world development report 2014

Risk and Opportunity
Managing Risk for Development

MAIN MESSAGES

Risk management can be a powerful instrument for development

The past 25 years have witnessed unprecedented changes around the world—many of them for the better. Across the continents, many countries have embarked on a path of international integration, economic reform, technological modernization, and democratic participation. Economies are growing, people are escaping poverty, and hundreds of millions are enjoying the benefits of improved living standards and scientific and cultural sharing across nations.

As the world changes, a host of opportunities arise constantly. With them, however, appear old and new risks, from the possibility of job loss, crime, and disease to the potential for financial turbulence, social unrest, and environmental damage. If ignored, these risks can turn into crises that reverse hard-won gains and endanger the social and economic reforms that produced them. The consequences of mismanaged risks may destroy lives, assets, trust, and social stability. And it is often the poor who are hit the hardest.

The *World Development Report (WDR) 2014* contends that the solution is not to reject change in order to avoid risk but to prepare for the opportunities and risks that change entails. Managing risks responsibly and effectively can save lives, avert economic damages, prevent development setbacks, and unleash opportunities. It has the potential to bring about security and a means of progress to people in developing countries and beyond (box 1).

What does effective risk management entail?

Risk management is the process of confronting risks, preparing for them, and coping with their effects. Its goals are twofold: resilience, the ability of people, societies, and countries to recover from negative shocks; and prosperity, derived from successfully managing positive shocks that open opportunities for development. Preparation for risk consists of three actions that can be taken in advance: acquiring knowledge, building protection, and obtaining insurance. Once a risk (or an opportunity) materializes, people take action to cope with what has occurred. A strong risk management strategy would include all four of these components, which interact and reinforce each other (diagram 1). Better knowledge, for example, can lead to more efficient allocation of resources between in-

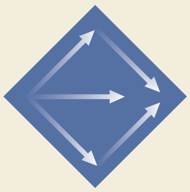
BOX 1 *Five key insights on the process of risk management from the* WDR 2014

1. Taking on risks is necessary to pursue opportunities for development. The risk of inaction may well be the worst option of all.
2. To confront risk successfully, it is essential to shift from unplanned and ad hoc responses when crises occur to proactive, systematic, and integrated risk management.
3. Identifying risks is not enough: the trade-offs and obstacles to risk management must also be identified, prioritized, and addressed through private and public action.
4. For risks beyond the means of individuals to handle alone, risk management requires shared action and responsibility at different levels of society, from the household to the international community.
5. Governments have a critical role in managing systemic risks, providing an enabling environment for shared action and responsibility, and channeling direct support to vulnerable people.

DIAGRAM 1 *The interlinked components of risk management*

Insurance
To transfer resources across people and over time, from good to bad states of nature

Knowledge
To understand shocks, internal and external conditions, and potential outcomes, thus reducing uncertainty



Coping
To recover from losses and make the most of benefits

Protection
To reduce the probability and size of losses and increase those of benefits

Preparation ⟵⟶ **Coping**

surance and protection. Likewise, better insurance and protection can make coping less difficult and costly.

The benefits of preparing for risk outweigh the costs

Crises and losses from mismanaged risks are costly, but so are the measures required to better prepare for risks. So, does preparation pay off? Evidence suggests that the benefits can outweigh the costs—sometimes overwhelmingly so. For example, mineral supplements designed to reduce malnutrition and related health risks may yield benefits at least 15 times greater than the costs.

Risk management also requires evaluating different risks and the relative need of preparing for each. Given limited resources, setting priorities and making choices is both unavoidable and necessary. For instance, a small country prone to torrential rains and also exposed to international financial shocks must decide how much to spend on flood prevention and how much to save to cushion against financial volatility.

Not only trade-offs must be considered, but also synergies. "Win-win" situations can both diminish risk (the possibility of loss) and increase potential benefits. Prime examples are investments in nutrition and preventive health; improvements in the business environment; and disciplined monetary and fiscal policies. Such synergies are widespread and should be emphasized—which is not to say they are costless or easy to implement.

People and societies struggle to manage risk

If risk management can have positive impacts and is cost-effective, then why aren't people and societies better at managing risk? The specific answer varies from case to case, but is always related to the obstacles and constraints facing individuals and societies, including lack of resources and information, cognitive and behavioral failures, missing markets and public goods, and social and economic externalities. This realization leads to an important message. Identifying risks is not enough: the obstacles to risk management must also be identified, prioritized, and addressed through private and public action.

A holistic approach to managing risk

Individuals' own efforts are essential for managing risk, but their success will be limited without a supportive environment (box 2). Most individuals are inherently ill-equipped to confront large shocks (such as the head of a household falling ill), systemic shocks (such as a natural hazard or a financial crisis), or multiple shocks (such as a drought followed by a food price shock). In such cases, risk management requires shared action and responsibility at different levels of society, from the household to the international community. These social and economic systems can support people's risk management in different yet complementary ways.

