PERSPECTIVE:

Risk & resilience in small open economies

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Resilience will become an increasingly important source of competitive advantage

Governments will likely face an increasingly turbulent global economy

Small, open economies have benefited enormously from the strong, stable global growth that has been generated over much of the past few decades. But it seems likely that after the relatively benign global economic environment of the previous decades, the global economy is moving into a more volatile and uncertain period. This will have a significant impact on globally exposed economies, and will require policy innovation.

Over the past few years, of course, there has been elevated volatility in trade and capital flows, as well as in GDP, commodity prices, and exchange rates. And the recent global financial and economic crisis has reminded countries, particularly those with relatively open economies, that they are significantly exposed to variation in global economic performance.

But this is more than a short-term issue. There are structural forces driving the increased volatility. Globalisation has led to more significant uncertainty for countries, governments, corporations, and households – as well as much increased global inter-connectedness of risks. And there is risk and uncertainty associated with the pace of technological change, new sources of global competition, the price and availability of core commodities, and so on.

Further, there is significant, and perhaps unprecedented, uncertainty on many dimensions of global economic policy – such as those relating to external imbalances, fiscal consolidation, (simultaneous) concerns about inflation and deflation, and the future role of the USD.

This increased background uncertainty and volatility is exacerbated by the tectonic changes that are occurring in the global economy. The world is coming to the end of 200 years of Western economic dominance, the multilateral institutions such as the WTO are declining in influence, and the Washington Consensus, which placed free markets at the core of economic policy, faces real competition.

Periods of structural change are often coincident with periods of elevated risk and uncertainty. The US National Intelligence Council recently noted that "Historically, emerging multipolar systems have been more unstable than bipolar or unipolar ones…the next 20 years of transition to a new system are fraught with risks."

And there is much less redundancy available to deal with these heightened exposures. Across much of the developed world, monetary and fiscal policy settings are such that governments have little ability to respond to any further economic volatility. The shock absorbers have already been used, which will exacerbate the economic impact of future shocks.

This is not to say that there are not also substantial growth opportunities, particularly in emerging markets. There are strong fundamental forces at work – demographics, urbanisation, technology, productivity catch-up – that provide some confidence that economic growth rates will be robust. But the distribution of possible outcomes is likely to be significantly higher.

For small countries, say countries with populations of 10 million or less, who tend to be particularly reliant on the global economy, this uncertainty and volatility has the potential to have substantial impacts on their economic performance. At a national level, countries are exposed to changes in investor sentiment and the withdrawal of capital, to the security of supply of food and other commodities, as well as variation in export demand from key markets. And for households, this national risk exposure can cause employment risk and increased financial risk.

Because of this, an increasingly important policy priority will be for governments to build resilience into their economies so that their countries can prosper in a more complex and turbulent world. Although improving growth rates is the primary focus of the current global economic debate, countries will be increasingly focused on the resilience of that growth and the allocation of risk within the economy.

The size and nature of a country's risk exposure can be deliberately shaped by the government

So how should governmennts, particularly of small, developed economies, respond to this exposure to a potentially more turbulent global economy. One response is to say that the increased exposure is simply a necessary price to pay given the need for small economies to be actively engaged in the global economy. Although this is partly true, it is important to recognise that the extent and nature of national risk exposure can also be significantly shaped by deliberate policy action.

At a global level, for example, there has been a systematic tendency to remove sources of protection against economic shocks in the pursuit of greater flexibility and efficiency over the past few decades. For example, there was a shift to floating exchange rates, capital controls were largely removed, and financial markets were deregulated. Conversely, several economies in the Asian region took measures to protect their economies against risk: for example, by accumulating substantial foreign exchange reserves, imposing capital controls, managing exchange rates, and so on.

The message is that different policy choices can substantially shape the effective risk exposures that countries face. Countries have real choices to make in terms of shaping their portfolio of risk exposures, and need not simply accept a changing risk profile.

So how should governments respond to the changing global environment in order to better manage economic risks and build resilience into the economy? There are at least three issues that governments should be thinking about deliberately and systematically.

First, to understand the size and nature of the risk exposures that are faced by the country through a formal national risk exposure assessment. What are the most material risk exposures; volatility in exchange rate and capital flows, changes in demand from key export markets, supply and price risks relating to imports of energy, food, and other resources? What are the key drivers of these risks, and what sort of economic impact would occur under different scenarios?

Second, once these risks are understood and sized, to determine which risks to take on, and which to seek to avoid or manage. Do the risks that are absorbed generate an appropriate return? Are they worth taking, or does the exposure not provide meaningful economic upside?

