The Real Risk to the Global Economy

By "Smart_Christopher" *Thu, Nov 16, 2017*

'The risk [to financial stability] stems less from unpredictable shocks than from the slow erosion of institutions that investors trust to make an uncertain world more predictable,' writes the senior fellow at the Carnegie Endowment for International Peace.

One of the great mysteries of today's global markets is their irrepressible enthusiasm, even as the world around them appears on the verge of chaos or collapse. And yet, investors may be more rational than they appear when it comes to pricing in political risks. If investing is foremost about discounting future cash flows, it's important to focus precisely on what will and will not affect those calculations. The potential crises that may be most dramatic or violent are, ironically, the ones that the market has the easiest time looking through.

Far more dangerous are gradual shifts in international global institutions that upend expectations about how key players will behave. Such shifts may emerge only slowly, but they can fundamentally change the calculus for pricing in risks and potential returns.

Today's market is easy to explain in terms of fundamental factors: earnings are growing, inflation has been kept at bay, and the global economy appears to be experiencing a broad, synchronized expansion. In October, the International Monetary Fund updated its global outlook to predict that only a handful of small countries will suffer a recession next year. And while the major central banks are planning, or have already begun, to tighten monetary policy, interest rates will remain low for now.

Political crises, however sensational they may be, are not likely to change investors' economic calculus. Even after the greatest calamities of the twentieth century, markets bounced back fairly quickly. After Japan's attack on Pearl Harbor, US stock markets fell by 10%, but recovered within six weeks. Similarly, after the terrorist attacks of September 11, 2001, US stocks dropped nearly 12%, but bounced back in a month. After the assassination of President John F. Kennedy, stock prices fell less than 3%, and recovered the next day.

Yes, each political crisis is different. But through most of them, veteran emerging- markets investor Jens Nystedt notes, market participants can count on a response from policymakers. Central banks and finance ministries will almost always rush to offset rising risk premia by adjusting interest rates or fiscal policies, and investors bid assets back to their pre-crisis values.

Today, a conflict with North Korea over its nuclear and missile programs tops most lists of potential crises. Open warfare or a nuclear incident on the Korean Peninsula would trigger a humanitarian disaster, interrupt trade with South Korea – the world's 13th largest economy – and send political shockwaves around the world. And yet such a disaster would most likely be brief, and its outcome would be clear almost immediately. The world's major powers would remain more or less aligned, and future cash flows on most investments would continue undisturbed.

The same can be said of Saudi Arabia, where Crown Prince Mohammed bin Salman just purged the government and security apparatus to consolidate his power. Even if a sudden upheaval in the Kingdom were to transform the balance of power in the Middle East, the country would still want to maintain its exports. And if there were an interruption in global oil flows, it would be cushioned by competing producers and new technologies.

Similarly, a full-scale political or economic collapse in Venezuela would have serious regional implications, and might result in an even deeper humanitarian crisis there. But it would most likely not have any broader, much less systemic, impact on energy and financial markets.

Such scenarios are often in the headlines, so their occurrence is less likely to come as a surprise. But even when a crisis, like a cyber attack or an epidemic, erupts unexpectedly, the ensuing market disruption usually lasts only as long as it takes for investors to reassess discount rates and future profit streams.

By contrast, changes in broadly shared economic assumptions are far more likely to trigger a sell-off, by prompting investors to reassess the likelihood of actually realizing projected cash flows. There might be a dawning awareness among investors that growth rates are slowing, or that central banks have missed the emergence of inflation once again. Or the change might come more suddenly, with, say, the discovery of large pockets of toxic loans that are unlikely to be repaid.

As emerging-market investors well know, political changes can affect economic assumptions. But, again, the risk stems less from unpredictable shocks than from the slow erosion of institutions that investors trust to make an uncertain world more predictable.

For example, investors in Turkey know that the country's turn away from democracy has distanced it from Europe and introduced new risks for future returns. On the other hand, in Brazil, despite an ongoing corruption scandal that has toppled one president and could topple another, investors recognize that the country's institutions are working – albeit in their own cumbersome way – and they have priced risks accordingly.

The greatest political risk to global markets today, then, is that the key players shaping investor expectations undergo a fundamental realignment. Most concerning of all is the United States, which is now seeking to carve out a new global role for itself under President Donald Trump.

By withdrawing from international agreements and trying to renegotiate existing trade deals, the US has already become less predictable. Looking ahead, if Trump and future US leaders continue to engage with other countries through zero-sum transactions rather than cooperative institution-building, the world will be unable to muster a joint response to the next period of global market turmoil.

Ultimately, a less reliable US will require a higher discount rate almost everywhere. Unless other economic cycles intervene before investors' expectations shift, that will be the end of the current market boom.

Christopher Smart is a senior fellow at the Carnegie Endowment for International Peace and the Mossavar-Rahmani Center for Business at Harvard University's Kennedy School of Government.