

**Beyond the “Davos Consensus”:
A New Approach to Global Risks**

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Beyond the “Davos Consensus”: A New Approach to Global Risks

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Abstract

A new consensus has recently emerged among analysts: we label it here the “Davos consensus” since it has been reinforced by analyses and contributions presented during the 2006 annual World Economic Forum. Based on these views, the current benign economic environment is jeopardized by persistent geo-political risks and new global threats such as pandemics, international terrorism, and climate change. The recipe for policy-makers would be to focus their efforts on global strategies to cope with these risks as a way to minimize the impact of potential shocks to the economy. In this paper we take a different view: we argue that the most likely scenario for political risks is one where it is efficient for countries to adopt muddle-through behaviours, while hidden economic vulnerabilities are building up in many economies, carrying with them the risk of disorderly unwinding of existing financial

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imbalances. As global risks are on the rise, including in areas where markets have clear failures (e.g., climate change), actions are needed. However, government and regulatory failures should also be considered when asymmetric information prevents market mechanisms from working efficiently. The main conclusion of the paper is therefore that increasing global risks call for more action on the part of economic agents, not just governments. In particular, insurance provision is key to mitigating the impact of severe risks, while underinsurance leads to suboptimal conditions for both households and enterprises.

Keywords: Political Risks, Game Theory, Insurance

Background

A new consensus has emerged worldwide among analysts: according to this prevailing view, the global economic environment has become increasingly resilient to financial stress and to changes in market sentiment. Shocks that have hit many emerging market economies in the past would be made less likely, according to this approach, by a host of factors, which include progressive trade integration on a worldwide scale and financial liberalization. These trends, though to varying degrees, have been common to the majority of countries, as emerging market economies have matured and new key players have entered the field. While markets have become less volatile and financial innovation allows economic agents to better offset the negative implications of macroeconomic and asset price cycles, a new ghost seems to be wandering across the globe: political risks are on the rise as a result of persistent military conflicts in several regions – e.g., the Middle-East, tensions are mounting across energy-hungry new economies for access to and control of scarce natural resources, and the threat of global terrorism fostered by religious fundamentalism is rising.

The stage for airing these views has been provided by the recent World Economic Forum meeting held in Davos at the end of 2006. In the beautiful landscape of the winter sport resort, policymakers, analysts, economists, and journalists have long discussed the results of a report (WEF, 2007) that pointed to the lack of global governance as the main source of risk in today's economies. The main argument was that risks have gradually shifted from country-specific to global, while policy responses remain national, with little coordination across countries. Moreover, as political risks emerge as the main threat to today's economies and macroeconomic risks seem to be subdued, traditional market and policy instruments at both national and multilateral level are clearly not adequate. In light of the multinational nature of

the sources of vulnerability, this is tantamount to a recipe for disaster: “think global, act local” environmentalists have been advising for years: now the saying seems to go “act global to sort out local issues” (which have, in fact, a worldwide relevance in our integrated economies, as Nobel price winner Stieglitz often mentions).

This view, that we label for simplicity the “Davos consensus”, although not officially brought forward by the organizers of the Swiss event, has been quickly reported in the media and has fostered a number of articles and scientific papers. In fact, as it happened for the concept of Washington consensus developed during the 1980s to summarize the set of economic and structural reforms that formed the basis for a general agreement between development economists at that time, the bits and pieces that compose the substance of the new consensus cannot be traced down to a single author. They can however, be summarized through three main messages: (i) geo-political risks are rising; (ii) macroeconomic risks have declined; (iii) global risks - such as climate change - are an increasing potential threat to stability and require policy actions.

The objective of this note is to provide some arguments to move beyond this “Davos consensus” drawing on stylized facts and empirical evidence. To anticipate the thrust of the conclusions, the paper shows that macroeconomic risks are still with us and continue to jeopardize financial stability, particularly in countries with weak fundamentals as in the “bad old days” of economic crises. Contrary to the “Davos consensus” findings, this paper shows that political risks could be overstated and that, for different factors, a muddle-through scenario is the most likely outcome of the current situation, where geo-political instability ranks particularly high on the agenda of government concerns: similarly to the Cold War balance of military power, the more democratic environment of today is likely to favour a second-best equilibrium. In this environment, agents (countries) do not have incentives to move away from the current unstable equilibrium because the expected pay-offs are not sufficient to offset

the risks, including those stemming from incomplete information. We do find, however, that some global risks have worsened as a result of lack of adequate governance at the worldwide level. We draw from these results a few normative conclusions. Traditional orthodox macroeconomic measures (e.g., prudent fiscal policy, anti-inflation rule-based monetary policy, and financial sector regulation) combined with better risk protection through adequate insurance provision are the appropriate mix of actions to minimize the negative implications of potential shocks, which may eventually materialize.

The rest of this paper is organized as follows: section 2 briefly discusses the main arguments that lay at the basis of the “Davos consensus”, in section 3 we tackle the issue of geo-political risks, and in section 4 we discuss macroeconomic and financial risks. We introduce the concept of strong uncertainty in section 5 and conclude that underinsurance is a source of strong vulnerability and inefficiency in this context. We use the comprehensive insurance framework developed by Ehrlich and Becker (1972) to provide some evidence of the shift in global risk towards less frequent, higher expected-loss events and derive the policy implications for economic agents in these conditions. Section 6 presents a summary of the discussion and the final remarks.

