Global risk into 2013:

Time for some cautious optimism?

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Back to normal?

After several years dominated by bad economic news, the past few weeks have brought a degree of optimism to financial markets regarding the outlook for 2013 and beyond. In particular, there seems to be a growing hope that 2013 could see a degree of stability return to what has been a palpably unstable global economy.

So, after several tough years, can we now afford to be (cautiously) optimistic about the set of risks shaping the global economic outlook? Or is this just another false dawn?

From the abolition of risk to risk fatigue

It's probably stating the blindingly obvious to note that the period between 2008 and 2012 has been marked by a major focus on risk – much of it associated either directly or indirectly with the state of the global economy. This intense focus on 'what could go wrong' represented a major shift from the preceding 2003-2007 period, when, lulled by the relative economic calm of the Great Moderation, risk seemed to have been relegated to a second-order concern. Some optimists even dared wonder if modern macro policy had abolished the business cycle while modern finance had abolished risk!

Of course, to a large extent it was this complacency, and in particular the significant mis-pricing of risk by financial markets that it encouraged, that helped lay many of the foundations for the crisis that followed. Indeed, as we now know all too well, the Great Moderation has been followed by a period of extreme economic turbulence, encompassing the global financial crisis and the subsequent Eurozone/European sovereign debt crisis.

As a result, observers of the global economy have had to spend a large amount of their time over recent years worrying about extreme or tail risks. Would the world economy re-run the Great Depression of the 1930s? Would the global financial system collapse? Would the Eurozone fracture? Would the Arab Spring trigger political collapse in the Middle East and a huge spike in oil prices? Would the US (technically) default on its debt? Would we have a global food crisis? The list goes on . . .

One consequence of this surfeit of tail risks has been the emergence of a risk on / risk off (Ro-Ro) world, with a marked increase in correlations across global financial markets and financial assets. (In other words, when market participants have felt confident about the world, all risk assets have tended to rise together. Conversely, when nerves set in, those same assets would then fall in lock-step.)

A second consequence has been the onset of a degree of 'risk fatigue' and hence a growing desire to see global markets and the international economy overall return to more normal settings.

Indeed, sheer risk fatigue may well explain some of the shift in market sentiment we have seen since the start of this year, and in particular the appearance of a degree of cautious optimism about the likely direction of the global economy this year.

Bullets dodged, pitfalls avoided, and tail risks averted

Another, more concrete, factor explaining this change in sentiment is the feeling that over the past year (and even the past month) the global economy has dodged some bullets and avoided some pitfalls. This is particularly the case for three big economic stories:

- ***US budgetary policy and the fiscal cliff:*** We entered 2013 with a big focus on US budgetary politics. Back in mid-2011, the unfortunate combination of US political hyper-partisanship and the mechanics of the debt ceiling had threatened a technical default and triggered an actual sovereign ratings downgrade. This year, we faced a combination of fiscal cliff (an ill-timed tightening of US fiscal policy that would almost inevitably have pulled the rug out from under a fragile US recovery and sent the economy back into recession) plus the prospect of a re-run of the debt ceiling debacle. (At one stage, US policymakers even seemed to be contemplating minting their own US$1 trillion platinum commemorative coin to mark the incredible dysfunctionality of their budgetary politics.) In the event, the fiscal cliff was mostly avoided (albeit largely by kicking the proverbial can down the road) and any debt ceiling showdown postponed.

- ***Mario Draghi and the Eurozone:*** The first half of 2012 saw continued scepticism about the robustness of the Eurozone and speculation about the likelihood of outright collapse, whether triggered by a 'Grexit' or by some other political-economic crisis across the European periphery. But a July 2012 speech by Mario Draghi, President of the European Central Bank (ECB), at which he promised to 'do whatever it takes to preserve the euro' is now seen by many as a turning point in the crisis. Draghi's ECB had already demonstrated a degree of willingness to innovate with the so-called longer-term refinancing operations (LTROs) for banks, first introduced in late 2011, and July's speech was followed by the announcement of outright monetary transactions (OMTs), a commitment to buy potentially unlimited amounts of Eurozone government debt in the context of country program conditionality. Although never formally activated, the magic wand of the OMT (together with the introduction of the European Stability Mechanism (ESM), some modest progress towards banking union, and some relaxation in Berlin's attitude to Greece) together managed to convince markets that Eurogeddon had been averted. As a result, spreads on the public debt of the Eurozone periphery have narrowed significantly. The success of OMT has seen Draghi named the Financial Times' person of the year for 2012, and at times the ECB president has seemed to come close to financial market canonization. It's also seen a creature once thought to be in danger of extinction – Euro bulls – appear once again in the wild.

- ***China 'hard landing' risk:*** Last year was supposed to be a quiet one for the Chinese economy. With a major political transition scheduled for the second half of the year, many China watchers reckoned that 2012 would be stage-managed to ensure a calm economic backdrop and a smooth political environment. It didn't quite work out that way. China's economy slowed sharply through the first half of the year, and instead of the promised smooth political environment, we got the Bo Xilai saga. This combination of political noise and disappointing economic data encouraged the China bears to resurrect what has now become almost a tradition whenever China's data enters a weak patch: the hard vs soft landing debate. This time around, however, this old debate was supplemented by the 'Is China falling into the middle income trap?' question to provide added complexity. However, following a run of disappointing GDP readings which had been feeding the bears, the data on Chinese activity have delivered more positive news recently, as the impact of Beijing's belated shift to a more simulative policy stance has kicked in. As a result, China-watchers have started calling a recovery in China's growth prospects for this year.

There have been some other good 'misses' as well. For example, despite tight global food demand and supply conditions, we managed to avoid a food crisis in 2012. Likewise, we also managed to dodge some geo-political bullets. In particular, last year's tensions in the South and East China Seas were contained and serious mishaps avoided.

