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EDITORIALS/OPINION

The International Financial System Is Crisis-Prone

NEW HAVEN, Connecticut — When the top industrial nations hold their annual summit meeting this week in England, they can start designing what is being called a "new architecture" for global finance, including tighter regulation and more extensive disclosure of financial statistics in emerging markets.

Also, they can create the conditions for a more effective IMF.

They can even propose experimenting with controls on short-term investments, which can destabilize developing nations by moving in and out of markets with startling speed.

But even if all that is done, the problems threatening the global economy will not go away. The international financial system has become crisis-prone in the last two decades.

In the early 1980s, the Latin American debt bomb was detonated. In 1987, stock markets crashed around the world. In the 1990s, Japan's bubble burst, the European Monetary System nearly collapsed, and Mexico needed a bailout of unprecedented size. The East Asian meltdown is only the latest in a series of financial collapses.

No one can predict where the next crisis might come from, or precisely when, but there are at least four reasons to suspect that trouble is on the way.

By Jeffrey E. Garten

First, the combination of explosive growth in world trade, direct foreign investment and cross-border trading in stocks and bonds has created an ever tighter web of connections among countries, all of which are in very different stages of development. The network is highly vulnerable.

Japan's problems include \$600 billion or more in bad debts, dragging down the banking system, as well as shrinking industrial production, sagging consumer confidence and a political system that is all but paralyzed.

China, too, is potentially at risk. Beijing has carried out many important reforms, but it has yet to tackle a banking system as insolvent as Japan's, and it has yet to close down thousands of bloated state companies.

Brazil's economy, which provides 40 percent of South America's GDP, has an overvalued currency and a large budget deficit, the kinds of imbalances that could cause foreign speculators to pull out. And the fate of the new European currency is creating nail-biting uncertainty in currency markets.

The global economy is vulnerable to wild market swings, too. In the last five years, the American balance of pay-

ments deficit has risen by more than 100 percent, while Europe's surplus has grown fivefold.

The total amount of capital flowing to Southeast Asia dropped to \$12 billion from \$93 billion, from 1996 to 1997.

In an ever smaller international marketplace, these sharp course changes are akin to major storms in a big ocean. And emerging markets, being small boats, could be easily capsized.

A second reason for concern is that financial regulation lags well behind the phenomenal expansion in banking and in securities trading. More money is moving around the world than ever before, in more complicated ways and at ever faster rates.

The supervisory agencies face additional uncertainties. In the United States, the rules separating banking, securities underwriting and insurance are being rewritten. In Britain, regulatory agencies are being merged into one Securities and Investment Board. In Japan there is extensive deregulation of financial services.

In this unsettled environment of complicated moving parts, no one is minding the entire global store.

A third cause for alarm is the so-called emerging economies. These nations have yet to meet the awesome challenge of building economic and

social systems capable of dealing with global capitalism. Virtually all of them lack antitrust laws, bankruptcy courts, and patent and copyright protection.

It will take at least a generation for these countries to develop a culture of credit assessment to replace the typical take-care-of-your-family ethos.

The most serious threats to financial stability occur when an economic and political system is in transition — the condition that obtains today in Asia, Latin America and the former Communist countries. We can expect all manner of booms and busts in the emerging markets, with global fallout.

Finally, while the financial playing field is supposedly more sophisticated now, investors and lenders are no smarter than in the past. They take the risks that traders always have, whether in the early 1700s, when European financial wizards went broke investing in the South Sea Company, a speculative real estate venture, or in the prolonged spree of the 1920s that led to the crash, or in the current Asian debacle.

The writer is dean of the Yale School of Management and author of "The Big Ten: The Big Emerging Markets and How They Will Change Our Lives." This comment has been adapted from a longer article in The New York Times.