The Shanghai Shock

BY HARALD MALMGREN

Financial lessons from the late-February 2007 hiccup.

At the start of 2007 an eerie calm had settled in across world financial markets. Global economic growth seemed to be spreading outward to encompass virtually every economy in the world. The U.S. and world economies seemed to be in a "Goldilocks" mode—not too hot, not too cold, but just right.

National markets and major asset classes all seemed to move in unison across world markets. Market volatility had all but disappeared. With less and less volatility, and copious liquidity, market risks seemed to fade away.

In this seemingly benign environment, hedge funds and proprietary trading desks continued to increase leverage, buying into virtually every tradable asset in relentless pursuit of higher yields. Accelerating financial innovation seemed to disperse risk ever more widely, providing a feeling that individual institutions and their portfolios were invulnerable to significant hits from any conceivable negative development. Emerging market debt, subprime loans, junk bonds, and other assets traditionally classified as "risky" were eagerly bought, driving down their yields to the point that spreads over high-quality government debt became paper-thin.

However, central bankers were not complacent. While investors seemed unafraid of potential negative surprises, central bank officials increasingly fretted that the markets had priced every asset "to perfection." Central bankers worried that risks were no longer being adequately priced to account for any negative shocks that might lie ahead.

On February 27, the Shanghai composite index abruptly fell almost 9 percent. Without knowing exactly what had taken place and why, sleepily complacent investors were abruptly awakened. They started to cut back holdings of their most liquid assets in a frantic effort to build cash shock absorbers. Like an unanticipated earthquake far away, the Shanghai shock sent a wave of selloffs across world markets throughout the remaining hours of the day. News and

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media commentators rang alarms. Panic spread among big and small investors in Asia, Europe, and North America. By the time the wave hit Wall Street, the Dow Jones fell by more than four hundred points, with more selling halted by the close of the market.

The White House responded by describing the worldwide selloff as "an anomaly." When selling on the New York Stock Exchange reached its peak at 3:00 p.m., trading volume overwhelmed the NYSE's computers. Transactions were left in limbo for precious minutes, followed by an abrupt and inexplicable drop of two hundred points in the Dow. An NYSE spokesman described the computer disruption as a "glitch." In the next few days, various U.S. and European central bank officials pronounced that world markets had proven "resilient." Was this really a one-off event, or was it a warning of something more fundamental?

Volatility had returned to markets, and not just for a day or two. After the Shanghai shock, financial markets throughout the world remained jittery.

Although the global wave of selling was unanticipated by most traders, the fact that a shock in one national market should spread to the entire global financial market should not have been surprising. Moreover, the big correction in the Shanghai composite index should not have surprised anyone paying attention to Chinese government spokesmen. For months, individual investors in China had been piling into the Chinese market for stocks and real estate. Millions upon millions of investors frantically increased borrowing against everything they owned in a frenzy of speculation. The domestic markets were bubbling faster and faster. This posed a financial management problem for Chinese authorities. But more than that, it posed a monstrous political problem. Officials warned of the dangers of growing bubbles, but investors seem undeterred.

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Shanghai Stock Exchange

MANUEL PAJER

New York Federal Reserve Bank

Fed Capability in Question?

It is not at all clear that the Federal Reserve has the relative degree of capability that it had only a few years ago. The Federal Reserve and the extension of its presence in financial markets through the New York Federal Reserve can no longer rely on personal relationships with a handful of financial leaders. Instead, Fed officials these days are continuously seeking to understand and explore ways of influencing the exploding complexity of financial markets. Looked at closely, the Federal Reserve in Washington and the New York Fed are not well staffed with people experienced in and knowledgeable about modern-day financial trading. One reason is that they simply cannot offer enough pay to attract market experts to undertake a regulatory role. The New York Fed has consequently found it necessary to improvise, by calling together experts within the financial industry, and relying on the help of former Fed officials.

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What would happen if large parts of the population were caught up in a financial meltdown, having already borrowed against every asset they had managed to scrape together in recent years? Would the public unrest be containable?

