The changing face of global risk

Nouriel Roubini | Roubini Global Economics | 31 March 2014

The world's economic, financial, and geopolitical risks are shifting. Some risks now have a lower probability - even if they are not fully extinguished. Others are becoming more likely and important.

A year or two ago, six main risks stood at center stage:

- A eurozone breakup (including a Greek exit and loss of access to capital markets for Italy and/or Spain).
- A fiscal crisis in the United States (owing to further political fights over the debt ceiling and another government shutdown).
- A public-debt crisis in Japan (as the combination of recession, deflation, and high deficits drove up the debt/GDP ratio).
- Deflation in many advanced economies.
- War between Israel and Iran over alleged Iranian nuclear proliferation.
- A wider breakdown of regional order in the Middle East.

These risks have now reduced. Thanks to European Central Bank President Mario Draghi's "whatever it takes" speech, new financial facilities to stabilise distressed sovereign debtors, and the beginning of a banking union, the eurozone is no longer on the verge of collapse. In the US, President Barack Obama and Congressional Republicans have for now agreed on a truce to avoid the threat of another government shutdown over the need to raise the debt ceiling.

In Japan, the first two "arrows" of Prime Minister Shinzo Abe's economic strategy - monetary easing and fiscal expansion - have boosted growth and stopped deflation. Now the third arrow of "Abenomics" - structural reforms - together with the start of long-term fiscal consolidation, could lead to debt stabilisation (though the economic impact of the coming consumption-tax hike is uncertain).

Similarly, the risk of deflation worldwide has been contained via exotic and unconventional monetary policies - near-zero interest rates, quantitative easing, credit easing, and forward guidance.

And, the risk of a war between Israel and Iran has been reduced by the interim agreement on Iran's nuclear program concluded last November. The falling fear premium has led to a drop in oil prices, even if many doubt Iran's sincerity and worry that it is merely trying to buy time

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while still enriching uranium.

Although many Middle East countries remain highly unstable, none of them is systemically important in financial terms, and no conflict so far has seriously shocked global oil and gas supplies. But, of course, exacerbation of some of these crises and conflicts could lead to renewed concerns about energy security.

More important, as the risks of recent years have receded, six other risks have been growing.

For starters, there is the risk of a hard landing in China. The rebalancing of growth away from fixed investment and toward private consumption is occurring too slowly, because every time annual GDP growth slows toward 7%, the authorities panic and double down on another round of credit-fueled capital investment. This then leads to more bad assets and non-performing loans, more excessive investment in real estate, infrastructure, and industrial capacity, and more public and private debt. By next year, there may be no road left down which to kick the can.

There is also the risk of policy mistakes by the US Federal Reserve as it exits monetary easing. Last year, the Fed's mere announcement that it would gradually wind down its monthly purchases of long-term financial assets triggered a taper tantrum in global financial markets and emerging markets. This year, tapering is priced in, but uncertainty about the timing and speed of the Fed's efforts to normalise policy interest rates is creating volatility. Some investors and governments now worry that the Fed may raise rates too soon and too fast, causing economic and financial shockwaves.

Third, the Fed may actually exit zero rates too late and too slowly (its current plan would normalise rates to 4% only by 2018), thus causing another asset-price boom - and an eventual bust. Indeed, unconventional monetary policies in the US and other advanced economies have already led to massive asset-price reflation, which in due course could cause bubbles in real estate, credit, and equity markets.

Fourth, the crises in some fragile emerging markets may worsen. Emerging markets are facing headwinds (owing to a fall in commodity prices and the risks associated with China's structural transformation and the Fed's monetary-policy shift) at a time when their own macroeconomic policies are still too loose and the lack of structural reforms has undermined potential growth. Moreover, many of these emerging markets face political and electoral risks.

Fifth, there is a serious risk that the current conflict in Ukraine will lead to Cold War II - and possibly even a hot war, if Russia invades the east of the country. The economic consequences of such an outcome, owing to its impact on energy supplies and investment flows, in addition to the destruction of lives and physical capital, would be immense.

Finally, there is a similar risk that Asia's terrestrial and maritime territorial disagreements (starting with the disputes between China and Japan) could escalate into outright military conflict. Were they to materialise, such geopolitical risks would have a systemic economic and financial impact.

So far, financial markets have been sanguine about these new rising risks. Volatility has increased only modestly, while asset prices have held up. Noise about these risks has occasionally (but only briefly) shaken investors' confidence, and modest market corrections have tended to reverse themselves. Investors may be right that these risks will not materialise in their more severe form, or that loose monetary policies in advanced economies and continued recovery will contain such risks. But, investors may be deluding themselves that the probability of these risks is low – and thus may be unpleasantly surprised when one or more of them materialises.

Indeed, as was the case with the global financial crisis, investors seem unable to estimate, price, and hedge such tail risks properly. Only time will tell whether their current nonchalance constitutes another failure to assess and prepare for extreme events.

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