GROWING RISKS, DOWN ECONOMY – A BRIEF IDENTIFICATION OF SYSTEMIC RISKS OF THE CURRENT PERIOD

Assoc. Prof. Narcis Eduard Mitu Ph. D
University of Craiova
Faculty of Economy and Business Administration
Craiova, Romania

Abstract: : After the shock to the global financial system and world economy in 2008, period that followed is one of analysis and conclusions. What has changed dramatically, compared to last period, is the level of recognition that global risks, like the world, are now tightly interconnected and shocks and vulnerabilities are truly global, even if impact and response can still differ at the ”local” level. The current economy is impacting global businesses in numerous ways. Organizations have been forced to adjust their business model and operating costs by reducing workforce, downsizing production, seeking cost savings opportunities, and developing business contingency plans for changing economic conditions. In this context, in the pages that follow, we will try to make a brief analysis of the potential risks that may affect the global economy in future periods.

JEL classification: H12, G20, G32.

Key words: systemic risks; economic risks; moral hazard; morality; crisis.

1. INTRODUCTION

During the current period, a high increase of the inter-connectivity of national economies is developing, and this situation generates increased systemic risks. The vulnerabilities are no longer local, but global. Still, the manner in which these risks are treated is different from one country to another, from one area to another. Furthermore, since the systemic risks evolve over a longer period of time, they can be seriously underestimated. The risks range in this category range is various and growing (Figure no.1).

Synthetically, according to the World Economic Forum (WEF), the range of risks can be divided into economic risks, geopolitical risks, environmental risks, social risks and technological risks.

Detailing, among the main current risks related to each category we can identify the following:

Table no. 1

Economic Risks		Geopolitical Risks		Enviromental Risks		Social Risks		Technological Risks	
1	Food price volatility	11	International terrorism	20	Extreme weather	29	Pandemic	34	Critical information infrastructure
2	Oil price spikes	12	Nuclear proliferation	21	Droughts and desertification	30	Infectious diseases	35	Nanoparticle toxicity
3	Major Fall in the US $	13	Iran	22	Water scarcity	31	Chronic diseases	36	Data fraud/loss
4	Slowing Chinese economy (<6%)	14	North Koreea	23	Cyclone	32	Liability regimes		
5	Fiscal crises	15	Afganistan instability	24	Earthquake	33	Migration		
6	Asset price collapse	16	Transnational crime and corruptin	25	Inland flooding				
7	Retrenchment from globalization (developed)	17	Israel-Palestine	26	Costal flooding				
8	Retrenchment from globalization (emerging)	18	Iraq	27	Air pollution				
9	Burden of regulation	19	Global governance gaps	28	Biodiversity loss				
10	Underinvestment in infrastructure								

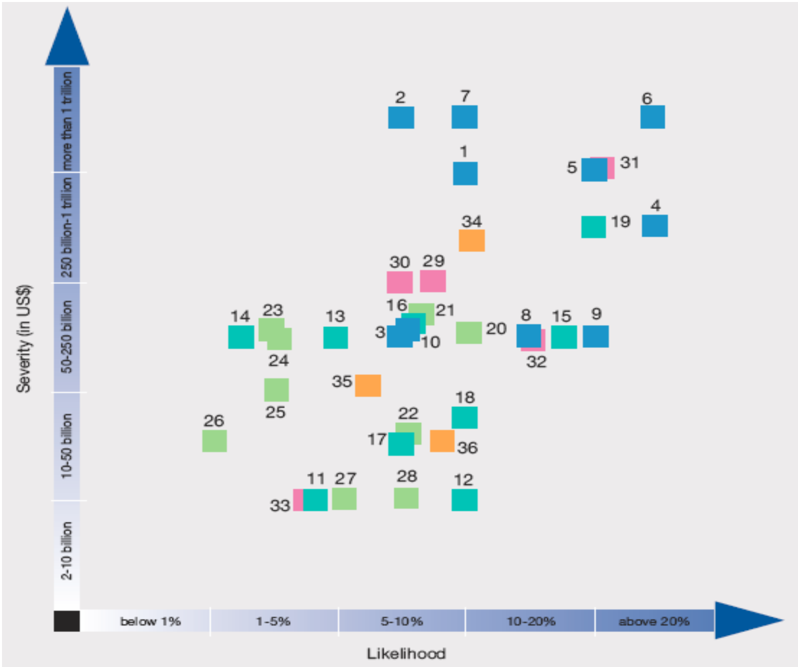
Source: Global Risks 2010 – A Global Risks Network Report

As can be easily noticed (Figure no. 1) the most likely and severe risks are those in the economic category.