- The *household* is the primary instance of support, pooling resources, protecting its members—especially the vulnerable—and allowing them to invest in their future.
- *Communities* provide informal networks of insurance and protection, helping people deal with idiosyncratic risks and pooling resources to confront common risks.
- *Enterprises* can help absorb shocks and exploit the opportunity side of risk, contributing to more stable employment, growing income, and greater innovation and productivity.
- The *financial system* can offer useful risk management tools such as savings, insurance, and credit, while managing its own risks responsibly.
- The *state* has the scale to manage systemic risks at the national and regional levels, to provide an enabling environment for the other systems to function, and to provide direct support to vulnerable people. These roles can be achieved through social protection (insurance and assistance), public goods (national defense, infrastructure, law and order), and public policy (regulation, macroeconomic management).
- The *international community* can offer expertise, facilitate policy coordination, and pool resources when risks exceed national capacity or cross national and generational boundaries.

These systems interact, often complementing and sometimes substituting for each other's risk management functions. For instance, enterprises rely on macroeconomic stability, public services, and financial products to remain dynamic and continue to provide income and employment to people. The financial system can provide tools of insurance, saving, and credit only if enough households and enterprises are able to partici-

BOX 2 ***A few facts about risk and risk management from around the world***

Despite some progress, many people remain vulnerable:

- More than 20 percent of people in developing countries live on less than $1.25 a day, and nearly 75 percent on less than $4.00.
- 70 percent of people in developing countries do not use formal financial tools.
- Over 70 percent of the labor force in South Asia and Sub-Saharan Africa are self-employed and do not benefit from risk-sharing within firms.
- People living in fragile and conflict-affected countries made up 15 percent of the world population, and one-third of people living in extreme poverty in 2010.

When risk is mismanaged, crises ensue:

- More people die from drought in Africa than from any other natural hazard, whereas virtually no one has died from drought in developed countries in the past four decades.
- The mortality rate from illness and injury for children under age five is almost 20 times higher in low-income countries than in high-income countries.
- 147 banking crises struck 116 countries from 1970 to 2011: the average cumulative loss of output during the first three years of crises in emerging markets was 26 percent.
- During 2011–12, the famine in Somalia claimed 258,000 lives, despite 11 months of repeated warnings; opportunities for early intervention were missed by the donor community to avoid political and security risks.

Effective risk management can improve resilience to negative shocks and the ability to take advantage of positive shocks:

- Between 1990 and 2010, the share of people in developing countries with access to improved sanitation increased from 36 to 56 percent, while the immunization rate for measles doubled. Infant and maternal mortality fell by more than 40 percent.
- Farmers in Ghana and India—among other countries—who have rainfall insurance have increased their investments in fertilizer, seeds, and other inputs.
- Whereas a decade ago most developing countries suffered from a procyclical bias, now more than one-third of them conduct recession-reducing countercyclical macroeconomic policies.

pate in the system and the economy features a certain degree of stability and predictability. Markets, in general, can provide risk management tools and resources at a growing scale only if the necessary public services, such as the rule of law and a sound regulatory framework, are in place.

Mainstreaming risk management into development programs

The *World Development Report 2014* offers dozens of specific policy recommendations to improve risk management at various levels of society (box 3). Its overarching advice, however, is that these recommendations should be implemented in a proactive, systematic, and integrated way to optimize their effectiveness. For this purpose, it advocates that countries establish a national risk board, which can help mainstream risk management into the development agenda. This could be a new agency or come from reform of existing bodies: what is most important is a change in approach—one that moves toward a coordinated and systematic assessment of risks at the national and even international levels. Implementing this recommendation may require a substantial change in the way governments develop and implement their general plans, considering change and uncertainty as fundamental characteristics of modern economies.

Five principles of public action for better risk management

Analysis throughout the *WDR 2014* suggests that the public action essential to supporting people's risk management can usefully be guided by some key principles.

1. Do not generate uncertainty or unnecessary risks

The state should strive to lessen uncertainty and reduce risks—or, at minimum, not worsen them. Why or how would a government do that? First, it may perpetuate social norms that discriminate against certain groups, such as women or ethnic groups, making them more vulnerable. Second, it may favor the group that supports it politically against the legitimate interests of others. Third, a government that is internally fragmented and disorganized may adopt ambivalent policies or implement policies ineffectively. Finally, the government may be guided by ideology, wishful thinking, or simple desperation when confronting difficult problems, instead of relying on measures based on good evidence and analysis.

