Draft Speech to Ft. Worth Chamber of Commerce, June 8

HOW POLITICAL RISK IS SPOOKING MARKETS AND WHY THIS WON'T END FOR A LONG TIME

By Jeffrey E. Garten (June 5/ 12 noon)

Ever since the financial crisis in Greece flared up in February, financial markets have turned sharply negative. The euro is down about 15% against the dollar this year, the Dow Jones Industrial Average just had its worst May in 40 years, the interbank lending rate has doubled in the past few weeks, oil prices have been heading south. There is increasing concern about bank liabilities, particularly to the weaker economies in Europe. The volatility index for stocks has moved up sharply, too. Anyone attempting to explain the behavior of markets must do so with a large dose of humility, given the massive cross-currents of instruments, time frames and motivations among the participants – equity investors, bond traders, commodity speculators, currency hedgers, and so forth – but I believe that at least one new and powerful undercurrent explains the anxiety among investors and traders: the quantum increase in political risk. Moreover, to the extent that markets are not totally spooked by this trend, I predict they soon will be.

The definition of political risk has generally meant the risk of war, coups d'état, government expropriation of private property, or sharp, capricious increases in regulation. But today financial markets think more broadly about such risk and include in their definition the growing incapacity of governments to accurately define the magnitude of the challenges they face, and then to devise and execute policies appropriate for the scale of their problems. Political risk entails the increasing failure of governments to anticipate upcoming problems, let alone to prepare for them – think 9/11, SARS, the sub-prime credit implosion, the volcanic ash explosion in Iceland, the BP oil spill. It includes the increasing ease—or at least frequency -- with which governments are taking extremely aggressive stands against private companies (however well deserved in the public's eye) – think

Toyota, Goldman Sachs, BP – and the uncertainty surrounding which corporation will be the next victim. And political risk also includes the much-too-limited ability of governments to cooperate with one another to solve global problems.

It's a short jump from political risk to economic risk because markets want a predictable and enforceable governmental framework, the lack of which can lead to uncertainty, fear, and responses to new developments that overshoot either on the upside or the downside. Political risk raises the cost of taking any kind of risk –therefore raising the cost of capital. Moreover, it is contagious, for once confidence in governments is lost, then every action that politician and policy-makers take is seen as ill-considered. Markets hate political risk because it is all about calculating the unpredictable actions of people and organization, and it cannot fit into Wall Street's computer models.

Here are some examples of how political risk is increasing:

Inability of governments to do what is necessary. Markets have been worried that Germany, France and other users of the euro are not capable of the economic changes that the IMF and EU are demanding. Spain, for example, says it will cut its budget deficit from 11.2% of GDP in 2009 to 3% in 2013, a staggering cut back. Just last week Madrid's socialist 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 Rodriguez Zapatero's political fate is hanging by a thread, and both events make 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.

The US, the UK, and Japan are all are running the unprecedented peacetime deficits relative to GDP. Each will not only have to make drastic budget cuts and raise taxes, but will need to dramatically downsize pension guarantees and state subsidies. All will need to pare down the cost of police, health and publicly financed education. Markets do not believe enough of this 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.

Feeling that governments are in denial or else hiding the real truth. Markets do not believe that Greece and others will be able to grow their way out of their debts nor continually refinance them, even with the new $1 trillion rescue package. They think that debt restructurings – a polite term for 'default' – are a certainty. But if governments wait too long, as they are prone to do, then the defaults will be chaotic and send shock waves throughout markets well beyond the euro zone.

This lack of believability extends to other arenas, too. The recent past shows that the very definition of contingent liabilities is much more elastic than most market participants thought. No one expected, for example, that the US would guarantee the debts of all the large banks, no one thought it would bailout the nation's largest insurance company, or its largest auto company. In more than theory, the US now owns AIG and GM and is liable for all of their liabilities. The point is, the markets can be forgiven for not knowing just what the limited of government liability are, and the governments can be forgiven for not wanting to answer the question.

Lack of political will. 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 key country, shows no inclination to subordinate its policies to broader European needs, such as stimulating domestic demand to allow for expansion of its trading partners exports. As a result, traders and investors are increasingly betting against the euro.