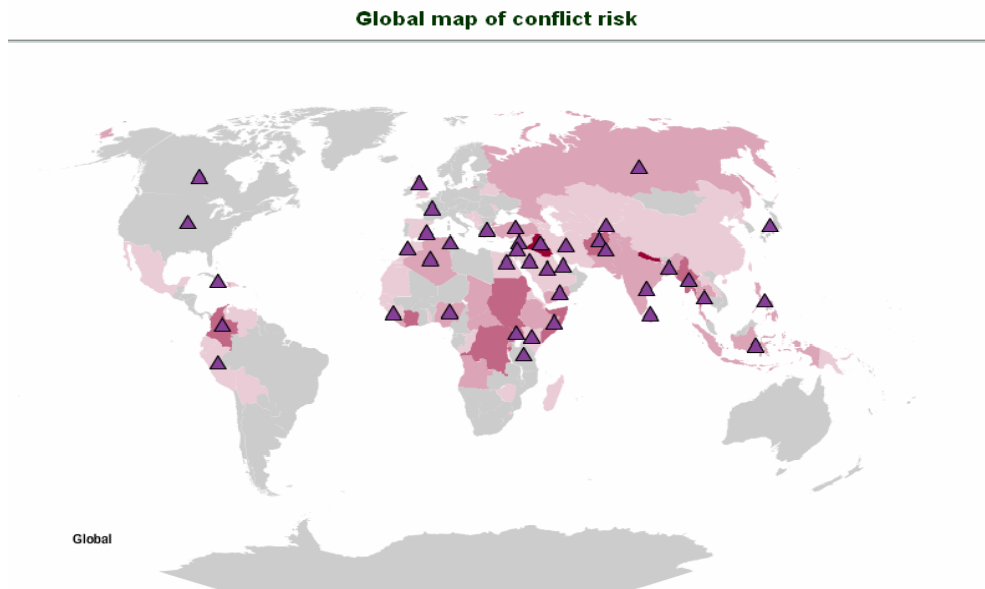
The “Davos consensus” in a nutshell

As in the well-known bestseller written by Peter Friedman (2005), the idea that the world is flat lays at the ground of the arguments that compose the new consensus. As the playing field of the global economy has been levelled by the forces of trade, innovation, ITC revolution, and migration new risks have arisen. These include new geo-political conflicts related to ethnic and religious contrasts that were superimposed on the persistent instability in areas of the world such as the Middle-

East or Southern Asia. Geo-political vulnerabilities have always been a source of concern for global analysts, so what makes them so special in the flat world we live in? Part of the story has to do with rising inequality and the increasing distance between those groups that benefit from globalization and those that get worse. Increasing inequality is in part a result of the flattening world: returns to physical and human capital increase in line with the higher productivity associated with the ICT revolution and the related product and process innovation (Venables, 2006). Wider disparities, however, can be exploited by fundamentalist and other violence-prone groups and are an important source of tension worldwide.

Natural resource hunger is another factor accounting for the increase in political risk across the globe. As the giant emerging markets of Asia (China and India) continue to grow at double digit speed, their needs for commodities, including oil and gas, rise fast and lead to competition for scarce resources. At the same time, emerging markets rich in natural resources (e.g., Russia) may see the scope for expanding their political influence in the world by befriending the new economic powers and becoming more independent from the G7 countries. While this development does not necessarily have to lead to higher risks of conflict, it may nonetheless create incentives for confrontational policies across regions. An example is the new natural resource “imperialism” that the Chinese government is accused of, as a consequence of its increasing economic and financial ties with the sub-Saharan Africa region and in particular its commodity-rich countries. The advanced world reaction to the increasingly important role of Asian diplomacy in the region can be a good predictor of future tensions.

Chart 1 Global political risks around the globe



As political risks are widespread (Chart 1), the consensus goes, macroeconomic risks are declining. The world has benefited in 2006 from the fifth consecutive year of stellar expansion, with GDP growth in PPP terms in the range of 5 percent per year. International trade is booming and growth in trade is almost twice as fast as the increase in the production of goods and services. The trade intensity of economic growth has increased, with approximately a ratio of two goods traded for each additional good produced in GDP unit terms. The economy is in good health (Chart 2) and most macro indicators point to the reduction in risk: interest rates are low, currencies are stable within flexible exchange rate arrangements in an increasing number of countries (with important exceptions as China and Middle-Eastern countries), international reserves have been piled up, and inflation is down to historical lows (IMF, 2006).

Macroeconomic indicators are also much healthier in emerging market economies (Chart 3) than a decade ago (Ferrari, 2006), while the commodity cycle bonanza has provided countries the resources to repay their debts (which have also been cancelled through multilateral initiatives - e.g., the HIPC program of the IMF and the World Bank- in poorer countries). On the policy side, the outlook seems to be bright as well: rule-based monetary policy has mitigated the pressure on inflation stemming from the commodity price boom, prudent fiscal policy seems to prevail with few exceptions, and structural reforms have gradually been introduced in the labour and product markets in many countries. Demographic pressures are also well contained and population ageing has become in most countries, including in the emerging markets, the top fiscal policy priority over the medium term.

