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A Continuous Quest for Economic Balance

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As the economic crisis dies down, its full ramifications are still unclear — but it's becoming possible to see just what cracks the storm revealed in the foundations of national economies. Although countries around the world have experienced the crisis differently, and are recovering at varying rates, a single unifying element has left them vulnerable: Their economies are not sufficiently diversified.

That statement would probably come as a surprise to most of the national leaders responsible for economic development. After all, *economic diversification* has traditionally had a fairly narrow definition referring only to a country's mix of industries. Discussion of insufficiently diverse economies usually centers on countries whose entire industrial base relies on oil or another single resource, such as some nations in the Middle East, Africa, and Latin America.

However, even countries that appear extremely diversified — such as the United States — may still be vulnerable to unexpected events. Imagine that every country in the world falls along a continuum. At one end is a country with just a handful of companies producing a limited number of commodities, and sharing them with very few trading partners. Although such a country would be at severe risk of external shocks — for example, a sudden glut of one of its key products in global markets — the parameters of its economy are simple to track, and such threats are easy to predict.

At the other end of the continuum is a country with a fully diversified economy in every possible sense — in its exports, investments, industries, sources of spending, labor pool, technology, and knowledge. It has anticipated and accounted for every possible risk and diversified its assets so thoroughly that even a complete collapse in one area cannot significantly damage the whole.

Both of those countries are pretty safe from global economic risk. The exposed countries are those in the middle of the continuum; at present, that includes every country in the world. No single country has diversified its economy so completely that it will be protected from all shocks, but nearly all are so diverse, complex, and globally connected that they cannot fully anticipate each potential source of risk. In other words, although most nations aren't aware of it and most economic leaders believe the opposite to be true, global economies are simply not sufficiently diversified.

Exposing Over-Concentration

At present, there is little statistical data to prove the correlation between lack of diversification and economic instability, but the recent economic crisis has provided a plethora of anecdotal evidence that countries can be over-concentrated in any number of ways — with too

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much reliance on consumer spending, exports, small business, large companies, or foreign investment.

For example, in 2007, as the global crisis was about to break, Ireland's foreign trade (i.e., imports plus exports) was equal to roughly 150 percent of its GDP. The credit crunch of the following year and the recession in the economies of Ireland's major trading partners resulted in the collapse of its export growth. Real GDP contracted by 3 percent in 2008 and about 7 percent in 2009, and unemployment increased from 4.5 percent in 2007 to 12 percent in 2009. Today, it's clear that Ireland is doubly burdened: Its economic crisis has turned into a fiscal crisis, with over-concentration in the banking sector translating into major liabilities for the government as it was forced to bail out major institutions.

For other countries, such as the U.S. and U.K., the problem is another form of over-concentration: Rather than too much trade, these countries have an overdependence on domestic consumers whose purchasing activities are largely financed by debt. In the early days of the crisis, in 2008, consumption made up 71 percent of GDP in the U.S. — roughly six times the share of exports. Even during times of expansion, such economies are subject to seasonal swings and the whims of consumer behavior. During periods of economic contraction, when household income typically declines, consumer confidence plummets, with devastating effects; the fact that the U.S. economy is still bogged down with high unemployment and relatively low confidence is a case in point.

The slowdown in U.S. consumer spending has caused an inverse — although equally vexing — problem in countries such as China, Russia, and Germany, which all have a sizable percentage of their GDP tied to exports. In China, for example, 37 percent of GDP comes from export activity, mostly to a single trading partner: the United States. When the U.S. economy contracted in 2009 and its consumers slowed their purchasing, the economy in China suffered and the government was forced to spend considerable funds to stimulate domestic demand. The export issue is equally pronounced in Germany, which had 47 percent of its GDP tied to exports during the crisis in 2008. The appreciation of the euro that year caused a spike in the price of goods produced in Europe, and German exports contracted sharply. Although its export activity has recovered somewhat since then, and it has made an attempt to diversify in emerging markets, Germany is now becoming increasingly dependent on China, and any contraction in that market could have severe ramifications for German exports.

Other countries find their economies overly dependent on one kind of company, with their enterprise bases either consisting primarily of small businesses or dominated by a few large conglomerates — each of which presents its own problems. Italy, for example, has a preponderance of small and medium-sized companies: Roughly 95 percent of Italian companies fall into this category, and they employ more than 80 percent of the Italian labor force. These companies are the first to shed jobs during a recession, making the country less able to ride out downward trends in the business cycle.

