A CALM BETWEEN STORMS

Christopher Mills
DRI-McGraw Hill

In putting this presentation together, my colleagues and I wrestled with a title that summed up how we see the world economy at the current time. During the first half of 1995 the world economy was in turmoil. More recently the storms have died down, and the picture now looks more calm. However, this is only temporary, and there are sure to be new upsets and new storms — if not this year then next. Therefore, we decided the situation was best described as a calm between the storms.

REVIEW OF ECONOMIC PROBLEMS IN 1995

Let me start by reviewing of some of the happenings in the first half of 1995 that caused turmoil in the world economy and upsets in world financial markets. The year started with the collapse of the Mexican peso, which began at the end of December 1994 and unrolled throughout the first quarter of 1995, causing both considerable damage to the Mexican economy and severe strains in world financial markets.

In the first quarter of this year there was a major earthquake in Kobe, Japan, that caused ripples in the world's financial markets and ongoing problems that plague the Japanese economy to this day. Early 1995 also saw a period of free fall, or what appeared to be free fall, of the U.S. dollar against other major currencies, notably the German deutschemark and the Japanese yen. This set off a series of reverberations in European currency markets. Some European currencies, particularly the Swedish krona and the Italian lira, were very badly hit by investors' fears about the global financial situation. The strong value of the yen during early 1995 contributed to persisting financial problems in Japan by raising the cost of Japanese products in world markets.

With the exception of Japan, the general world picture has become calmer than it was in the first half of the year. The dollar has made a satisfying recovery in the last few months, not only against the deutschemark and the yen, but also against a wide range of other currencies. The Mexican situation, while still problematic, is improving. The value of the peso has stabilized, Mexico is returning to international markets to borrow funds, and the slump in the economy appears to have bottomed out. European financial markets have stabilized as well, and a level of confidence has returned to some of the high-risk markets such as Italy and Sweden in the past two or three months. This has had a general encouraging effect on financial markets and exchange rates throughout Europe.

At least in part, recent global financial jitters are due to anxiety about low levels of savings in industrial countries and Latin America (Figure 1). Low levels of savings put pressure on global capital markets during 1994 and continuing into the early part of 1995. This pressure caused substantial increase in global bond yields and set the scene for many of the problems that have unfolded this year.

These problems were made worse by a general lack of confidence in the macroeconomic policies of key countries — not just emerging markets but major industrial countries as well, including the United States. During 1994, and early 1995, confidence in the ability of the Federal Reserve Board to manage the U.S. economy was very low indeed. It appeared that the Fed could really do no right as far as the financial markets were concerned. Every time the Fed raised interest rates, the financial markets sold off the dollar, believing that the Fed had basically lost control of the situation.

In retrospect, those fears appear to have been exaggerated, but financial markets and investors remain uneasy with the situation in many places throughout the world. In Canada, for example, there has been a loss of confidence in Canadian fiscal policy. The Canadian Government continues to run very large budget deficits, and there is ongoing concern about the separatist movement in Quebec. Hopes are that the October 1995 referendum on independence for Quebec will be defeated, but in the meantime Canada has been paying quite a high price in terms of risk premium that investors are demanding to hold Canadian assets.

In Italy and Sweden, the problems mentioned earlier have led to investor concerns about control over fiscal policy. Several other European countries where there have been very loose fiscal policies in the last two years also suffer the same problem to some degree. In a global environment where interest rates have risen sharply since 1994, investors have become worried about the sustainability of high levels of government and private borrowing.

In France, the concern is different. The French policy of pegging the franc against the German deutschemark has proved unsustainable in the face of

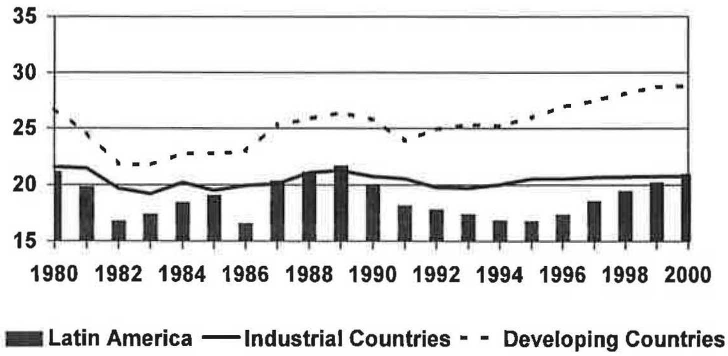

FIGURE 1 National saving rates for industrial and developing countries, 1980–2000.