Chart 2 Emerging market economies: a growing global player

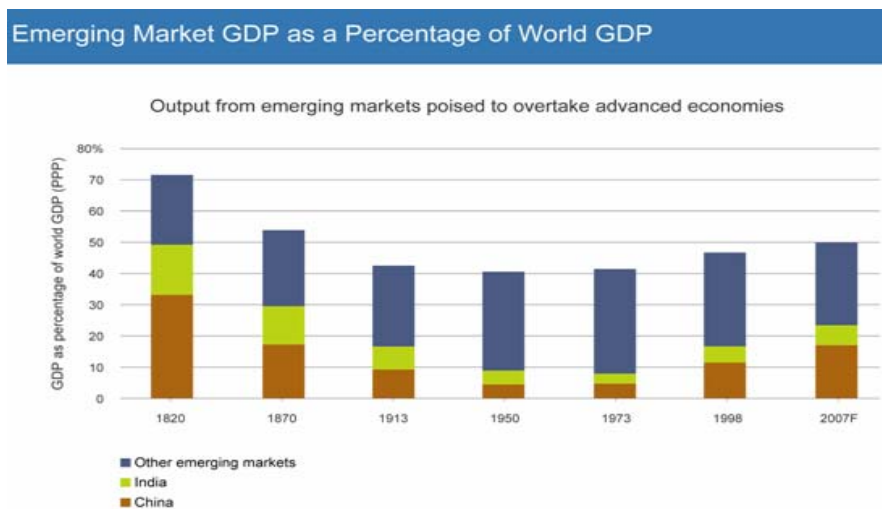
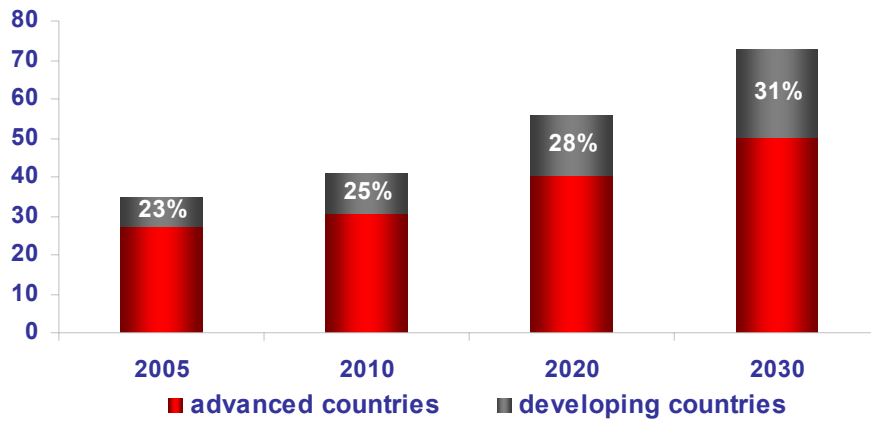


Chart 3 Emerging markets: eating a larger slice of the pie



Finally, as political risks have risen and economic risks seem to be well contained, global systemic risks have come to the fore. The avian flu pandemic is an increasing source of concern, not just for health specialists but also for economists, owing to the heavy cost of a potential worldwide outbreak of the disease. The recent Stern report (Stern, 2006) has highlighted with precise figures the cost to the economy arising from global warming and other climate-related effects: the conclusion is striking, as the cost of inaction can be as high as 5 percent of global GDP: the equivalent of a whole year of work for 6 billion people. While risks get more global in the flat world economy of today, institutions are dangerously behind the curve: global institutions are weak and consensus building in many of these areas is inconclusive. The result is that high-severity risks are overwhelmingly becoming a more important distress factor than financial and macroeconomic risks, particularly when combined with geopolitical risks on the regional scale that prevent global solutions.

To summarize the “Davos consensus” redux can be illustrated, in a rather simple way as follows:

- Regional geo-political risks are increasingly important;
- Macroeconomic and financial risks are more under control today than a decade ago;
- The new kids on the bloc are emerging high-severity risks, which dwarf economic shocks in terms of potential losses.

Geo-political risks: towards a muddle-through equilibrium

With political risks on the rise, why should political instability not be the main concern for policymakers and risk analysts? The rather counterintuitive conclusion we support in this paper can be based on two explanatory factors: asymmetric information and the link between democracy and globalization. In this section we argue that the combination of these factors can lead to stable solutions to the political instability dilemma. These are not what economists would label first best equilibria that maximize agents’ utility function, but can be described as second best solutions or in a non-technical way as a muddle through scenario. The latter is a solution where the level of risk remains stable, although high, but agents have incentives not to move away from this equilibrium as the associated cost in terms of likely severe negative pay-off is well above the potential benefits. Therefore, despite high political risk levels, this solution implies that equilibria can be found that do not lead to political instability or widespread conflicts.

Asymmetric information has generally been used by micro economists to explain market failures. However, this concept can be usefully adopted also in the different

context of political risk analysis. In this case, agents are represented by countries that compete for natural resources and political influence using a variety of tools, including, as a last resort, a military strategy. The latter can be a fully global military attack against one or more countries or a more subtle low-intensity war that can be fought by states or paramilitary groups in regions (e.g., in certain breakaway regions of the former Soviet Union) or new areas where civil conflicts have erupted (e.g., in Iraq). If information is complete, rational policymakers will behave in a way to achieve their objectives including through military options. The latter case happens when the agent is able to assess the net gain of his action taking into account the relative strength of the opponent and the likely reactions of other agents. However, the real world works differently as no player can assume to have perfect information on the relative strength of other agents. This can lead to different types of equilibria.

In a political world with partial information (Akerlof, 1970), the likely outcome is well described by the iterated prisoner's dilemma solution frequently used in game theory. This is a type of non-zero-sum game in which two players can cooperate with or defect the other player. If each individual is maximizing his own payoff, in the classic form of the game, cooperating is dominated by defecting. The unique equilibrium for this game is a sub-optimal solution—in equilibrium, each prisoner chooses to defect even though both would be better off by cooperating. However, in its generalized version the game can have a different outcome (Axelrod, 1984). In the iterated prisoner's dilemma the game is played over time. Thus each player has an opportunity to "punish" the other player for previous non-cooperative play. Cooperation may then arise as an equilibrium outcome. The incentive to defect is overcome by the threat of punishment, leading to the possibility of a cooperative outcome. If the game result is infinitely repeated, cooperation may be a Nash equilibrium, although both players defecting always remains an equilibrium. This model has been applied, for example, to the arms-race issue: it can be concluded that

the rational strategy is not always to build up the military, when rival states actually compete in an iterated setting.

