

THE BIG PICTURE

Strategic Risks and Uncertainty in a Changing World

Strategic planning is a vital board responsibility. To add value it needs to position the organisation astutely for the medium to long term which, in some businesses with long life assets and commitments, can mean working to a 10 or 20 year plus horizon and grappling with large, complex and difficult issues. Now is not only an unusually uncertain time but also one of high risks and potentially major shifts. This paper considers a range of these issues, some of which are critical for New Zealand's future.

GLOBAL

Power and leadership

Major economic, political, environmental, social and conflict issues, ranging from the global financial crisis to terrorism, sustainability and climate change, merit attention because of their potential impact on the business environment, either directly or through government policies.

The US, since at least the Second World War, has often provided global leadership on important issues. Its Marshall Plan was a major factor in the post-war reconstruction of Europe, it assisted the development of new economic and political institutions and of trade, financial and other markets. It built a bridge with China, won the Cold War, and has been the dominant economy, an advocate of economic development and democracy and something of a global policeman.

Now, however, there are indications of significant shifts amongst regions and countries, reflecting politics, capability and performance. The credibility and leadership credentials of the US have been eroded over several decades by its poor judgment, major systemic failures and inability to achieve key goals. Failures include the Vietnam War, the Middle East peace process, Iraq, Afghanistan, ENRON, Lehman Brothers, the 'irrational exuberance' bubble economy and the global financial crisis (GFC). They all reflect major failures of accountability, judgment and ethics amongst politicians, officials, policy makers, regulators, corporate managers and directors of major institutions, the military and markets themselves.

The policy response to ENRON et al, including Sarbanes Oxley, was intended to prevent any repetition, yet less than a decade later the US-led bubble economy and the GFC were even larger failures, on a scale that fundamentally threatened the whole global financial system, did enormous damage in many countries and will continue to affect the global economy for many more years. A key question now is which countries will lead internationally in the future and what will their

agenda be? Also can the US restore its capability, effectiveness and credibility? US politics, attitudes and values suggest that this will be a big ask.

Moreover, the US Federal debt is now some \$12 trillion, about 85% of GDP, the budget deficit is forecast at 13.5% of GDP in 2009 and \$9 trillion over the next ten years and the net present value of unfunded federal liabilities for retirement and health care are an estimated, \$99 trillion (Dallas Federal Reserve). How will the deficits be funded and how will short-term domestic political interests be balanced, prudently and responsibly, against longer-term and international issues? There are no grounds for complacency here!

Meanwhile, a number of other countries have demonstrated an increasing dynamism, independence, capability and astuteness in managing their affairs and achieving their objectives – China in particular – while Japan and Europe may also be losing their effectiveness, preoccupied or constrained by internal challenges. Japan's debt is now 170% of GDP, reflecting health and welfare spending on an ageing population and protracted economic stimulus efforts. There is the basis now for a serious shift in the nature of global power and institutions and in the influence and power of countries in a new world order.

Economy

The US share of the world economy was relatively stable between 1970 and 2007, boosted by the bubble economy. In contrast, Western Europe's relatively low growth rate reduced its share of world GDP from 34% to 25%, while Asia's relatively high growth rate increased its share from 19% to 28%. China's share was 1% in 1970 but 6% in 2007 and the third largest economy after Japan which has been stalled for a decade.

Since 1990, more economies experienced higher rates of economic growth. While the US, Canada and Western Europe grew at about 4% and Japan 2% the former Soviet Union economies averaged over 6% with many in the 7%-10% range, the Middle East 6%, Asia (excluding China) 7% and China 12%. The top 20 countries in Africa averaged 5% and in South America 6%. The BRIC economies (Brazil, Russia, India and China) grew by 300% 1990 to 2007, but the USA, Japan, UK France, Germany and Italy by only 100%.

These shifts in growth rates are significant, but then the GFC intervened, causing carnage in markets and recession. Key questions now are: will global growth recover quickly and recent growth trends continue or will GFC fallout, increased debts and adjustments to global imbalances – in trade and capital markets in particular – cause slowing, dislocation or serious recession? Expert views are seriously divided.

Is the GFC over? No. There are many aspects still to be worked through and there has been little progress in reforming financial markets and their regulation. While many markets have recovered from their crisis, international trade volumes are down 20%, many goods and services markets remain weak and unemployment is rising. Large government stimulatory packages have had a big impact but cannot be sustained and some high government debt levels already have serious implications for the future. So from a strategic viewpoint, forming a view on future economic performance is a serious challenge!

Environment

There are an unprecedented number of serious environmental issues now in focus, including climate change, water, energy, resource sustainability, oceans, pollution and waste disposal, which could have major strategic implications for business. Climate change is a good example.

There are many indications of a changing world climate. The causes and effects are not clearly understood, but could be serious for the earth's inhabitants and economy. There is intense debate on policy options and a range of divergent, often strongly held views. Resolving the scientific uncertainties will take many years and delay will lose valuable time.

There are strong pressures in some countries for politicians to act quickly and decisively, even though the level of uncertainty means high policy risks. There are also major differences amongst countries on what should be done and who should pay, but it is a global issue which needs a global solution. This is a very high risk situation. New Zealanders are flirting with policy options which are betting their futures. Many do not appreciate this as they pressure politicians to lead the world and take bold decisions quickly, in spite of a fragile economy.

Is the necessary level of international leadership and cooperation likely? Is there any policy response that will be effective? After the GFC what is the capacity and willingness of the wealthy economies to meet the cost, especially a higher cost to assist less well off countries? Similar complexities apply to other challenging and important environmental issues. In most cases the alternative to timely and effective policy is serious damage – depletion of fish stocks or other resources, damaging pollution etc, so how are these to be factored into a business strategy?