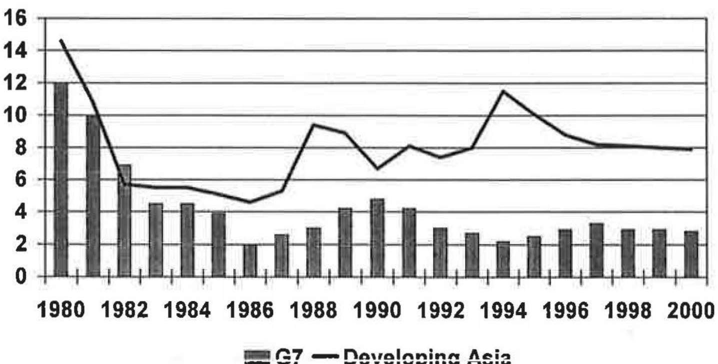

FIGURE 2 G7 and Asian inflation rates (CPI), 1980–2000.

very low economic growth and rising unemployment that have created serious social and political unrest. Here, too, it appears that fears have been overstated, and the situation seems to have improved in recent months.

The good news is that financial crises do not usually cause recessions. For evidence of this, look back to the U.S. economic situation in 1987, when there was a major shakeout in the equity market both here and abroad. As it turned out, the impact of that financial crisis on the U.S. economy and on other major industrial nations was very limited. The causality the other way around is much stronger. Financial turmoil is closely associated with a recession, but it is economic problems that are causing financial turmoil, not vice versa. A clear case of that is Mexico, which got itself into a very difficult economic and political situation in 1994 that triggered a financial crisis.

This is good news because it implies that world economic growth is unlikely to be hurt seriously by financial disturbances in the near future. Inflation remains low in most regions of the world and long-term bond rates have been falling in recent months (Figure 2).

SHORT-TERM OUTLOOK

The U.S. economy is likely to grow at around 2.5 percent in 1995. While this is not a particularly high figure, it is nowhere near the recession that many feared earlier in the year. The European economy is likely to grow at around three percent, or perhaps a little below, in 1995 , with similar performance expected in 1996. This is quite encouraging, given Europe's relatively lackluster performance in recent years.

Japan is the only major industrial country with really serious problems now. The Japanese economy will probably show zero growth at best this year, and it is unlikely to see growth as high as two percent in 1996, even if the yen remains around current levels. If the yen holds at the current rate of 80 to the dollar, 1996 could be another year of zero growth in Japan.

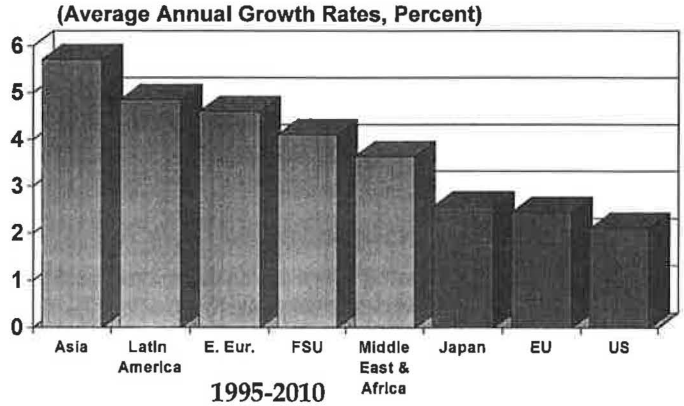

FIGURE 3 DRI forecasts of growth in emerging markets.

Despite the problems in the Japanese economy, DRI's forecast is that the major industrial economies as a whole will grow at the rate of 2.5 percent this year and next. These are not outstanding growth figures, but it is perfectly respectable performance and not one that should not cause concern to most businesses.

For the short term, and for the long term as we will see later, it is the developing countries that will show the most rapid growth. Despite the problems in Mexico and other parts of Latin America, developing countries overall are likely to grow by an average of about five percent in 1995 and 1996, i.e., twice as fast as the major industrial economies.

