

# 2012: another year of living dangerously

*It is always possible to envisage threats to economic and political stability, but the next 12 months look likely to harbour many unhappy surprises, says David Rowe*

Having started my career as a would-be economic forecaster just six weeks before the first successful Arab oil embargo in October 1973, I have seen a good deal of political and economic upheaval over the years. Never before, however, have I felt a time to be fraught with as many fundamental uncertainties as we face today. A whistle-stop tour of the globe will illustrate my point.

In the Middle East we have the uncertainty unleashed by the Arab Spring – the latest chapter in the longer-running struggle within some Islamic countries over how to interact with the technical, cultural and political changes elsewhere in the world. To raise the stakes, this drama is playing out in a region that is a major source of the world's energy.

Moving east, Russia will see the transition to the second presidential era of Vladimir Putin. In some respects it can be argued that this reduces uncertainty by removing any doubt about who is in charge – although even when Putin was merely the prime minister, there was relatively little debate. But Putin's United Russia party performed surprisingly poorly during December's parliamentary vote, despite blatant vote-rigging that triggered the biggest protests since he came to power at the turn of the century. A further risk is the Russian economy's continuing dependence on oil prices. A global recession with a major fall in oil prices could trigger significant internal political unrest, as Russian public finances suffer constraints not seen in years.

China is facing its most significant political transition since Deng Xiao Ping faced down the Gang of Four during the late 1970s.

The last two regimes involved leaders that were hand-picked and groomed by Deng himself. Xi Jinping and Li Keqiang – widely seen as China's next president and prime minister – are the first new leaders not directly chosen in this way.

Whether they can establish and maintain their authority remains uncertain, and they will take power as a burgeoning middle class is finding its political voice.

Moving across the Pacific, the US will conduct a presidential election characterised by

a bigger philosophical divide than we have seen since the election of 1980. In 2008, Barack Obama ran a masterful but largely aspirational campaign, and the coming election will be a referendum on his administration's record. The outcome will have a substantial impact on the full range of US policy in coming years and the result will remain uncertain until November.

Finally, we have the unfolding eurozone crisis – arguably the most immediate and serious threat to the world economy. Yoking countries as varied as Germany and Greece in a monetary union – without a corresponding fiscal or political union – was always a high-stakes gamble. Removal of the safety valve of devaluation was supposed to ensure healthy fiscal discipline in countries where it had traditionally been in short supply. In fact, a stable currency and historically low interest rates had the opposite effect.

Now the eurozone countries face a situation where the demands of fiscal austerity in the south, combined with the burden of fiscal subsidies in the north – especially Germany – look to be incompatible with popular opinion and representative political institutions. Something has to give. Many believe Europe can muddle through, but the mercurial nature of market opinion is hard to manage – confidence in the fiscal responsibility of many eurozone countries has been severely damaged and will be slow to restore. Nor will any political fix resolve the competitive disadvantage facing Greece and other southern European countries relative to Germany. If the euro remains intact, a grinding and divisive internal devaluation, forcing down nominal wages and prices in the south, will be a prolonged process – if it is possible at all.

Lest Americans think this is a purely European problem, consider three things: first, Europe is a major source of demand for US exports; second, many US firms have substantial European operations, the earnings of which will be seriously affected by a major upheaval there; and as argued last month, US banks may well suffer losses from wrong-way risk on credit default swap protection purchased from European banks (*Risk* November 2011, page 70, [www.risk.net/2125869](http://www.risk.net/2125869)).

In brief, close attention to structural issues will be increasingly important as the year unfolds. Detailed statistical analysis will be less powerful than judgement, experience and common sense, as we try to manage risk in this era of fundamental uncertainty. ■

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