THE 5TH COLUMN

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Perhaps the End is Nigh

By Jeffrey E. Garten

When I was in the Clinton administration, I spent a good deal of time touting the potential of big emerging markets, including China, India and Asean. I also used to argue that these markets would change the face of the globe—not just economically but also with regard to the distribution of political power. Six months after leaving Washington, I'm more convinced than ever that the emerging markets, particularly the big ones, constitute the critical international challenge of our times. Their very act of emerging is likely to be chaotic and disruptive, and investors in stock and bond markets would do well to take a more sober look at some of the political and economic contingencies that loom ahead.

More broadly speaking, a good deal of today's optimism rests on the continuation of peace, steady progress towards democratic capitalism and continued trade liberalization. Yet none of this should be taken for granted—especially not the trade part.

So far it has been hard to discern much healthy caution among financial-market investors. Emerging markets are booming—they were up 5.8% in the first quarter of 1996 compared with the same period last year. Enormous funds are flowing to the likes of Thailand, Malaysia and Brazil. Indeed, some analysts expect a tripling of equity investments in emerging markets, from $15 billion last year to nearly $50 billion by the end of 1996. Investment in mutual funds has grown to the tune of a billion dollars a week in the United States; Western pension and insurance funds are searching for higher returns; and emerging stockmarkets' capitalization, having grown 300% since the mid-1980s, still amounts to only 15% of the world total (while emerging markets account for 40% of world production).

But surely there's a big danger of instability ahead. For one thing, with China rattling its sabre, heightened tensions between the two Koreas, and nuclear rivalries between India and Pakistan, a lot can happen to change today's relatively calm military environment.

Then there's the difficulty of sustaining economic-reform policies in the face of greater democracy. Yes, democratic governments are to be warmly welcomed. But they create greater uncertainty: Newly enfranchised and unseasoned voters focus their attention on those who suffer from budget cutbacks and other reforms, and on witchhunts to punish the sins of past rulers. Elections in India could result in cooling enthusiasm for foreign-investment liberalization. In South Korea, enormous political energy has been spent accusing past presidents of criminal behaviour while they were in office, and this has rattled confidence in long-term economic policies.

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The Achilles' heel of emerging markets is trade. Underlying the emerging-market boom has been an assumption that the global economic system will continue to evolve in the same way it has—toward lower trade barriers and a rising volume of sales across borders. The prediction rested on the recent run of big trade negotiations—the North American Free Trade Agreement, the Uruguay Round, annual Asia-Pacific Economic Cooperation summits, etc.

No one can deny that globalization is growing, but the big question is whether its pace will slow down. I think it will.

It will be a while before we see more big-time trade negotiations and liberalization. Inflated rhetoric to the contrary, the action on trade will be to consolidate gains, improve enforcement and flesh out existing agreements with excruciating legal detail. In the U.S., anxiety over wage stagnation and lay-offs will put a lid on aggressive liberalization. Slow-growth Europe will be much the same.

All this is happening precisely as emerging markets bank on higher exports to maintain their growth momentum. In addition, countries such as Thailand, Malaysia and Indonesia want to boost exports to offset their rising current-account deficits. East Asia's emerging markets depend on the U.S. alone for 25% of their exports, and the percentage has been rising. There's a risk of a downward spiral: Emerging economies, unable to find the markets they need, will slow their own import liberalization. This in turn will undermine exports from Europe and America, slow the economies' growth, and ignite more protectionist pressure against the emerging markets.

Increased volatility in financial markets could also be a problem. Both the wider use of computers and greater transparency of regulations have facilitated the enormous flows of cash into emerging stockmarkets. But those same developments can reverse the flows as well. Trouble in a market is easier to spot today because it's more possible than ever to get up-to-the-minute information, and a keystroke is all it takes to unwind an investment.

A final danger—shorter term—is rising interest rates in the economically developed nations. The rates would suck capital back to home countries. Strong growth in the U.S. has the Federal Reserve edgy; at a minimum, the widely predicted reductions in rates now seem remote. In Japan, while near-zero rates may help a badly needed recovery, the Ministry of Finance is clearly nervous about creating another bubble. And across the board, large fiscal deficits mean tighter monetary policy.

Will any of this bad news materialize? No one can say for sure. But if the emerging markets do not experience their share of panics, busts and reversals it would be the first time in history. When things are going well, we are all optimists. But when a bubble bursts, we're all capable of explaining why it had to happen. ■