2. Provide the right incentives for people and institutions to do their own planning and preparation, while avoiding imposing risks or losses on others

The right incentives are critical to avoid cases in which some benefit at the expense of others. Bailouts should be avoided, but if they occur, they should be designed to prevent providing the wrong incentives. Turkey's experience after the 2000–01 banking crisis (and especially the unwavering stance of the country's bank regulatory agencies) offers a prime example. Social protection can be criticized for not encouraging self-reliance and posing an unsustainable burden on the state. These problems can be avoided by a design that takes people's incentives directly into account. Well-designed safety nets—such as conditional cash transfers or workfare programs in Bangladesh, Brazil, India, and Mexico—have promoted better household practices in education, health, and entrepreneurship, while remaining fiscally sustainable. Two changes in people's mindset related to individual and social responsibility

BOX 3 ***Selected policy recommendations from the* WDR 2014**

For the household:

- Public health insurance, run in partnership with the private sector, with emphasis on preventive care and treatment of contagious diseases and accidents
- Public education, run in partnership with the private sector, with focus on flexible skills, adaptable to changing labor markets
- Targeted safety nets for the poor, for instance, conditional cash transfers with payments directly to women
- Enforceable laws against domestic abuse and gender discrimination

For the community:

- Public infrastructure for the mitigation of disaster risks, built in consultation with surrounding communities
- Transportation and communication infrastructure, especially to integrate and consolidate isolated communities
- Police protection against common and organized crime, especially targeted to communities under threat
- Enforceable laws against racial or ethnic discrimination

For the enterprise sector:

- Secure and respected private property rights
- Streamlined and predictable regulations for taxation, labor markets, and entry and exit of firms
- Enforceable regulations for workplace safety, consumer protection, and environmental preservation
- Consider the possibility of delinking social insurance (that is, health insurance and old-age pension) from work status

For the financial system:

- Sound financial infrastructure (payment systems, credit information) to facilitate financial inclusion and depth
- Enforceable regulations that foster both consumer protection and competition among financial institutions
- Macroprudential regulation, for the financial system as a whole, to lessen financial crises and avoid bailouts
- A national financial strategy that addresses trade-offs between financial inclusion, depth, and stability

For the macroeconomy:

- Transparent and credible monetary policy, oriented to price stability and conducted by an autonomous central bank
- For the majority of countries, a flexible exchange rate regime, in a context of transparent and credible monetary policy
- Countercyclical and sustainable fiscal policy, aided by an independent fiscal council
- Provision for contingent liabilities, such as natural disasters, financial crises, and pensions of an aging population

For the international community:

- Engagement in bilateral, regional, and global agreements to share risks across countries, enhance national capacity, and confront common risks, favoring proactive and coordinated interventions
- For elusive global risks, such as climate change, formation of a "coalition of the willing" with like-minded country governments, creating incentives for other countries to join in.

are critical for effective risk management: moving from dependency to self-reliance, and from isolation to cooperation. Providing the right incentives can contribute in both regards.

3. Keep a long-run perspective for risk management by building institutional mechanisms that transcend political cycles

Institutional mechanisms are needed that induce the state to keep a long-run perspective that outlasts volatile shifts in public opinion or political alliances. For instance, the state's provision of health services must be funded on a continuous and sustainable basis to succeed. Thailand and Turkey offer successful examples with their recent shift to universal health insurance programs. The financial system must strike the right balance between inclusion and stability. In Malaysia, the central bank, the finance ministry, and the private sector are preparing a long-run strategy for the financial sector. Countercyclical monetary and fiscal policies also require a long-run perspective. To this effect, Chile, Colombia, and Norway have been targeting a long-run budget balance.

4. Promote flexibility within a clear and predictable institutional framework

Flexibility in adjusting to new circumstances is essential to promoting resilience and seizing opportunities. Prime examples include household migration in response to shifting economic trends, and innovation by enterprises in the face of technological and demand shocks. A challenge for the state is to promote flexibility while preserving a sensible, transparent, and predictable institutional structure. For enterprises, the Danish model of "flexicurity" offers such balance, combining labor market flexibility alongside a strong social safety net and reemployment policies. For the macroeconomy, inflation targeting regimes with floating exchange rates offer a good model of flexible yet institutionally sound monetary policy.

5. Protect the vulnerable, while encouraging self-reliance and preserving fiscal sustainability

For households that remain highly vulnerable to shocks, the state can provide safety nets. These are possible even in low-income countries, provided the support is clearly targeted to vulnerable populations and is designed to encourage work effort. Ethiopia's Productive Safety Net System protects millions of households from food insecurity while investing in community assets. The international community can also provide resources and expertise to vulnerable populations. Although much criticized, foreign aid has been successful when provided in coordination with accountable local institutions, as occurred in Indonesia after the 2004 tsunami. Effective risk management, by promoting sustained growth, can lessen vulnerability and help eliminate extreme poverty.

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