New Frontiers in Global Risk Assessment

By Robert McGarvey, 2006

Robert McGarvey is Principal, Founder and Director of Strategic Performance at the firm of Beckett Advisors (www.beckettadvisors.com).

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The Changing Context of Global Risk Assessment

In this white paper we'll be investigating global risk in its larger context, analyzing and evaluating the deep-seated forces that are driving globalization. These forces are creating the stresses, strains, conflicts and contradictions that lie behind global political and economic risk.

Globalization – Through Rose Colored Glasses

Our modern perspectives on globalization were powerfully influenced by events in the 1980s, particularly the extraordinary economic growth of the Asian Tigers and the shocking and unexpected collapse of Soviet Communism. There was at the time widespread euphoria, a belief that the ending of the Cold War represented a victory of Western culture in the global battle of ideas. In many people's minds the demise of communism removed the last impediment to the eventual integration of all the nations and peoples of the globe into Western style economic and political institutions. Consider the triumphal tone of Francis Fukuyama's 1992 essay, The End of History[1]:

> *"The triumph of the West, of the Western idea, is evident first of all in the total exhaustion of viable systematic alternatives to Western liberalism.*
>
> *…What we may be witnessing is not just the end of the Cold War, or the passing of a particular period of postwar history, but the end of history as such: that is, the end point of mankind's ideological evolution and the universalization of Western liberal democracy as the final form of human government."*

This new orthodoxy changed many people's perspectives on the future of global capitalism, envisioning every individual as a potential customer, and every nation as a new market opportunity. The implications in terms of risk were plain, with the war of ideas over, i.e. with the 'ends' agreed, the only substantial risks in globalization were

[1] ***The End of History and the Last Man (1992)*** by Francis Fukuyama expanded on his 1989 essay "The End of History?", first published in the international affairs journal The National Interest.

associated with the ‘means’. In other words, while there might be commercial risks associated with globalization, the larger political issues and conflicts were essentially resolved. On the whole, globalization looked like the ‘happy hunting ground’, a relatively risk free world, there for the pickings.

The New Sober Reality

Evidence that the situation was not as promising as imagined was there right from the beginning: in Tiananmen Square in 1989, in the rapid criminalization of the economies in the former Soviet Union, in the explosive growth of urban poverty in Latin America, and most particularly in the rise of Islamic fundamentalism with its anti-western, anti-capitalist, anti-globalization bias.

Globalization for the vast majority in the world meant change, painful change. It meant adapting from an existing system, which may or may not have enjoyed widespread popularity, to the institutional form and rigid discipline of Western capitalism, defined by the so called ‘Washington Consensus[2]’. As it turns out, many people around the world reject both the ‘ends’, the final destinations, and the ‘means’ of globalization. As this discord plays itself out, it is clear that the degree of political and economic risk is very much greater than previously imaged.

A New Context for Analyzing Global Risk

In order to fully appreciate what is happening in the world and to begin to put some rational parameters around the risks inherent in globalization, we need a new context for analyzing global risk: a new theoretical lens through which to view the evolution of the global political economy. The source of risk is change, and there are cultural differences in the ways that nations, their politicians, central bankers, government bureaucrats, corporate leaders and individuals adapt (or not) to changes brought about by a dynamic global capitalism.

[2] http://www.cid.harvard.edu/cidtrade/issues/washington.html, The phrase “Washington Consensus” is today a very popular and often pilloried term in debates about trade and development. It is often seen as synonymous with “neoliberalism” and “globalization.”

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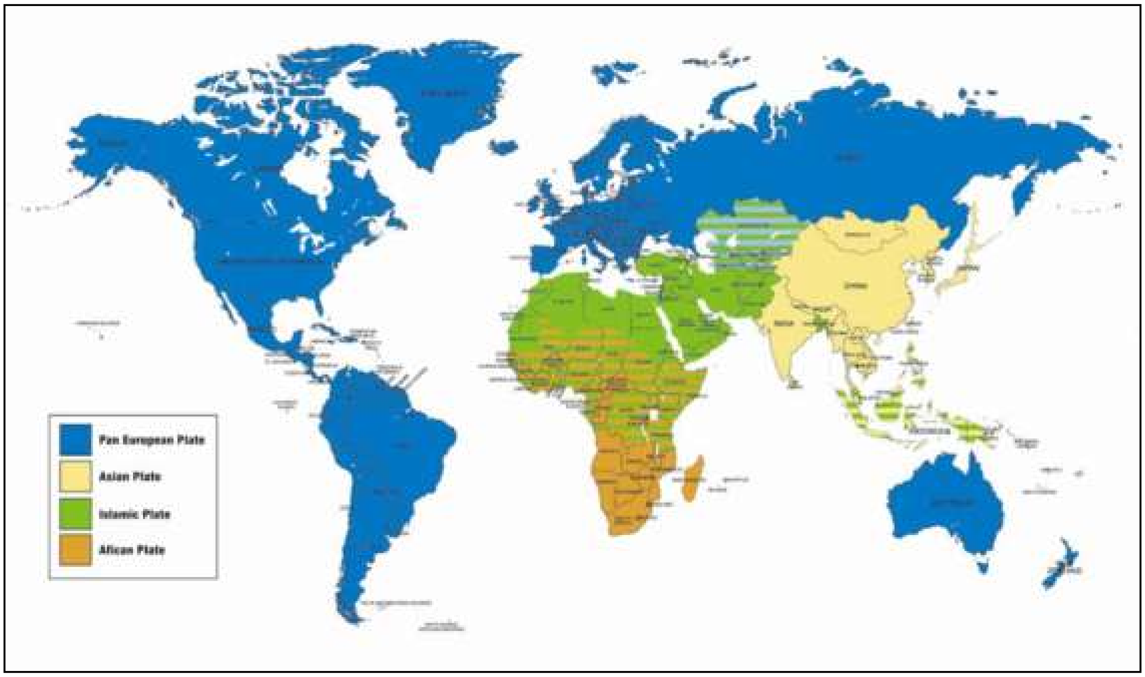
The Tectonics of World Politics

We'll begin with an overview of the *tectonics* of world politics, a theory that world society is composed not simply of discrete nations, but of much larger gatherings of nations and peoples distinguished by differing philosophical characteristics. These differences manifest themselves in fundamentally differing attitudes toward global capitalism, and, most importantly for this discussion, differing adaptabilities to change.