This example can be assimilated to the muddle-through scenario we argue is the most likely outcome for the political risk environment today. With the balance of power heavily tilted in favour of the United States and no other “superpower” able to play the role on the global stage - but at the same time the relative easy access to the nuclear technology by many other countries - the importance of asymmetric information has grown: in this context, even low-intensity regional conflicts may degenerate into longstanding confrontations that erode political support and have a huge cost in terms of human lives and for the budget. The conflict in Iraq is a good example of this situation. In this context, it may be more efficient for countries not to test the strength of their opponents and prefer the muddle-through solution: a situation also typically found in innovation conflicts among firms in situations where patents and other intellectual property rules are not enforced leading to lack of any action on both sides (also called the “chicken game”). Moreover, the increasing media coverage of conflicts and the rising power of public opinion on governments’ ability to conduct foreign policy is another factor that favours non-conflict solutions to the political instability dilemma. How stable is this solution? As in the case of the iterated prisoner’s dilemma, it can be as stable as other more inefficient equilibria to the extent that the drivers that led to the solution are not affected by an information shock (e.g., the discovery that a country has a new weapon of mass destruction, structural changes in public opinion sentiments).

The second argument in favour of a second-best solution to the political instability issue is the increasing link between globalization and democracy. Eichengreen and Leblang (2006) have shown that over the last decades the number of democratic governments has increased dramatically (Chart 4) and has affected the level of trade among countries. At the same time, globalization has had a positive significant

impact on democratic reforms, raising incentives for countries to move away from authoritarian regimes to fully exploit the benefits of global trade. This democracy-globalization link is such that a departure from the equilibrium condition because of a positive shock caused by the increase in democracy (e.g., new countries adopting a democratic system) would lead to a new solution as shown in Chart 5 (a move from A to B through A'), whereby both global trade and democracy are higher. If globalization pushes countries in the direction of democracy, this is a reinforcing factor for the muddle through solution we have been arguing the reasons mentioned above (e.g., public opinion control, institutional checks and balances, civilian decision making).

However, this is not the only effect that can be drawn from the Eichengreen and Leblang paper. Also a shock to global trade (e.g., a new trade agreement) can lead to higher democracy. This is consistent with the “great unbundling” theory formulated by Baldwin (2006): global production networks are increasingly based on the trade of tasks that is replacing traditional import export activities. With integrated production networks replacing traditional national production systems trade within the networks is accelerating leading to higher volumes of goods and services being exchanged across the world and changing the operating paradigm also for the financial and insurance sectors, including export credit companies (Chart 6).

Despite increased political risks, the likely outlook for global risks is one where muddle through rather than instability is likely to prevail. This is not to say that political risks should not be given adequate attention by policy makers. The potential for non-cooperative equilibria, even under the iterated prisoners' dilemma approach used here, are always a possible outcome. Political instability is here to stay, but is not the top priority in the to-do list of the risk analyst.

Chart 4 Democracy flourishing?

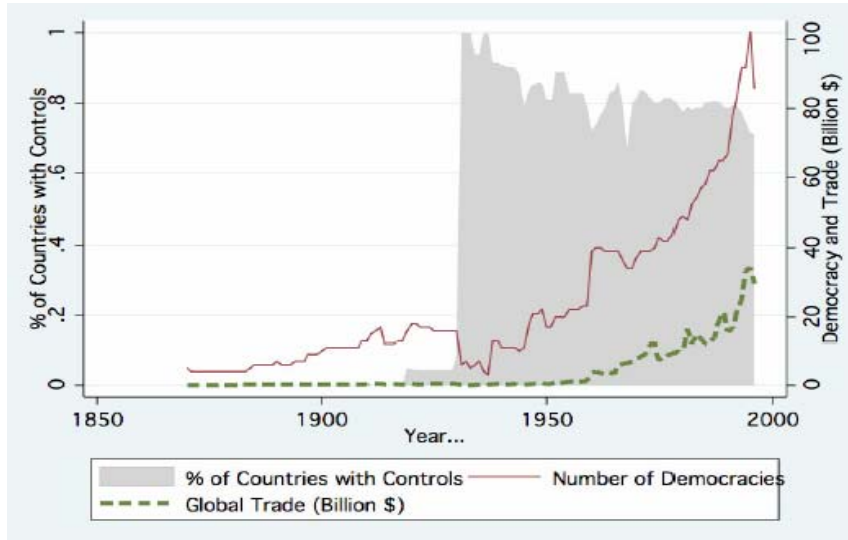


Chart 5 Globalization and democracy

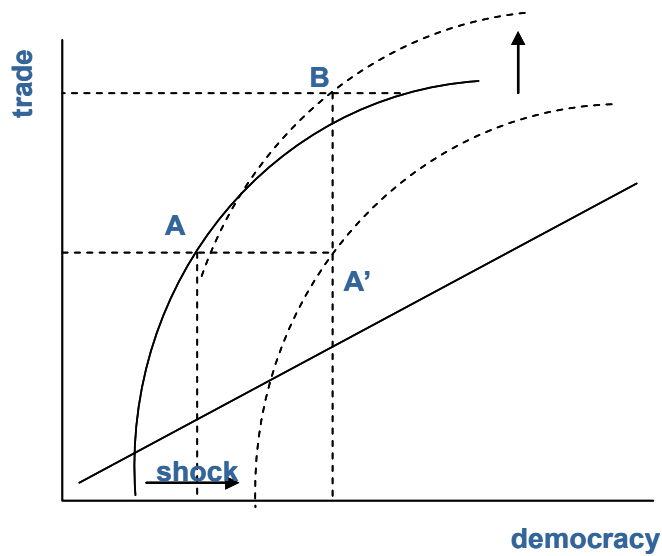
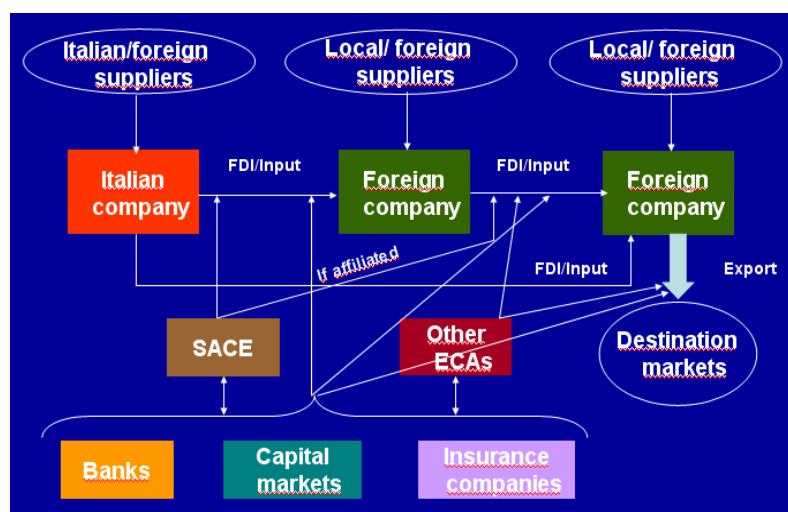