LONG-TERM OUTLOOK — 1995 TO 2010

It is long-term developments that really drive business prospects in many economic sectors. This is particularly true in the aviation industry. Figure 3 summarizes the DRI forecasts for average annual economic growth rates in different regions over the next 15 years. The most evident point is the extent to which the emerging markets, particularly in Asia, are going to outperform the major industrial countries over the long term. There are two major reasons this conclusion: production capacity and risk.

Production Capacity

To assess long-term growth prospects it is necessary to analyze supply. Demand is important in determining the performance of an economy in the short term; but when looking at the long term, what matters in economic performance is the ability of the economy to increase capacity, the amount that it can produce.

In economic terms, production capacity depends on several factors. Labor supply, the number of people available to work in an economy, is of obvious importance. In the major industrial economies, labor supply is growing quite slowly in most cases because the population is growing quite slowly as well. In fact, in some European countries and in Japan, population growth is essentially zero, and it will become negative by 2010.

Equally important is the growth in the capital stock: the tools, machinery, equipment, and plant available for workers to use. Major industrial countries have quite low levels of investment. This is particularly true in the United States where only around 15 percent of total output is plowed back in for investment, but it is generally true across the board in industrial countries.

Finally, there is the technology used by labor and capital in order to produce. Oftentimes in major industrial nations, and in the United States in particular, technology has to be created before it can be introduced. Emerging markets, on the other hand, can essentially copy technologies that have already been developed elsewhere and gain quantum leaps in productivity. In the United States most technological improvements have to be researched and developed before they can be introduced. Moreover, the pace at which they can be introduced is held back by the fact that investment is relatively low. Technology is embedded in capital in the sense that a new software program or a new kind of machine tool cannot be used until computers have been purchased and factories built to house the new machinery.

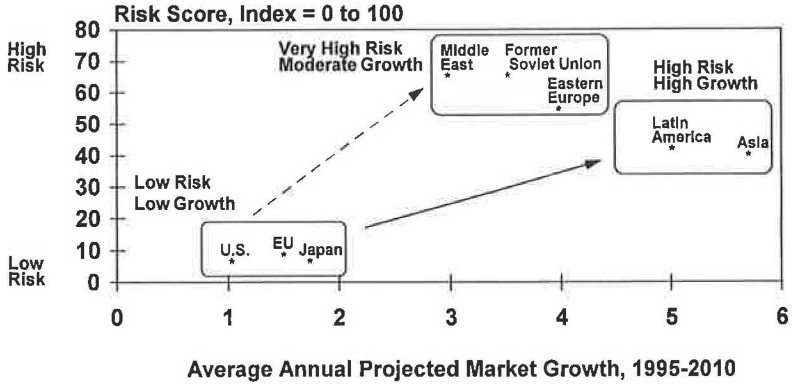

FIGURE 4 Risk-reward trade-offs by region.

If the factors determining the long-term growth prospects just mentioned are applied to Asia, it is clear why Asian economies can continue to grow much more rapidly than highly industrialized countries. Population in Asia is growing much more rapidly, and there is an adequate labor supply. Investment is continuing at much higher rates than in the west. In most Asian countries investment is running around a third of GDP, and in some countries it is approaching half of GDP, which is a figure difficult to comprehend. But what it means is that half the total production of the economy is being plowed back into new investment, new infrastructure, new buildings, and new equipment.

These countries are able to apply technologies that already exist to gain quantum leaps in productivity; and with very high rates of investment, those new technologies can be introduced very rapidly.

These factors allow Asian economies like China and Singapore to grow at around 10 percent a year and to sustain this rate for perhaps the next 15 years. Obviously, there are good performers and bad performers, but the Asian economies as a whole can reasonably be expected to grow at roughly six percent per year through to 2010.

Risk

Emerging markets are a mixture of opportunities and risks. The opportunities are quite clear. One, just mentioned, is much more rapid market growth. Many companies are looking at emerging markets as low-cost production centers. Fund and portfolio managers see emerging markets as sources of high return on investment.

On the other hand, all of these opportunities have risks attached — risks that have been driven home by events such as those in Mexico and Latin America during the past year. Growth can be high, but can also be volatile from year to year. Abrupt economic swings can matter greatly to some businesses, and perhaps not so much to others. In emerging markets one must always expect the risks of fluctuating exchange rates and inflationary surges.

