INSURANCE FUTURES

Trade futures

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Unprecedented uncertainty hangs over international trade. While markets and multinationals are—understandably—fixated on the immediate prospects for trade relations between the US and China, far bigger long-term questions cloud the future. This is often simplistically framed as a binary question: is globalisation set to go into reverse? Or more politically, are the US and China heading for a new Cold War? But in practice, the future pattern of international trade could take many different forms over the next decade or two.

The huge expansion of international trade in recent decades has been driven by three G factors: globalising technology, government policy and geopolitics. Digital technologies have made many more services tradable and together with falling transport costs facilitated the development of complex international supply chains for the production of physical goods. Governments have opened markets and liberalised regulations, both unilaterally and through bilateral, regional and multilateral trade deals. A stable, rules-based, liberal international order led by the United States and anchored around the World Trade Organisation (WTO) has also prevailed. All three of these factors are now in flux.

Localising technology, localising systems?

For a start, technology may in future be localising as well as globalising. Vertical urban farms and locally produced synthetic alternatives to meat ('alt-meats') could trim agricultural trade. A shift to renewable energy could cut fossil-fuel trade. And if robots and artificial intelligence can take over many more human tasks, why rely so much on foreign factories in countries with cheaper labour? Thus trade in food, fuels and factory goods may fall, especially since these sectors are likely to continue shrinking as a share of the global economy, which is increasingly dominated by services and intangibles.

At the same time, the emergence of remote 3D manufacturing may herald a world in which trade in ideas and design soars, both in terms of value and production.[1] The range and volume of trade in digitally provided services may also continue to rise. Now that surgeons can operate remotely using robotic arms, even the archetypal local service—a haircut—could eventually be provided from afar too.[2]

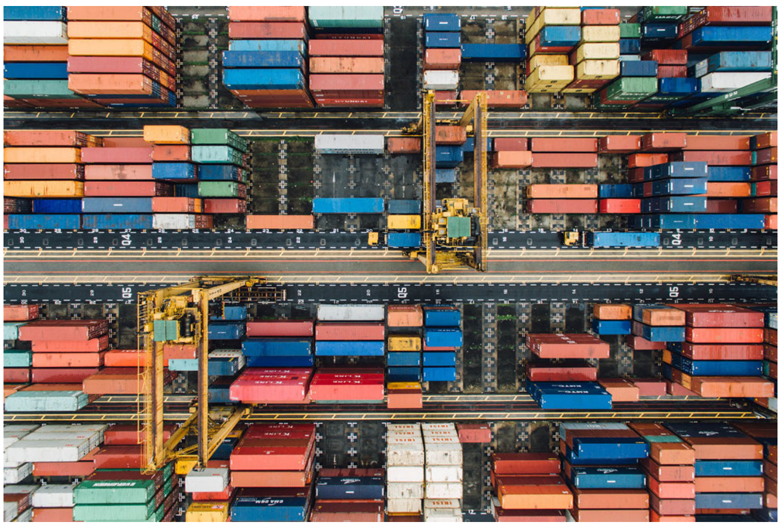
Multi-dimensional policy drivers

Government policy could accentuate or mitigate these technological shifts. Climate, digital, tax, immigration and, of course, trade policies could all have a localising impact, while the latter two could potentially have a globalising impact instead.

While it is plausible that measures to curb climate change in coming decades will be inadequate, it seems unlikely that governments will do nothing. Tougher climate measures could push up transport costs for trade in physical products and travel costs for international tourism. Changing public attitudes to travel and tourism may also, in the extreme, present existential risks to airlines. In addition, carbon border taxes—in the EU, for instance—might penalise imports from jurisdictions that fail to put a proper price on carbon emissions, such as, say, the US.

Governments everywhere are seeking to regulate the ever-growing and previously freewheeling digital economy. As they do, it becomes more likely that their disparate regulations will conflict and fragment the digital economy, affecting almost every business.