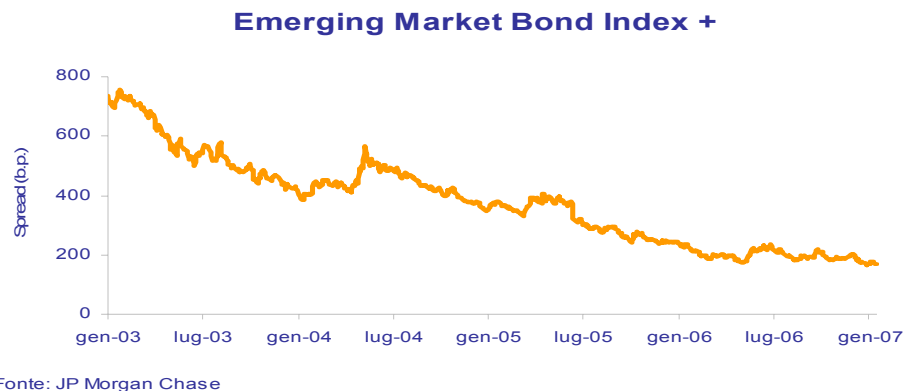
Chart 6: The unbundling of global production



Global economic and financial risks: look better you will discover them

The second pillar of the “Davos consensus” is the assessment of economic and financial risks. The common view is that the balance of risks is positive, with the economic outlook for world GDP growth at about 5 percent per year and volatility to historical lows. In fact, financial markets are quite sanguine on the global outlook, particularly for emerging market economies. The EMBI+ index that measures the spread on government bonds for a pool of important emerging economies signals a quite robust downward trend, as the default probability is expected to have declined significantly (Chart 7).

Chart 7 Emerging markets spread have declined



This has been labelled a Goldilocks environment by analysts such as Roubini,² hinting at the fairy-tale, all-rosy picture it provides, but also at the potential threat of encountering the three bears of the story. What lays at the ground of the Goldilock economy is a combination of positive factors that in theory have reduced the vulnerability of the world economy to potential adverse shocks, such as financial crises like the ones experienced over the last two decades in Asia, Latin America, and Russia. There are five components to this positive outlook for the world economy, according to most analysts:

- Economies have strengthened their macroeconomic fundamentals: debt ratios have declined, growth is not only higher and sustained in the new industrialized emerging economies, but also at the periphery of the flat world, including in Africa. For example, the GDP growth outlook for 2007 is for world growth to be at about 5 percent. With most emerging market regions projected to grow well above the average - with the exception of Latin America and the Caribbean that will in any case take home a growth rate above 4

² See www.rgemonitor.com for comments on the Goldilocks economy and the three bears that threaten it.

percent, despite the slowdown expected in the main trade partner economy: the United States (IMF, 2006).

- Financial markets have become deeper, as a result of financial innovation and the incredible amount of low-cost liquidity. At the same time, financial reforms have brought about important structural changes with a decline of the bank-led financial system and the rise of what the IMF (2006) has called arm's length financial intermediation: a system where capital markets play a more significant role than in the past and where the importance of traditional financial intermediaries is reduced and confined to the retail banking sector. Finally, globalization has also dramatically increased the capital flows into and from emerging countries, including portfolio and equity flows. Corporate debt has replaced in part government debt in the process.
- Rule-based monetary policy has achieved low inflation around the globe. This is a result of the dramatic increase in central bank independence in the conduct of monetary policy and the de-linking of fiscal and monetary policies. At the same time, central bankers have become better market communicators and the financial system regulation has improved. There may be also other structural factors behind low price growth worldwide: namely, increasing competition from low-cost emerging economies has reduced the cost factors for cheaper goods and services, thereby contributing to moderate the price dynamics of widely consumed goods.
- Fiscal prudence has become the main policy objective in many countries. This has been achieved by running important budget surpluses in countries with high public debt levels and resorting to fiscal rules to constrain spending-prone legislators. In most countries, this process has been helped by strong commodity prices and buoyant growth that sustained revenue collection.

However, the real economy may differ slightly from this rosy picture, or perhaps more fundamentally than one might think. According to some analysts, the real world does not look like a Goldilock economy.³ We argue here that they may be right, as looking more carefully at some “positive” economic data might enable to detect problems that have been largely overlooked. For the sake of space the discussion will focus on few important topics, which are not necessarily a complete list of risks. The relevant factors addressed here are overstretched financial markets, macroeconomic risks associated to the liquidity boom, and the not-so prudent fiscal behaviour of many governments, particularly in emerging market economies.

Financial markets are stretched out. Capital flows to emerging markets totalled \$502 billion in 2006, just slightly below the \$509 billion observed in 2005 and well above the \$349 billion recorded in 2004. Portfolio investment and bank loans are on the rise, while FDI and non-bank loans represent a lower share of the total. Looking at capital flow destinations, emerging Europe has surpassed Asia as Russia, central European economies, and resource-rich former Soviet Union countries have boomed (Chart 8). While these huge capital inflows have been favoured by positive economic developments and easy liquidity conditions, they are strongly concentrated in sectors that are heavily dependent on the commodity price cycle and in particular the energy sector. As a result these flows, that are also for an important share on a short-term basis, may be reversed quickly as market conditions change and commodity prices end their long boom cycle (and this is necessarily the case, unless one believes that economic cyclicalities has disappeared: we do not believe this end-of-history argument, of course).