Political risk is an important factor in emerging markets. The sanctity of contracts and the rule of law do not mean much in many emerging markets. Companies that are used to working in such countries know this full well, but those less familiar with the political climate find unpleasant surprises when they move into emerging markets. Even the most experienced firms have come to expect a much riskier and more difficult business climate than those of the United States, Western Europe, and other familiar markets

Traditionally, DRI's business has been forecasting opportunities and market growth. Because of the increasing interest in emerging markets and the higher level of risk associated with them, DRI has put more effort into risk analysis. While DRI has always done a certain amount of risk analysis, extra attention is now being given to systematizing the analysis of risk and providing the results to clients on a regular basis.

RISK ANALYSIS BY REGION

The following is a presentation of preliminary results of the type of analysis DRI is undertaking. Figure 4 is a

- **Territorial Disputes and the Potential for Military Conflicts**
- **Political and Leadership Transitions**
- **Overheating Economies**
- **Infrastructure and Labor Market Constraints**
- **High Foreign Debt Levels**
- **Anti-Western Undercurrents**
- **Corrupt, Capricious Bureaucracies**
- **Thin, Volatile Financial Markets**

FIGURE 5 Risk profile: Asia.

- ***Tequila* Effect Still Hurting**
- **Overvalued Exchange Rates**
- **Vulnerability to International Capital Flows**
- **High Levels of Poverty**
- **Slow Progress on Political Reform**
- **Poor Infrastructure Hurts Competitiveness**
- **Culture of Corruption/Nepotism**
- **Narco-Terrorism Still a Problem**
- **Strong Populist Tendencies**
- **Dependence on Commodity Exports**

FIGURE 6 Risk profile: Latin America.

graph that compares opportunity, the growth in markets, on the horizontal axis, with aggregate measures of risk in different economic regions of the world.

One conclusion is obvious. The United States, the European Union (EU), and Japan are low-growth markets, but they are also relatively low-risk markets. Looking at Asia and Latin America, one sees much higher growth. However, firms doing business in these markets must also accept, on average, a higher level of economic and political risk.

What is perhaps less intuitive, when looking at other emerging regions such as the Middle East, Africa, the former Soviet Union, and Eastern Europe, is a much worse tradeoff between risk and reward in comparison to Asia and Latin America. The Middle East and Africa exhibit particularly high levels of risk, and they do not have the growth opportunities to be found in Asia and Latin America.

Given below are summary risk profiles by region. The focus is on emerging markets, where risks are highest. This is not to imply that North America is a riskless market; clearly it is not. Nor is it the case in Europe, and certainly not in Japan. All markets have some degree of risk, but it is relatively lower in the mature economies of advanced industrial nations.

Asia

See Figure 5. One key risk not found in the major industrial countries but one that must be reckoned with in Asia is territorial disputes and potential military conflicts. The continuing contention between the Peoples Republic of China (PRC) and Taiwan or the long-standing enmity between North and South Korea are two familiar examples. The takeover of Hong Kong by the PRC in 1997 is also a source of concern. The India-Pakistan situation has been simmering for 50 years, and the fragile peace in this area could break down at anytime.

- ❑ **Painful Effects of Economic Transformation**
- ❑ **Ethnic Wars/Aggressive Nationalism**
- ❑ **The Ugly Face of Capitalism**
  - ◆ **Crime**
  - ◆ **Corruption**
  - ◆ **Monopolies**
- ❑ **Lack of Political Stability due to Primitive Democratic Institutions**
- ❑ **Financial Volatility Because of Embryonic Market Structure**

FIGURE 7 Risk profile: Central and Eastern Europe.

- ❑ **Extreme Levels of Poverty and Illiteracy**
- ❑ **High Levels of Political Instability**
- ❑ **Ethnic/Religious/Tribal Wars**
- ❑ **Islamic Fundamentalism**
- ❑ **AIDS Epidemic (Sub-Saharan Africa)**
- ❑ **Fragile Economies**
- ❑ **Poor Macroeconomic Policies**
- ❑ **Dependence on Commodity Exports**
- ❑ **Restrictive Capital Markets**

FIGURE 8 Risk profile: The Middle East and Africa.

