on tax bases that in turn are dependent upon the output levels of national economic systems.

Since 2008, illusions of supranational authority capable of backing up, or even over-riding, these sovereign state prerogatives have been shattered. Iceland and now Greece both prove that national fiscal authorities can assume contingent liabilities to private financial corporations so large that their own sovereign credit-worthiness can be jeopardised. The idea that some higher level authority – the ECB, the IMF or the Federal Reserve – will always be available to reinforce sovereigns in fiscal distress can no longer be taken for granted.

> *"The idea that some higher level authority – the ECB, the IMF or the Federal Reserve – will always be available to reinforce sovereigns in fiscal distress can no longer be taken for granted."*

In fact it is now becoming apparent that not only a few over-extended peripheral states, but even leading advanced capitalist nations (such as Italy) may, in extremis, prove unable to pay. If so, state power will be used to disrupt market outcomes. The acute financial uncertainties that had destabilised Europe and the world in the 1930s were relegated to the margins of risk analysis before 2008, but are now resurgent in the eurozone and potentially more widely.

Environmental sector

Although the most spectacular shift from risk back to uncertainty can be observed in the domain of finance, there are also parallel trends in evidence elsewhere. For example, in the domain of global climate change modelling and management, the dominant assumption from the founding of the UN IPCC to the 2010 conference to upgrade the Kyoto Treaty was that as more accurate scientific evidence was accumulated, the range of uncertainties would be narrowed, and a rational cost-benefit strategy for mitigation of carbon emissions would consequently emerge. The peak of this risk assessment optimism was provided by the Stern Report. Even at its apex, this still required a level of trust that went beyond what was warranted by the hard evidence.

Over the past couple of years the objectivity of the science, the reliability of the data, and the trustworthiness of the process for risk managing global warming have all come under sustained pressure. While there is no longer much serious doubt about the importance of anthropogenic climate change, this generates more uncertainty than consensus on the necessary and feasible steps required for effective damage limitation. The uncertainties are multiple and overlapping; some concern timeframes, others concern costs, while others concern the risk of unintended side effects. In addition, there are imponderables concerning the respective responsibilities of the numerous and heterogeneous decision-makers.

Collective action and agency difficulties compound the other uncertainties. Confidence that these risks can be accurately assessed and then appropriately mitigated has been thrown into reverse. As a result (compounded by the financial crisis) this category of risk and uncertainty has simply slipped far down the policy agenda. Whereas a risk management philosophy would focus on the greatest dangers, a switch to undifferentiated uncertainty can cause a crucial issue to simply become shelved as too hard to tackle (until the neglect generates an unmistakable compulsion to react).

Security sector

Similar considerations may be operating in the security realm. The West’s unexpectedly comprehensive victory in the Cold War dismantled the Soviet Union, which was one longstanding and rigid structure of security risks. For a decade or so defence spending was reduced, and it seemed that progress might be made in taming the remaining risks. But since the unexpectedly traumatic and effective asymmetric war technique used by al Qaida in September 2001 the proliferation of new security dangers has overturned any such optimism.

“In addition to “terrorism” ... these dangers include accelerated nuclear proliferation between antagonistic states; intensified vulnerability of advanced economies to cyber-attack; and various forms of biological and chemical warfare that may be operated either by non-state as well as state actors.”

In addition to “terrorism” nurtured in “ungoverned spaces”, these dangers include accelerated nuclear proliferation between antagonistic states; intensified vulnerability of advanced economies to cyber-attack; and various forms of biological and chemical warfare that may be operated either by non-state as well as state actors. In response to this harsher security environment, the dominant western powers have attempted to maintain their ascendancy, and to mitigate risk, by accelerating the production of new military and security technologies. Currently Washington is coming to depend more on “drone” attacks, and the associated warfare capabilities, to police remote enemy havens, and to economise on increasingly less expendable national manpower.

This, and other, innovations may seem to defence planners to be effective instruments of risk management, but they are relatively untried and may carry with them grave unintended consequences. For example, drones discredit a foundational principle of national sovereignty – citizens obey the law in a jurisdiction in turn for an assurance of basic security. It is uncertain whether current western military doctrine and practice will prove a successful instrument of risk mitigation, or a potent engine of delegitimisation in countries where the beneficiaries of anarchy themselves will turn out to be themselves an intensified source of danger. Whereas the logic of cooperation may help to stabilise insecurities in the financial domain (everyone suffers if cooperation fails) in the security domain it is the logic of conflict that necessarily structures behaviour. Thus, every risk mitigation strategy has to be assessed dialectically – ie, by considering how an opponent will react to exploit its associated vulnerabilities.