Businesses can already fall foul of countries' conflicting data-localisation requirements.[3] The EU's new General Data Protection Regulation (GDPR) also bans personal data flows—which in practice means almost all data flows—to jurisdictions deemed not to protect such data adequately. In part for domestic reasons but also because the US does not want the EU to set the global standard, the US seems likely to craft its own data-protection regulations. Meanwhile, the Chinese market is largely closed and other authoritarian regimes such as Russia are increasingly tempted to emulate elements of the Chinese model. Competition policy could also segment markets: if the European Commission decided that, say, Google ought to be broken up, it would most likely withdraw from operating in the EU instead.



Since almost all businesses are now reliant on data (as they are on electricity) governments' conflicting digital policies could impede all kinds of trade, with digital services hardest hit. Even local decisions can bite: witness many cities' curbs on Uber and Airbnb. However, the resulting Balkanisation of the digital economy could eventually spur governments to seek an international agreement to facilitate such trade and the EU to complete its single market in services.

Tax competition between different jurisdictions shapes the location of business activities, both real, such as where factories are built, and notional, notably where intellectual property (IP) rights and associated payments are attributed for tax purposes. In an era of high public debt and growing public disquiet in many countries about the tax-minimising profit-shifting of international companies, it seems plausible that governments will increasingly seek to increase their tax take, either unilaterally or in cooperation with their counterparts. This may redirect and decrease both real and notional levels of international trade, notably licenses and royalty payments to IP rights-holders nominally located in low-tax jurisdictions.

Immigration policies could also have a big impact. Trade in services often relies on people flows.[4] Sometimes producers, such as IT workers, management consultants, construction teams and foreign university campuses, move to provide services. In other cases consumers—such as tourists, patients and international students—do too. Digital technology, such as online university courses, for instance, may in future remove the need for many people to move, changing the means and location of internationally supplied services. Tighter immigration controls, on students or academics, may accentuate that; where alternative means of supply are not feasible or economical, they would reduce trade. Conversely, more flexible visa policies could open up new opportunities for international trade. For instance, Polish construction companies could bid for contracts to build American roads.

Last but not least, trade policy itself could also have a major impact. Increased import tariffs and quotas as well as greater use of trade-discriminatory standards, regulations and subsidies could impede all kinds of trade—as could security-motivated export restrictions and politically-motivated trade sanctions. Reduced barriers could facilitate it.

At a national level, the economic intermeshing fostered by global supply chains, the political power of business lobbies that benefit from them and the constraints of multilateral rules are all powerful obstacles to protectionism even in difficult times, as the post-crisis period shows. But they are not insuperable: nationalism and anti-establishment politics can overwhelm them. Even policy inaction can lead to an increase in trade barriers: as the mostly open manufacturing sector shrinks and more protected services sectors expand, the global economy becomes less open.

The scope for regional or multilateral action on trade depends largely on the broader geopolitical context, scenarios for which are presented below. But even in scenarios where the WTO collapses or the world splits into rival US and Chinese blocs, there will still be some scope for countries to pursue unilateral policy changes and bilateral trade agreements.

In short, many aspects of government policy could shape the pattern and volume of international trade. The policy choices are likely to differ country by country and indeed sector by sector depending on the political ideas, economic interests and intermediating institutions that hold sway. National policy choices will also be shaped by the broader, geopolitical context.

Geopolitical uncertainty

Perhaps the biggest uncertainty hanging over the future of international trade is geopolitical. The US is in relative decline. Nationalism is on the rise around the world. Moreover, the US has a protectionist, unilateralist president who believes that trade is zero sum, that America is losing and that he can extract better deals out of both allies and rivals by ignoring international rules and flexing his muscles, while the US is still dominant. As a result, the US-led liberal international order—the system of largely open markets, multilateral rules and institutions and security alliances, underpinned by American hegemony that has prevailed globally since the end of the Cold War—is crumbling.

Meanwhile, a new era of great-power rivalry is emerging between the US and a rising and increasingly assertive China, with trade and technology as key economic and security battlegrounds. Future scenarios range from the *collapse* of globalisation at one extreme to *cooperation* restored at the other, with strategic *competition* or *conflict* as intermediate possibilities.

