

Briefing Note #6

A riskier world need not be full of fear

THE NEW PUBLIC FINANCE IS UNLEASHING IMAGINATIVE TOOLS FOR BETTER RISK MANAGEMENT.

Open borders increase the risks that countries, organizations and people face and reduce their control over potentially adverse outcomes. A well-managed country may be in economic trouble because of a financial crisis in a neighboring country. Or because of the disorganized unraveling of macroeconomic imbalances in the world economy. Or because the price of a key commodity like oil relentlessly increases. Or because its main export destination undergoes a recession. Add the risks of natural disasters, pandemics, international terrorism and environmental degradation, and it is no surprise that open borders often inspire fear.

Yet the opening of borders is an entirely purposeful and man-made process. The path to economic openness is an option, not a requirement. The gains from globalization have propelled the opening of borders, leading to the current stage of deep interdependence. But the perceptions of the risks and the awareness of possibly adverse outcomes generate demand for a better managed, less volatile and less crisis-prone globalization.

Rather than retreat and close down borders, this new era of globalization appears to be characterized by selective management of borders. Countries are also using better tools to protect against risks—tools that not only protect people, organizations and countries but enhance risk management.

Risk management does not eliminate risk. It allocates a portion of risk to an entity that agrees to bear it in exchange for a payment for doing so. This is similar to how insurance works, with insurance companies agreeing to compensate individuals and firms for all sorts of adverse outcomes in exchange for the payment of a premium.

The tools emerging for better risk management are part of the new public finance. They draw on the opportunities posed by open borders and the partnering between public and private actors to protect people and countries.

One example is sovereign bond issuance with repayments linked to the economic performance of the issuing country—as measured by its economic growth or income. When the country is underperforming—or in a recession—the repayments are reduced or stopped. When it is overperforming, the repayments are increased. When it is affected by a neighboring nation's financial crises or a drop in demand for its exports through no

* *The New Public Finance: Responding to Global Challenges* (edited by Inge Kaul and Pedro Conceição; New York: Oxford University Press, 2006).

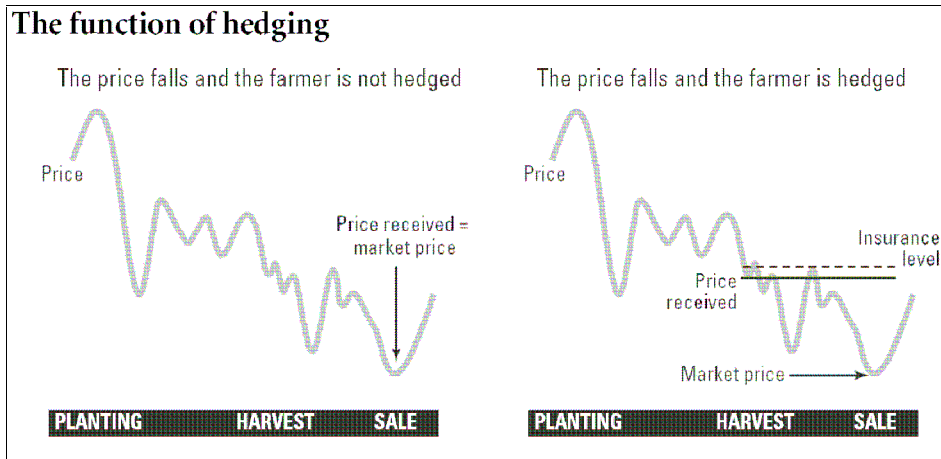
fault of its own, the indexed bonds work as an insurance policy for the country. Bondholders bear some of the risk that the economy will underperform. By promising to forgo repayments when the country is under economic stress, they provide the country with more resources to address its economic goals.

In a closed world, this tool would probably be ineffective—a country could only sell its bonds domestically. Stopping payments to domestic investors would likely not help (and could worsen) a recession. But with open borders, the investors taking this risk trade in international capital markets. They ask for some compensation for taking on the risk, but not an onerous amount because the structure of the bond has an upside if the country's performance improves. For the government, this reduces debt payments when the country is under stress. Governments and private actors are, even if tacitly, partnering in a decentralized arrangement to share some risks linked to the country's economic performance.

Similar arrangements could protect people against drops in the value of real estate—since most people's main economic asset is their house—or in the income in one set of occupations. Similarly, bond repayments could be indexed to events—such as a natural disaster. In that case, a country would see its debt repayments reduced or stopped if it were affected. This type of instrument is already in the market in the form of catastrophe bonds, typically issued by reinsurance companies to allow them more leeway to pay insurers in the event of a catastrophic event. This is attractive, given that the insured losses from catastrophic events have increased steadily over the last 50 years (see figure).



Enhanced risk management can also be achieved by relying on financial markets for derivatives. For example, to mitigate the risks of price volatility, a commodity producer can hedge by asking investors to bear some of the adverse risks through a future or option contract at a fixed price at a certain time (see figure).



The lesson is that where risks are rooted in the functioning of the world economy and are global in scale, they are often too big for any one government, or even a group of governments, to bear. The expanding and deepening financial and insurance markets are better equipped to handle these challenges—to spread and share risks so that they do not overwhelm and destroy anyone.

The emerging tools for risk management are based on cooperation between states and global markets, with markets often replacing national or intergovernmental policy tools. Consider protection against commodity price volatility. In earlier times, the major tool was a national buffer stock. Then came intergovernmental commodity agreements (most now defunct). Today states are exploring futures and options markets or the commodity indexation of sovereign bonds. In combination with weather insurance and economic diversification, these tools help the nation and the individual producer to smooth income and prevent crises.

About the book

The New Public Finance: Responding to Global Challenges is published by Oxford University Press for the United Nations Development Programme (UNDP).

For more background information visit: www.thenewpublicfinance.org

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