EDITORIAL DESK

Adrift in the Global Economy

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When the heads of state of the top industrial nations hold their annual summit meeting this week in Birmingham, England, one of their most important tasks will be to figure out how to prevent another Asian-type crisis. Unfortunately, they cannot succeed.

This is not to say the leaders cannot shore up parts of the world economy. They can start designing what Treasury Secretary Robert Rubin and the Federal Reserve Chairman, Alan Greenspan, call a "new architecture" for global finance -- including tighter regulation and more extensive disclosure of financial statistics in emerging markets. They can create the conditions for a more effective International Monetary Fund. They can even propose experimenting with controls on short-term investments that can destabilize developing nations by moving in and out of markets with startling speed.

But even if all these ideas are carried out, the problems threatening the global economy will not go away, because the international financial system has become crisis-prone over the last two decades. In the early 1980's, the Latin American debt bomb was detonated, and in 1987 stock markets crashed around the world. In the 1990's, 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.

Although no one can predict where the next crisis might come from or precisely when it will happen, there are at least four reasons to suspect trouble is on the way.

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 to its many weak links.

Start with Japan, the world's second largest economy. Its 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. While Beijing has carried out many important reforms, it has yet to tackle a banking system that is as insolvent as Japan's, and it has yet to close down thousands of bloated state companies, a move that would result in the layoff of tens of millions of workers.

Then there is Brazil. Its economy, which constitutes 40 percent of South America's gross domestic product, 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-payments deficit has risen by more than 100 percent, while Europe's surplus has grown fivefold. In the last three years the American dollar has risen 60 percent against the yen. Meanwhile, 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. Take the $1.5 trillion in foreign exchange dealings that occur each day and the tenfold increase in private capital that has moved to emerging markets since 1989, not to mention the trillions of dollars of so-called derivatives, including options, futures and swaps.

If this were all that was happening, regulators in each nation would have a hard enough time. But the supervisory agencies face additional uncertainties. In the United States the rules separating banking, securities underwriting and insurance are being rewritten, while in Britain, regulatory agencies are being merged into one Securities and Investment Board, and in Japan there is extensive deregulation of financial services. In this unsettled environment, there are too many complicated moving parts, and 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 able to deal with global capitalism. Virtually all of them lack antitrust laws, bankruptcy courts, patent and copyright protection and a history of effective corporate governance. It will take at least a generation for these countries to develop a culture of objective credit assessment to replace the typical take-care-of-your-family-and-friends ethos. The most serious threats to financial stability occur when an economic and political system is in transition -- as is the condition 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 today than in the past. They take the same risks that traders always have, whether in the early 1700's, when European financial wizards went broke investing in the South Sea Company, a speculative real estate venture, in the prolonged spree of the 1920's that led to the crash, or in the current Asian debacle.

Similar features recur in all these crises. To begin with, there is good news, and confidence rises. Then more lenders and investors appear on the scene, attracted by the new opportunities.

Soon, optimism turns to euphoria, and new theories emerge to justify why this particular business cycle will not have a downswing or why these super-high valuations aren't really excessive. (Remember how in the 1970's lending to Latin America exploded on the theory that sovereign nations couldn't go broke? Or how just before the '87 crash, experts declared junk bonds and highly leveraged companies to be the wave of our financial future?) At last, a troublesome event -- a default, or a change in investor sentiment -- causes the bubble to burst, and everyone rushes for the exit. The pattern has hardly varied.

Today two new developments reinforce it further. Computers now insure that investors, traders and bankers have instant real-time information. As a result, hundreds of billions of dollars move by keystroke in response to a rumor, thereby worsening the damage caused by lemming-like financial behavior. Also, lenders have become emboldened to take ever greater risks with increasing sums of money because they believe -- with good reason -- that in a crisis Uncle Sam and the I.M.F. will bail them out to limit global fallout.

None of these factors should deter the leaders at this week's summit meeting from doing the best that can be done now. But down the road they'll have to do more, like stabilize exchange rates among major countries and establish real global financial regulation. For the time being our leaders resemble King Canute, who, in the old legend, tried vainly to hold back the tides. As things now stand, the global economy will not be submerged, but we're all going to get wet for a long time to come.

Photo (Todd Waterbury; Photo courtesy of the Fraenkel Gallery, San Francisco)