The Pan European World

The Pan European world comprises the peoples of Europe—East and West, Australasia, and much of the New World—North and South. The uniqueness of Pan European societies lies in their social dynamism[3]. The deep core of Pan European society, unlike that of certain other civilizations, is unable to resolve itself for any length of time into a stable and lasting philosophical unity. The result is a persistent reorientation of the philosophical principles of the group, which has manifest itself over the centuries in a

[3] Western culture is significantly more dynamic and therefore economically and politically advanced than the rest of Pan Europe. What Western culture shares with all Pan European societies, including Russia and other Eastern nations, is a similar pattern of history and overall philosophical direction.

progressively evolving sense of social justice. This ethical transformation has set Pan European society in motion, creating an internally driven engine of change.

It was from the depths of the Dark Ages that the present progressive cycle in Pan European history began. Throughout the intervening centuries, the various nations of this political world have been slowly transforming their essential character, progressively liberating themselves from medieval restraint[4]. Massive institutional changes have occurred in the general movement away from the restriction of feudal life with its vast concentrations of power and rigid social divisions, to more open and democratic institutions. These changes, which have occasioned the rise of representative government and several connected stages of capitalist development, have unleashed vast quantities of human potential, stimulating innovation and creativity, and consequently greatly expanding the total energy and wealth in Pan European societies.

The Islamic World

It is somewhat ironic, given the present state of world politics, to note that the Islamic world shares many philosophical similarities to Pan Europe. The Islamic world, like Pan Europe, is in motion, characterized by a similar internally generated dynamism. However, despite these innate similarities at the core, it appears that the world of Islam and Pan Europe are historically counter-cyclic. During the Medieval Period, when European societies were at their lowest ebb, Islam was in full bloom, characterized by dynamic expanding societies making significant contributions in science, mathematics, literature and poetry. At a time when there was little capitalist development in Europe, Islamic traders ruled the Mediterranean and beyond.

From that point in time many centuries ago, however, the two most dynamic political worlds have almost completely reversed their relative positions. Pan Europe has progressively widened the estate of ownership in its societies, with vast economic, political and social consequences, while Islam has for many centuries been slowly narrowing its estate of ownership, becoming less tolerant of diversity, less capitalistic, and in the process, more similar politically and economically to Medieval Europe.

[4] The date upon which serfdom was abolished seems to be a critical starting point. England abolished serfdom out of necessity at the time of the 'Black Plague' in the 14th century; France during its 18th century Revolution, Germany and Russia maintained the institution of serfdom in some form or another until the 19th century.

The Asian World

The Asian world is governed by quite different philosophical conditions. These nations, including China, Japan, East Asia, parts of S.E. Asia and the Indian sub-continent, tend to preserve a philosophic and therefore ethical balance over long periods of time. As a result, they have a strong bias toward the preservation of the social status quo. The challenges the more successful Asian economies face, now that they've integrated into the global economy, is how to stay competitive, i.e. adapt to meet new challenges, when the social dynamism necessary to accomplish this goal is alien to their central character.

Japan is a case in point. Significant changes (that widened the estate of ownership in Japan) were imposed by the U.S. occupying authorities after World War II, and, despite a period of painful adjustment, the Japanese economy responded vigorously, rising to dominate world trade in the '70s and '80s. However, having developed a 'system' that worked, the Japanese found it difficult, if not impossible, to sustain the degree of social dynamism necessary to maintain their economic momentum. The result was the 'lost decade' of the 1990s[5] where the Japanese economy experienced negative growth and massive deflation. Today when it is becoming increasingly obvious that economic success requires progressive social and political reforms, the Japanese government seems about to retreat to older more conservative social norms.

Today, both India and China are experiencing massive changes, a vast widening in their estates of ownership, as their economies literally explode onto the global stage. It can be expected that their essential conservatism will eventually re-emerge, and like Japan they will, no doubt, attempt to stabilize around a fixed social order, albeit on a higher level of efficiency than historically.

The African World

The African world, those non-Islamic portions of Africa south of the Sahara, is like Asia philosophically and therefore socially conservative. Like Asia, Africa is having

[5] It does not appear that Japan even now, in 2006, is prepared to deal with its problem; Japan appears frozen, unable to resolve a crisis that continues to dampen investment and growth.

change imposed upon it by external forces beyond its control. Unlike Asia, African institutions have disintegrated under the twinned forces of 19th century colonialism, and now, 21st century global capitalism. This disintegration has led to a breakdown in traditional African social and political structures and a general narrowing of the estate of ownership in Africa.

Major Trends in Pan European Development

Suggesting that Pan European societies are dynamic is one thing, but in what ways does this dynamism impact the economy? Having examined economic history, many observers speculate that technological innovation and driving improvements in productivity are the principal drivers of capitalist development. Certainly innovation had a dramatic impact on the Industrial Revolution and many economists today see knowledge driving modern day innovation, growth and change.

However, innovation or indeed technological leadership has seldom - in itself - automatically led to capitalist growth. China provides an interesting historical example. Although the Chinese at various times in their history have enjoyed a clear technological superiority over the rest of the world (inventing gunpowder, printing presses and iron ore production centuries prior to their Western counterparts), they were not able to exploit these technological advantages within their historical system of centralized political/economic control. Chinese economic growth has, until very recently, been stymied by historic limitations on the rights of individual ownership and the absence of appropriate property forms necessary to exploit the opportunities and create sustainable asset wealth.

The institutions of ownership and property are vital to capitalist development, but more importantly, they are responsible for two major trends driving globalization:

