

Still Life of the World Markets

Global finance is now a thick network, with multiple circuit breakers. Yet these same links may prove too weak to contain the next crisis.

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Aug. 15, 2005 issue - For all the talk these days of jittery traders, we live in a time of implacable serenity in the global markets. Consider the death of Saudi King Fahd, which sent oil prices to record highs last week, and his replacement by fellow octogenarian King Abdullah, who faces a live terror threat in the world's pivotal oil state and a highly uncertain succession battle for his own position. Two days after the funeral, most world equity markets were surging to new highs. The markets also took in stride the May rejection of the EU constitution, which cast some doubt on the longevity of the euro itself. Ditto for China's recent move to delink the yuan from the dollar, which could foretell a Chinese retreat from financing America's consumption binge, a key driver of recent global growth.

So what's going on here? In each of the cases above, the answer from analysts was that the markets had already "priced in" the downside of the event in question. The implication is that Wall Street and the world markets are increasingly well prepared to handle surprises and potential shocks because they now rest on a firm foundation of risk management and regulation.

This school of thought is led by U.S. Fed chairman Alan Greenspan. He has said that U.S. deficits, while worrisome, can be accommodated in the open world economy, because it is now possible to tap the savings of other countries, and currencies can adjust to surpluses and deficits gradually and smoothly. He has applauded the growing complexity of financial instruments on the theory that they spread risk in ways that reduce the possibility of financial shocks. He has tended to see problems like a potential housing bubble as local in nature and no threat to global markets.

However, some renowned investors are in the opposing camp, which says that the financial system is dangerously and perhaps increasingly precarious. George Soros, for example, points to the huge financial imbalances between the United States and Asia, and the exploding debt in America, too, and warns that a major correction is on the horizon. Warren Buffett worries about the unfathomable complexity of financial instruments, especially derivatives, which he calls the weapons of financial mass destruction. And a host of highly respected economists, such as Yale's Robert Shiller, have an eye on new asset bubbles—such as soaring prices for housing—created by a long period of low interest rates.

On July 27 a group representing some of the world's most prominent banks weighed in with a report that comes down somewhere between Soros and Greenspan. The authors, from Goldman Sachs, Lehman Brothers and Deutsche Bank, among others, say the system is stronger than ever, and better managed. But the increasing size of capital markets, speed of transactions and complexity of financial products all require better adherence to existing rules of risk management, more disclosure and regulatory vigilance. You never expect private financiers to say the sky is falling, but this report is sobering not only because it enumerates many scary risks, but also because it shows that the system can contain the threat only if everyone is on guard.

My own view is that no one really knows whether the system is strong enough to weather a potential crisis. Reason: it has grown so big, so interdependent, so complex that either scenario is equally plausible. On the one hand, global finance has evolved into a thick network, with multiple circuit breakers and redundancies. Yet these same linkages may prove too weak to contain a crisis triggered by America's massive debts, and some could transmit problems across the globe with extraordinary speed.

All we know is the massive scale of what we are dealing with. For example, foreign-exchange transactions had increased to \$1.9 trillion each day as of April 2004, a 57 percent increase from two years earlier. Trading in derivatives had increased to \$1.2 trillion daily, up 112 percent in the same period. The growth of financial players such as private-equity investors and hedge funds has been phenomenal, and has taken place outside the banking system and beyond the reach of regulators. The pace of innovation in financial products is breathtaking for its ingenuity, but when all is said and done, the mushrooming of these high-tech financial instruments has pushed the global financial system onto uncharted ground.

We should all hope that the markets are right in not getting too excited about the future of Saudi Arabia and oil, the euro and the yuan. But I can't help thinking about something former secretary of the Treasury Lawrence Summers once said. He compared the modern global capital markets to today's system of airline traffic. There are fewer plane crashes today than at any time in history, he said. But because so many aircraft carry many more people, when there is an accident the damage is that much greater than it used to be. I'd say he got it about right.

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