Chinese political leaders recognized that bold action was needed. At that moment, near the end of February, former Federal Reserve Chairman Alan Greenspan happened to express to investors and news commentators in Hong Kong his judgment that a recession was "possible" in the U.S. economy by the end of 2007. Coincidentally, other negative news also came out of the U.S. market, especially deterioration in the mortgage market and signs of weakening in capital spending. Since most Chinese investors still believe that the U.S. economy is the engine that propels China's growth, government officials decided the timing was just right to prick the bubble. Rumors were spread that the government intended to sell into the market large quantities of shares of some of China's biggest companies. A capital gains tax was said to be imminent.

Who are the slow movers? Public and private pension funds, mindful of their "prudent man" considerations, tend to follow market trends rather than trade ahead of market turning points.

The bubble was pricked, and heavily leveraged Chinese investors had to scramble to sell. Some analysts said the China shock was a big event for China's market, but hardly big relative to the scale of global financial markets. However, the convergence of the Shanghai shock with disappointing news about the U.S. growth outlook—and the apparent confirmation by the Maestro, Alan Greenspan, that change for the worse might lie ahead—all heightened apprehension among investors worldwide.

February 27 and subsequent days revealed that there was underlying uneasiness and even apprehension among investors below the seemingly placid surface of world markets. Some traders suffered severe hits when they were caught by surprise by the tsunami which swept across the world. On the other hand, many

The recent surge in mega-buyout funds has surprised many analysts, who usually ascribe this to the "global liquidity," which they rely on to explain everything that happens in the markets.

big traders were apparently poised with hair-trigger readiness to liquidate positions. The China shock set in motion a sharp increase in market volatility, and the return of volatility brought with it an elaborate process of global market "corrections."

With the return of volatility, most investment managers have had to rethink their trading strategies. Many hedge funds and proprietary trading desks also busied themselves assessing the damage to their positions, but because of the opaqueness of their trading activities, that fallout would not become visible until months later.

CHALLENGES FOR INVESTMENT STRATEGIES

Analysts are now arguing heatedly with one another whether this storm out of China was a one-time event, or evidence of long-term "climate change" in world financial markets. Was this just an ordinary, overdue market correction, or did it represent a tipping point?

To seek an answer to this fundamental question it is necessary to step back and reflect on how global financial markets have changed in recent times, and where the risks may lay as we look ahead.

First, the return of volatility suggests a need for reassessing risks and investment strategies. With low volatility, risk spreads had become unusually thin. Now that volatility has returned, risk spreads have started widening. Initially, the main impact was on subprime debt, but eventually many asset classes will experience "repricing." Even in the weeks following the Shanghai shock, volatility still remained well below historical averages. More volatility lies ahead. Relatively weaker market segments will likely experience the biggest repricing consequences. Most vulnerable to repricing are emerging market debt and lesser-quality debt in the industrialized countries.

A repricing of a significant part of the debt market had already been set in motion before the Shanghai shock. The rapid deterioration in the subprime U.S. mortgage market had begun a substantial repricing of mortgage debt and the valuations of mortgage generators. A couple of dozen subprime mortgage originators shut down or went bankrupt. In February and March, cracks even began to appear in the prime borrower market segment. A large share of the entire mortgage market and the inextricably linked residential mortgage-backed securities (RMBS) market came into question. (Even a behemoth like General Motors came under reexamination, because of its exposure to GMAC's mortgage business.)

Second, the markets for almost all asset classes had become "correlated." It has become commonplace for market analysts to point to the increasing globalization of financial markets as a defining phase in the evolution of the world economy. Markets in New York, London, Frankfurt, and Tokyo all tended to move in the same direction at the same time. But globalization means more than increasingly close interaction among national markets. Flush with liquidity and with diminished fear of risk, investors throughout the world poured capital into almost every asset class, and in every sub-segment within each class, driving investment returns from disparate market segments into global convergence.