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<http://www.comstockfunds.com/index.cfm/act/newsletter.cfm/CFID/5750646/CFTOKEN/13375118/category/Market%20Commentary/menuitemid/null/MenuGroup/Home/NewsLetterID/1289/startrow/2.htm>

Global financial imbalances are the other side of the same coin. Emerging Asia and resource- rich countries, particularly in the Middle-East region, have piled up huge amount of reserves. China alone passed the \$1 trillion mark last year and the accumulation of international reserves is large also for the other countries with trade surpluses. This has contributed to the increase in liquidity worldwide and has generated a downward pressure on the United States long-term interest rates, thereby contributing to support domestic consumption and finance the large trade imbalance that exceeds 6 percent of GDP.

Financial markets innovation has been determinant: hedge funds activities have reached \$1.5 trillion or about 40 percent of global international reserves. Pension funds and other institutional investors have also created the conditions for an upward pressure on asset prices. The funds exchanged in the derivative market have reached more than \$500 billion. Global financial risk aversion is at historical lows (Chart 9) in combination with the persistent excess aggregate saving-investment imbalance that has pushed interest rates so low. All well then?

Chart 8 Equity markets booming

Chart 6: Emerging Market Equities
(January 2003 = 100, MSCI, US\$ terms)



Chart 9 Global risk aversion reached historical lows

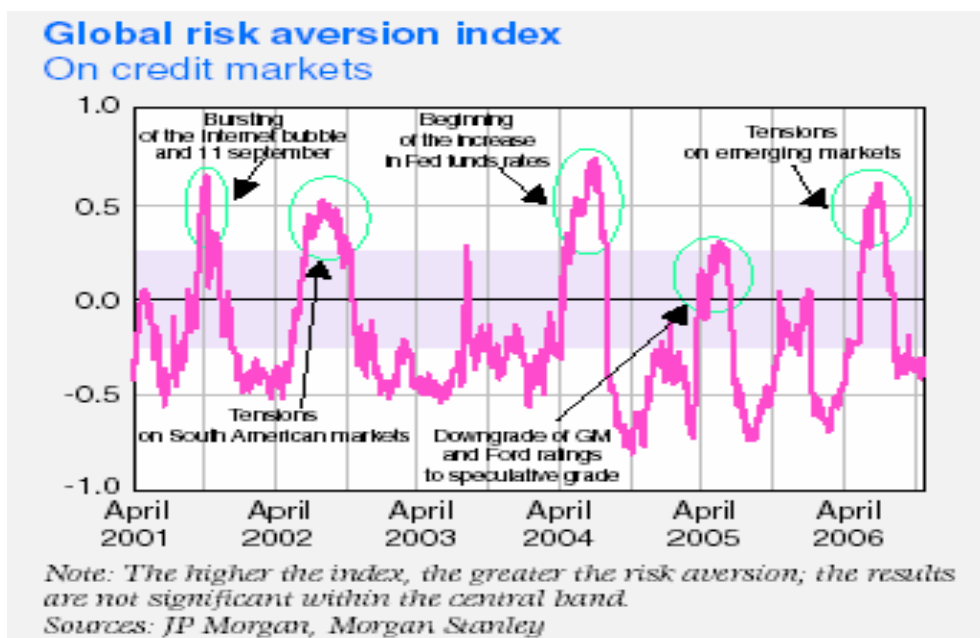
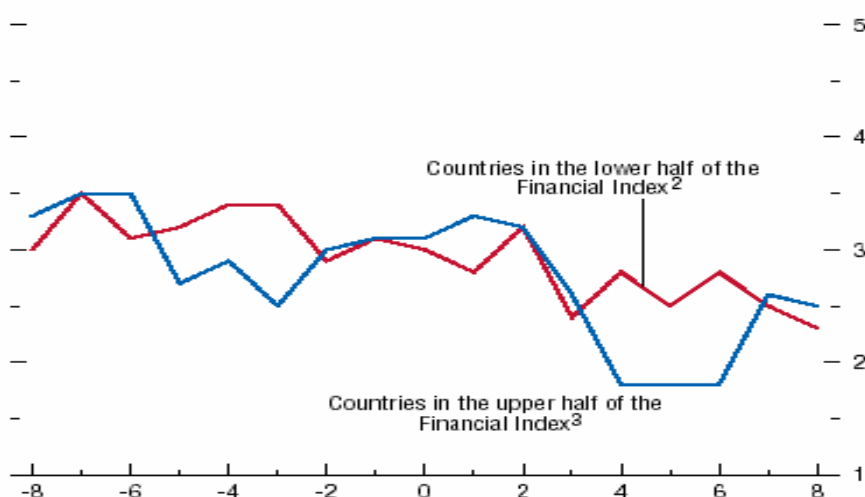


Chart 10 Effects of financial innovation

The consumption response to equity busts has been larger in more arm's length financial systems.



Sources: OECD Analytic Database; and IMF staff calculations.

¹ Zero denotes the quarter after which a bust begins.

² Countries included are Austria, Belgium, Finland, France, Germany, Greece, Japan, Portugal, and Spain.

³ Countries included are Australia, Canada, Denmark, Italy, the Netherlands, Norway, Sweden, the United Kingdom, and the United States.