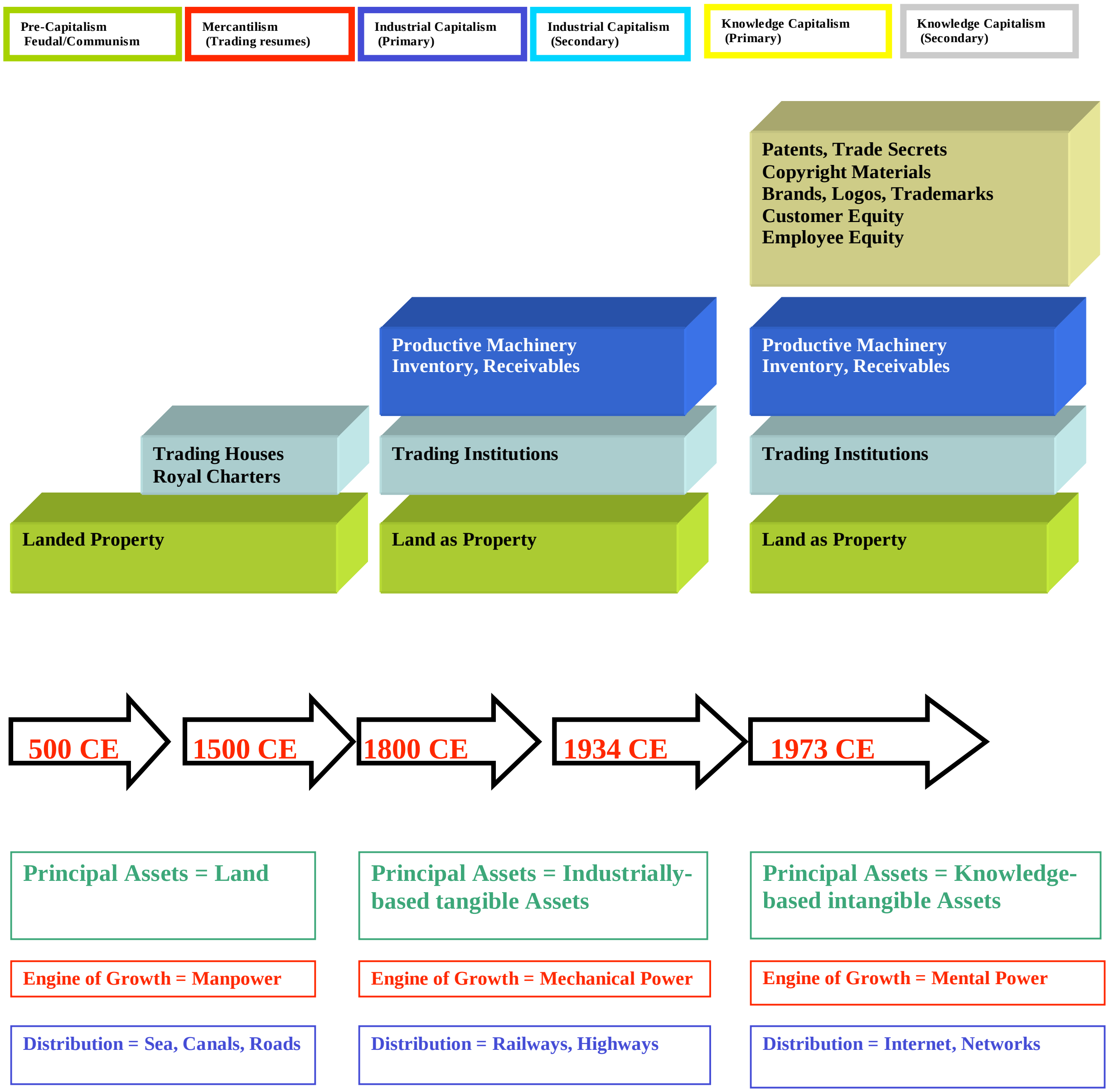
(1) The historic capacity of the capitalist system to expand the property matrix, increasing the quantity and quality of economic assets available to the economy, and

(2) Steadily widening estates of ownership, increasing over time both the proportion and absolute numbers of people owning and controlling those economic assets.

Naturally, in combination, these dynamic forces have had a profound impact on long-term growth in the economy. For as you increase the absolute number and total proportion of 'owners' in the economy, the opportunities to add value to an ever-expanding matrix of economic assets can lead, when optimized, to a geometric expansion in market activity and economic growth.

Not surprisingly, this growth comes with a price. Both of these major trends carry significant associated risk. The asset changes that have accompanied the expanding property matrix, for example, have at various points in history, led to sharp and painful learning curves for business people, investors, bankers, securities regulators, and the public at large, as they slowly come to grips with new and unexpected orders of risk. The Dotcom bubble is only one of many instances in history when a 'new' economy, founded in a new class of assets, seduced investors into periods of 'irrational exuberance' with catastrophic consequences.

Capitalism's Expanding Asset Foundation



Economic assets have undergone an extraordinary metamorphosis over the centuries. The expansion in the property matrix, leading to significant changes in capitalism's underlying asset foundation, is amply demonstrated in economic history.

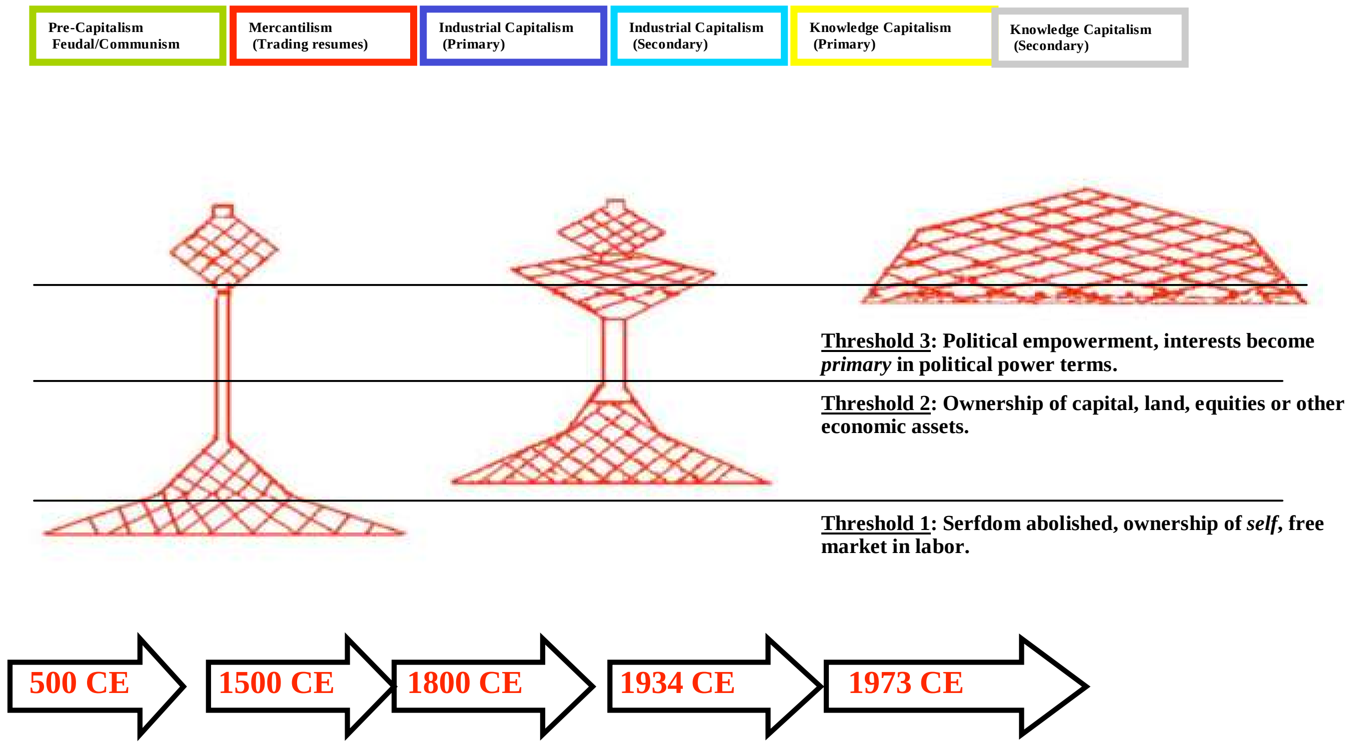
New Frontiers in Global Risk Assessment

During the roughly 1000-year Medieval Period (5^{th} to 15^{th} centuries) of Pan European history, property per se was limited in its definition and very restricted. Feudal economic life, such as it was, revolved around rural agriculture. There were very few identifiable economic assets during this period; apart from coin and a few trading ships, landed property was the principal economic asset. And we should not forget, the control of landed property was solidly in the hands of the aristocratic 'few'. With little in the way of private property ownership, there was very little trading and as a consequence, few markets in Medieval Europe. This pre-capitalist economy operated essentially as a command economy, not dissimilar in ownership structure to Soviet style communism.