This emerging convergence, or "correlation" of most asset classes, has not been the focus of much attention from market commentators, but it has major implications for risk management strategies of institutional investors and hedge funds. In 1979–80, U.S. laws and regulations regarding the management of pension funds were altered to allow investment in "non-registered securities." What this did was open the doors for pension funds to invest in venture capital and private equity partnerships. These "alternative investments" were said to be "uncorrelated" with equities, bonds, and other tradable asset classes. Historically, those pension managers mindful of changing risks had continuously shifted allocation among equities, public and private debt securities, resources and commodities, real estate, and so forth, in ongoing fiduciary efforts to rebalance risk exposure. Since the end of the 1970s, U.S. pension

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fund managers and other asset managers were advised to guide an increased share of their investment portfolios into a variety of "uncorrelated" alternative investments, so as to offset cyclical risks, geographic risks, short- vs. long-term risks, and so forth.

In recent times financial innovation combined with abundant global liquidity brought the investment performance of most traditionally tradable assets into convergence. Returns on commodities, stocks, bonds, real estate, and other tradable assets increasingly moved together. Sectoral or geographic rotation became less significant as volatility diminished and risk spreads converged.

As a consequence, in the past twenty-five years, public and private pension funds, endowments, insurance companies, and other institutional asset managers in the United States, and to a lesser extent in other industrialized countries, gradually dipped their toes into private equity and venture capital as one means of diversification into non-correlated market segments. In this process, public and private pension funds and other such asset managers became the dominant suppliers of capital for U.S. private equity and venture capital funds. It was these pension-funded private equity and venture capital funds that played a crucial role in revitalizing American industry and boosting American technological breakthroughs in the last twenty-five years. Slowly, but cautiously, the exposure of pension funds to these less liquid, longer-lockup "alternative investments" has continued to increase.

A significant part of the yen carry trade is accounted for by Japanese retail investors who are heavily invested in currency trading and positioning themselves in foreign-denominated assets—desperately searching for investment returns greater than the miniscule yields available inside Japan.

Now, given the growing correlation of most other traded assets, the search for non-correlated assets or markets has become narrower, with private equity looking increasingly attractive to asset managers, in terms of risk management strategy. The percentage allocation to these so-called alternative assets is now rising markedly among virtually all public and private pension funds, foundations and university endowments.

Throughout the last two decades Yale University's endowment was far out in front in growing its allocation towards alternative assets to more than half its entire investment portfolio. Until recently, many other asset managers questioned the prudential wisdom of Yale's "extreme" commitments to alternative investments. Now, Yale's long-term strategy is being emulated by a growing number of asset managers who are discovering their own fiduciary need to diversify into non-correlated markets because of the growing correlation of most other asset markets.

This combination of abundant liquidity and institutional efforts to increase holdings of alternative investments is making the task of raising private equity capital easier and easier. Private equity partnerships are enabled to raise larger and larger pools of capital. The recent surge in mega-buyout funds has surprised many analysts, who usually ascribe this to the "global liquidity," which they rely on to explain everything that happens in the markets.

This trend is not simply a result of growing liquidity. This trend is not transitory—it is not just an investment fashion of the moment. This trend towards far bigger commitments to private equity represents a calculated effort by institutional investors to increase the share of their continuously growing portfolios into non-correlated alternative investments. This trend is likely to intensify in the next few years. At the outset of 2007, there is a pool of more than $250 billion of uncommitted private equity available. Before this decade is over, a pool of several times that size is likely to be available in any given year, for investment not only in the United States but in other major markets as well.

Thus, it is likely that private equity partnerships will become increasingly important determinants of the

Mr. Experience

At this moment in history, the U.S. Treasury Secretary, **Hank Paulson**, is personally an expert in the complexity of today's global financial marketplace. He is bringing into place a team of experienced and knowledgeable experts from the markets, a team composed of people who can probably help to manage the consequences of the new working party guidelines with sensitivity and discretion. However, it is too much to expect that future Treasury Secretaries and their staffs will be equally experienced.

