Newsweek

# The Next Wave of the Crisis

***Now it's all about the political risks.***

by Jeffrey E. GartenMay 28, 2010

Any comment on the mood of Wall Street should be delivered with a strong dose of humility. After all, the markets include stock and bond traders, derivatives dealers, currency speculators, pension-fund managers, and many more. Some markets move on macroeconomic trends, some on technical information, still others look for long-term value. All the crosscurrents notwithstanding, I believe that much of the recent fury and volatility in the markets—the rapid descent of the euro, the tightening of rates at which big banks lend money to one another, the tumbling stock-market indices, the big swings in commodity prices—can be traced in large part to a new and powerful theme: the perception on the part of investors and traders that the world has entered an era of extreme political risk.

Traditionally, political risk has been interpreted to mean war, coups d'état, sudden and disruptive regulatory action, and expropriation of property. But today the meaning of political risk can be broadened to include the perception that governments are unwilling or unable to reform their economies, that they are rushing into an era of regulation without calculating the potential collateral damage, and that they or too preoccupied with national troubles to manage a complex global economy. Growing political risk is raising uncertainty about when and where the next big problem will arise.

When markets looked at the early European response to the Greek crisis, for example, they saw governments paralyzed, not knowing what to do at first, then lacking the courage to roll out a rescue plan large enough to slow the contagion. They now see governments falling way short of the necessary collective solutions, which would include a real debt restructuring for Greece, and perhaps others down the road, and more centralized political control that would allow Europe to manage its debts more coherently. At every stage, government inaction or delay made the problem worse.

Markets are also beginning to worry about how policymakers in the U.K., Japan, and the U.S. will handle their soaring debts, all at unprecedented peacetime levels, relative to GDP. It's not that governments don't recognize the problem; it's that, as last week's OECD report documented, there is no evidence so far that the top politicians of any of these countries is remotely prepared for the significant tax increases and savage spending cuts that their out-of-control deficits will compel. The results could be soaring inflation or wholesale debt restructuring.

Another current political risk is an uncoordinated crackdown on banking by governments. Right now the U.S., the EU, and the Basel Committee on Banking Supervision are all moving on different timetables, and no one can say what the new rules will look like—not what new taxes banks will be liable for, not what level of reserves they should carry, not how derivatives trading will be handled, not how short selling will be regulated, not how hedge funds will fare, not who will monitor global, systemwide risks.

Down the road there are more potential political risks. Markets are concerned that after the big stimulus packages and bailouts of the past few years, governments will find it politically impossible to borrow more to stem another big crisis. What then? Will central banks have to buy trillions of sovereign and private bank obligations, seriously weakening the one set of institutions that still have credibility?

There is apprehension that with so many countries saying they will cut spending, and with no globally coordinated plan, large parts of the world could enter a prolonged deflationary period, raising unemployment and paralyzing government action to reduce debts.

There is the fear that with every major country obsessed with increasing its competitiveness, each is going to be tempted to embrace a weak currency policy, setting the stage for an era of competitive devaluations.

Even local political sparks could light a global fire, given the heightened sensitivity to the connections among national economies. If massive public demonstrations against raising the retirement age in France caused the Sarkozy government to back down, the shock wave would travel from all European capitals to Washington and to Wall Street. If a city such as Los Angeles declared a debt default, the murky financial status of big municipalities as far away as Guangzhou would immediately raise deep, potentially market destabilizing concerns.

We have just been through a financial crisis. Get ready for its political sequel.

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