Geopolitical realm

Finally, globalisation has produced profound long-term geopolitical shifts in power and resources. Such shifts are still on-going at a very rapid pace, and to some extent their dynamics can be assessed and planned for. However, the successful management of such tectonic adjustments requires solid institutional, security and financial basis. As noted above, there has been a rise of uncertainty and the displacement of measurable risks in these various domains. That can make the steering and containment of geopolitical tensions more problematic, more short-term and more crisis-prone. This is much discussed in relation to the "rise of China" and the "reset" of US-Russian relations. It also arises with the associated and potentially disorderly weakening of the European Union. But perhaps the best way to illustrate the broader uncertainties that can arise is to consider the Greater Middle East.

This region remains the most crucial reserve of global oil and gas supplies. It is also the most heavily committed to extravagant defence procurement policies funded either from oil rents or via foreign aid. The invasion and overthrow of the Saddam Hussein dictatorship was imagined as a first step toward the creation of a more stable and democratic Middle East better aligned with the interests of the dominant powers in the "international community". But the tensions and uncertainties that have arisen throughout the region in the wake of that intervention have produced repercussions that are hard to calibrate and extremely difficult for the authors of the operation to manage. Perhaps the recent intervention in Libya and the current conflict in Syria will prove side events along the route to the intended overall restructuring of the Middle East's political profile. But the uncertainties (concerning Iran, Israel, the electoral outcome in Egypt, and so forth) still seem to dwarf the predictabilities. The Middle East remains a major pivot of geopolitical turbulence which lacks much reliable basis for long-term strategic planning.

"...the uncertainties (concerning Iran, Israel, the electoral outcome in Egypt, and so forth) still seem to dwarf the predictabilities. The Middle East remains a major pivot of geopolitical turbulence which lacks much reliable basis for long-term strategic planning."

In summary, risk management has weakened, and uncertainty has returned with a vengeance over the last few years. Uncertainty has become more central to financial, security and geopolitical assessments. Risk management of the orderly and rational variety derived from micro-analysis of insurable events has not proved so extendable into these macro-domains as was expected a few years back. So, how should responsible analysts and global policymakers respond to this emerging panorama of challenges?

Some principles for coping with macro uncertainty

Deriving prescriptive conclusions from such an open-ended global analysis as the preceding depends on what time scales, policy domains and interest standpoints are in question. This section stands back from those issues, and suggests some very broad and general principles:

Alertness and sceptical monitoring

The great drawback to excessive reliance on quantitative risk management techniques is that they can lull the unsuspecting user into a false sense of security and dull alertness to contrary indicators. In all the examples outlined above, it was possible to detect signs that something was missing from the mainstream analysis. But this required scepticism concerning the predictive reliability of the most fashionable management tools, and a willingness to incur the – often not inconsiderable – costs of challenging prevailing "groupthink". A comparative and historical perspective could often provide the foundation for discordant questioning. But, of necessity, the doubter might find him or herself alone for an extended period of time. And, given the uncertainties under consideration many sceptics would never be vindicated by the eventual turn out. Organisations, therefore, need to create institutional structures and procedures that shelter well-informed and sincerely held minority viewpoints. Even when a sceptical stance is not borne out by experience, it can improve analytical capabilities by stimulating alertness.

Contour analysis and scenario planning

The rise of uncertainty and the decline of statistically reliable risk measurement do not mean that all contingencies are equally plausible, or that future developments are entirely unknowable. To the contrary, scaling back reliance on spuriously accurate predictive models can open the way to more helpful and realistic evaluations of prospective trends based on qualitative evidence, interpretative theorising and well-honed judgement. The starting point for such evaluations is to recognise that different analytical techniques are required for different issue domains and policy debates. A first step must therefore be to assess the relative weight to attach to tight causal prediction as opposed to looser and more subjective contour mapping and scenario planning, when addressing the specific problem area under consideration.

Contour analysis involves mapping the overall "lie of the land" on which specific contingent developments will play out. For example, although the nature and effectiveness of the Gaddafi regime's response to the Arab uprisings was hard to predict (not least given the centralisation of power and the eccentric personality of the ruler) there were underlying structural characteristics of Libya's political and social geography and its economic structure that could be studied with more reliability and that would be sure to contribute constraints and reserves to shape the resulting regime change. Similarly, even though the full consequences of a doubling of atmospheric CO_2 may be highly uncertain, there are more definite elements that can be studied and taken into consideration; for example, if one considers the sea level rise associated with the melting of polar ice sheets. When direct measurements to risk are unreliable it may nevertheless be possible to track major components of the unknowable total through a systematic contour analysis approach.