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structure and valuations of equity and debt markets, not only in the United States but in markets throughout the world. Alongside the accelerating growth of private equity investments, many corporations have increased their commitments to share buybacks and merger and acquisition activities. If the present trend in management of corporate cash flow continues to favor stock buybacks and merger and acquisition activity, and if private equity partnerships continue to take a growing role in financial markets, equity markets should become increasingly efficient as weaker companies become revitalized and newcomers are given momentum. The exceptions will be those equity markets that remain encumbered with excessive national or local regulatory intervention and political attempts to shield "national treasures" and weaker enterprises.

Third, financial innovation had allowed banks, investment banks, and other pools of capital to assist in financing ever-larger merger and acquisition deals and vastly expanded lending operations, both wholesale and retail—but without raising their own risk exposure. The providers of capital were enabled to "facilitate" deals while dispersing risk through the sale of a growing variety of collateralized debt obligations and exotic credit derivatives. One consequence is that many banks and investment banks became much less sensitive to central bank interest rate decisions and to weakness in particular market segments (such as subprime debt).

Financial innovation, assisted by "rocket scientists" and their computer models, is expanding into almost every asset market. This not only enables many investors to take out "insurance" on their portfolios, but it also allows them to trade on expectations among the myriad array of financial derivatives that are being generated.

The scale of the securitized debt market can be measured, but the scale of the credit derivatives market is essentially unknown. There are many estimates, in the tens of trillions of dollars—but no one really knows the size of the credit derivatives market, not even the major participants.

Financial innovation has made credit markets far more complex. Institutional investors and hedge funds have had difficulty keeping up with the speed and complexity of their own innovative deals. One consequence is that execution often lags long behind agreement on a deal, and documentation lags even longer.

Inside many institutional investment enterprises and hedge funds, the growing complexity has posed serious challenges for managing risk exposure. Simple tools like VAR (value at risk) have proven inadequate, particularly at moments of high market volatility.

Regulators in New York, London, and a few other financial centers are now pushing for increased emphasis on stress-testing large portfolios, but this requires increased staffing of risk management personnel. Risk managers are part of staff overhead costs. As such, they find themselves in continuous conflict with deal makers who generate profits. It will take time—measured in months and even years—to implement sufficient risk management procedures to catch up with the rapid pace of financial innovations.

Needless to say, fee generators often win daily battles over the attempts of risk managers to curtail risk and reduce exposure. Moreover, top management is rarely able to keep track of increasingly complex trading and structured finance activities of their highly profitable merger and acquisition and proprietary trading departments. The hard reality is that top management of some of the biggest "facilitators" of the credit markets are not fully knowledgeable about the complexity of their own trading activities, and therefore about the degree of leverage or exposure of their own enterprises.

Fourth, markets are increasingly sensitive to leveraged trading. Gentle slowing of economic growth has come at a time when investment yields are thinning in virtually every asset class. To keep up investment performance and hold on to their investors, hedge funds and investment banks have been increasing the use of leverage, chasing thinning spreads with ever larger trading positions.

The extent of leverage in trading is not well known, but virtually everyone in the financial markets knows that the amount of leverage continues to increase.

Some analysts point to the yen carry trade as a major provider of such leverage, but while that carry trade is one of the sources of leverage, it is constrained by currency risk. Market commentators have often focused on Bank of Japan interest rate policy as a determinant of the carry trade. However, raising, or "normalizing" interest rates in Japan will take several years. By the time that happens many other influences will have been brought to bear. Little attention has been paid to Japanese households. A significant part of the yen carry trade is accounted for by Japanese retail investors who are heavily invested in currency trading and positioning themselves in foreign-denominated assets—desperately searching for investment returns greater than the miniscule yields available inside Japan. If Japanese households experience a further strengthening of the yen, a big swing from long dollar positions to short dollar positions could bring about an abrupt correction of the yen. Most hedge funds that do utilize the yen carry trade are not sufficiently mindful of this huge potential role played by Japanese household savers.