This is an area of active debate globally. There is a widely-held view that the process of removing controls and buffers may have been pushed too far. A growing number of governments are taking steps to build national economic resilience. For example, several governments have introduced capital controls and begun to intervene in exchange rate markets to curb excessive movements; long term contracts for energy and food supply are increasingly common; and there are attempts to rebalance the structures of economies that have been unduly reliant on either consumption or exporting to Western markets.

The apparent view of some governments is that they are too exposed to the vagaries of global markets, and that this exposure needs to be managed. This should not be caricatured as turning away from the global economy; but it is an attempt to engage with the global economy in a deliberate way.

Third, to strengthen the risk bearing capacity of the economy by increasing the ability of the government and households to bear risk, and ensuring that risk is allocated to the parts of the economy (individuals, corporations, or the government) who can bear and manage that risk most efficiently. To get the best economic outcomes, risk should be borne by those who can bear the risk at lowest overall cost.

In many developed countries, it is far from clear that this principle has been followed. Indeed, it seems that there has been a large transfer of risk from companies and the government to individuals, who are not always best placed to manage it, because of changes such as increased job insecurity, the move to defined contribution pension schemes, and the reduced generosity of social insurance.

Governments have several options to both strengthen their own risk-bearing capacity, and to strengthen that of other parts of the economy. Strengthening the balance sheet positions of governments, and ensuring that the balance sheet is constructed to be robust to shocks, enables the government to absorb a greater amount of economic risk. Unfortunately, many governments are moving in the opposite direction, accumulating substantial amounts of debt, which makes their economies much less resilient to future shocks (and perhaps increases the likelihood of a financial crisis in the future).

And governments can also strengthen the risk bearing capacity of other parts of the economy, through measures such as appropriate financial market regulation, the efficient provision of social insurance, and encouraging households to make financial provision for themselves (eg encouraging private saving).

These second and third steps are related: the amount of risk that it is efficient for a country to absorb depends in part on the risk-bearing capacity of the system. And the investments that are made in strengthening the risk bearing capacity of the system make more sense to the extent that it allows the country to take on additional risks that generate economic returns.

In the context of the potential for increased global economic turbulence, governments need to be thinking more intensively about their risk exposures, how to shape this exposure, and how to build risk-bearing capacity. Singapore is perhaps better placed than many governments in terms of having a managed exchange rate system, substantial reserves, and relatively healthy household balance sheets. But there is scope for further progress to be made in terms of managing emerging exposures and building resilience. Given the scale of the changes, substantial policy innovations are likely to be required .

Indeed, to the extent that the world does continue to become more risky and turbulent, issues of risk and resilience are likely to become much more central to economic policy, perhaps in a similar way to the renewed policy focus on resilience after the experiences of the 1930s.

There was increased appetite for the active management of economic risks at national and global levels, through macroeconomic demand management and the establishment of the Bretton Woods institutions, as well as for households, through the introduction and extension of various social insurance programmes.

Building resilience is an important source of competitive advantage

There are, of course, better and worse ways to manage risks. One way to reduce risk exposure, for example, might be to disengage from the global economy – which would be economically damaging.

In general, however, countries that build resilience efficiently will generate a competitive advantage, relative to those countries that do not manage risk well. There are two sources of this advantage. First, external shocks will have less of a negative effect on individuals, corporations, and governments, resulting in increased investment, growth, and welfare. And second, increased resilience means that there is greater potential for these economies to take on additional growth enhancing risks.

Not all protection against risk necessarily depresses economic performance. Arguing that bearing risk is important for sharpening incentives and that nothing ought to be done to manage this exposure is like arguing that investors should select the highest return portfolio irrespective of risk considerations, a strategy that few would follow. The challenge is to manage risk, resilience, and growth in an integrated way.

Indeed, there can be a complementary relationship between the provision of insurance and strong economic performance. Consider, for example, limited liability companies, a fundamental institution in modern capitalist economies. The security provided to shareholders by limited liability – that they would not be exposed to claims beyond their investment if their company failed – unlocked enormous sums of capital and put it to productive use. This intuition is also common in the context of finance. Diversification allows investors to pool risks, reducing the overall risk of the investment, and making it more attractive to investors.

The challenge is to build resilience in a way that does not compromise the growth potential of the economy. There are several ways in which this can be achieved; for example, encouraging self insurance (eg unemployment insurance accounts), promoting household saving, and ensuring that private insurance markets are working well. Singapore's emphasis on using asset-based methods of providing assistance provides a good platform to build on.

Managing risk and building resilience need not require the insulation of the economy from the forces of change. Indeed, it can create a more efficient economy with higher levels of growth, innovation, and risk-taking. In this sense it is perhaps unsurprising that there is a tendency for the most open economies, who have been able to maintain popular support for global engagement, to provide relatively high levels of social insurance. In Joseph Schumpeter's famous metaphor, cars can go faster when they have good brakes.

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