It seems likely that the perception that the world economy has managed to avert or avoid some of the biggest tail risks out there has had positive consequences for sentiment. One striking sign of this is that investors have even been able to muster up some optimism about the prospects for the long-moribund Japanese economy, sparked by the advent of Japan's newly elected prime minister, Shinzo Abe and his version of 'Abenomics'.

Optimism's upside and downside

One implication of this shift in sentiment regarding the economic outlook is the possibility of positive spillovers for the real economy. For example, improved confidence might be expected to influence firms' willingness to invest in new capital or to employ new workers, or to boost banks' willingness to lend.

Changes in sentiment also influence the probability of self-fulfilling crises. For example, take the case of Eurozone debt. In the pre-crisis period, market participants had managed to convince themselves that the risk of holding the public debt of an economy on the Eurozone periphery (say Greece or Spain) was not significantly different from that of holding the public debt of a core economy like Germany. As a result, economies on the periphery were able to borrow at relatively cheap rates and hence – despite in some cases very high stocks of public debt – their debt dynamics still looked (relatively) manageable. But when sentiment on the Eurozone turned negative and consequently the risk premia on their debt were adjusted upwards, those debt dynamics no longer looked sustainable at the new interest rates. Now, with the advent of Saint Mario Draghi, risk premia have declined again, and the debt sustainability dynamics no longer look quite as impossible as they recently did (although in several cases they still really don't look too good).

That's the upside of the change in sentiment. The downside is that it also risks leaving the world economy vulnerable to complacency at a time when the real international economic outlook is still characterised by major risks.

The limits to good news

The danger of becoming too complacent about the current state of the global economy can be seen by returning to the 'dodged bullets' and 'avoided pitfalls' described above. Take each of these in turn, starting with the big three:

- ***US fiscal policy:*** While its true that we (sorta, kinda) dodged the fiscal cliff and the debt ceiling, there are other potential fiscal shocks to negotiate, including the next fiscal cliff (the so-called spending sequester) due on 1 March and the expiry on 27 March of the current 'Continuing Appropriations Resolution' funding US fiscal operations. Then there's still the next round of the debt ceiling circus to negotiate, probably in May. More fundamentally, all of these fiscal scuffles are symptoms of fundamental political differences as to the appropriate size and scope of the US government and over how best to finance it. Until these differences are resolved, US fiscal policy will tend to remain hostage to political forces.

- ***The Eurozone:*** Likewise, although it's correct to conclude that markets have changed their views on the likely longevity of the Eurozone project, and that this has had positive effects on the financial positions of some European economies, once again some fundamental problems remain. In particular, the last couple of years have demonstrated that the model of the Eurozone as a kind of halfway house (combined monetary policy and a single market but no fiscal or banking or (genuine) political union) on the road to full union is an unsustainable one. That underlying judgment remains the same: the project either has to go forwards to a more complete union or it will unravel. And although the past year has undoubtedly seen some genuine forward motion, there is still an awfully long way to go, and some daunting political obstacles to be negotiated en route. That leaves the Eurozone vulnerable to adverse political shocks (for example, there are Italian and German elections to be negotiated this year, as well as delicate political conditions in several other member economies) and to future swings in market sentiment.

  It's also worth noting that the last time the financial markets decided to canonize a central banker, it all ended in tears. Remember Saint Greespan?

- ***China:*** Similarly, despite the fillip provided by some stronger economic readings, the challenges facing the sustainability of China's economic model remain. Ever since then Premier Wen Jiabao used the four U's (unstable, unbalanced, uncoordinated and unsustainable) to describe the Chinese economy back in 2007, there has been broad acceptance of the need to move away from the incredibly successful but now past-its-sell-by-date high investment, high export model and towards one with a greater role for consumption. Again, that basic judgment hasn't changed. Here, economic history tells us two useful things. First, that is quite possible to make the shift from one model to another and to escape the middle income trap. Other economies, including East Asian economies, have done so successfully. But second, experience also tells us that the transition can be quite difficult to pull off, and even then may involve either a significant slowdown in economic growth, or a major disruption to that growth, or both.

Similar caveats can be applied to some of the other risks mentioned above. So, for example, in terms of the risks of a food crisis, we know that even in a good year, global grain production is now only just sufficient to meet rising demands for food, feed and fuel. That leaves the world vulnerable to adverse climate or other shocks. Similarly, the geo-political situation in the East and South China Seas remains vulnerable to miscalculation or mistake, and meanwhile there are plenty of other geo-political risks (Iran? North Korea? Syria's civil war?) that offer a credible alternative source of potential nasty surprises.

Conclusion: Be cautiously optimistic if you like, but keep the emphasis on cautious . . .

In summary, then, the start of 2013 has brought with it a degree of cautious optimism regarding the outlook for the world economy. In part, this might just reflect a reaction to 'risk fatigue'. However, it also seems to be driven by the judgment that we have avoided some of the key tail risks that have been occupying minds over the past year. This success in dodging bullets and avoiding pitfalls has in turn encouraged at least some market participants to be a little more confident about 2013.

It's true that some of the most commonly-cited risks over the past 12 months have been avoided or averted, at least for now. It's also true that the consequent shift in sentiment may have some positive results for the actual economic outlook. Put those two things together, and its possible to find at least some justification for the cautious optimism that's been evident in recent weeks.

That said however, a deeper look at some of the key risks that kept people awake during the past year suggests that in most cases we are still very far from a satisfactory resolution of the underlying issues, and hence, many of these risks that we have dodged this past year are still very much in play.

In other words, if you want to start off 2013 with some cautious optimism, fair enough. But it really would pay to keep the emphasis on being cautious.