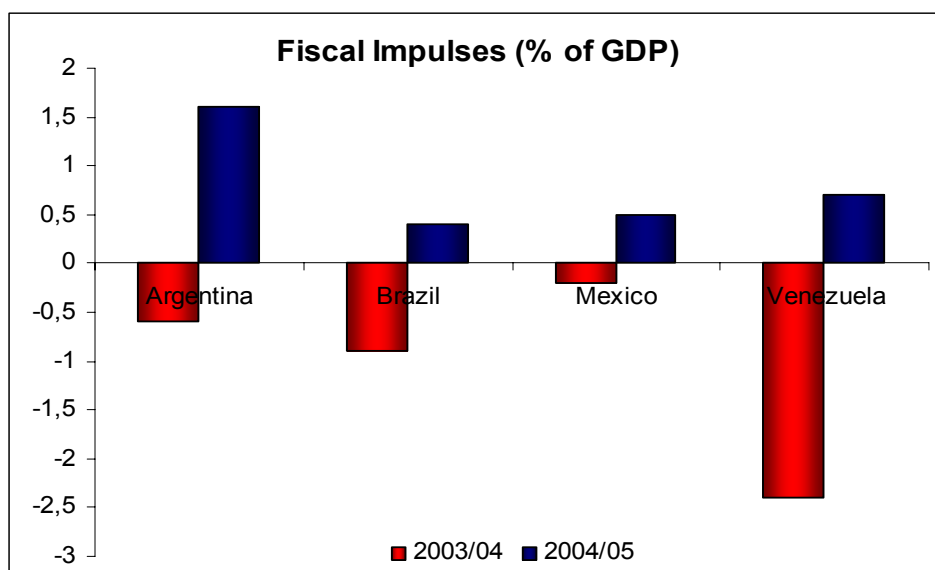
Not necessarily. Excess liquidity will inevitably push domestic inflation up if countries do not want to undermine competitiveness and allow exchange rate to move freely. Exchange rate undervaluation (e.g., in China, Japan, and the Middle-East) may give rise to sudden adjustments that can have negative real economic implications. Regulation on the new financial instruments is clearly inadequate and shifts in market sentiment can move around money very quickly, as the “mini” financial turmoil experienced by Turkey and other emerging markets during 2006 and the recent Shanghai’s equity market shock in February of this year witness. Moreover, historical data show that, in general, global slowdowns have been preceded by peaks in liquidity: even though no mechanical extrapolation should be made of this correlation, it is nonetheless important to stress that exceptional situations cannot last forever. Even more innovative financial systems are at risk (Chart 10): arm’s length financial systems have been more able than bank-based systems to smooth consumption during downturns, but are more sensitive to asset bubbles.

Macroeconomic risks are still important in many countries. Despite healthy economic indicators may show otherwise, in fact vulnerability conditions have not been completely eliminated in many emerging market economies. High-inflation is still an issue in Turkey and Iran, Russia suffers from exchange rate appreciation and the competitiveness impact of Dutch disease, China is still at risk of investment overheating, and the property asset boom in many Asian and Middle-eastern economies should be closely monitored. Current account imbalances and fiscal deficits are still a concern in high-investment-growth central Europe, and countries in Latin America have not really been that prudent at all in the conduit of fiscal policy (Chart 11). Oil and commodity revenue windfalls have been saved only in few countries (e.g., Chile). Quantitative fiscal rules do not seem to be working well in emerging markets, which still have relatively weak institutions and limited budget

transparency: more needs to be done to ensure that fiscal policy is sustainable and not leading to instability. New research (reported in Cariani, 2007) shows that fiscal imbalances always lead to price pressures and that rule-based monetary policy is a precondition, but is not sufficient to ensure price stability.

Macroeconomic risks are therefore still there, particularly for emerging markets, if one looks at the right indicators. The liquidity bonanza, including through capital flows to these high-growing economies, may be more problematic than most economists seem to believe. CDS and TRS markets are not very liquid and heavy hedge funds' exposure may lead to dramatic capital flow reversals in combination with weaker-than-expected news on macroeconomic fundamentals. The high level of private debt that has replaced government debt is not necessarily without problems either, as companies' balance sheet may get under stress if the unwinding of global financial imbalances (that sooner or later may happen) will be less gradual than many hopes.

Chart 11 Fiscal stance: not as prudent as it might seem



Strong uncertainty and the need for risk protection

The current risk environment can be associated to the existence of what environmental and experimental economists call “strong uncertainty”. This exists when “the effects of human activities on the environment are not at all known and the discovery of damages comes as a complete surprise”.⁴ Strong uncertainty is not confined to environmental problems and in fact has to do with most global risk issues confronting our societies (Chart 12). The problem with strong uncertainty is that we do not know in advance the probability distribution of the events that may give rise to the risks we would like to offset. Therefore, traditional risk mitigation instruments may fail. With risks becoming increasingly global, the response cannot be confined to the national borders. This is the dilemma faced at Davos: global risks are rising, global governance is shrinking.

There are many reasons why this may be a likely outcome, which include both institutional and economic incentive arguments. Among them, we regard the following as the most important:

- International financial institutions’ role has become marginal in terms of amount of funds they are able to move in the case of a large crisis. These resources are largely inferior to what financial markets demand. Therefore, private markets should be involved in the solution, but in some case they are the cause of the problem.
- Free riding by individual countries may jeopardize important global agreements, as in the case of climate change issues. This is because the system

⁴ A definition provided by Frank Waetzold of the Center for Environmental Research in Leipzig.

of incentives is such that cooperation may not be the most efficient option. The strength of multilateralism is therefore reduced in such an environment.

- When costs of actions are visible and short term and expected benefits are less clear cut, long term, and not clearly appropriable by countries, again the incentive structure is such that inefficient short-term solutions could be the chosen option. Localism and resource nationalism are two cases where this may apply.

All these factors prevent far-sighted global policy responses from being effective, but leave agents exposed to important risks. Our conclusion, on the basis of the comprehensive insurance framework theory developed by Ehrlich and Becker (1972), is that in the current risk environment underinsurance is clearly inefficient and leads to adverse conditions for economic agents. Risks are shifting away from frequent, low-severity events to the large-loss, less-frequent region of the scheme (Chart 13). As a result, the theory calls for more pooling (insurance) of risks and less coping and prevention as effective instruments as illustrated in the chart.