> *"When direct measurements to risk are unreliable it may nevertheless be possible to track major components of the unknowable total through a systematic contour analysis approach."*

4. what the experts say

Scenario planning can also provide a constructive substitute for misleadingly rigorous predictive forecasting techniques. At the time of writing there is very little reliable basis for predicting the near-term outcome of the current eurozone financial crisis. The alternative possibilities are starkly at variance, the inevitability of a fork in the road is apparent, but guessing which option will prevail is a highly subjective and basically quite arbitrary exercise, at least for now. Instead of attaching untenably precise quantitative probabilities to the various alternatives, a scenario planner would concentrate on sharpening the logical structure of the contrasting trajectories, and highlighting the drivers and obstacles at work in each case. This is a modelling procedure that inevitably oversimplifies and stylises the rival scenarios (in practice outcomes are almost always some messy hybrid of the options considered). But, if conducted with judgement and insight, it can provide more help to decision-makers who need to anticipate future trends than any overly mechanistic projection or extrapolation.

"Navigating" contingencies rather than "controlling" variables

The numerical precision of standard risk management techniques can create the illusion that decision-makers are fully in control of all the relevant variables. While that might be a reasonable approximation to reality in some policy domains (sales volume will fall by X per cent if tobacco tax is raised by Y per cent) it can be a source of error and danger if unthinkingly extended to such macro-domains as have been considered above. Policymakers who liquidate banks or launch drone attacks, or close nuclear power stations need to be helped to recognise the limits of their ability to foresee all the consequences of their actions, let alone to control all the relevant variables. They may well become prisoners of the dynamic they have unleashed, no longer in control but rather controlled by forces they could not fully anticipate. Even so, there are many situations in which policymakers must act one way or the other, or accept the consequences of their inaction. The course of wisdom may be to map the relevant contours, to review the alternative scenarios, to carefully consider discordant voices, and then if necessary to take the critical decision, in full knowledge that what then follows may well be contingent and uncertain.

"The course of wisdom may be to map the relevant contours, to review the alternative scenarios, to carefully consider discordant voices, and then if necessary to take the critical decision, in full knowledge that what then follows may well be contingent and uncertain."

The metaphor of "navigation" is relevant here. Even the most powerful of political, economic, business or scientific leaders will often be unable to measure in advance the costs or returns of their strategic choices. Once a policy is set in motion it may be possible to evaluate the out-turn by comparison with initial expectations. But when large scale and complex problems require full-scale engagement, it can be no easy matter for powerful leaders to obtain independent and objective feedback on how well they have been chosen. There will be powerful vested interests in presenting a favourable interpretation of the results, and (if necessary) in generating alibis or counterfactual justifications to cover up failures. Complex dynamic processes like eurozone reform, or financial market intervention, seldom produce short-term clear-cut and final results. Instead they unfold stochastically, with each new stage presenting further decision points, and changing the parameters of the initial choice set. Instead of launching a rocket to the moon, the policymaker is more likely to have embarked on a sailboat across the Atlantic. Even if the eventual destination is fairly reliably known, the intervening storms and currents, and other possible surprises both on board and en route, can mean that the time of arrival and detours during the voyages remain unpredictable contingencies. Recognition of such imponderables, and preparedness for the unexpected, constitute the foundations of wisdom when contemplating any such undertaking.

Adherence to basic principles

> *“If reaction times have become more volatile, if interaction effects have become more complex, and if key actors have lost trust in one another and become more short-term and defensive, then Fordist-style management techniques may no longer deliver as expected.”*

If statistically robust tools of risk management were reliably available then the task of the decision maker would be greatly simplified. All that would be required is for the desired outcome to be identified, followed by a technical exercise to ensure that the means chosen to achieve it were the most efficient/reliable/cost-effective available. This is roughly how the Stern Report conceptualised global strategy to limit anthropogenic climate change, how the Federal Reserve has approached “quantitative easing”, and it may be how the Pentagon operates its drones programme. But despite the operational appeal of this model of decision-making, the post-2008 world system is proving more uncertain, unstable and unreliable than this approach assumes. If reaction times have become more volatile, if interaction effects have become more complex, and if key actors have lost trust in one another and become more short-term and defensive, then Fordist-style management techniques may no longer deliver as expected. Yet global macro-problems of great urgency and complexity must nevertheless be addressed. Decision-makers faced with such adverse conditions may deserve our sympathy and encouragement, but they also need public legitimacy. Their actions (or omissions) can be expected to inflict big costs on some, as well as conferring large benefits on others. If the truth is that they are not fully in control of all the consequences of their choices, then they will risk provoking resistance and non-cooperation. Some pragmatic mid-cause corrections are bound to be necessary, but the big danger is that the holders of public office could appear to be zigzagging expediently merely to serve the narrow interests of their inner circles, and to conceal their misjudgements from the wider public.

