



## Globalization Keynote

- Speaker: **Niall Ferguson**, William Ziegler Professor of Business Administration, HBS; Laurence A. Tisch Professor of History, Harvard University

### Overview

Neither globalization nor financial crises are new. What may be new is that today's highly efficient global financial system is so optimized that it appears vulnerable when unexpected events occur, which they invariably do.

While most people seem surprised when financial crises take place, they shouldn't be. Taking a long view of history—such as 100 years or more—shows that financial crises and unexpected events occur frequently. While most business leaders have not personally experienced a major financial crisis, they should consider history when developing their strategies, plans, and models, and should keep in mind that outlier events occur. When such events do occur, the consequences are often immediate and significant.

### Context

Professor Ferguson offered a historian's view on globalization and on the current financial crisis.

### Key Takeaways

- **One's perspective on globalization is based on the map that is used.**

There is not one map of the world, but many different maps, each of which tells a different story. There are geographic maps, which show land mass; maps that show the populations of each country; and maps that show relative GDPs (which show that wealth is not synonymous with population).

But perhaps the maps that best illustrate globalization are those that show transport lanes—through which physical goods flow around the world—and maps of submarine cables, through which information flows. It is the network of transport lanes and cables that truly connects the world.

*"Globalization is about connectivity and integration."*

— Niall Ferguson

- **Globalization isn't new, but globalization today has both similarities to and differences from 100 years ago.**

When Harvard Business School was founded 100 years ago, there was in fact globalization; it was an era of Anglo globalization as the British Empire governed (directly or indirectly) about 25% of the world. Using sea lanes, there was significant global trade, there was significant financial integration, and it was a wired world that was connected by telegraph lines. In the late 1800s and early 1900s, the speed of moving information increased dramatically, while the cost of moving information fell equally dramatically.

Important similarities between globalization today and 100 years ago include:

- *Free trade.* Despite the restrictions that exist, there is trade of goods and services.
- *Free capital markets.* Then as now, the world is financially integrated and capital flows around the globe.
- *Migration of labor.* Labor continues to move, often through mass migrations. However, 100 years ago, labor was moving away from Europe; today labor is migrating to Europe.

Important differences include:

- *Dominant world power.* As it was 100 years ago, the dominant power is English-speaking: 100 years ago it was England; today it is the United States.
- *Behavior of the dominant world power.* England was a "saver" and the United States is a spender/consumer. (England was viewed as the saver of last resort; the United States is the consumer of last resort.)
- *Currency.* Money was gold 100 years ago. Today, there are currencies with floating exchange rates.
- *Foreign direct investment.* FDI was less important 100 years ago, but is extremely important today in how companies do business in international markets.
- *Institutions.* One hundred years ago, there was no global framework for international trade. Today, there are entities such as the World Trade Organization and the World Bank that work to facilitate global trade.

- **Optimized global networks may be vulnerable to crises.**

The current financial crisis and the series of previous crises over the past century raise the question: Is globalization chronically crisis prone? Further, is a downside of globalization that the market periodically blows up?

Over the past 100 years, there have been two major economic crises: the Great Depression, from 1929 to 1937; and the stagflation of the 1970s. It appears that the current financial crisis will be an equally significant and perhaps even greater crisis. In addition, there have been other economic crises over the past 100 years, with a significant crisis occurring every 10 to 20 years. (In the past 100 years, there have been six years when the S&P index declined by more than 20%: 1917, 1930, 1931, 1937, 1974, and 2002; 2008 could be the 7th such year.)

It may be that as financial markets and global supply chains have been driven to maximize efficiency, they have become more fragile. Author Nassim Nicholas Taleb has written that "a flat world is over-optimized to maximum vulnerability." The interconnected, globalized world may work well in normal, stable times. But because this world has no slack, if/when the expected occurs—which it invariably does—crises result.



*"This [a global network where efficiency is maximized] may be the Achilles heel of globalization."*

— Niall Ferguson

- **Business and political leaders are often surprised by crises; they don't take a long enough view of history.**

Despite the fact that economic crises occur every 10 to 20 years, leaders seem to always be taken by surprise.

*"Financial crises are more frequent than we expect them to be, happening roughly every 10 to 20 years."*

— Niall Ferguson

One reason may be attributed to a "black swan" way of thinking. Because most people have never personally seen a black swan, they have a tough time actually believing that such a swan even exists. So too is the case with financial crises: people have a difficult time imagining events that they have not experienced personally.

However, people's personal experiences are limited. Take, for example, the duration of the careers of today's Wall Street CEOs, which are 25 years on average. This means that, on average, these individuals began their careers in 1983. Their world view is based on those 25 years, during which time minor, but not major, financial crises occurred. Even experts such as former chairman of the Federal Reserve Alan Greenspan and current chairman Ben Bernanke made statements in recent years about decreased economic volatility—statements based on a short-term, not a long-term, perspective.

Nowhere was this failure to take a long-term view more acute than in the models used by those on Wall Street. Such models often used just five years of data, and made assumptions that eliminated rare low-probability/high-risk events—providing an inaccurate and overly optimistic perspective.

*"Models can be blamed for the current crisis more than any other single factor."*

— Niall Ferguson

The reality is that when looking at 100 years of data, there have been nine months during that time when the monthly return of the Dow Jones Industrial Average was more than four standard deviations from the mean. This longer view of the data shows that crises do occur with some degree of regularity. It is impossible to predict when a financial crisis will occur and what its magnitude will be, but it is not impossible to predict that there will be another major financial crisis in the next 10 to 20 years.

*"History reminds us that 10 sigma events do happen, and when they do, liquidity can ebb much more quickly than it previously flowed."*

— Niall Ferguson

For those who see economic history as a waste of time, Professor Ferguson suggested creating models with 100 or 200 years of data, which will help leaders and their organizations be prepared for black swans.

- **Biological evolution is a metaphor for the financial system, with a few key differences.**

When most people and firms think about financial evolution, they see it as concentration. For example, Citigroup was previously hundreds of smaller entities that "evolved" into the behemoth it is today. But concentration from many small entities into one large entity distorts the term evolution. In biological evolution, there is one common root that branches out and creates multiple different results. Evolution is about the creation of new species that use the same resources and compete to survive; some species adapt and flourish while others go extinct.

The concept of biological evolution is a good metaphor for financial evolution, with the following important differences:

- *Conscious mutation.* In the natural world, mutation is random, but in the financial world, mutation—through means such as innovation and M&A—is controlled.
- *Endogenous change.* In the natural world, evolution is often triggered by external events, such as an asteroid hitting the earth. ("The environmental factors that affected dinosaurs weren't the dinosaurs' fault.") However, the disasters that affect the financial system are endogenous; they are caused by the financial system.
- *Intelligent design.* In the theory of biological evolution, there is no intelligent design; evolution doesn't involve divine intervention or moral judgments. But in the financial world, there are regulators who are supposedly intervening to intelligently design the system. These regulators are torn: If they don't regulate at all, there will be crises that have negative consequences. But when they do regulate, they are usually regulating to address the last crisis, not prevent the next one, and the nature of regulation creates a moral hazard and stymies innovation. Intelligent design impedes natural selection.

Considering biological evolution as a metaphor for financial evolution brings to mind Joseph Schumpeter's concept of "creative destruction." In a capitalistic system, as in biology, the companies that don't adapt will fail. This reality revolutionizes the world's economic structure by destroying the old and creating the new.