

The dramatic decline of risk - part 2 - geopolitical risk

Dr Woody Brock | SED | 17 May 2017

In a world of risk-on/risk-off investing, it is important for investors to know where true risks lie and where they do not lie.

In this part two of this new PROFILE looking at the transformation of risk confronting investors, we consider the second of three risks – risk in the world political order.

GLOBAL POLITICAL RISK

This variable is very hard to quantify – and we won't attempt to do so. Rather, we will discuss how the structure of the international balance of power has been changing in a manner that has significantly increased global political risk. Yet, despite this reality, the probability of outright war is paradoxically lower than it might have been at any previous period in history. Real war, not skirmishes such as in Syria. The reasons why this is true are very interesting.

The balance of power – increasing riskiness

As we have pointed out in earlier research, game theory offers the best insights for understanding the concept of the balance of power and its relative stability.

The most stable of all games is the two-person game of "complete information" exemplified by the Cold War between the US and the USSR. There were only two superpowers and each knew a great deal about the resources and the goals of the other. Moreover, due to the joint possession by both of the H-bomb, each knew that if it bombed the other, it in turn would be bombed – the Mutual Assured Destruction strategies familiar from the movies. The Nash equilibrium strategies in such a game are for each power to refrain from attacking the other. And this was exactly what happened during 1950 to 1990. Yes, proxy wars were fought in Korea and Vietnam, but there was no outright conflict between the two superpowers.

Game theory then instructs us that, the greater the number of players and the less the information possessed by any one player about its antagonists, the more unstable the situation becomes. More specifically, the greater the number of players and the less information the players have about each other, the greater is the probability of a "mistakes equilibrium" leading to war. In such an equilibrium, rational behavior by each player leads to "mistakes" – moves that are misinterpreted by others and acted upon. The end result is a war that no one intended or wanted. The German mathematician Reinhard Selten developed this theory.

The outbreak of WWI has been successfully modeled in this manner. It no longer needs to be assumed (and should not be) that Kaiser Wilhelm was the bad guy who sought war and initiated the Great War, as Hitler would do two decades later. He did not seek war, as we now know. The resulting paradox of how the Great War began has now been resolved via the concept of a game of many players with "incomplete information" about each other, and about the various coalitions that form.

Today, there are once again many key players – Russia, China, the US, the Iranian axis, ISIL, Europe, and North Korea. All have – or soon will have – nuclear and other weapons of mass destruction. Thus, all must be taken seriously. Coalitions are fluid, with few powers trusting any others, alleged allies or not.

We thus now have a six-power game with incomplete information. The situation is very unstable, and has been made more so by the diminished role of the US in its foreign affairs, notwithstanding Trump's Syrian strike.

North Korea is arguably the most problematic player due to universal ignorance about the true nature and intentions of its leader, and to the belief that Kim would rather be killed at home than captured by his opponents. While ISIL is said to be highly irrational, it is not. Its goals and methods are quite clear. But North Korea is textbook irrational. Given President Trump's ultimatum to the Chinese to either end their support of North Korea or bow out of the picture – and soon – the risks of conflagration are rising monthly. This time, something serious will happen during the next four years.

All in all, the morphing of the structure of the balance of power during the Cold War into that of today has made the global order much more unstable and risky.

Two developments dampening the risks of traditional war

There are two principal reasons why, for any given level of tension, outright war is less probable than it ever was before. Why is this true?

To begin with, consider that most all wars throughout history were motivated by the desire of a chief or a king to enrich his people by seizing the gold, the food, and slaves of neighboring territories. Moreover, if a ruler did not aggress in this way against his neighbors, then they would aggress against him and his country would end up impoverished and its people enslaved. Both sides realised this. In such a game, the equilibrium strategy for each of the players is "attack or be attacked".

For this reason, war has accounted for some 50% of global GDP for time immemorial. The driving force here was that seizing the territory of neighboring states was the only way in which a king could enrich his people and gain popularity.

In one of the greatest changes in human history, the advent of the Rule of Law and of modern capitalism reversed this situation. It became possible for a ruler to enrich his people

by fostering trade with other nations, and by home-grown productivity growth. Prior to 1650, productivity growth had been essentially zero for 4,000 years. Economists have shown that neither living standards nor life expectancy rose at all between 3500 BC and 1650 AD.

Additionally, war became ever more costly given the growing destructive power of modern armaments.

As a result, it is now as irrational for a ruler to attempt to grab neighboring territories as it used to be rational. This is a profound change. Even Putin has learned and admitted that there is little to be gained by seizing, say, Chechnya today. The land is largely worthless and the people cannot be profitably enslaved as they once could. Indeed, the vanquished become terrorists who subsequently set off bombs in buildings and subways in Moscow. Worse, little can be done to stop them.

The second development auguring reduced warfare is the change in attitude of young people towards fighting wars initiated by their elders. The author witnessed the fall of two US Presidents due to five words that had probably not been heard before the Vietnam anti-war protests: "Hell no, we won't go". Fifty years later, it is hard to imagine any politicians of the West having the courage to draft 20-year-olds to go fight a war. Most youths simply would not go.

New kinds of warfare

We have proposed that the risks of traditional warfare are quite low, notwithstanding today's fragile balance of power. Nonetheless, aggression will occur utilising new forms of electronic warfare, cyber-attacks, drones, and sanctions. Major players such as Russia and China will be able to launch a war of sorts by utilising the hacking capabilities of third parties such as Iran and North Korea. Doing so will obscure the issue of culpability, and this could increase the incentives for one great power to challenge another.

We shall not speculate further on what might happen along these lines. But what is clear is that, if the motivations for aggression are clear, the methods of waging future wars are new, and untested.



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