Should We Be More Worried?

Wall Street is notorious for being too optimistic for too long, and then too despairing when things go bad. I fear it is in its Pollyanna phase now.

By Jeffrey Garten
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OCt. 17, 2005 issue - Hurricanes Katrina and Rita did not roil global financial markets. Neither did the terror attack in Bali, nor the growing threat of a flu pandemic. As October began, in fact, the dollar was up, European markets were focused on prospects for a new German government and Tokyo traders were bullish on Japanese recovery. Commentary from the big investment banks centered on normal musing about corporate earnings for the fourth quarter, concerns about rising inflation, the budget battles in Washington. Could it be that Wall Street's short-term preoccupations are obscuring a set of problems that sooner or later will upset today's seemingly benign financial picture? Put another way, are the capital markets in denial?

The thousands of traders and investors in the global economy who are moving trillions of dollars around the world every day are a tough lot to scare, to be sure. In the last five years alone they have coped with everything from 9/11 to health scares such as SARS, to a massive earthquake in Japan, to the Asian tsunami that killed more than 250,000 people. The financial system took these crises one by one, assessing the damage, rarely panicking—and then moving on. This cool and calculated modus vivendi works fine as long as big disturbances are evenly spaced and the market has time to evaluate and then digest what is happening. It could be a decidedly different situation if the world experiences several crises at once or disasters of greater magnitude.

No one can be sure how the future will unfold, and Wall Street rightly looks askance at doomsayers who just spill out lists of what could go wrong. It wants hard numbers, at least plausible probabilities, in its forecasts. But the Street seems to be ignoring a subtle lesson of recent disasters: while we have become much better at predicting crises, the problem has been in acting on the warnings. For example, advanced signals of the attacks of September 11 were available, if only our intelligence officials had been well organized. Federal, state and local officials were well aware for years that New Orleans could be destroyed by a high-powered hurricane, but they never took the necessary precautions. The tsunami death toll might have been much lower, had rumblings picked up by sensors in the West been translated rapidly into warnings to the people of Aceh.

So what should we make of the current predictions? In Washington, officials warn that another terrorist attack is highly likely, very possibly in the form of small weapons of mass destruction. Worldwide, health officials see a high risk of a global flu epidemic emerging from the avian-flu strain in Asia, or some other strain, with potential casualties in the many millions. There is a growing consensus that global warming will make hurricanes more powerful, with particularly ominous implications for typhoons in Asia.

Corporations ranging from BP to Intel are taking this era of heightened risk more seriously than the capital markets are. They are establishing elaborate riskassessment systems that CEOs and boards of directors review not just for the depth of analysis but also for the plans to recover from disasters. Many such as Wal-Mart and Home Depot have set up state-of-the-art crisis-management centers to make sure that they can deal with discontinuity of operations and dislocated employees, and even to pitch in to help governments respond to emergencies. Financial firms like Goldman Sachs are stress-testing all their assets against crisis scenarios that include such nonfinancial events as storms that knock out backroom facilities.

Banking regulators, too, are obsessed with risks, even beyond their usual worries. For example, the European Union is now imposing requirements on its financial institutions to be prepared not just for risks in the market, such as changing interest rates, but also for external events that derive from outside the banking system altogether, such as debilitation of key customers by terrorism.

The first signs of capital market concern for risk would probably be sharp movements in the dollar either up or down—it's hard to say which; the bidding up of interest rates; rising share prices for companies in disaster recovery, and declining share prices for heavy energy users. We see some of this already—Halliburton is up and Du Pont is down—but not by much. The one hint of real worry in the financial markets; the price of gold is now at almost 20-year highs.

Markets may be confident that governments can deal with emergencies. But recent events hardly bear out that trust. Such confidence also ignores the growing complexity of responding to crises in a globalizing world, and the difficulty of mounting a global response among officials who report to different bosses. Maybe the bulls and bears are balancing out one another now, neither quite sure of what to do. Then again, Wall Street is notorious for overshooting, being too optimistic for too long and then too despairing when things go bad. I fear it is in its Pollyanna phase now.

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