Trade cooperation restored?

Start with the most benign scenario, cooperation restored. Trump's trade conflict with China might prove too costly for the US and largely ineffective in changing Chinese behaviour. Post-Trump America might therefore decide to cooperate with China to maintain the current rules-based system and prolong US influence as its power declines. China would continue to benefit from sustaining the openness and predictability of the multilateral trading system for now and bide its time in anticipation that it would be stronger in future. At the same time, both would seek to develop alternatives in case relations broke down again.

A cooperative scenario could give a new lease of life to the WTO, both as a dispute arbiter and as a negotiating forum. The prize would include a more open global economy, more stability and predictability for business and a greater say for smaller and weaker countries. Sustaining the cooperative scenario would require activist counter-cyclical macroeconomic policies, generous welfare safety nets and active retraining and regeneration policies to maintain political support for openness. Even in a broadly liberal global environment, however, the combined impact of localising technology, technocratic climate policy and an increased taste for services could all limit many kinds of trade.

At the same time, both the US and China would likely wish to pursue their competing regional and bilateral trade initiatives. The US might rejoin the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP). It might also pursue a free-trade agreement with the EU. Meanwhile, China would press forward with the Regional Comprehensive Economic Partnership (RCEP), a China-centred Asian free-trade agreement. More broadly, it would continue to develop trade, finance and infrastructure ties with a wide range of partners in Eurasia and beyond through the Belt and Road Initiative (BRI).

While such a cooperative scenario would be highly appealing to liberal internationalists and global businesses, there are good reasons to think post-Trump US-China relations may be less cooperative. While they may disagree with Trump's tactics, a broader consensus has formed among American elites that an authoritarian and mercantilist China needs to be confronted and contained. And unless China's development is derailed by its demographic ageing, a financial crisis or indeed a political one, the global power shift looks set to continue, increasing future US administrations' sense of vulnerability.

History highlights that when a declining hegemon is challenged by a rising power, the chances of conflict and chaos are high. War between the US and China is certainly not inevitable; *pace* Graham Allison, our nuclear age is very different to the world of ancient Athens and Sparta.[5] Even so, increased geopolitical conflict seems likely, as the essay on geopolitics in this collection suggests. Moreover, as Robert Kagan observes, as the liberal order underpinned by American hegemony retreats, the jungle grows back.[6] Even the least antagonistic geopolitical power shift, from the British Empire to the American Republic, led to the breakdown of the international system in the first half of the 20th century.

The collapse of globalisation?

An alternative scenario is that international order could collapse and with it the international trading system, as in the 1930s. Conscious of its relative decline, an increasingly protectionist and isolationist US might step back from providing global public goods to focus on domestic priorities. Meanwhile, China may not yet be willing or able to fill the vacuum.

Like the inter-war League of Nations, the WTO would fall into disuse. Without an independent means of settling trade disputes, and political pressure from greater powers to do so, trade wars would erupt; the recent escalation of the conflict between Japan and South Korea may be a foretaste of that. Economic pain and political nationalism would feed on each other. Policy and technology would renationalise production.

In between the two extreme scenarios of cooperation and collapse are two more nuanced ones that involve changes to the current model of globalisation but not its collapse: strategic competition between the US and China, and strategic conflict.

Strategic competition?

Strategic competition would involve increased tensions between great powers and more restrictions on their interactions, on technology transfer for instance. But some or even much of their economic and financial interdependence might be maintained. Global institutions such as the WTO would be weakened, but US- and China-centred regional and bilateral arrangements could overlap. Other regional blocs such as the European Union could continue to pursue independent trade policies.

Such a scenario is compatible with continued nationalism. While this is often associated with protectionism, as with Trump's America First stance, it can also sustain some degree of openness if access to international capital, imports and technology are deemed vital to strengthen a state's economic power, as is true to some extent of China.

Strategic conflict?

