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Wanted: Competent Leaders With Vision To Tackle Global Crises

Markets around the globe analyze and quantify risk. But governance and politics present too much uncertainty, and investors are increasingly troubled by governments' inability to address pressing problems and coordinate responses to problems including climate change, massive debt of any one country and other imbalances. Because of countless interconnections through labor, capital, environment, transportation or trade, the consequences of failure to address any problem can spread quickly. "Our political leaders need the courage to make bold changes in economic and social programs and in the organization of bloated bureaucracies, let alone face the political heat from citizens who feel aggrieved," writes Yale professor Jeffrey Garten. "A massive increase in international coordination is required, too." In the meantime, uncertainty reigns and markets reel. – YaleGlobal

Markets spooked by leaders' lack of courage before great challenges

Jeffrey E. Garten

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All fall down: Stock exchanges all over the world see blue, worried about Europe

NEW HAVEN: Ever since financial crisis in Greece flared up in February, financial markets have turned sharply negative. The euro is down about 15 percent against the dollar this year, the Dow Jones Industrial Average just had its worst May in 40 years, the interbank lending rate doubled in the past few weeks and oil prices head south. At least one new and powerful undercurrent explains the anxiety among investors and traders: the quantum increase in political risk.

The definition of political risk has generally meant the risk of war, coups d'état, government expropriation of private property, sharp or capricious increases in regulation. But today the market concern is with an expanded concept of political risk that encompasses the growing incapacity of governments to accurately define the magnitude of the challenges they face, and then to devise and execute policies befitting the scale of their problems. Political risk also includes the increasingly limited ability of

governments to cooperate with one another to solve global problems. Markets hate political risk because it is all about calculating the weakness of people and organizations, something that doesn't fit well into Wall Street's computer models.

Here are some examples of how political risk is increasing:

Markets worry that Germany, France and other users of the euro are incapable of the economic changes called for by the International Monetary Fund and EU. Spain, for example, says it will cut its budget deficit from 11.2 percent of GDP in 2009 to 3 percent in 2013, a staggering cutback. Just last week Madrid's socialist

Governments have a growing incapacity to define the magnitude

government barely passed the first of what should be many more cuts to come by a vote of 169-168. But now GDP is expected to slow even more and President José Luis Rodríguez Zapatero's political fate is hanging by a thread, both making further budget cuts more problematic. A similar drama could play out in France, when legislation comes up this summer to raise the retirement age for public sector pensions from 60 to 62.

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Markets remain unconvinced that Greece and others can grow their way out of their debts, even with the new \$1 trillion rescue package, and assume that debt restructurings – a polite term for “default” – are a certainty. But if governments wait too long to postpone pain, as they are prone to do, then the defaults will be chaotic and send shockwaves throughout markets well beyond the euro zone.

Markets doubt that the rhetoric about achieving a stronger economic European union – the *sine qua non* for a credible and stable euro over time – far outstrips the willingness of European governments to make the necessary hard decisions. Germany, the most important country, shows no inclination to subordinate its policies to broader European needs, such as stimulating domestic demand to allow expansion of its trading partners' exports. As a result, traders and investors increasingly bet against the euro.

The US, the UK and Japan all run unprecedented peacetime deficits relative to GDP. Each will not only have to make drastic budget cuts and raise taxes, but must dramatically downsize pension guarantees and state subsidies. All need to pare down the cost of security, health and publicly financed education. Markets doubt that enough cuts will happen, given the certainty of powerful and sustained political pushback, and they worry about what kind of economic chaos the resulting fiscal paralysis will cause.

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The quality of government in China also represents a gigantic political risk, especially since all big economic decisions emanate from Beijing. Massive pressures are mounting on China to grow fast while avoiding inevitable bubbles and to remain ferociously competitive while simultaneously facing pressures to improve wages, revalue the currency and export into a slow growing western world. If China falters, all bets on a global recovery are off.

Another political risk is increased financial regulation in America and Europe, where the lack of transatlantic coordination is creating the specter of a spaghetti bowl of conflicting rules that lead to opportunities for destabilizing regulatory arbitrage. Even after a year of intensive effort, including three G-20 summits, it is not clear how banks will be taxed, what level of reserves they will have to carry, what rules will govern short selling, what constraints will be put on derivatives trading and much more.

Markets watch the big deficit nations like the US, and the big surplus countries like China and Germany for signs of a major global economic rebalancing, a key requirement for a more stable global economic system. They see virtually no progress. US savings rates have reached a plateau, and Beijing and Berlin want a continuation of the old system, the one that helped usher in the global credit crisis.

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Markets sense that in the event of a double-dip recession, governments are out of fiscal and monetary ammunition, and could force central banks to monetize debt by printing money to buy it, thereby setting off serious inflation. Already the European Central Bank has come under attack for buying low-rated Greek bonds.

Markets recognize that what may be logical for one country doesn't work for all of them. They wonder how both the US and Europe can regain competitiveness by supporting weak currencies, the implicit underpinning of their respective future hopes, without setting off a protectionist binge of competitive devaluations.

It doesn't take much imagination to conjure up scenarios for which governments are not yet prepared, because they are so overwhelmed handling current

Problems facing

crises. What if a rating agency downgrades a major country's debt – say Japan – which is skirting deflation and has sky-high debt and weak government, the latter symbolized by the recent resignation of Prime Minister Yukio Hatoyama, the fourth prime minister to quit in the last four years? What if a major city like Los Angeles declares bankruptcy, sending shockwaves through municipal financial markets around the world?

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We should not be surprised if governments have big trouble rising to the challenges they face. After all, the past few decades have celebrated deregulation and the reduction of trade and financial barriers, while high-paying business jobs siphoned off top talent from public service – the talent in great demand today. And the problems facing society – such as the phenomenal growth of financial markets or the profound issues surrounding climate change – have become much more complex due to technical sophistication and global linkages.

If political risk is to become less of a menace to the markets, the knowledge and experience of politicians must be vastly upgraded. Our political leaders need the courage to make bold changes in economic and social programs and in the organization of bloated bureaucracies, let alone face the political heat from citizens who feel aggrieved. A massive increase in international coordination is required, too. Hopefully, all this will happen in time, but right now it's hard not to sympathize with those on Wall Street who see all this as a bridge too far.

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