> *“A final prescriptive conclusion, therefore, is that in such uncertain conditions it becomes even more important for policymakers to keep in mind some basic principles of probity and public interest.”*

A final prescriptive conclusion, therefore, is that in such uncertain conditions it becomes even more important for policymakers to keep in mind some basic principles of probity and public interest. Even if they are not able to achieve legitimacy by delivering desired results, they can try to maintain trust through the observance of correct procedures and the maintenance of strong accountability.

5. The three scenarios

In the previous section, a number of pre-eminent authors identified significant and interrelated socioeconomic risks, which could have severe implications for long-term peace and prosperity. By pulling together some of their key conclusions, it is possible to outline a few simple, socioeconomic futures facing the world.

In this context, three scenarios are set out below; an **upside**, which represents a best case, a **downside**, which represents a worst case, and a **central** scenario which represents something in between. Each scenario reflects on how the decisions and actions taken by policymakers in the short run (both those in government and elsewhere) can play a key role in determining which long-term future the world faces. We then relate each scenario to possible implications for the future of insurance and financial services.

A couple of caveats before delving into these scenarios: in each, we assume that; 1) Asian, and in particular Chinese growth is relatively robust and 2) whilst experiencing robust growth, China, **will not** play a leading role in ensuring global stability through internationally coordinated action. Crucially, both assumptions may not hold in practice.

For example, as mentioned earlier in this report, China faces an economic predicament of its own linked to artificially high asset prices – particularly related to the housing market. The risk is that these asset prices could tumble derailing Chinese economic growth[25] with adverse implications for the global economy. There is also the possibility that economic liberalisation in China will ultimately trigger a transition to a democratic system of government by unleashing the forces of an increasingly large, well educated and articulate middle class. Whilst a democratic China would be welcomed by many, the transition process may be painful.

Regarding the second assumption, it has been suggested that China's recent purchases of Euros was motivated by a desire to see a return to stability in Europe[26] – a key regional source of demand for Chinese exports. In the last quarter of 2011, due to decreasing EU demand, Chinese exports fell way below market expectations[27] negatively affecting the position of its current account. Ensuring a global framework for economic stability and cooperation is therefore of vital importance for China's continuing success, so there is the possibility that China will take on a leading global role sooner than is generally believed. The dynamics of what this might look like, though, are highly uncertain.

In summary then, the below scenarios are deliberately simple and necessarily exclude many possible permutations and interaction effects that could lead to futures completely different to the ones envisaged here. Therefore, rather than being used as concrete forecasts for future planning, these scenarios should instead help guide decision makers into considering how they might react as different possible futures unfold.

25 David Barboza (April 2011), ***Fast Growth and Inflation Threaten to Overheat Chinese Economy***, article in the New York Times

26 Chen Man-Nung and Staff Reporter (July 2011) ***China buying euro debt for political reasons: academics***, WantChinaTimes: http://www.wantchinatimes.com/news-subclass-cnt.aspx?id=20110708000044&cid=1502 (last accessed, 28 February)

27 Simon Rabinovitch (Nov 2011) *China export growth dips as EU slows*, article for the Financial Times http://www.ft.com/cms/s/0/fce7b050-0b4a-11e1-ae56-00144feabdc0.html#axzz1ngo9vllQ (last accessed, 28 Feb 2012)

Scenario 1

Upside: dynamic Asia and a rebounding west

In this scenario, Asia drives global economic growth but it does not leave the West behind. A comprehensive resolution to the eurozone crisis, an end to US political paralysis and a reconfiguration of trade with the East helps ensure that the West remains competitive in the new world order. This reconfiguration of trade is aided by China embarking on a policy of gradual liberalisation of its economy and an appreciation of its currency. Not only does this policy help rebalance the global economy, but it also has the effect of improving per capita income in China, easing the risk of civil unrest.