All this began to change in Northern Europe in the 16^{th} century. Capitalism began to stir; trade and commerce began their inexorable rise. During this mercantilist period, capitalism grew in large measure through the creation of trading houses and, more formally, Royal chartered trading monopolies. The East India Company (1600), the Virginia Company (1606), and the Hudson's Bay Company (1670) are examples. These trading houses and chartered monopolies represented new forms of economic property and, eventually, significant assets to the founding members. In the more successful enterprises, asset wealth accumulated in large amounts, developing over the period into a considerable economic and political force.

By late 18^{th} century, Britain was leading the world into a new 'industrial' form of capitalism. The Industrial Age really hit full stride in the mid 19^{th} century when steam power and the railway networks became widely accessible and affordable for local manufacturers. This new production and distribution infrastructure allowed industrialists to produce their goods in mass quantities and get them to market at a profit on a regular basis. In other words, steam power and railways, by linking factories to customers and a stream of future earnings, created collateral value in industrial assets. This revolution, creating entirely new classes of bankable assets in 'industrial plant' and 'inventory', was a critical foundational reform that triggered and sustained economic growth in the Industrial Age.

Capitalism’s Widening Estate of Ownership



Over the centuries, there has been a vast widening in the estate of ownership in Pan European (particularly the Anglo) economies; massive increases in the numbers and proportions of individuals who own their own home[6], own shares in public companies, or who have more direct ownership of small privately-held businesses[7]. More indirectly, ownership of various forms of ‘human capital’ have been realized in western society due to the almost universal commitment by western government to advanced education and technical training of all sorts. As a result, the proportion of individuals ‘owning’ and value-adding economic assets is much greater than it was in the past. All this has

[6] http://www.ncbi.nlm.nih.gov/entrez/query.fcgi?cmd=Retrieve&db=PubMed&list_uids=2731620&dopt=Abstract, in the US and the UK, home ownership today stands at about 70%, this is up from approximately 30% home ownership at the end of the 19th century.
[7] http://clinton4.nara.gov/WH/Accomplishments/Small_Business.html, Again, US government statistics support an explosive growth in small business ownership. These statistics from the Clinton era are typical of the late 90s. Similar trends are present in the UK and other western economies.

occurred despite a recent and quite staggering concentration of wealth upward in the economy.[8]

Widening in the estate of ownership is a major driving force behind capitalist growth. However, it does generate its own special types of risk—political risk in this case.

There is little argument about the impact of property ownership on individuals; asset ownership can be a reliable source of income and a storehouse of accumulating value as (historically) assets have generally risen in value over time. The rights of ownership, if they are to have real meaning, must be legally defined. Of course, it is at the legal level where individual entitlement to property is established and maintained. But ownership rights also exist at the higher political level, where the rules of ownership are established by society. Anyone who owns a house knows that legal title attaches great value, but the rules that govern home ownership are made by local councils, regional and state levels of government. Ownership's political character is conditioned by this duality; it is the central reason why the advance of democracy has been so important to the evolution of capitalism. In a very real sense, the security in assets is a function of the degree to which those who own property have their interests appropriately represented in the rule-making process at the political level.

The widening estate of ownership has triggered several stages of political reorganization in Pan European history, most notably the Age of Revolution during the 18th and 19th centuries. During the Commercial Revolution and the early stages of the Industrial Revolution, vast commercial empires were constructed as early capitalism began to re-emerge in European culture. Major fortunes were amassed, controlled by middle class individuals who, as a general rule, had little or no political influence. During this pre-democratic era, political power was almost exclusively in the hands of absolute monarchs of one sort or another. Needless to say, this was a recipe for conflict. And certainly conflict was the order of the day during this critical period. In almost every situation, a rising merchant or industrial class, whose asset wealth was under threat by an absolute monarch or aristocratic class, championed political reforms. The more

[8] http://www.endgame.org/primer-wealth.html, The facts are indeed staggering and could potentially be fatal to western capitalism, In the late 1970s, the top one percent of the US population held 13 percent of the wealth; in 1995 it held 38 percent, today it is over 40%.

recent evolution of representative democracy, which has transitioned western institutions from their early producer bias to more broadly based consumer bias, has paralleled the growth in asset wealth and become more inclusive as asset ownership has become more widely distributed in the economy.

The Stages of Economic Development

Stage 1: Feudal (or Communist) Command Economy

- Pre capitalist, Concentrated economic control, little or no private property ownership,
- Few, if any, markets
- Concentrated political control
- Economic and political stability

Stage 2: Mercantilism or Neo-mercantilism

- Early stage capitalism, beginnings of private property rights, (trading resumes, Royal chartered companies etc)
- Market (cities) begin to emerge or re-emerge
- Concentrated political control
- Increasing economic volatility, political stability

Stage 3: Primary Industrialization

- Accelerating capital growth, rapid growth in industrial assets
- National markets consolidate, rapid urbanization
- Devolving political control, producer dominated politics
- Economic volatility leading to political instability

Stage 4: Secondary Industrialization

- Stable capital growth, established industrial assets
- Stable growth of transnational markets
- Broadly representative political institutions, consumer dominated politics
- Economic stability, political stability

Stage 5: Primary Knowledge Economy

- Accelerating capital growth, rapid growth in intellectual assets
- Rapid growth of globalized markets
- Continued devolution of political power, increasing consumer activism
- Economic volatility leading to political instability

Stage 6: Secondary Knowledge Economy

- Stable knowledge capital growth, established knowledge assets and intellectual property rights
- Global market consolidation??
- Continued devolving political control??
- Economic and political stability???