Too much riding on one government. The quality of government in China also represents a gigantic political risk, especially since all big economic decisions emanate from Beijing. It is true that most market participants would give Beijing high marks for economic management these past few decades. But 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. At some point, the juggler will drop the ball, unless China defies the history of every other government. And if China falters, all bets on a global recovery are off.

Haphazard intervention in markets. 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 will 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 the rules will govern short selling, what constraints will be put on derivatives trading, and much more.

Beyond financial regulation, markets sense that the balance between government and business is shifting fast towards the former. The implications are uncertain, but the concern should be that public sectors don't have the wherewithal to execute the additional responsibility they will acquire by taking a good deal of autonomy from private companies – the knowledge, the experience, the capable managers -- especially in the highly indebted west at a time when public budgets will be severely cut .

Serious shortfalls in global cooperation. Problems in the global coordination don't stop with financial regulation. Markets are also watching 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 where they pile up export proceeds, the one that helped usher in the global credit crisis.

Markets recognize that what may be logical for one country doesn't work for all of them. They are wondering 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..

Lack of government preparedness and crisis management skills. 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.

In the last several years, the world has experienced a series of massive setbacks – terrorist attacks, health epidemics, natural disasters, financial calamities, horrendous accidents. Governments have not distinguished themselves in either anticipating these tragedies or in responding to them, even though in some cases (9/11, Katrina, BP, for example) retrospective investigations showed that the event could have been anticipated. The sheer number of big surprises, and the damage they have wrought, should make markets nervous that governments are not up to the job of crisis prevention and mitigation.

It doesn't take much imagination to conjure up all-too-plausible scenarios for which governments are not yet prepared, either because they lack the ability to look ahead, because they are so overwhelmed with current crises, or because they simply wouldn't know how to prepare for the contingency. What, for example, if a rating agency gives a big downgrade to a major country's debt—say Japan -- which is skirting deflation, has sky high debt, and has had four prime ministers resign in the past four years? What if a major city like Los Angeles declares bankruptcy and sends shock waves through municipal financial markets around the world?

Lack of leadership. At the base of market concerns on all global issues, be they regulatory or related to global capital and trade flows, is the fear that no one is really in charge, and that every government is marching mostly to a domestic beat, not an international one. The US lost a lot of its leadership credibility when its housing market collapsed under the weight of subprime madness, revealing unconscionably weak discipline on Wall Street and in Washington, and exporting its virus around the world. Europe is mired in its own debt crisis. China and Germany are unwilling to make any effective changes in their highly mercantilist policies.

The problem doesn't end here. National governments have proved incapable of handling their own problems adequately, and they are frequently challenged now by regional or city governments theoretically under their jurisdiction. This kind of fragmented authority means increasing uncertainty about where decisions are made, and which ones matter.

* * *

To be sure, the perception of growing political risk hasn't dented the optimism of many forecasters. At the end of May, the Paris-based think tank, the OECD, projected that rich countries would grow this year by 2.7% and the world economy would expand by 5%. But we are coming off a disastrous 2009, when rich nation growth was a negative 3% and world growth a paltry 0.9%, so we should wait to see whether market concerns will allow such progress to continue.

We should not be surprised if governments have big trouble rising to the challenges they face. After all, the past few decades have been ones that have celebrated deregulation and the reduction of trade and financial barriers, while high paying business jobs have siphoned off top talent from public service. 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 and policy-makers will have to be vastly upgraded. It may be too much to expect them to have the kind of in depth understanding of financial markets that they need. Our political leaders will also need the courage to make bold changes in economic and social programs and in the organization of bloated bureaucracies, let alone to then face the political heat from citizens who feel aggrieved. This will be increasingly difficult in an era where democratic societies are splitting into less cohesive national entities, and where, because of Internet-enabled communication, every special interest has its own grandstand.

A massive increase in international coordination will be required, too. That will take more than additional whirlwind summits and politically correct communiqués, but willing to trade off short-term domestic concerns for longer horizon global ones. It will also take one nation to grab the mantel and show the way for others, the way Great Britain did in the 19th century and the US did in the second half of the 20th century.

If we are lucky, 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.

Jeffrey E. Garten is the Juan Trippe professor of international trade and finance at the Yale School of Management. He was formerly a managing director of Lehman Brothers and the Blackstone Group, 1979-1993, and Undersecretary of Commerce for International Trade in the Clinton administration.