In contrast, strategic conflict would entail two rival blocs in trade, investment, technology, payments systems and security arrangements. This new Cold War might even become hot. Unlike the Cold War with the Soviet Union, this would be very disruptive economically, since it would rupture the existing ties between the US and China. But international economic integration within blocs would survive and might deepen. Businesses would need to reshape supply chains, financing, hiring and much else.

For smaller countries caught between the two giants, their rivalry could have upsides. Whereas in the era of American hegemony, there was no-one else to turn to, it might be possible to play off the superpowers against each other, as some countries did during the Cold War.

The danger though is that both countries and businesses might be forced to choose sides. The huge US pressure on foreign governments and businesses to stop doing business with the Chinese technology company Huawei to build their crucial 5G telecoms networks is a foretaste of this. So is the updated trade deal that the US has struck with Mexico and Canada, which precludes them striking deals with China.

Choosing sides would be particularly difficult for countries in Asia-Pacific that trade primarily with China, but which currently enjoy a security relationship with the US. Further considerations would include how the relative strengths of the US and China are likely to evolve within the region and globally, and what strings are attached to joining each camp.

Implications for the insurance industry

The uncertainty that clouds the future of international trade has important implications for the insurance industry. It will affect the demand for particular insurance products and their pricing. It will impact both the asset and the liability side of insurers' balance sheets. It will create new risks that may be neglected or poorly understood, as well as systemic uncertainty that, by definition, does not conform to a known probability distribution. Successfully navigating these choppy waters and potentially disruptive storms will require new sources of data and new models for thinking about the future.

Some potential changes are relatively easy to prepare for and adjust to. A decline in trade in physical goods, for instance, would reduce demand for trade credit insurance.

Others would require greater adjustments. Except in the scenario of cooperation restored, increased geopolitical uncertainty is likely to stimulate much greater demand for political risk insurance. Many businesses would face increased risks of supply-chain disruption, licensing issues, being left with stranded assets or indeed government expropriation. As the example of Canadian executives detained in China in retaliation for the arrest of Huawei's CFO in Canada shows, such risks extend to company executives too. While this offers huge and potentially lucrative opportunities for savvy insurers, the challenge will be how to price risks accurately.

In a world of increased geopolitical uncertainty, an increase in the size and frequency of insured losses is likely. To cope with this, insurers will need to be better capitalised, have better financial planning and where possible lay off more risks with reinsurers and markets.

Geopolitical uncertainty will also affect insurers' investment portfolios. Trade disruptions could spark financial crises. While US Treasuries have traditionally been a safe haven in a crisis, rupture with China would accelerate the development of alternatives to the US dollar. A breakdown in international cooperation would also undermine the collective action by the authorities of major countries in the G-20 that limited the global damage from the 2008-9 financial crisis.

The changing trade context will also affect the competitive landscape for the insurance industry. While digital technologies are likely to facilitate the development of new competitors to established Western insurers, protectionism, digital regulation and other regulatory barriers could segment markets. If globalisation collapses or strategic conflict between the US and China develops, the scope of international competition and the opportunities for international expansion will be reduced.

To successfully navigate such an increasingly uncertain world, the insurance industry will need to draw on new sources of data and new ways of thinking about the future. Data gleaned by AI can give an early warning of weak signals that hint at future business and political risks. More detailed and regularly updated scenario planning can better map risks and uncertainty. More strategic thinking can bolster business resilience and profitability.

Conclusion

To conclude, technology, policy and geopolitics will continue to frame the future of international trade, but very different scenarios are possible. In 'Walled Gardens', we explore a hyper-localised world in which trade is dominated by intellectual property and local manufacturing production. Cross-border licensing of ideas, patents and designs in everything from synthetic food to buildings would create a fundamental shift in which air and shipping volumes decline.

Since businesses cannot prepare for every eventuality, it is essential to build in resilience: the ability to cope with a wide range of circumstances. The guiding principle that pervades this series of essays is that a portfolio of imaginative options that pay off in even the most extreme possible future scenarios are vital. Long-term foresight and flexibility are also key. The sooner you know that changes may be coming, the better you can prepare and the faster you can adapt.

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About the author

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