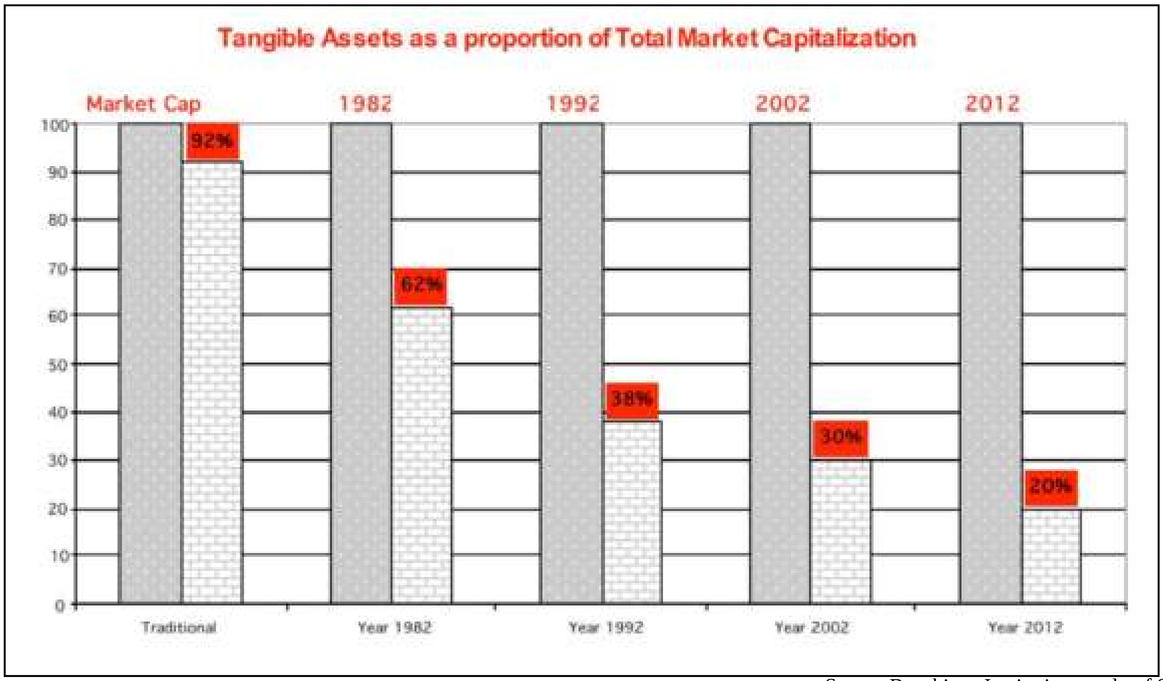
The Twin Asset Revolutions Configuring Global Capitalism

From an asset and economic development perspective, there are two major transformations being undertaken simultaneously around the world. The advanced economies of the Pan European world and selected Asian economies, e.g. Singapore, are engaged in transitioning from an industrial asset base to a knowledge asset base, while major emerging economies in Asia and Pan Europe are transitioning from agricultural (or communist command) economies into industrial asset foundations.

The Developed World: Initiating the Knowledge Asset Revolution

Since the 1970s, there have been revolutionary changes taking place as Western economies transition from economies largely underpinned by familiar industrial assets to economies dominated by 'intangible' knowledge and relationship-based assets. For those who doubt that major changes are impacting the economy, consider that between 1995 and 2002 the world's 20 largest economies lost 22 million industrial jobs. Nevertheless, despite the shrinking of their industrial work forces, the output in these countries as a measure of GDP increased by an astonishing 50%[9]. Today, in the U.S. and other Western economies in particular, market services have displaced industrial production as the primary engine of growth[10]. Studies suggest that 'intangible' assets are now contributing over three-quarters of U.S. GDP[11]. Consider the following observation from Juergen H. Daum, Chief Solution Architect of SAP in Walldorf, Germany: "… *indeed the source of value creation in the industrialized economies has shifted from tangible to intangible assets. In 1982, the value of tangible assets, reported on the balance sheet of Standard & Poor 500 companies in the U.S. on average made up still most of the market value of these companies. To be exact, 62% of the market value of S&P 500 companies in the U.S. in 1982 was covered by the value of tangible assets. In 1998, this ratio has been totally turned around"[12].*

[9] "The Misery of Manufacturing", *The Economist*, September 27, 2003
[10] Consider that in 1965, the ratio of service to manufacturing jobs in the US was 1.5:1. Today, it's about 5:1. Source: Bureau of Labor Statistics, Payroll Survey.
[11] KNOWLEDGE AND SHAREHOLDER VALUE, Baruch Lev, January 2000, Page 2
[12] http://www.juergendaum.com/news/07_06_2001.htm



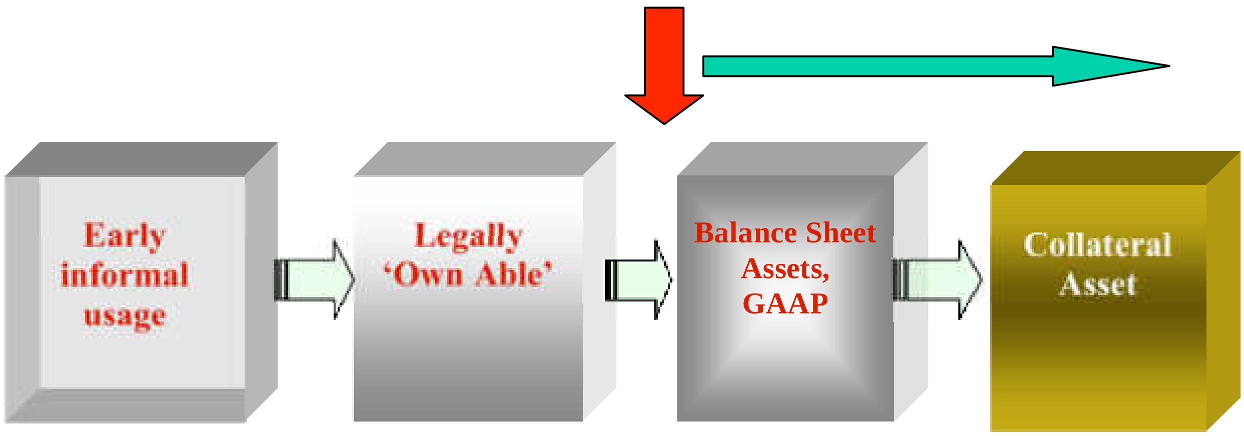
Source Brookings Institution, study of S&P 500

A Digital World?

One of the most controversial aspects of 21st century globalization is the outsourcing of high skilled knowledge-intensive jobs from western businesses to India or other emerging economies. Many see outsourcing and other similar developments as proof of a truly global digital economy, a 'flat world' so to speak. There is no doubt that outsourcing is a serious business (and now) political problem in the developed economies, but the economic reality is significantly different if looked at from the institutional level. Although the Knowledge Revolution per se has global implications, in significant ways the knowledge 'asset' revolution is quite localized. The process of converting intellectual forms of property and relationships of various types into formal assets requires a wholesale social commitment to change. There are suites of accompanying political, legal, accounting, management and attitudinal adjustments that are necessary to establish solid, dependable assets out of such intangible forms of wealth.