There are political issues and questions of leadership transition in several Asian countries. The PRC is a case in point. India's unstable democracy provides another instance of political risk. There are political problems in Thailand, where the military has been making threatening noises since the new government was elected. In Pakistan, Prime Minister Bhutto is in serious danger of being dislodged, and serious political upheaval or even armed conflict could result.

Several Asian economies have the potential to grow rapidly, but some have been growing too rapidly in recent years for the government to cope with, and their economies are seriously overheated. Here again, the PRC is a case in point. Too rapid growth means that there are underlying infrastructure constraints and shortages in the labor market — conditions that make it more difficult to do business. The traffic congestion in Bangkok is well-known for the cost it imposes on businesses in Thailand. This is a prime example of how inadequate infrastructure inhibits the ability of an economy to produce.

High levels of foreign debt are a problem in some Asian countries, although by no means as serious a problem as we see in Latin America. Indonesia, Malaysia, and the Philippines all have seriously high levels of foreign debt that expose them to financial risk and the danger of a declining exchange rate in due course. There are anti-Western undercurrents in many Asian economies; and, if anything, they have become stronger in the last few years as economic confidence and power have grown in the region.

Corrupt and capricious bureaucrats whose actions add cost and risk to doing business can be found everywhere. They are certainly well in evidence in Asia. Thin, volatile financial markets are another risk, particularly for portfolio investors and the managers of financial operations in manufacturing companies.

Nonetheless, DRI considers Asia a less risky region in which to do business than other emerging markets.

Latin America

See Figure 6. The Mexican crisis has had an effect throughout Latin America. The so-called "tequila effect", the hangover from recent Mexican economic and financial problems, continues to hurt other Latin American economies. Overvalued exchange rates present problems, particularly in Brazil and Argentina. Both these economies are vulnerable to changes in capital flows. They need to attract foreign investment and finance external deficits. Their overvalued currencies jeopardize the flow of capital.

Latin America has a host of other problems — high levels of poverty, need for political reform, inadequate infrastructure, and political corruption. Terrorism, either politically inspired or the result of drug trafficking in northern countries such as Peru, Colombia, and Venezuela. The political structure tends to favor populist regimes. Many Latin American economies have a high dependence on commodity exports. Even a country such as Chile, which is relatively well-run and has low risks for business, depends heavily on exports of copper and other raw materials or agricultural products that make it vulnerable to swings in the commodities markets.

Central and Eastern Europe

Central and Eastern Europe, including the Confederation of Independent States (CIS) face a different set of problems as the region makes the transition from a planned to a free-market economy (Figure 7). The effects of this transition are very painful, not the least of which are civil warfare and armed secessionist movements. Many countries in the region have an ugly, Wild West, kind of capitalism that makes the prospects of doing business extremely problematic. Lack of political stability, due to a lack of democratic tradition, is an endemic problem almost throughout the region, perhaps with the exception of the Czech Republic, where there is a history of democracy and economic enterprise that has made possible a stable transition. Many countries suffer from financial volatility because their market structures are embryonic and have not been properly developed or tested.

The Middle East and Africa

The Middle East and Africa are the nadir as far as risk analysis goes (Figure 8). Nearly every problem imaginable can be found in the region, it is a very high-risk (and to a large extent unprofitable) place to do business. This is not to say that particular countries and particular industries do not offer exciting market opportunities. There are bright spots, but the overall picture is not inviting.

RISK ANALYSIS OF SELECTED COUNTRIES

The product of DRI risk analysis can be provided to clients in several forms. One is an aggregated risk profile by region, such as those presented above. The regional profiles can be disaggregated country by country for detailed comparison within a region or among countries in different regions. (DRI is in the process of preparing individual risk profiles for 175 countries around the world.) A further level of disaggregation can be made to pinpoint various sources of risk (financial, economic, political) and specific investment or business concerns. An example of this disaggregated risk analysis is shown in Figure 9.

Seven countries have been selected here for comparison of the types of risk that exporters may face in specific foreign markets — Brazil, Greece, Japan Taiwan, Thailand, Turkey, and the United States. For each type of risk, the calculated risk scores (0 = least risky, 100 = most risky) of each country are arrayed.