Most of the leverage in global trading continues to be provided by a relatively small number of banks and investment banks, primarily operating in New York and London. These large providers of capital have found it difficult to analyze the leverage of many of their own hedge fund clients, and even harder to analyze the leverage of other traders in the markets. In other words, even the big providers do not themselves know the extent of leveraging in the world financial markets.

Hedge funds in particular generate huge fee income for big banks and investment banks, but hedge funds thrive on secrecy in taking trading positions. They have a strong motivation to hide their trading positions from scrutiny by banks and investment banks that not only provide capital for them, but also directly or indirectly compete with them in trading.

Fifth, volatility, leveraging, and widening risk spreads require far greater attention to changing investor positioning. For example, early in 2007 many of the more agile hedge funds and proprietary trading desks were already reducing positions in riskier assets, while at the same time the more slow-moving institutional investors were still acquiring positions in the riskiest tranches of the credit markets. Who are the slow movers? Public and private pension funds, mindful of

The Newest Globalization Skeptic

In February, Senator **Hillary Clinton** (D-NY) [top] publicly positioned herself as a skeptic about unbridled globalization, and expressed deep concerns about the dependence of the U.S. economy and its people on international creditors. Her stance, in line with the changing political winds, caused surprise among supporters and admirers of her husband, former President **Bill Clinton** [bottom], because of his strong commitment to liberalization of world markets. Her speech was especially inconsistent with the long-standing views of prominent Wall Street figures, like former Treasury Secretary **Bob Rubin**, who continue to promote the benefits to the American economy of the globalization of world markets.

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their "prudent man" considerations, tend to follow market trends rather than trade ahead of market turning points. Prodded by unfunded liabilities, they too have been seeking higher returns in the higher-yielding, "riskier" assets. In this process they have often followed leveraged investors into the lower-quality credit tranches. Along with the pension funds have been inexperienced investors, like the Chinese, crowding into U.S. subprime residential mortgages and complex credit derivatives.

Although hedge funds thrive on secrecy, they often invest in herds, seeking to capitalize on market momentum. These herds can disappear in the night, leaving the unleveraged asset managers and inexperienced investors with the riskiest positions when the sun comes up. Crackups among some hedge funds may happen, but it is the pension funds and other relatively cautious asset managers we should worry about when leveraged traders reposition themselves. In 2007, the agile hedge funds probably pose less systemic risk than the public and private pension funds and other "passive" and inexperienced investors.

Market analysts need to shift their focus from hedge fund vulnerabilities to the ultimate holders of market risks, the public and private pension funds, and the relatively inexperienced newcomers to complex debt instruments. Pension funds mark their portfolios of collateralized debt obligations and credit derivatives at purchase price. Damage is not visible until the debt instruments they hold are downgraded by rating agencies—at which point their fiduciary rules force them to divest, selling off downgraded paper at distress valuations. Rating agencies have been very slow to adjust ratings of complex debt products, which means that damage will only slowly become visible as risk spreads widen.

GOVERNMENT RISKS

These characteristics of contemporary markets—return of volatility, growing correlation of markets, fast moving financial innovation, growing trading leverage, and ongoing "repositioning"—pose risks that require greater attention going forward.

Of course, these are not the only risks. There are macroeconomic risks, especially the risk of a decelerating economy, together with diminishing earnings growth. There are geopolitical risks, terrorism risks, pandemic risks, and weather and climate change risks.

Some of these latter risks are given much attention in the daily news. What should be given greater attention is "government risk"—what governments might do in response to market shocks and politically unpopular market outcomes.

China. Because the "China shock" triggered so much turbulence throughout world markets, it may be useful to start with consideration of the outlook for China and its huge role as an engine of global growth. Chinese authorities have long been valiantly trying to rein in a runaway economy, but with only limited success. The national government leadership is well aware that its economy is characterized by misallocation of investment, overcapacity in key sectors, rampant corruption, and pervasive financial weakness among Chinese enterprises. The crackdown on wild speculation in Chinese stocks and real estate was necessitated by the potential political consequences if the bubble threatened to become unmanageable. Only a few weeks after the Shanghai shock the Chinese stock market was again at record levels, which means that further shocks will be necessary.