This underlying institutional transformation is only a reality (at present) in the advanced post-industrial economies.

Maturity Pathway for Intangible Assets



The maturation process of a new class of assets takes time and experience. Appreciating the special risks and larger social responsibilities of new property forms are major challenges for society and management. And just as industrial assets grew and matured before they became established institutionally, so do all new property forms. Computer software, one of the most 'tangible' forms of intellectual property, spent a period of time in general usage before it became 'protect-able' under law and therefore technically 'own able'. It took the success of Microsoft, Oracle and others before investors and serious analysts would even consider software as a legitimate corporate asset. Nevertheless, despite these advances, even in highly developed economies the most productive assets in the economy are still being treated as suspect, almost illegitimate by the majority in the normal course of business. It is clear that for most senior management, investors, securities regulators and the public at large, intellectual property and intangible assets are still a maturing concept, whose development will accelerate considerably over the next decade.

The IASB (International Accounting Standards Board), in tandem with the U.S. FASB (Financial Accounting Standards Board), has taken note of these changes in the economy and is reforming reporting standards and GAAP. In modernizing accounting standards, the boards are both incorporating the new classes of intangible assets and moving off the traditional 'historical cost' model for reporting asset values. These two related areas of accounting reform (that are scheduled to take affect in January 2009) are designed to make financial reporting more accurate and relevant by (1) establishing a 'fair value' standard in the recording of corporate assets and (2) including the full range of tangible and intangible assets on the financial statements.

The Emerging Economies: Industrial Asset Revolution

If Foreign Direct Investment (FDI) and international trade statistics are anything to go by, industrialization in China, India and several other Asian economies is exploding. (FDI in developing economies is directed largely to 'Greenfield' industrial development, where as FDI in USA, and other developed economies, is largely directed toward corporate takeovers.) OECD (Organization for Economic Co-operation and Development) countries' net direct investment outflows to the rest of the world reached record levels in 2004 (US $261B FDI). China and a couple other financial centers in Asia continue to receive the lion's share of direct investment. India is making steady progress in establishing itself as an attractive place for FDI. Inward direct investment has tended upwards since the late 1990's to reach 5.3 billion in 2004.

But East Asia is not the only part of the world experiencing massive primary industrialization. There are many of the later developing economies in Pan Europe going through the same stage of development. FDI in South America is growing. Inflows in 2004 to Brazil were $18B. Chile was $8B. Argentina was $4B. All inflows are twice the levels of 2003. Inflows to Russia, having already picked up in 2003, gained further speed in 2004. As in earlier years, much investment went to the hydrocarbon sectors but there is a growing tendency towards consumer goods lately.

The Sources of Economic Volatility

Economic Volatility: *rapid swings in GDP performance, inflation, unemployment, FDI and discriminatory practices. These periods of change often lead to instability and roller coaster like volatility.*

Although economic volatility can have many causes, it has historically been most common in those periods of adjustment when a new class of assets, with new and unfamiliar risks, is being incorporated into the economy. For example, at the time of the Commercial Revolution during the 17th and 18th centuries, there were several notable episodes of economic volatility associated with growing international 'trade'. The most famous of which was the South Sea Bubble.

The South Sea Company was chartered in 1711 and granted a monopoly by the King of England for trading in the South Atlantic. Speculation around this new 'monopoly' enterprise was swift and excited. Unfortunately for the South Sea Company, Britain and Spain went to war again in 1718, undermining the trading opportunities with Spanish colonies in South America. But like many a modern-day business, the significance of these commercial reverses were not immediately apparent to investors. Indeed so popular was the stock that investors ignored the bad news and kept buying. As a result, the stock kept rising rapidly, encouraging more buyers and creating a momentum of growth that seemed unstoppable. Behind the scenes however, South Sea Company management (like the more recent Enron management) could see the writing on the wall and soon began to dump their shares into the rising market. Eventually word got out, the bubble burst, and panic selling initiated a market crash and economic crisis in England.

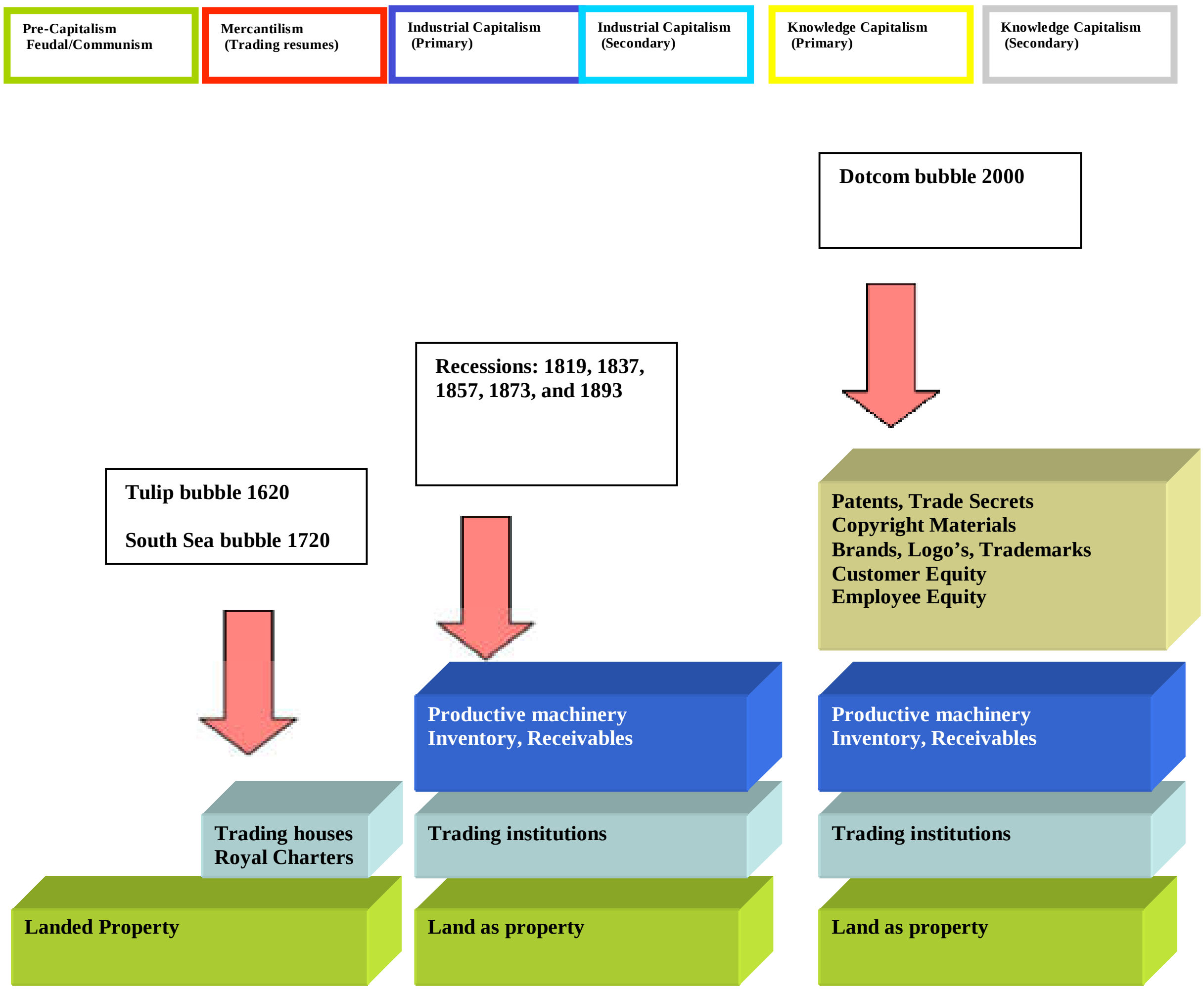
Although many see the South Sea bubble as simply a case of stock market greed, it was in many ways a function of unfamiliarity of risk. There was ignorance on the part of management, investors, securities regulators and the public at large with the nature and scale of trading risks. A new class of assets was being incorporated into a medieval economy that had been very slow moving and predictable; the Tulip bubble in Holland and the South Sea bubble were part of a steep learning curve associated with such changes.