In this example, Brazil is the most risky of the seven selected export markets. There are several reasons for this conclusion. One of the key risks that exporters face is that the market could shrink due to economic problems that reduce the ability of customers in that country to buy the exporter's product. This is a serious risk in Brazil at this time. The Brazilian economy appears to be slowing down after a period of rapid growth. There is a real danger that the slowdown could turn into a fullblown recession, particularly if the government encounters financial problems and has to slam on the brakes with a credit squeeze. The situation could be exacerbated if investors lose confidence in the Brazilian market. Exporters' problems could be made much worse if there were a serious decline in Brazilian currency — an occurrence that appears very likely in DRI's assessment.

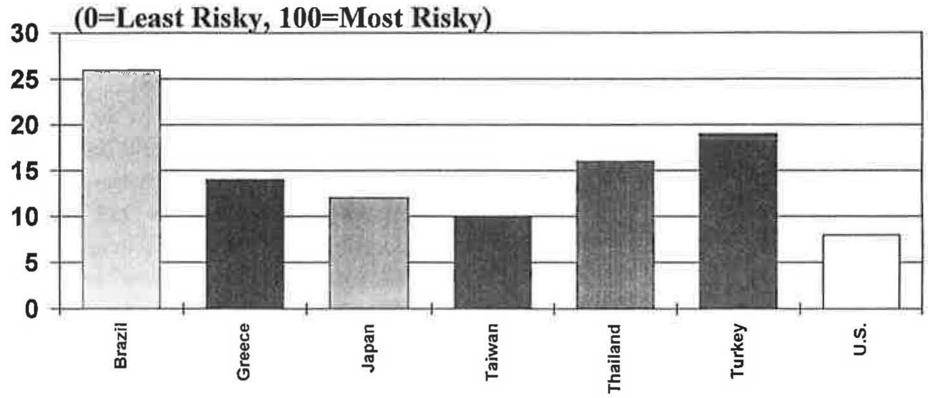

FIGURE 9A Comparison of financial risk.

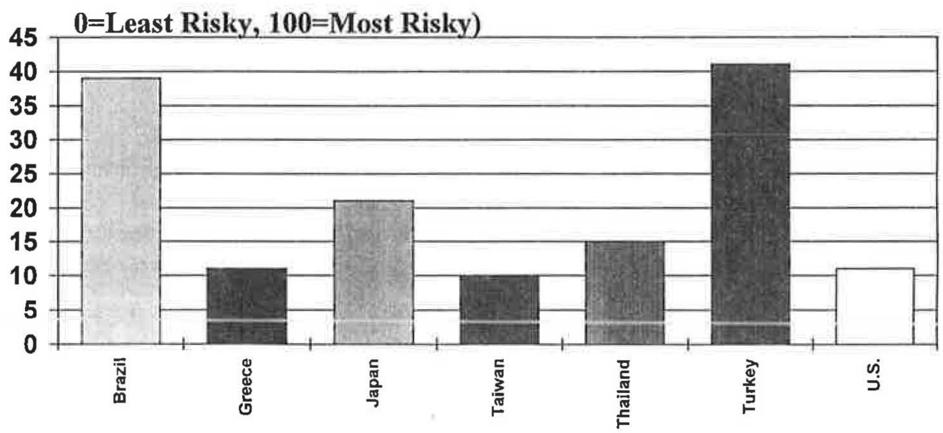

FIGURE 9B Comparison of economic risk.