China has shown such an extraordinary rise in economic strength over recent years that it has become commonplace to project continued straight-line growth, to the point that China is expected by many economic analysts to become the next global superpower. Because China's economy functions under Communist Party leadership, it is widely assumed that somehow the government will be able to steer the economy away from severe disruption or collapse.

Most likely, China will experience a number of economic and environmental accidents in the next few years. These accidents will stimulate social unrest and heighten strains within the political power structure of China, both at the national level and between the national and local levels. Troubles in China will inevitably affect China's neighborhood, the economies of which inextricably interact with China.

In 2007, the agile hedge funds probably pose less systemic risk than the public and private pension funds and other "passive" and inexperienced investors.

The biggest risk in China is that the central government will not have sufficient technical capability or political authority to engineer a soft landing or gentle market correction. If the Chinese Communist leadership continues to prevaricate in dealing with local governments and enterprises, the economy will become increasingly vulnerable to shocks. If the central government leadership fails to resolve differences among its ministries and the members of its Communist Party Central Committee, economic disruptions seem inevitable. President Hu Jintao has declared his intention to "recentralize" authority over decision making, but will he be able to do this? And is recentralization of economic planning and asset allocation the right answer?

There can be serious doubts about the capability of the Chinese government to manage the robust, increasingly decentralized economy. Hu Jintao's efforts to stabilize the economy through recentralization of decision making are apt to make unanticipated shocks even more likely.

The U.S. Government, the Fed, and the Congress. Turning to the U.S. market, there are myriad risks posed by the Federal Reserve, by government regulators, and by politicians in Congress responding to populist fears of "globalization" and to disruptions among homeowners and ordinary household savers.

To start with, there seems to be a growing feeling within the financial markets that if the U.S. economy weakens in 2007, the Federal Reserve would come to the rescue through cuts in interest rates. But Fed officials continued to try to convince the markets that they see a far greater risk of inflation than they do of economic deceleration. By March the bond markets once again started pricing in early interest rate cuts by the Fed, but it was evident that the Fed did not anticipate a degree of economic weakness that would justify rate cuts, especially when inflation remained a threat. More likely, the markets would experience steeper inversion of the yield curve in 2007, and the Fed would remain on inflation alert for months after the appearance of signs of weakening in consumption and investment. Since the Fed is also worried about the thinness of risk spreads, it will most likely allow pain to be felt in the market before providing relief. The most likely scenario is that the Fed will remain well behind the curve of events in the American economy.

Many investors also continue to believe that the Federal Reserve will still function as the "lender of last resort" in case there is a major financial shakeout which poses systemic risk. However, it is not at all clear that the Federal Reserve has the relative degree of capability that it had only a few years ago, at the time of the Long-Term Capital Management, Russian, and Argentine defaults. When those defaults occurred, it was relatively simple to call together a small number of investors and traders to bring about stabilization of the financial market. Today, there are some nine thousand hedge funds and a growing number of highly diversified multinational financial giants that play a dominant role in their interaction across global markets. In the midst of potential panic over systemic risk, it would take more than a short list of phone numbers to put in place a Federal Reserve operation sufficient to rebuild confidence in the complex markets of today.

On the contrary, the Federal Reserve and the extension of its presence in financial markets through the New York Federal Reserve can no longer rely on personal relationships with a handful of financial leaders. Instead, Fed officials these days are continuously seeking to understand and explore ways of influencing the exploding complexity of financial markets. Looked at closely, the Federal Reserve in Washington and the New York Fed are not well-staffed with people experienced in and knowledgeable about modern-day financial trading. One reason is that they simply cannot offer enough pay to attract market experts to undertake a regulatory role.

The New York Fed has consequently found it necessary to improvise, by calling together experts within the financial industry, and relying on the help of former Fed officials, most notably former New York Fed President Gerald Corrigan. This process of collective exchange of information and ideas among a handful of banks and investment banks, and concerted action, has already succeeded in curtailing the vast overhang of undocumented derivatives transactions—although a substantial amount of such derivatives transactions are still in varying states of completion, without clear designation of the ultimate counterparty risk.