And then there are countries with a disproportionate amount of economic activity tied to a few large companies, as demonstrated by the U.S. banks that undermined the national economy in 2008. In 1995, the five largest U.S. banks held 11 percent of total deposits; in 2009, they held 40 percent. The fact that these banks were too big to fail and were operating under a lax regulatory system made them a serious liability for the state. In South Korea, the chaebol system experienced financial difficulties in the late 1990s and dragged down the entire nation's economy. (See "What's a Chaebol to Do?" by Tariq Hussain, *s+b,* April 3, 2007.) Of the 30 largest chaebols (the Korean term for powerful, multinational conglomerates), 11 failed between 1997 and 1999; the Daewoo group collapsed with US$80 billion in debt, making it the largest corporate bankruptcy at the time. Many of the chaebols had taken on substantial debt to finance their expansion. In the aftermath of the crisis, when they could not service their debt, banks could neither foreclose nor write off bad loans without themselves collapsing.

Finally, some countries are over-concentrated in their sources of investment, particularly foreign direct investment (FDI). In Ireland, Bulgaria, and Estonia, FDI is a principal source of economic activity, making up a large share of GDP. This is problematic because FDI can fluctuate significantly from year to year, due to circumstances beyond a country's control. In Ireland, for instance, FDI constituted 2.2 percent of GDP in 2006, soared to 8.8 percent in 2007, and plummeted to –1.2 percent in 2008.

Iceland's recent economic woes stemmed in part from two FDI issues — an excessive reliance on such investments and the fact that these investments came from too few sources (primarily Belgium, Luxembourg, and the U.K.). Iceland also suffered from a lack of diversity in its industry base, having allowed its banking sector to dominate, which threw the overall economy out of balance. Bank liabilities increased more than fivefold from 2005 to 2008, and assets reached 10 times the size of the country's GDP. By 2008, the three largest Icelandic banks had $60 billion in debt, and the financial crisis triggered a depreciation in which the krona fell 98 percent against the euro. Only a $10 billion multinational aid effort and a $2 billion government injection averted a total economic meltdown in the country.

Achieving Balance

It is important to note that policymakers should not attempt to undermine or eliminate the elements that are at the heart of their countries' success. Large corporate conglomerates played a key role in the growth of South Korea's economy, the attraction of foreign investment was critical to Ireland's development, and China's exports launched its stratospheric growth. Instead of undermining them, policymakers should seek out counterbalances to these dominant influences to ensure they do not play a disproportionate role in the economy.

The fundamental question is whether the key elements of an economy are varied, flexible, and readily applicable to a variety of economic opportunities. The imperative for policymakers is not only to monitor these elements but also to continually seek out potential areas of over-concentration, including those that may not yet be evident.

This effort is an unending quest rather than a single hurdle. As policymakers attempt to address each area, they are reminiscent of a man attempting to hold back a bursting dam: Every time he plugs a leak in one place, another jet of water bursts through elsewhere. Instead of trying to stop the flow, he should be trying to understand how to redirect the rushing river in more productive ways. It's an enormous task: Seeking out the next potential source of over-concentration requires policymakers' continuous energy, attention, and action as they attempt to shield their economies from unnecessary risk.

Even as policymakers take a broader approach to diversification, moving beyond their industrial base, they must also take a deeper approach. For each single element of economic diversification, multiple ways to diversify can be found within that arena: If a country has expanded its export base to include a wide array of countries, is it shipping a broad enough selection of products to these countries? If it is exporting a diverse group of products, is it properly balancing its export portfolio among large and small companies? The permutations are very nearly endless.

Although no country has achieved complete diversification, some are farther along the continuum than others. Australia is a good example of a country that emerged relatively unscathed from the economic crisis thanks to its economic balance. Perhaps because of its geographic proximity to China and India, Australia saw the potential of these countries and began trading extensively with them and with other emerging markets prior to the economic crisis. As a result, Australia's trade portfolio was sufficiently diversified when the crisis began, allowing it to avoid the shock of being undermined by the collapse of a single trade partner. This diversity in its imports and exports had corollary effects on the economy; for instance, it led to diversity in the banking sector as institutions sought opportunities in emerging markets. As a result, Australia's financial system was spared the worst of the problems that affected banks in North America and Europe.

At the same time, Australia offers a cautionary tale about the need for constant vigilance. The country's exposure to emerging markets is growing steadily: China now accounts for more than a quarter of Australia's exports, and that percentage is still on the rise. It is not yet clear whether the growth shown by emerging markets for the last few years is truly sustainable; if those markets were to experience a crisis of their own, Australia would be left exposed. The government must be aware of this risk and must make a constant effort to avert this potential problem.

Comprehensive diversification is not simple to implement, because it requires ongoing calibration of every aspect of the national economy. Policymakers will need to be resolute in their determination to keep these risks under control, because properly managing the risks of over-concentration is critical to sustainable, long-term economic development. The global economic system is overly complex and becoming more so by the day. It may be difficult to begin the process of diversification now — but it could well be impossible in the future. +

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