The primary stage of industrialization in the United States was also characterized by economic volatility. The years 1819, 1837, 1857, 1873, and 1893 marked the beginnings of periods of grave economic disturbance that were caused by currency fluctuations, stock market crashes, banking and liquidity crises, and trade difficulties. The 1819 depression was one of the most volatile. The industrial era began in the U.S. with a great burst of nationalism. During the early 19th century, several major economic reforms, including the establishment of a national bank and protective tariffs, were undertaken to protect fledging American industries. Beginning in 1819 with cotton prices already declining sharply, the new Bank of the United States imposed strict credit restrictions. Although designed to curb inflation, these restrictions triggered a financial panic that swept across the economy. Unemployment rose rapidly, banks failed, prices fell, and investment collapsed. Much was learned from this self-inflicted wound, but more learning was required, as volatility swings in economic fortunes became regular features of the early primary stage of industrialization in the United States.

More recently in the U.S. as a consequence of another asset revolution, we've had the great Dotcom bubble. And while it is true that the Crash of 2000 did incalculable damage to investors and fledgling knowledge-based companies around the world, we can see that the meteoric rise and fall of the Dotcoms was, historically, nothing new. All these famous bubbles had their roots in a brave new commercial world, with dreams of staggering new wealth. In the case of the Dotcom bubble, it was the digital world with its strange intangible sources of wealth that captivated so many for so long. What none of these enormous market bubbles did was reverse the course of economic history. Growth in trade flourished in spite of these early bubbles, and the knowledge revolution continues despite the Dotcom market crash. At each stage, however, risks are identified and a body of experience and knowledge was assembled, institutional reforms undertaken, so that the new forms of wealth could be more effectively managed at all levels.

New Frontiers in Global Risk Assessment

Periods of Economic Volatility



The Sources of Political Turmoil

Political Turmoil: *Actions that can result in threats or harm to people or property by political groups or foreign governments operating within a country or from an external base. These are actions that lead to violence.*

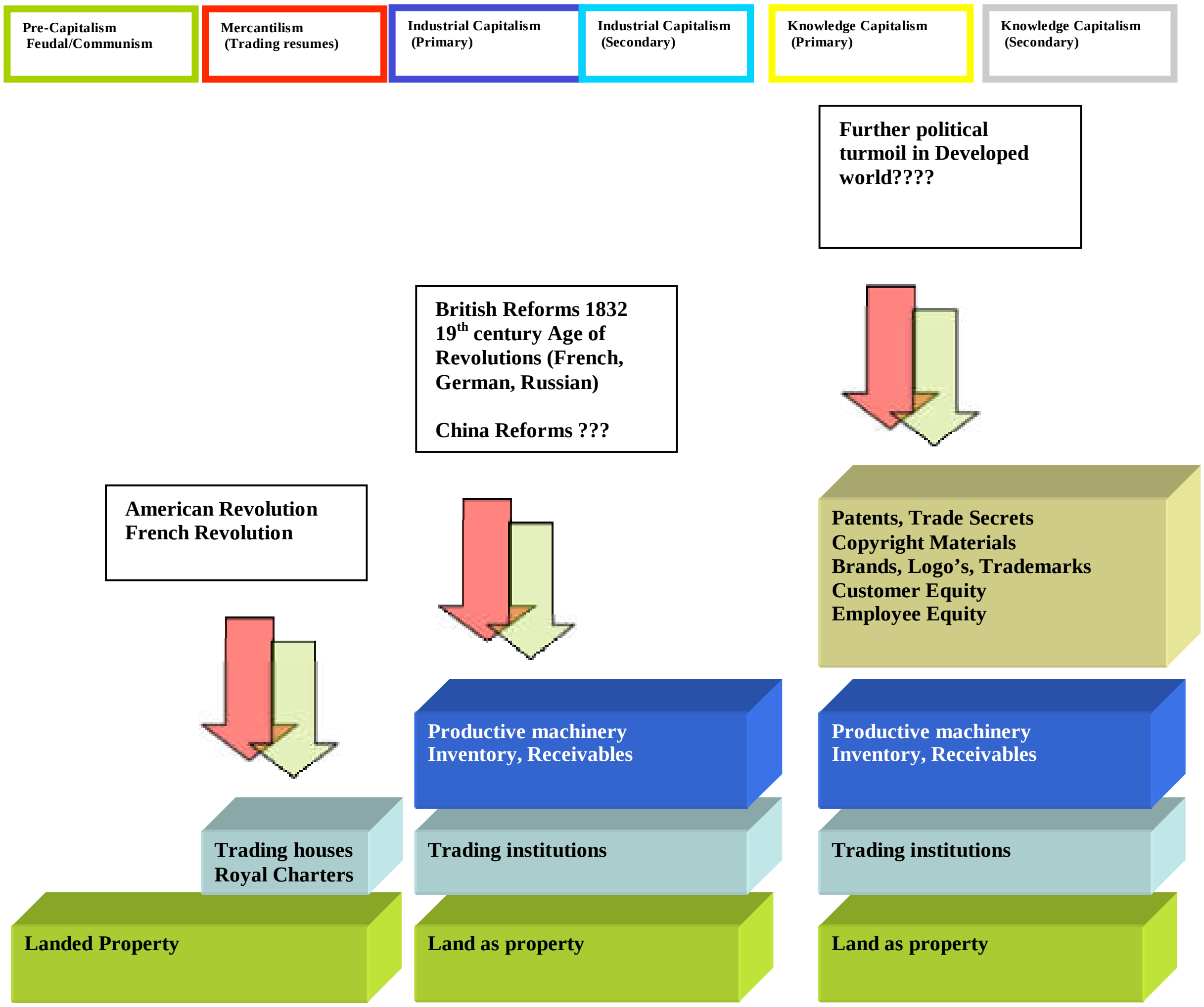
Political turmoil, like economic volatility, has many causes, but again has historically been most common in those periods of adjustment triggered by changes in the distribution of ownership and asset wealth in society. Political turmoil has tended to occur when the structure of economic power gets out of sync with the structure of political authority. One of the most notable periods of political turmoil associated with changing economic conditions was the American Revolution. The American colonists were (largely) property owning citizens, and resented being treated as peasant 'subjects' of a distant monarch. Their assets as much as their political integrity were under treat. Although the popular Revolutionary cry was 'Give me Liberty or Give me Death', a more relevant and pragmatic sentiment was surely 'No Taxation without Representation'. The American Revolution and accompanying political turmoil it initiated began a trend in Pan Europe that lasted almost unabated until the Russian Revolution in the early 20th century.