In this scenario, governments are also able to get to grips with rising longevity by ensuring easier movement of labour across borders, and by instituting workplace reforms to allow for more flexible working in old age. And crucially, decision makers (in government and financial institutions) maintain strong mechanisms for transparency and public accountability helping to ensure public trust at times of uncertainty.

Buoyed by a resurgent US, and a thriving China, international institutions like the IMF and G20 help to ensure cooperation between countries in meeting global challenges related to financial regulation and absolute poverty. In turn, the international system is characterised by relatively peaceful relations between states and limited incidences of civil war and other forms of political unrest.

Implications for insurers

In this macroeconomic scenario, Western financial services providers are likely to remain highly competitive though there will be substantial competition from Asia.

Whilst life insurers continue to face the strain of rising longevity, this will be eased somewhat by increased premiums as personal income and levels of trust in the industry remain strong stimulating demand. The life sector will also benefit from Government reforms which are effective at incentivising people to work for longer helping to reduce pension fund deficits.

In this environment, general insurers are likely to benefit from increased premiums, especially those that are able to tap into growing demand for financial services from emerging markets. A healthy global economy will also help ensure strong asset prices thereby improving overall investment income.

Coordinated international regulation is likely to lead to increased consolidation in the market. It could also lead to convergence in business practices – which may, conversely, increase the potential severity of a future financial shock. However, with well coordinated action, the international community is likely to be able to effectively foresee and mitigate against such a risk.

Scenario 2

Central: western stagflation

In the central scenario, Asia drives global economic growth but the West stagnates leading to lower overall growth rates than in the upside. The after-effects of the global financial crisis and eurozone sovereign debt crisis continue to hang over the West for years to come, which, compounded by the failure of the West to reconfigure trade with the East, depresses real incomes and aggregate demand. China gradually opens up its economy but this only has the effect of increasing consumption of domestically produced goods and services.

During this period, governments also struggle to face up to the challenge of rising longevity. They institute some reforms to provide for more flexible working but do not take necessary measures to encourage free movement of labour. Despite substantial attempts at deleveraging then, Western governments remain heavily indebted, pulled down by the burden of an aging, and unproductive population. Some key decision makers in business and public office do ensure full transparency and accountability, whilst others fail to put such mechanisms in place, which, when combined with the challenging macro environment, leads to an increasing proportion of citizens feeling disaffected with business and politics.

International institutions like the IMF and G20 continue to rumble on but are characterised more by deadlock than collaborative action. Regional blocks, generally acting in isolation, identify solutions to issues like financial market regulation and poverty. Some progress is made, but efforts are not well coordinated contributing to occasional financial and political shocks – (ie, incidences of financial turmoil and outbreaks of violent conflict between and within states).

Implications for insurers

In this scenario, Western financial services providers may struggle to remain competitive whilst large Asian firms, buoyed by income earned through a domestically burgeoning middle class, penetrate Western markets.

Whilst government action helps ease some of the burden of increasing longevity, Western based life insurers still experience rising liabilities, and it remains a real challenge to grow premium income at home, as personal income and levels of trust in financial services remain subdued.

In this environment, general insurers may also find it tough to generate increased premium and investment income. And, continually low interest rates will act as a further squeeze on returns for the sector.

Such an environment will likely necessitate a shift of business to regions of the world where demand is greater. However, regional regulation leads to an increase in costs for international firms complying with different rules across multiple jurisdictions.

Scenario 3

Downside: 1930s style depression

In the downside scenario, Asia struggles to drive global economic growth, constrained as the West suffers a severe and prolonged recession. The eurozone's ugly implosion leads to a number of countries defaulting on their currencies and a second, larger financial crisis. The resulting credit crunch prevents the West from investing in the types of industries that will help maintain international competitiveness and fiscal deficits swell across major Western powers. The failure of the West to reconfigure trade with the East is locked in, as China continues to fix an artificially low exchange rate. By failing to allow for an appreciation, China also fails to stimulate domestic consumption and investment. Chinese per capita income will, therefore, remain subdued potentially increasing the risk of civil unrest.

During this period, the West is largely powerless to counteract rising longevity. Efforts to improve the flow of labour are fruitless and only result in an outflow of young and able workers to Asia. Efforts to increase provision for flexible working result in the crowding out of the job market and increasing youth unemployment which acts to undermine social cohesion. Policymakers are paralysed by uncertainty, resulting in reduced trust in officials, business and ultimately state institutions.