As demonstrated by the current crisis, the financial stability plays an essential role within any financial system and in economy in the aggregate. Considering the increasingly larger number of financial institutions currently active in one or more countries in one or more continents, the global financial stability has become even more important.

In order to protect the financial system and ensure its stability, the sources of risk and vulnerability should be acknowledged.

The insurance companies, banks and other financial institutions should form the first line of defense against financial crises. But the reality is that most of the financial industry players have not yet assumed the role they have played in producing and perpetuating an unexampled crisis until now. Therefore, it can not be about having an important role in fighting the crisis but, contrariwise, they represent a high potential risk factor. The abuse of securitization, cheating clients by distributing products without a transparent trading (practically worthless), the rush for profit by neglecting the micro and macroeconomic risks, and so on, have turned large components of the financial industry into a genuine internal destabilizing element of the industrialized economies.



Source: Global Risks 2010 – A Global Risks Network Report

Figure no. 1 Global Risks Landscape 2010

2. CURRENT POTENTIAL RISK FACTORS

2.1 "Too big to fail" risks

Crisis has forced governments to rediscover the need for financial stability and to try to generate it. The philosophy of stimuli has historical European roots (the doctrine of cash flows and healing inflationism, preached by Keynes). The idea was rediscovered and used almost without exception by the governments of EU member states. The fabulous cash injections administrated to the banking companies, industrial sectors or some states, on behalf of the doctrine "too big to fail" do not indicate the coincidence of solutions, but describe an ideological climate. It is true that these interventions were accompanied by reform efforts of the regulation and supervision of the financial markets in fields such as: leverage limits (debt), increased equity, derivatives regulation, connection of performance remuneration, restricting speculative operations, and so on. The fact is, however, that this climate, by the disparate and incomplete measures adopted until now, may lead to some greater financial entities and an undesirable consolidation of their market.

Paradoxically, some banks have become larger amidst the crisis, even though it has been spoken about their breaking and separating the banking activities of depositing and lending from those of financial bets (investment banking). Bank of America has acquired Merryll Lynch during the crisis, JP Morgan has bought Bear Stearns and Washington Mutual, while BNP Paribas has taken over Fortis, and the examples do not end here. Even the increase in size of these groups can cause systemic risks to persist. "The large banking groups are the ones creating high systemic risks" said Daniel Dăianu in a recent article (*Bănci centrale sub foc continuu – Ziarul Financiar, 2011)* [2].

The theory “too big to fail” applied too open-handedly can generate a state of captivity of the governments towards the financial groups of a too large size. What is serious is that many times the operation logic of the market economy is perverted. It is not natural that losses of the financial industry to be socialized (on the account of the taxpayers) on a repeated basis, while the incomes of the investors in this industry to be protected.

2.2 The return to dangerous habits – Moral hazard

In economic theory, moral hazard is a situation in which a party insulated from risk behaves differently from how it would behave if it were fully exposed to the risk. Economist Paul Krugman described moral hazard as: "...any situation in which one person makes the decision about how much risk to take, while someone else bears the cost if things go badly" (*Krugman, 2009*). Krugman also asserts that “moral hazard” didn’t emanate from the banking environment. It appeared in New York, during the Great Depression and referred to the situation when an owner resold (by another legal entity) a property to an overestimated price, insured it at that price and then “it happened” that the building went up in flames, so that the owner to collect the insurance policy. In other words, “moral hazard”, which later also expanded to the banking system, means that, if you have been saved once, there is likely to be saved a second time. The “moral hazard” has been lately emphasized without being antagonized by the approach of some deep reasons. What should make us think is that banks progressively return to dangerous habits.

Recently, Mark Mobius said that a new financial crisis is imminent (*Din cauza derivatelor ne pândeşte o nouă criză financiară – Jurnalul, 2011*) [3] since the issues previous to the crisis, as the size of banks and derivatives have not been solved. To support this affirmation, Mobius noticed that total value of global derivatives exceeded global gross domestic product, creating volatility and a crisis on the stock market. More than 60% of the net incomes of the first six American financial groups is obtained by trading operations (*Rebuilding the Engine: The Bottleneck of Trading Operations in the Capital Markets*, *2007)* [4], as before crisis. This fact demonstrates that instead of decreasing from the speculative nature (of casinos) of the banking activity, it is perpetuating.

The progress of the Greek tragedy enhances the European drama. Among the great Greek bond owners there are the great market operators (market-makers), who have been saved, at least so far, by the governments’ intervention. It’s a clear situation of moral hazard but also a demoralisation of basic rules of market economy, saying that whoever assumes risks has to bear the consequences, too. It’s like we are heading a permanent crisis, a more moral one, financial only for some people.