Britain provides an interesting, if less violent, example of this phenomenon. The Commercial and Industrial Revolutions in Britain created a wealthy middle class of successful businessmen. The new asset classes in 'trade' and 'industry' provided the means for the business class to obtain asset wealth, while avoiding direct economic conflicts with the landed aristocracy. Having gained substantial wealth, the middle classes, not surprisingly, began championing political reform. Indeed, in the case of Britain, the Reform movement culminated in the 1832 Reform bill, which effectively transferred real political power from the aristocratic House of Lords to the business dominated House of Commons. Elsewhere in Pan Europe, the situation, although similar, was very often accompanied by violence and radical political change. The period of transition, the Age of Revolution, was the source of much political turmoil, significantly increased risks, and loss of life and property.

In the modern world the most rapidly developing economies are reproducing the circumstances that led to political turmoil historically. In particular, China has industrialized very rapidly, and, like western economies historically, has done so under a tightly controlled political despotism. This has allowed China to develop through a difficult period of rapid economic changes with a degree of order and stability. It remains to be seen if China can maintain its very centralized system of political control in the face of overwhelming forces of change brought about by their incorporation into the maelstrom of global capitalism. There is no doubt that the rising Chinese middle classes, with some of the world's largest and most rapidly growing fortunes, will eventually find that the 'harmony of interest' that has until now supported the status quo will break down, perhaps plunging China to period of political instability.

New Frontiers in Global Risk Assessment

Periods of Economic Volatility



New Frontiers in Global Risk Assessment

Managing Risk in the 21st Century

A risk manager's duties include helping management meet its larger goals while protecting the assets of the organization. Risk management generally employees a process with the following stages:

(1) Identification: an assessment of those significant risks that may possibly impact the company. Early identification of potential threats allows the risk management team to plan in advance, rather than simply reacting defensively after an event.

(2) Assessment: risk is a normal functional part of any business opportunity. A measured approach, based on a rational assessment of the risk in advance, is critical to the development of the appropriate policies and procedures to effectively mitigate that risk.

(3) Mitigation: there are generally two approaches to mitigation, risk reduction and impact reduction. Reducing risks generally involves preventative measures that can reduce the probability of the risk occurring in the first place. Impact reduction admits that bad things will happen, but puts in place policies and procedures that reduce the costs if the worst happens.

(4) Monitoring ongoing performance.

The Asset Revolution in Developed Economies

It's a simple truth that assets that cannot be identified cannot be managed or protected. It is precisely at the identification stage that many of the modern risk management challenges are accumulating at the moment. Needless to say, this seemingly simple task becomes much larger and more difficult in periods of asset transformation like we're experiencing today.

As a consequence of the rise of intangible assets in the western economies, the IASB and FASB have undertaken a joint program to modernize accounting standards. In the process they have identified 3O+ intangible asset classifications. These asset classifications include the more formal forms of knowledge assets, license based (contractual) intangibles, artistic and technology (copyright and patented) based intangibles as well as many other informal brand and customer equity (contractual and quasi-contractual) related intangibles. It is the Boards' intention to normalize reporting standards in these new asset classes and to gradually incorporate them into the mainstream of asset management.

What does a prudent risk manager do when upwards of 70% of the assets in the organization are unfamiliar intangibles? Although many firms are becoming aware of the value of patents and copyrighted software, few are aware of the largest and most valuable of the intangible assets in their organization. Brands, logos, trademarks and customer equity in its various forms constitute the bulk of most company's asset wealth. These are informal relationship-based assets that are vulnerable and subject to a wide variety of unfamiliar risks. Unfortunately, the most common form this risk takes is neglect.

For example, many organizations these days are lowering operating costs by outsourcing software development, customer relationship management and basic accounting functions to lower cost service providers in India and other parts of Asia. Although this makes sound bottom line sense, it carries a variety of associated risks to key intangible assets. In outsourcing software development, vital trade secrets are often inadvertently bundled with the process and sent half way around the world into economies where no legal protection of intangible assets is possible. The situation is even more critical on the customer relationship front. Outsourcing customer service and relationship management carries significant risk, placing, as it often does, the customer experience beyond the control of the company. Outsourcing risk can be managed, but only if the key assets are identified, treated as such with sound risk minimization procedures applied consistently throughout the process.

The Darkening Context of Risk

The global economy, and the world of risk management, is entering a new and more volatile period. The present period of instability is made worse by the fact that as a global economy we've become conditioned by a prolonged period of Post War era stability. If economic history has anything to teach us, there could well be stormy weather ahead. All major economies, in both the developed and emerging nations are transitioning, entering exciting new stages of economic growth. They are all, however, incorporating new (for them) classes of assets. They can be expected to experience the inevitable disruptions associated with that growth. Managing those predictable periods of volatility will require insight and judgment on the part of management and their risk management professionals. At a minimum, incorporating new models for identifying and analyzing global risk, as well as adapting to new higher thresholds of risk, are going to be required in order to prudently take advantage of the undoubted opportunities available in the 21st century global economy.