Since the US is preoccupied at getting its own house in order, the Washington Consensus collapses and with it, institutions like the IMF and G20. And, with the US concerned by rising unemployment and low exports, it is likely to institute protectionist economic policies triggering a full blown currency war with China. In the face of the ensuing global economic turmoil and lack of international governance, countries return to the kinds of 'beggar thy neighbour' policies last seen in the 1930s. Economic problems soon boil over into resentment between nations and against governments. During this period, the threat of geopolitical conflicts between major world powers become very real, and acts of terrorism, civil war and other forms of political unrest are commonplace.

Implications for insurers

In the short run, Western financial services providers (and particularly banks) face significant liquidity challenges as currency defaults and the subsequent financial crisis reduces the ability of firms to roll over their debts. Insurers are also likely to take an immediate and significant hit in the event of considerable sovereign debt right-downs given their exposures to government and bank securities.

In the long run, due to falling demand and compounded by low levels of public trust in financial services, insurers are likely to suffer from falling premium income. The effect of a prolonged recession will also cause asset prices to tumble leading to a further decline in investment income. The net effect could be significant year on year losses and, in some cases, insolvencies may result. Just to survive, many will have to try and redirect their efforts to emerging markets.

However, due to a rise in protectionist policies, exporting services to new markets will be tough. And there is also the threat of political turmoil – particularly civil war amongst so called "periphery" countries.

Reflecting on the three scenarios

According to the above scenario analysis, the world could look very different depending on the actions taken by key policymakers in government and elsewhere both in the short and long term. Crucially, the scenarios have made the assumption that the insurance industry is largely exogenous to the outcomes – efforts and decisions taken by the sector do not affect the macroeconomic environment. As our next chapter will show, this is unlikely to be the case in reality. In fact, the sector has a key role to play in driving growth, ensuring sustainable public finances and mitigating political risks in the decades to come.

6. The importance of insurance

Whilst the world's future direction will depend on a multitude of factors and stakeholders, the insurance industry can play its part in trying to deliver a more prosperous world. Critical to success, is for the industry to do the things it has done well in the past, even better in the years ahead and this can only be enhanced by the progress that is being made to develop as a profession.

Promoting growth and development

The industry can play a key role in driving growth in new industries, thereby ensuring the comparative advantage of mature developed economies like the UK. It can also help in strengthening the financial capabilities of many living in the developing world, helping to break vicious poverty traps.

In 2010, the global insurance industry accounted for $4.3 trillion in total written premiums and $24.6 trillion in total managed funds.[28] It also employed a significant number of people worldwide. In the UK, for example, insurance employed nearly **350,000** people, whilst in Japan it employed over **450,000** people.[29] As well as accounting for a significant proportion of GDP and employment in its own right, the insurance sector can also stimulate economic growth outside of financial services in a number of ways including, amongst others; facilitating trade and commerce, mobilising domestic savings, allowing different risks to be managed more efficiently, encouraging the accumulation of new capital and helping to reduce or mitigate losses.[30]

Robust empirical evidence supports this claim. For example, a study from the World Bank found that in the 1976–2004 period, both life and non-life insurance had a positive and significant effect on economic growth. Life insurance had a particularly positive effect in high income countries, whilst non life had a positive effect in both high and low income countries.[31]

Insurance can also help the world's poorest. It has been argued that so-called 'micro-insurance' – which refers to insurance with relatively small transaction costs and low premiums – can help alleviate poverty stricken areas where there is little conventional insurance penetration. Qualitative evidence implies that, when combined with micro-saving, the social value of micro-insurance "could be a major step toward improving the well-being of the world's poor".[32] SwissRe estimates that up to 4 billion people could ultimately benefit from such activities.[33] The micro-finance industry has seen tenfold growth in 10 years and microcredit now serves over 150 million customers.[34]

Ensuring sustainable public spending

Social insurance has historically played a key role in providing security and protection to those at the margins of society. This has included the provision of simple welfare benefits like the provision of a basic state pension, or protection in case of disability or unemployment. Whilst this has always been the role of the state, the private sector can help alleviate some of the burdens which fall on the taxpayer.

Governments are trying to encourage such a shift right now. In the UK, for example, instead of focusing on ways to increase state provision for those in retirement, the government is trying to find ways to stimulate demand for private pension saving. The government's flagship policy, automatic enrolment, is aimed at 'nudging' millions of people into long-term saving for the first time through a default workplace pension scheme known as NEST.