Politics

Domestic politics are not only affecting domestic policies but also the engagement and effectiveness of countries internationally. In the 'old democracies', including New Zealand, there is increasing tension between what the electorate will support and what is needed for its future security and prosperity. Many electorates are growing more slowly, have ageing populations, diminished retirement funds, weaker tax bases and sharply rising government

debt. This means strong pressure for short-term economic stimulus and welfare and health expenditure at the expense of future economic development and international initiatives and cooperation.

This picture contrasts with many of the 'developing' and less democratic economies where policy is less dependent on the will of the electorate in the short term. China, for example, in spite of its many challenges, appears to have benefited in recent years from reasonably decisive and astute decision-making on economic and other issues. Perhaps another aspect of significant shift amongst countries with important implications for the future!

Conflict

Terrorism and insurgency are serious threats which have increased the cost, complexity and risk of doing business. Examples are tighter border controls on people and goods, resource access issues and higher prices, controls on trade in sensitive materials and products, intensive anti money-laundering processes, piracy and tighter security generally. They also put a premium on the ability to engage, influence and project power effectively, to ensure access to trade routes and resources, adequate security and the safety of citizens.

It is a serious concern that NATO (including the USA) countries have been fairly ineffective against insurgency, the now-prevalent form of conflict. Often reluctant to engage, they have demonstrated their technological capability, often with heavy collateral damage, but the lack of effective follow-through has meant ultimate failure.

Vietnam was a comprehensive military and political defeat for the USA - incompetent leadership fighting the wrong war. It caused heavy collateral damage and had a searing impact on US politics and the military. Similarly with Somalia and Bosnia, Afghanistan and Iraq - the same tactical and leadership mistakes were repeated - and an unwillingness to plan and commit the resources needed to succeed with the critical, post-shooting aftermath. Iraq is a 'fiasco' according to Thomas E Ricks (1) and the US and its allies are proving equally ineffective in Afghanistan. They have not developed a 'poppy' strategy - if you eradicate the opium industry, what is the replacement economy? Yet both Iraq and Afghanistan are key elements in important regions where the stakes are high.

Critically, the US military establishment is not a learning organisation. The 'lessons learned' processes do not influence the overall system and promotion processes undervalue capability and entrench the status quo. So, can NATO, including the US, successfully protect their interests and achieve their objectives, including access to resources (oil) and control of insurgency, in a fractious and challenging world? The clear conclusion of recent decades is 'no'. And how will higher debt levels affect their willingness to engage? In contrast, Iran for

example, has for several decades pursued a low-profile, fit-for-purpose and effective strategy to increase its influence in the Middle East and control over oil and gas resources and logistics.

NEW ZEALAND

New Zealand's economic decline will almost certainly continue. Low productivity and weak competitiveness will constrain exports, living standards and policy choices. Low saving and continuing external deficits will increase the already excessive net foreign liabilities, dependence on foreign capital, foreign control and vulnerability to market shocks. Government expenditure is excessive – almost at 50% of GDP – and public service performance limitations inhibit improvement.

The State's ability to provide for health, education, welfare, environmental protection, and law and order will be increasingly limited by the weak economy and tax base. Government revenue to fund services and subsidies to the bulk of the population will undermine New Zealand's competitiveness and the ability or willingness of the small proportion of substantial tax payers to continue in that role. Its international ranking in terms of living standards will continue to decline. This outlook is predictable. It simply reflects the continuation of established trends which reflect a well established destructive nexus between the electorate and the needs of a viable and prosperous economy.

Persistently low productivity growth (about half Australia's) means low incomes for many voters, low taxes and a net annual financial benefit from government expenditure. These voters predictably prefer increased government spending to tax cuts. Specifically, 15% of personal income tax payers pay more than 60% of personal income tax but 58% pay only 15%. Reflecting this, about a quarter of tax payers pay enough income tax and GST annually to cover their share of current government expenditure. This means about 70% get a subsidy from the small proportion of substantial tax payers, leaving inadequate tax revenue to invest in higher productivity and a stronger economy.

Such circumstances seriously constrain policy options and explain why governments which want to be re-elected ignore the vital economic issues in favour of increased spending on social and environmental initiatives and reject tax cuts. *Working for Families* was introduced simply to compensate for the disastrous consequences of these policies for productivity, incomes and living standards. Increasing external obligations compensate for External deficits and inadequate savings. This situation is unsustainable.

This paradigm is now strongly rooted. It will take exceptional leadership and commitment to change it – but we are getting what we voted for. Labour-led governments exploited this situation and demonstrated little or no economic leadership. The Key government, having inherited the consequences, is struggling to deal with them responsibly – and avoid being a one-term government.

The Douglas policies are a critical indicator. They are the only serious attempt at real economic reform but the electorate, most media and ‘opinion leaders’ reject such policies with a phobic aversion, as did the outgoing government, which talked about economic policy but effectively did nothing. Trade agreements were good politics but of little value without a competitive economy. This approach avoided scaring voters while riding a boom, building an asset bubble, excessive household debt and high risk external obligations, while the fundamentals of the economy eroded. In a strategic planning context this all has rather serious implications for the future of business in New Zealand.

CONCLUSIONS

It is a daunting time for change, risk and strategic planning, but also one of exciting opportunities. Even forecasting economic growth is fraught, but potentially big shifts amongst nations with their power and influence, and large environmental, political and conflict issues, represent both threats and opportunities for the world. In contrast, New Zealand’s outlook seems all too predictable.

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1. *Fiasco – The US Military Adventure in Iraq*, Thomas E Ricks, 2008