Abstracted Chapter:
The Fraying Fundamentals
Risks to Economic Stability and
Social Cohesion
The Global Risks Report 2020
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The Fraying Fundamentals

Risks to Economic Stability and Social Cohesion
Recent editions of the *Global Risks Report* have warned of downward pressure on the global economy from macroeconomic fragilities and financial inequality. These pressures continued to intensify in 2019, increasing the risk of economic stagnation. Low trade barriers, fiscal prudence and strong global investment—once seen as fundamentals for economic growth—are being challenged as leaders advance nationalist policies and citizens’ discontent hardens with systems that have failed to promote economic advancement for all. A challenging economic climate may persist: according to the Global Risks Perception Survey, members of the multistakeholder community see “economic confrontations” and “domestic political polarization” as the top risks in 2020.
The global economy is at risk of stagnation. Rising trade barriers, lower investment and high debt are straining economies around the world. The margins for monetary and fiscal stimuli are narrower than before the 2008–2009 financial crisis, creating uncertainty about how well countercyclical policies will work. This uncertainty is exacerbated by a tense geo-economic and geopolitical landscape (see Chapter 1, Global Risks 2020), as well as by domestic challenges. Profound citizen discontent—born of disapproval of the way governments are addressing economic and social challenges—has sparked protests throughout the world, potentially weakening the ability of governments to take decisive action should a downturn occur.

Economic risk factors are compounding with widespread domestic discontent towards economic systems

Macroeconomic risk factors

During the last decade, moderate but stable growth has given way to what the International Monetary Fund (IMF) has called a “synchronized slowdown”—weakened growth among the world’s economies.\(^1\) We cautioned in last year’s Global Risks Report that a gradual deceleration was underway, and the evidence suggests that, since then, the slowdown of the world economy has further materialized. By the third quarter of 2019, six of the world’s largest seven economies (Japan is the exception), which together represent more than half of global production, had decelerated. The outlook is also precarious for other G20 economies. Except for Indonesia and South Korea, these economies are growing at a rate below 2%—with Argentina and Mexico contracting in the third quarter of 2019.\(^2\) These trends likely explain why our multistakeholder community rated “recession in a major economy” as the ninth risk most likely to increase in 2020 (see Figure 1.1 in Chapter 1, Global Risks 2020).

Going forward, rising trade tensions, lower investment, weak confidence and high debt risk a prolonged slowdown of the world economy. At the time of writing this report, the IMF had lowered its last five estimates of world output for 2019 and expected a growth rate of 3.0%—a sharp decline from 3.6% in 2018 and the slowest since the 1.7% contraction in 2009.\(^3\) For 2020, the IMF had also downgraded its forecast from 3.7% to 3.4% (see Figure 2.1).

Trade tensions

“Economic confrontations between major powers” is the most concerning risk for 2020, according to members of the Forum’s multistakeholder community; this is the same risk our multistakeholder network rated as the top risk last year. It is clear why short-term economic risks ranked high in the Global Risks Perception Survey: global trade, which for decades has been an engine for growth, is slowing down. World Trade Organization (WTO) data for the first three quarters of 2019 shows that total world merchandise trade decreased 2.9% from the previous year (see Figure 2.2)—it decreased in the world’s top ten traders.\(^4\)

Reduced trade volumes are largely the result of what the WTO has called “historically high levels of trade restrictions”.\(^5\) The potential result, according to the IMF, could be global growth slowing by 0.8 percentage points in 2020, should the United States and China uphold existing tariffs or implement new ones.\(^6\) While progress was made in late 2019 between the United States and China towards a trade agreement, the effects of having turned trade from an instrument of cooperation to a weapon of rivalry may persist.