More recently, the New York Fed has been working with the Financial Services Authority in the United Kingdom and other regulators in an effort to persuade the biggest banks and investment banks to step up scrutiny of collateral and financial leverage, or margins, among their clients. Again, this is being undertaken in an interactive exchange of information and ideas among a small number of banks and investment banks, with the aim of generating concerted action. It should be noted that a number of these banks and investment banks have had trouble gathering comprehensive information from within their own enterprises in order to make adequate evaluations of exposure, and of the degree of leverage and the valuations of the collateral of their own clients. In other words, one lesson from the collective exchange of information among the big banks and investment banks has been that they are not fully cognizant of their own exposure.

Fed regulatory pressure to scale back leverage is coming at a time when hedge funds, in the face of thinning spreads and diminishing corporate earnings growth, are increasing their leverage in attempts to maintain high investment performance. This enhanced regulatory pressure will impose additional stresses on many hedge funds, especially those already suffering damage from the return of market volatility.

There has been increasing worry within the U.S. government about the growing complexity and leverage in financial markets, and the apparent weakness of understanding among investors of potential risks. The U.S. Treasury, the Securities and Exchange Commission, and the Federal Reserve, functioning jointly under the framework of the President's Working Group on Financial Markets, have just issued new financial market "guidelines." Treasury Secretary Henry Paulson stated that these guidelines were focused on improving management of systemic risk and on increasing transparency so as to strengthen investor protection. Undersecretary of the Treasury Robert Steel presented an explanatory statement on February 27, coincidentally on the same day as the China shock hit the U.S. markets (although his text was prepared many days earlier). He stressed that the new guidelines were "not an endorsement of the status quo," but instead represented "heightened vigilance" by the U.S. government.

Most likely, China will experience a number of economic and environmental accidents in the next few years.

The working party report addresses four distinct groups in the financial markets: private pools of capital and their managers; counterparties and their creditors; fiduciaries and investors; and regulators and supervisors. The basic thrust of the new guidelines, as explained by Steel, is that "collective decisions of self-interested and informed counterparties, reviewed by regulators, provide the very best protection against systemic risk." What this means in essence is that significantly strengthened credit practices are expected to be implemented by providers of capital, counterparties and their creditors, fiduciary managers, and other institutional investors, and that these strengthened credit practices would be closely monitored and reviewed by the various relevant regulatory authorities. The working party expects more frequent stress testing, with evaluation of risk aggregated across counterparties, taking into account scenarios of "adverse liquidity."

The working party also expects the various relevant regulators and supervisors to involve themselves more frequently and more deeply in reviewing the strengthening of credit practices by participants in financial markets. The working party report concludes with these words: "Supervisors should take full advantage of both formal and informal channels of coordination and cooperation across financial industry sectors and international borders when carrying out their responsibilities related to internationally active financial institutions' management of exposures to private pools and leveraged counterparties." In other words, regulators will be looking over the shoulders of traders, often engaging in back-seat driving.

Implementing this latter guideline will be difficult because it requires communication and cooperation among many disparate regulatory bodies with differing legal jurisdictions domestically and internationally. Such regulatory bodies are notoriously defensive of their authority and jurisdictions, not only internationally but domestically. Involving regulators in reviews of day-to-day trading styles also raises the question of competence: how many regulators are really experienced and knowledgeable enough to judge the credit market trades they are asked to review?

More likely, regulators will simply want the brakes to be applied whenever they feel the roller coaster is going faster than they like, or when members of Congress say that something dangerous is happening.

The U.S. financial market is characterized by a multiplicity of federal and state regulatory jurisdictions which the Congress has never been politically able to master. It will take years to carry out the objectives implied by this final guideline. On the other hand, there is danger that many independent supervisors and regulators will exercise self-initiative and become more active in intrusive reviews, suggesting revisions in credit practices without understanding of the financial market consequences. In response, providers of capital may become increasingly cautious in such an uncertain supervisory environment. This could prove especially troublesome at times of "adverse liquidity" circumstances.