28 TheCityUK (Dec 2011) ***Insurance,*** Financial Market Series. http://www.thecityuk.com/research/our-work/reports-list/insurance-2011/ (accessed 20 March)

29 OECD data available from: http://stats.oecd.org/Index.aspx?DatasetCode=INSIND (accessed 20 March)

30 World Bank Policy Research, (Dec 2006) ***Does Insurance Market Activity Promote Economic Growth? A Cross-Country Study for Industrialized and Developing Countries,*** Working Paper 4098

31 Ibid

32 J. Morduch (Nov 2002) ***Micro-insurance: the next revolution?*** Working Paper for New York University

33 Swiss Re (Nov 2010) ***Micro-insurance: Risk Protection for 4 billion people, Sigma Series*** No6/2010

34 A. Kuper (Nov 2008) ***From Micro-finance to Micro-insurance***, Forbes Magazine http://www.forbes.com/2008/11/26/aig-insurance-zurich-pf-ii-in_ak_1126soapbox_inl.html (accessed 20 March)

In the view of ABI Director General Otto Thorensen, the future welfare state must build on the 'nudge' school of behavioural economics. He argues that "...if the state's welfare and tax systems reward and encourage those who protect themselves more, then society benefits and the individual is channelled in the right direction. This could be via matched benefits, tax reliefs, greater conditionality in benefit payments or any other number of mechanisms". The result, he argues could be a simpler and smaller state with a "clear interest in promoting certain outcomes and behaviours".[35]

Crucially, however, shifting the provision of welfare to the private sector will not just be down to government incentives. The public must, in turn, be convinced of the need to buy protection and save for the future. Currently, even in regions of the world where insurance penetration is high, a significant proportion of the population is underinsured. In the decades to come then, insurers, in collaboration with government, must find ways of connecting with this group to close the so called savings and protection gap.

The recent successes in the UK of simple savings products like ISAs[36] demonstrates that even in a challenging economic environment, people are prepared to put money aside for the future – particularly when the vehicle is easy to understand and provides some flexibility. This is not to say that this particular form of saving is some kind of magic bullet, but that the design and distribution of savings products will be crucial to increasing the level of savings in the years to come.

There is every reason to believe that the life insurance sector can meet this challenge. The sector has proven to be highly innovative since James Dodson first developed a scientific selection rating that based premiums on age and life expectancy in the 17th Century. Today, the sector covers a multitude of long term risks including, amongst others; helping to provide income for those in retirement, supporting people with life threatening illnesses and helping to fund the costs associated with long term care. The sector is also in the process of fashioning new products to explore emerging niche markets. Hybrid products, for example, combine different types of cover such as incorporating a long-term care benefit into a life or annuity product.[37]

Distribution will also be important in capturing the underinsured, and here too the sector is continuing to innovate. For example, on the general insurance side, the German firm Friendsurance is attracting attention for its use of social networking to encourage users to take up cover and to create an insurance network amongst friends.[38] Research from Deloitte has indicated that buyers across all age segments, and particularly the young, are very interested in having multiple points of interaction (ie, face to face, phone, internet social media and mobile technology) with their insurer.[39]

Mitigating political risks

The industry's continuing efforts to underwrite political risks can also play an important role in helping to shape our socioeconomic future. A number of firms cover political risks such as war, revolution, terrorism and civil unrest. Such insurance not only helps protect companies and investments with links to emerging markets, but also helps broaden our general understandings of political risks and how to take effective action in the face of them.

35 O. Thorensen (2012) ***From guarantor to enabler: the future of the state***, essay for Reform series, "The Next 10 Years"

36 R. Evans (Feb 2012) ***Savers shun 'complex' pensions for simplicity of ISAS***, The Daily Telegraph. http://www.telegraph.co.uk/finance/personalfinance/investing/isas/9113471/Savers-shun-complex-pensions-for-simplicity-of-Isas.html (accessed 20 March)

37 Deloitte (Mar 2012) ***2012 Global Insurance Outlook: Generating growth in a challenging economy takes operational excellence and innovation***

38 Post Magazine article (Mar 2012), ***Social media-based broker heralded as five years ahead of the game***

39 Deloitte (Mar 2012)

Maximising effectiveness through professionalism

In short then, the insurance industry is already doing many of the things necessary to play an important role in helping to shift the world towards a better future. The industry is also relatively well equipped to face some of the storms that may come its way should the worst case scenario of a prolonged recession materialise, given its relatively strong capital position.[40]

However, in order to help maximise its impact in terms of stimulating economic growth, alleviating poverty, taking on some of the burden for welfare provision, and mitigating political risks, it is essential that the industry continues to grow into a profession. By making continual voluntary improvements in professional standards, practitioners will be better placed to provide appropriate solutions to many of the socioeconomic challenges of the 21st century, and to inspire necessary confidence in the industry.