Risk insurance implies better knowledge of global risks: political, financial, and economic. Monitoring risks is a way to better govern them. Underinsurance is increasingly sub-optimal, as it undermines risk-taking and can push economic agents to adopt a survival strategy that would not allow them to deal with the new challenges of the flat world. However, risk protection demand may not necessarily increase as a result, because of agents' myopia. This is the real dilemma risk insurers and policy makers face today.

Chart 12 Global risks advancing according to the World Economic Forum research

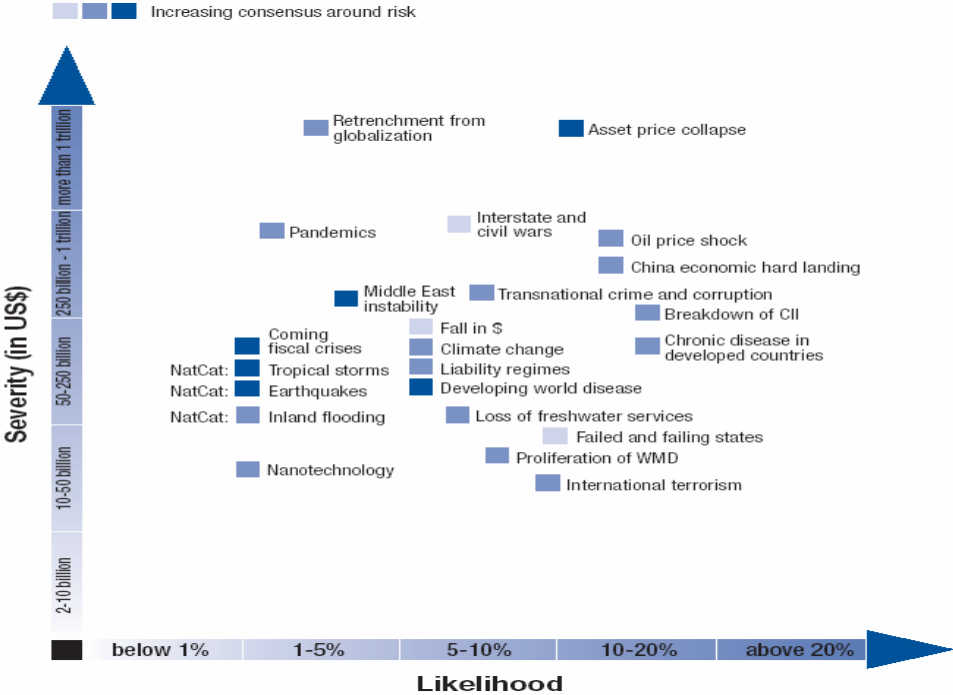
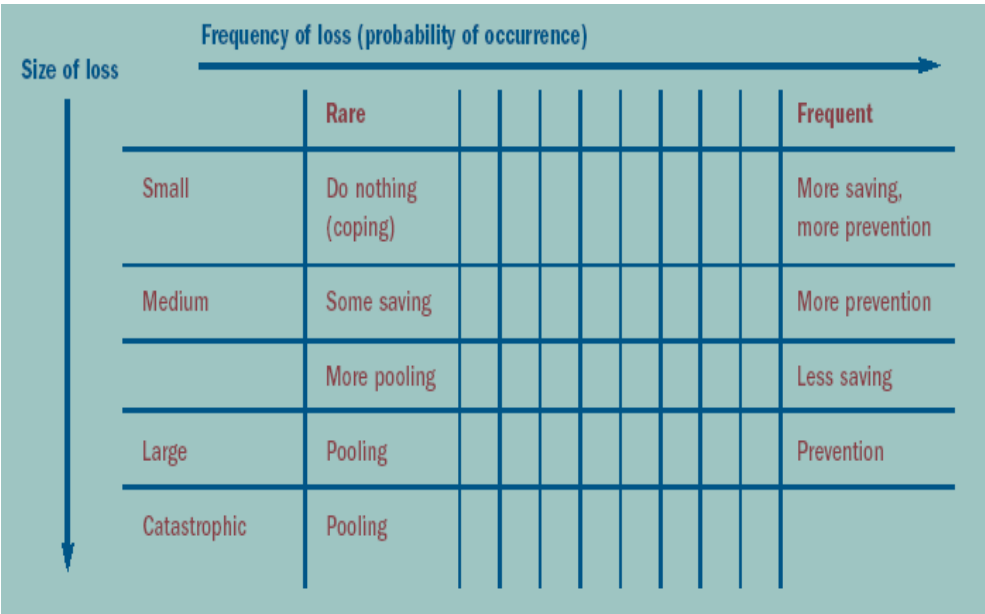


Chart 13 The comprehensive insurance framework today



Conclusion

A new consensus has recently emerged among analysts that we have labelled here “Davos consensus”. Based on these views, the current benign economic environment is jeopardized by persistent geo-political risks and new global threats, such as pandemics and climate change. The recipe for policy-makers would be to focus their efforts on global strategies to cope with the latter, as a way to minimize the impact of potential shocks to the economy. In this paper, we take a different view: we argue that the scenario for political risks is one where muddle-through behaviours are more likely, while hidden economic vulnerabilities are carrying with them the risk of systemic disorderly unwinding of existing financial tensions. Global financial risks are therefore on the rise, including in areas where markets have clear failures and governments are unprepared to respond. But government and regulatory failures should also be considered when asymmetric information and the incentive structure prevent market mechanisms from working efficiently. The main conclusion of the paper is that increasing global risks call for more action on the part of economic agents, not just governments. In particular, insurance protection is key to mitigating the impact of (increasingly more) severe risk and underinsurance leads to suboptimal conditions for both households and enterprises. Risk insurance implies better knowledge of global risks: political, financial, and economic. Monitoring risks is a way to better govern them. However, risk protection demand may not necessarily increase because of agents’ myopia. This is the real dilemma faced today.

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