Lower investment

Investment is indispensable for boosting productivity. Globally, investment has been affected by low expected returns, uncertainty about economic policy in major economies, and ongoing and emerging geopolitical tensions (see Chapter 1, Global Risks 2020). In our survey, “protectionism regarding trade and investment” and “populist and nativist agendas”—two major obstacles to the free flow of foreign direct investment (FDI)—were rated as the fifth and sixth risks most likely to increase through 2020.
Like global growth, FDI remains lower than it was before the 2008–2009 crisis. It has decreased for the last three years. In 2018, net FDI inflows were down 38% compared to 2017, and less than half of the level they were in 2015.\textsuperscript{7} The sharpest decline has been in the euro area (see Figure 2.3), where less appealing yields, lower production and uncertainty surrounding Brexit have led net FDI inflows to the region to fall to a record low since the euro was adopted in 1999.\textsuperscript{8}

**Weak confidence**

Business confidence, a precursor to investment, has also deteriorated during 2019. The Business confidence index—constructed by the Organisation for Economic Co-operation and Development (OECD) using production data and business sentiment to anticipate future performance—signals that the state of the global economy is expected to worsen in the short term. At the time of writing this report, the index had declined for
14 consecutive months, dropping below the no-change threshold for the first time since 2016 and reaching a 10-year low in October of last year (see Figure 2.4).9

**High debt**
Private and public debt has been accumulating since the crisis. According to the IMF, the global ratio of debt-to-GDP increased by 11 percentage points between 2009 and 2017. Across G20 economies, public debt is expected to reach 90% of GDP in 2019—the highest level on record—and to grow even more, to 95% in 2024 (see Figure 2.5).10

Private debt has built up on the basis of lower interest rates—particularly in China and the United States, where more than 40% of total private debt is located.11 In the second quarter of 2019, non-financial corporate debt reached 156% of GDP in China.12 In the United States, non-financial corporate debt reached 47% of GDP in the third quarter—the highest level ever recorded—according to Federal Reserve Bank of St. Louis data.13 The IMF has listed “rising corporate debt burdens” as a key vulnerability in the global financial system.14

**Narrow margins for stimuli**
As economic warning signs begin to flash, there is a risk that the tools previously used to brake economic slides may no longer be available. Financial market stress and strained public finances are creating uncertainty as to whether conventional monetary and fiscal policy instruments, which have worked to boost growth in the past, could be as effective in the future.

**Monetary constraints**
As the IMF has signalled, interest rate cuts have helped boost growth, but they have also fostered higher debt and riskier rent-seeking, which affect financial market stability.15 In 2019, monetary policies worldwide saw profound reversals, with most central banks persistently cutting interest rates to very—sometimes historically—low levels.16 In the United States, after nine consecutive hikes between 2015 and 2018, the Federal Reserve lowered its target interest rate from 2.50% in December 2018 to 1.75% currently.17 The European Central Bank (ECB) cut its deposit...
rate to a historic low of -0.50% in September 2019.\textsuperscript{18} The Bank of Japan’s deposit rate has remained at -0.10% since February 2016.\textsuperscript{19} Such low rates raise concerns about the soundness of banking systems. The ECB has warned that decreasing profits are challenging Europe’s banking sector;\textsuperscript{20} in the second quarter of 2019, European banks yielded an average return-to-equity of 7.0%,\textsuperscript{21} compared to 12.1% in the United States.\textsuperscript{22}

The role and reach of monetary policies are also challenged by wider factors such as technological change, climate change and rising inequality. Christine Lagarde, President of the ECB, for example, announced a “strategic review” of the ECB’s mandate to preserve price stability to “address the major changes that have taken place over the course of the last 16 years”—when the last such review was conducted.\textsuperscript{23}

**Fiscal constraints**

The margin for fiscal stimulus in most of the world’s main economies has narrowed, as higher spending has reduced budget coffers. Public debt in 15 of the 20 largest economies has increased every year since the 2008–2009 crisis.\textsuperscript{24} Researchers from the ECB analysed four decades worth of data from 17 European countries and concluded that fiscal stimuli may not be effective when public debt is high.\textsuperscript{25}

At the same time, tax rates have increased across G20 economies—their average maximum income tax rate has risen by more than two percentage points since 2009, to 37.7%.\textsuperscript{26} Lowering tax rates could be a potential stimulus measure, but strong political and social pressure may arise as these monies are often used for public services that attempt to combat inequality.

Higher debt and economic stagnation help to explain why “fiscal crises” are the top-rated risk for businesses globally over the next 10 years—according to our Executive Opinion Survey.\textsuperscript{27} In the current global context, weak public finances have two implications: they jeopardize whatever remaining margin governments have to address a recession, and they could aggravate already hard-felt social tensions.
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(see 2019 Regional Risks for Doing Business report). The world learned from the European sovereign debt crisis that drastic fiscal corrections and public austerity measures can shrink the welfare state with political and social consequences that many governments would be neither willing nor able to incur. However, if the combination of a prolonged economic slowdown and a public finance crisis pressures governments into spending to address citizens’ immediate needs, they will be left with little margin for investment to confront the slowdown.