Some firms and practitioners are already making substantial improvements in this regard, as demonstrated by the significant growth in the number of Chartered insurance practitioners and firms over the last decade or so and the growth of professional standards in emerging markets. These efforts are a great step forward and, as more practitioners and firms make the leap, it should help engender greater overall trust in the sector.

Research supports this claim. A 2009 poll conducted for the CII by YouGov[41] found that:

- Consumers have greater trust in advice from Chartered professionals than professionals that are not Chartered.
- Consumers believe that you can generally trust the advice you get from Chartered organisations.
- Consumers have more confidence in the quality of organisations that use the term Chartered than those that are not Chartered.

It is clear that insurance already makes an important difference in influencing the trajectory of economies and societies. It must now press on to consolidate these gains and to maximise its effectiveness in determining the security and prosperity of the world it serves.

40 See Swiss Re (Dec 2011), ***Global insurance review 2011 and outlook 2012/2013***. In the research they refer to the implications of a 50% haircut on Greek, Irish and Portuguese sovereign debt for the insurance sector. They estimate that losses can be readily absorbed through existing capital. An additional haircut on Italian and Spanish sovereign debt would, however, be far more problematic

41 CII (Polling by YouGov) (2009), ***Consumer Views of Chartered Status***

7. Conclusion

There are many socioeconomic risks facing the world which have the potential to shape our long term future. In this report, expert authors have discussed some of these in detail, like the economic implications of US decline, the risks to the solvency of governments posed by rising longevity and the threat to western competitiveness associated with a shift of economic power to Asia.

These authors have also carefully considered a number of related political risks like rising geopolitical uncertainty between major world powers and continuing political unrest in parts of the Middle East. Taken together, it is possible to envisage a bleak future, where states, isolated from one another in an anarchic international system, are unable to meet the challenges of this century, condemning their citizens to a life of unemployment, poverty and conflict.

Thankfully, such a future is far from certain. The rise of the East, for example, may lead to an absolute improvement in living standards the world over. Similarly, an increasingly old population could provide important advantages through enhanced knowledge and experience albeit with dangers of skills shortages in specific areas.

However, in order to deliver a better future, it is clear that decision makers in government and elsewhere must take action now to address current problems like the eurozone crisis and US political paralysis, both of which could have significant long term knock on effects for Western competitiveness and global economic productivity. Crucially though, the insurance sector can play its part too in helping to determine which socioeconomic future we ultimately face.

Insurance has proved to be an important engine for growth – both with respect to the developed and developing world – so there is no reason why it cannot perform the same function in the decades to come. The industry is already, for instance, helping sustain the comparative advantage of the West by underwriting investment in new technologies, as well as helping to alleviate poverty in the developing world through new types of insurance like micro-insurance.

In many ways then, key to success is for the industry is to continue doing the things it has done well in the past, even better in the future. Being part of a profession will be very important in this regard. In the new world, likely to be rife with uncertainties and complex, interlinked risks, a commitment to high levels of competence and ethical practice will be vital – not just for providing appropriate advice and adequately underwriting risks – but also, and perhaps most importantly, for maintaining the trust and confidence of the consumers and societies it will serve.

The next report

In our next report within the centenary series, we will look at possible environmental futures. Similar to this report, experts will set out diverse and compelling narratives on what the future might hold, and we will seek to build a number of simple scenarios to set out some implications for the insurance and financial services industry.

Who to contact

CII

Ben Franklin
Policy and Research Co-ordinator
Chartered Insurance Institute
20 Aldermanbury
London
EC2V 7HY

Email:
ben.franklin@cii.co.uk

About the Chartered Insurance Institute (CII)

Professionalism in practice

The CII is the world's leading professional organisation for insurance and financial services, with over 100,000 members in 150 countries.

We are committed to maintaining the highest standards of technical expertise and ethical conduct in the profession through research, education and accreditation.

Our Charter remit is to protect the public by guiding the profession. For more information on the CII and its policy and public affairs function, including examples of the range of issues in financial services and insurance that we cover, please see:

www.cii.co.uk/policy

The Chartered Insurance Institute 42–48 High Road, South Woodford, London E18 2JP
tel: **+44 (0)20 8989 8464** email: **customer.serv@cii.co.uk** website: **www.cii.co.uk**

© The Chartered Insurance Institute 2012

Ref: CII_socioeconomicLFH (03/12)
CII_6414