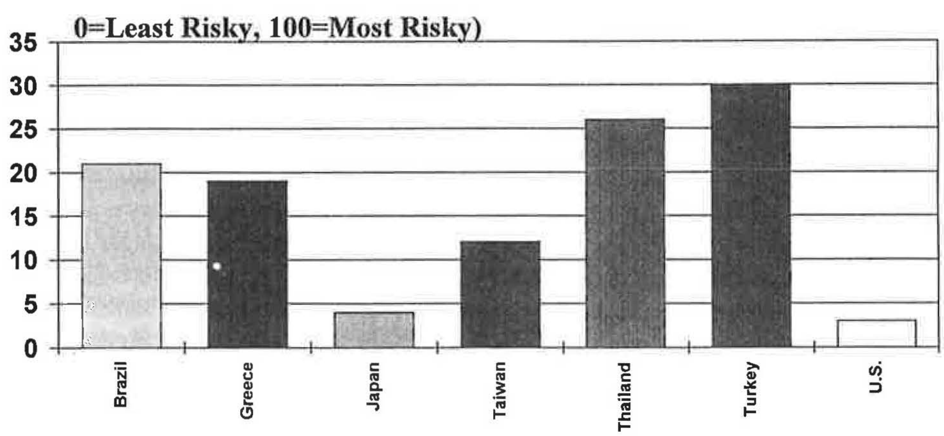

FIGURE 9C Comparison of political risk.

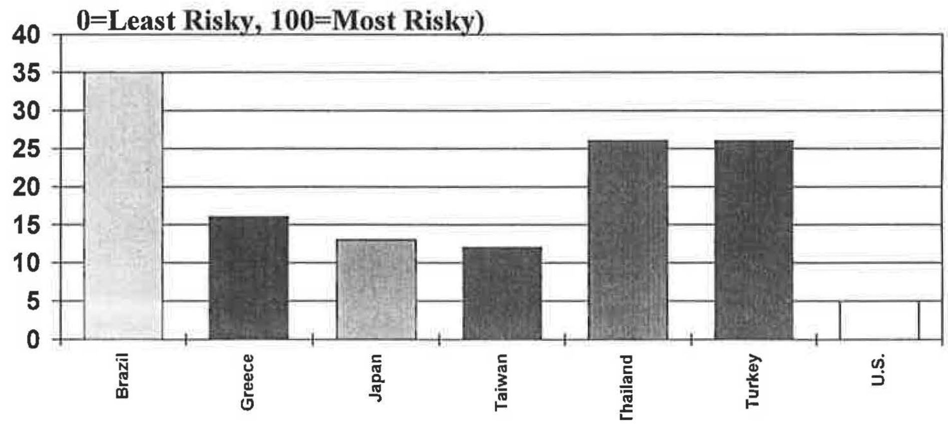

FIGURE 9D Comparison of business risk.

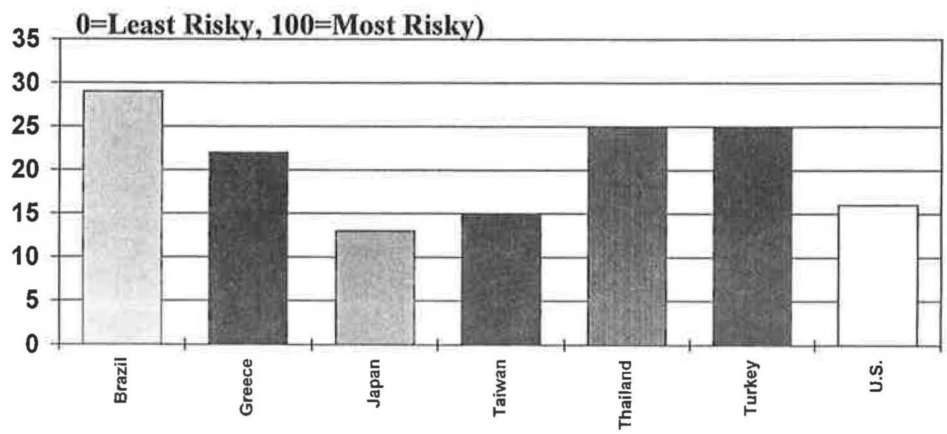

FIGURE 9E Comparison of risk facing portfolio equity investors.