Vulnerable societies

Compounding the economic risk factors that are manifesting is a widespread domestic discontent with current economic systems, perceived to be rigged and unfair.

Recent social upheaval

Concern about inequality underlies recent social unrest on almost every continent, although it may be sparked by different tipping points—such as corruption, constitutional breaches, or the rise in prices for basic goods and services. Although global inequality has declined over the past three decades, domestic income inequality has risen in many countries—particularly in advanced economies—and reached historical highs in some. The OECD reports that “income inequality in OECD countries is at its highest level for the past half century.”

Many of those protesting have long been excluded from their country’s wealth and share frustration that the elite have captured gains at the expense of others.

In Chile, for example, a 3% increase in metro fares triggered violent demonstrations, forcing the government...
Economic growth, political will and social stability are fundamental for a model of “stakeholder capitalism”

to change its policy. Chile is one of the fastest growing and most stable Latin American economies, and it is becoming less unequal: its Gini coefficient—the most widely used measure of income inequality—fell from 0.57 in 1990 to 0.47 in 2017. Nonetheless, it still has the second highest Gini coefficient among OECD members, well above the OECD average of 0.32. In Hong Kong, the recent months-long demonstrations on political issues have also been aggravated by inequality: at 0.54, Hong Kong’s Gini coefficient is at its highest level in 45 years, significantly above those of China (0.39) or the United States (0.42). As Andrew Sheng and Xiao Geng have argued, “a powerful, but oft-ignored factor underlying the frustrations of Hong Kong’s people is inequality.”

In Lebanon, where the Gini coefficient is 0.51, nation-wide protests were triggered by the government’s decision to impose a tax on the popular communication app WhatsApp. In Iraq, protests began in October—mostly led by people from the disenfranchised working class and middle-income groups—over issues of corruption, unemployment and demands for access to basic public services.

Economic and political consequences
Inequality hinders growth and damages macroeconomic fundamentals, as the IMF has pointed out: it slows down economic activities and casts doubt on a country’s stability. This damages investor confidence and undermines political capital—both fundamental conditions for prosperity, especially in times of economic volatility. In France, for example, the persistence of the “gilets jaunes” movement had caused businesses more than US$11.4 billion in losses by December 2019 and complicated the government’s plans for economic revival. At the time of writing this report, growth in France was expected to slow from 1.7% in 2018 to 1.3% in 2020. The protests in Chile cost businesses over US$1.4 billion and forced the government to cancel the Asia-Pacific Economic Cooperation (APEC) and COP25 summits scheduled to take place in Santiago. Hong Kong’s economy contracted by 3.2% in the third quarter of 2019, with the Government Economist stating that “local social incidents dealt [it] a very severe blow”.

The profound political consequences of inequality can also undermine economic growth by making a country harder to govern—in ways ranging from legislative impasses to complete government paralysis. This risk is accentuated by the decentralized and spontaneous nature of recent demonstrations: with pop-up protests, it is difficult for governments to negotiate with demonstrators and develop concrete measures to meet their demands. During 2019, distinctive issues exacerbated by inequality forced the reshuffling of the entire presidential cabinet in Chile and the resignation of the heads of state in Bolivia, Iraq and Lebanon.

According to our expert community, “domestic political polarization” is the second risk most likely to increase in 2020—up from ninth in 2019. Our global business community also ranked “failure of national governance” as the sixth most concerning risk for doing business over the next 10 years.

Stakeholder capitalism
The World Economic Forum has argued since 1970 for the need to consider social well-being alongside economic gains. Unless the global economic system is reformed to be more socially conscious, the twin risks of prolonged slowdown and stronger defiance towards the current economic model will continue to exacerbate each other. Economic growth, political will and social stability will be fundamental to ensure a prompt and smooth transition to a more cohesive and sustainable model of “stakeholder capitalism”.
Notes


8. Ibid.


17. Ibid.


27 This is the survey that feeds into the Forum’s annual Global Competitiveness Report. It was conducted between January and April 2019 and received 12,879 responses.


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