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Markets Rule

Moneymen are still calling the shots.

By Jeffrey E. Garten | NEWSWEEK
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as momentum builds for tough financial reform in Congress, and as the U.S. Securities and Exchange Commission and the Justice Department seem to be gearing up for high-profile investigations of financial firms' behavior, it would be tempting to conclude that Washington is in the process of taming Wall Street. But no matter what kinds of rules the U.S. or other governments pass, it will be the traders and investors in New York, London, Dubai, Hong Kong, and Tokyo—not the men and women in the world's respective seats of political power—who will resolve most of the big challenges of the day. We are entering the Era of Regulation, and yet it will still be the financial markets that decisively push our leaders in one direction or another. Not only in the U.S., but around the world, markets still play the role of disciplinarian when our elected leaders cannot make hard decisions, and the financial markets still cast the deciding votes about how things work—in the form of currency movements, bond prices, equity values, and the cost of credit default swaps—even more so than the votes of millions of citizens at the ballot box.

The Greek saga shows how banking and trading dominate politicians. Neither the Athens government, nor the combined governments of the 16-nation euro zone, nor the additional firepower of the European Commission, the European Central Bank, and the International Monetary Fund could overcome delay, indecision, and bureaucratic inertia until the markets unambiguously announced the procrastination game was up and that a concrete and painful bailout package would be essential. Only then did governments act. Now the financial markets will tell Europeans whether they have done enough, and what must come next not just in Greece but also in Portugal and Spain.

In the U.K., it has been entertaining to watch the three parties try to differentiate their approaches to dealing with Britain's severe deficits. But as the elections end, watch the value of the British pound, the interest rates of British bonds, the value of the FTSE 100, and the price of debt insurance on British borrowings. Those figures, more than the commitments of the prime minister, will give you a sense of the order of magnitude of the belt tightening and tax increases ahead.

After America's mid-term elections in November, the financial markets will press the Obama administration and Congress into doing what the nation's fractured and polarized political system simply won't do on its own—come to grips with trillion-dollar deficits and soaring debts. Traders and investors will be demanding major tax increases for everyone, not just the rich, with severe spending cuts in entitlements, defense, and discretionary programs. They will do that by driving up interest rates, or pushing down the dollar, forcing politicians to do what they would never be able to do on their own steam.

In parts of Asia, governments have been slow to respond to rapid growth, inflationary pressures, and potential property bubbles. They may dither, but markets will soon force a more decisive approach.

Why will markets and not governments rule? First, their size is overwhelming. Studies by McKinsey & Co. show that the world's financial assets have grown from $12 trillion in 1980 to more than $200 trillion by 2008. This growth dwarfs the expansion of trade or world GDP. Cross-border capital flows, moreover, have been increasing by double-digit compounded annual rates during that time, reaching $11 trillion in 2007 from $1.1 trillion in 1990. Just before the financial credit implosion, foreign investors owned one in three government bonds around the world, one in four equities, and one in five private-debt securities. There is every reason to believe that this trajectory will continue.

Second, the new regulations designed to constrain financial institutions will likely be full of loopholes and cross--border inconsistencies, allowing markets to easily move in and around new laws.

Third, policymakers everywhere are too often paralyzed by the combination of complex issues they can't understand and the short-term need to get reelected. The markets, on the other hand, can assimilate massive amounts of information and move quickly and with enormous force, even as they often overshoot. Governments are usually fighting the last war. Markets, on the other hand, are forward looking.

All this is not to say that financial reform isn't necessary to improve functioning of markets, to make them more transparent, or to keep egregious excesses in check. Nor is it to say that we should be happy that markets will continue to rule. But they will.

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