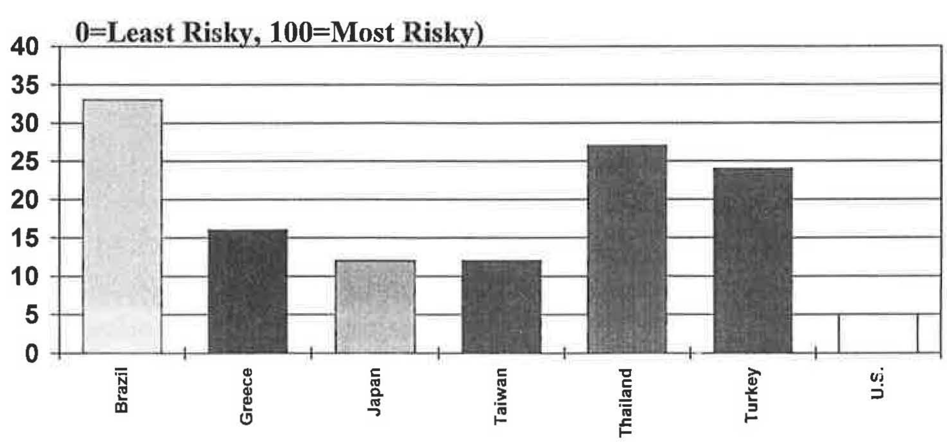

FIGURE 9F Comparison of risk facing direct foreign investors.

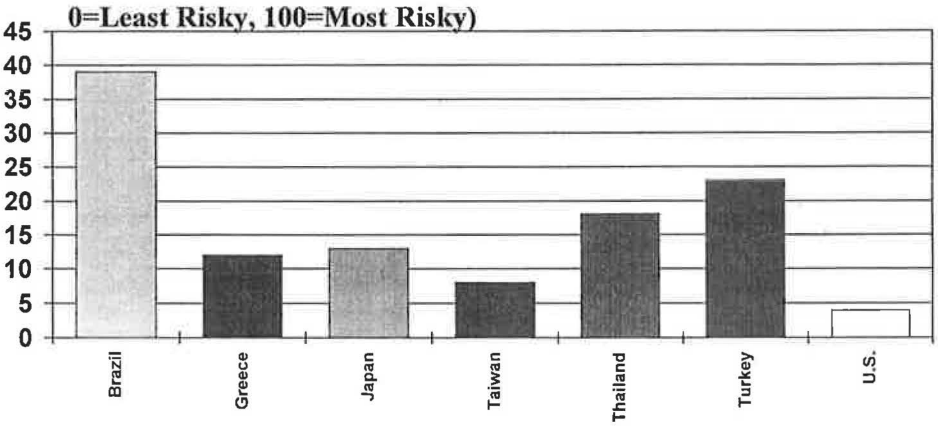

FIGURE 9G Comparison of risk facing exporters.

It has been over a year now since July 1994, when Brazil introduced a new currency (called the *real*) at parity to the dollar. After an initial dip in value, the real recovered and is now slightly stronger than one to the dollar. In nominal terms the exchange rate has not changed very much. However, in the course of the past year, prices and the cost of producing goods in Brazil have risen by 50 percent. As a result, the competitive situation of Brazilian industry (exporters from Brazil and producers trying to sell locally produced goods in the Brazilian market) has deteriorated substantially. This, combined with strong growth in domestic demand, has led to a sharp worsening in Brazil's external trade balance and an increasing trade deficit.

DRI's assessment indicates a very high probability of serious decline in the exchange rate within the next 12 months. This would hit exporters to Brazil very hard if they are not careful to hedge against those risks.

For these reasons, Brazil appears to be a very high-risk export market.

Comparing Brazil to the Taiwanese export market, DRI finds that the latter has risks also. The political and military risks posed by the threat from the PRC cannot be ignored, but the probability of the PRC invading or blockading Taiwan or causing some other problem serious enough to significantly harm exporters to Taiwan is very low, at least on the short-term horizon.

The other components of Taiwan's situation are very favorable. Taiwan has a very strong economy. There is little chance of Taiwan slipping into a recession in the short term. The exchange rate of the Taiwanese dollar remains very robust because it is well supported by the fundamental economics of Taiwan, an external trade surplus, and over $100 billion in foreign exchange reserves. Thus, the risk facing exporters to Taiwan is much lower than it is in Brazil

SUMMARY

1995 started with a series of crises in the global economy, but the situation has calmed somewhat in the last few months. On the other hand, it is fairly sure there will be new upsets either this year or next. It is impossible to forecast exactly what these upsets will be, when they will occur, or where. What we can do is systematically analyze risks in the global economy that may confront businesses and investors and provide information about what could go wrong, the probability of occurrence, and the dangers posed. Detailed risk measures can be combined with traditional analysis of market opportunity to devise strategy for the best risk-reward tradeoffs.