2.3 Middle class decreasing

As the World Development Indicators (*The World Bank, 2010*) [5] of World Bank survey data reveal a new phenomenon with greater seismic risk has occurred in European countries and USA. It refers to the middle class decrease in the last two decades.

This phenomenon can not be entirely the result of economic evolution, but the financial crisis accentuates the middle class decrease, because the salvation of the financial industry has greatly encumbered the public budgets (which usually had the task to maintain certain welfare of the population). Right before the financial crisis, Larry Summers and Robert Reich (professors at Harvard) drew attention of the dangers arising from the middle class decrease (*Has Larry Summers gone soft?- The Economist, 2007)* [6]. When the society polarizes, premises for social fragmentation are created, for public space deterioration (as area of dialogue and compromises), for the vigorous revival of extremism. High political polarization, intolerance, increasing xenophobia and chauvinism, are in their turn dangerous side effects of the middle class decrease, too.

In many advanced economies the public debts have increased over 40% in a few years and the trend continues. Since major budgetary negative corrections shall be inevitable in time, this means an important part of population shall confront significant increases of fees and taxes and reductions of social expenses in the next years. Also, the present tendency, especially in moments of crisis of many of those who have significant financial resources to make investments in entities registered in tax sheltering, accentuates the fiscal burden and implicitly the financial one for the middle class, significantly decreasing it.

2.4 The risk of apparent morality

An important weakness of the state's capacity to take care of its citizens leads to an evident increase of the power of private, non-state interest groups. Nicholas Stern, the former World Bank chief economist, in a detailed analysis (*Stern Review on the Economics of Climate Change, 2006*) [7], pointed out an interesting phenomenon: the fact that markets do not properly internalize the man-nature relation and some consistent public policies are needed to remedy this phenomenon. Unfortunately in this period, public policies focus more on man-money relation, removing the man from its natural environment. When the interest groups grow too stronger they can capture public policy. The same happened with the wave of deregulations, beyond the influence of a cosmology of the perfect markets (the efficient markets hypothesis) omitting the systemic risks and simplifying until distortion the understanding of reality.

More and more companies speak of "the social corporate responsibility" (social corporate responsibility/SCR). The phenomenon seems hilarious today: the more the number of those speaking of morality and responsibility in business increases the more the immorality in the business environment is more consistent. Where is social responsibility when big or small corporations or companies (some of them saved from bankruptcy in the last years with public money) with consistent incomes, registered in tax sheltering, pay to the tax authorities in the countries where they run their business activity almost nothing? Also, how big and real is the social responsibility of a company activating also on the domestic market of oil products, great polluter, promoting its actions of tree planting with the aid of volunteers? This kind of action seems rather hypocrisy since the company, as a great polluter, has the legal obligation to plant trees. When governments or environmental organizations in developing countries "close the eye" (maybe both eyes) at the contamination of the air, waters and earth by the companies in exchange for sponsorship contributing to the achievement of some environmental protection action, can we still talk about moral and social responsibility? Is it moral and normal for a company producing carbonated beverages to be in the top of World's Most Ethical Companies – 2011 [8], when there is no secret that the sold product leads to obesity and a significant range of diseases destroying the life of consumers? And the questions can continue.

Adam Smith, Max Weber, Kenneth Arrow, Amartya Sen and many others have stressed the relation between moral values and the good operation of economy, of society. When the cynicism, greed, irresponsibility towards the fate of others, selfishness, are spreading, the anomalies can seriously disturb the society. It is not enough for the managers to proclaim only the necessity of social responsibility and ethics of actions for their organizations. The good or expected efforts do not come from proclamation. The entire organizational culture has to support the social responsibility and at the same time has to reward and consolidate the ethical actions. If top managers proclaim the desirability of ethical behaviour and then establish the financial targets achievable only by illicit activities or at the legal limit, then apparent ethic and morality shall be noting else but a new and insidious risk facing the global economy.

3. Conclusions

The conclusions are simple but complex at the same time. The recklessness of the law givers affects global economy, and the companies that don't review their exposure to risk are subject to insolvency or even bankruptcy. Global unitary measures are needed to treat and minimize the risks threatening the proper course of global economy. The welfare state has to be reformed, as it operates over its powers and in this context a raised individualized responsibility of the citizens is required (which doesn't have to mean that the weakest ones in society have to be abandoned). But the financial system has to be radically reformed. These two reforms imply a rewriting of the social contract between citizen, corporations and state and a financial industry return to the benefit of the entire society. Without returning to the initial logic of Bretton Woods' arrangements (which held up the destabilizing capital movements), the crisis shall be more and more devastating.

The current period is characterized by a serious blockage questioning historical structures and arrangements. The god rush is played at one end. Sinking in misery is at the other.

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