At this moment in history, Treasury Secretary Paulson is personally an expert in the complexity of today's global financial marketplace. He is bringing into place a team of experienced and knowledgeable experts from the markets, a team composed of people who can probably help to manage the consequences of the new working party guidelines with sensitivity and discretion. However, it is too much to expect that future Treasury Secretaries and their staffs will be equally experienced.

Inside the Fed, there is serious weakness in knowledge of today's complex financial market trading. Among the top Fed officials and staff, at the start of 2007, there is strong analytical capability but little experience with, or knowledge of, current trading methodologies and styles. If systemic risk does appear, there will most likely be need for an intense learning period before the Fed is in position to be able to address the specific challenges.

This leads to yet another concern, that the capability of the U.S. government and of the Federal Reserve may not match the good intentions of the New York Fed and the working party's new guidelines for financial markets.

Moreover, in Congress there is a growing mood of suspicion about globalization, including both globalization of financial markets and globalization of trade and investment. Most of the newly elected members of the House won their seats on a platform characterized by anti-globalization rhetoric. All six of the losing Republican Senatorial incumbents were supporters of liberalization of trade and investment; one of the newly elected Democratic senators is openly opposed to further liberalization. The political winds are shifting toward a more nationalistic economic policy, with populist doubts expressed about the benefits of "outsourcing" and further opening of borders to foreign goods and capital.

In February, Senator Hillary Clinton (D-NY) publicly positioned herself as a skeptic about unbridled globalization, and expressed deep concerns about the dependence of the U.S. economy and its people on international creditors. Her stance, in line with the changing political winds, caused surprise among supporters and admirers of her husband, former President Bill Clinton, because of his strong commitment to liberalization of world markets. Her speech was especially inconsistent with the longstanding views of prominent Wall Street figures, like former Treasury Secretary Bob Rubin, who continue to promote the benefits to the American economy of the globalization of world markets.

The new Congress, frustrated by political divisions about Iraq and domestic fiscal policy, may shift attention to the "dangers" of globalization.

Greater federal government scrutiny of foreign investment is already in motion, strongly encouraged by Congressional concerns about the attempted purchase of U.S. ports by Dubai Ports World last year. Since that time, the U.S. government's Committee on Foreign Investment in the United States (CFIUS) has become a far more cumbersome and unpredictable process for reviewing foreign investment proposals. Under growing Congressional pressure, CFIUS has become more vulnerable to bureaucratic concerns, technical security cautions, and lobbying by private interested parties. Politicized, CFIUS has become a deterrent to foreign investment. Now Congress is considering new legislation outlining what CFIUS should do and not do, to provide greater clarity, but there are deep divisions within Congress about the detailed contents of such a new law, particularly between the anti-globalization factions and the members interested in maintaining U.S. competitiveness in world financial markets.

Regarding world trade liberalization, the Bush Administration has made some progress in negotiating with key committees in the House and Senate to renew legislative authority needed by July to conduct further negotiations to liberalize trade. However, many Democratic politicians are preparing to impede or delay consideration of a continuation of the trade liberalization activities of the last several Administrations. The intention of many of these politicians is to stop all further trade agreements, at least until after the next presidential election.

Domestically, the increasingly populist-leaning Congress will try to heighten public attention on issues like "excessive" compensation of corporate executives, questionability of deferred compensation agreements, and inappropriate or illegal stock options. Given the widespread popular discontent with record-breaking profits in the energy sector at a time of rising energy costs to the public, there will be stepped up pressure in Congress to alter the balance of incentives and penalties which are now perceived to favor "big oil."

In general, the political mood seems to be shifting toward punishment of greed and greater attention to income differentials between the rich and the poor. Many politicians will be tempted to amplify this mood into a frenzy of "class warfare."

Federal and state regulators in every field—and politically ambitious state attorneys-general—will find political encouragement for them to crack down on business "excesses." Whether or not Congress passes more stringent legislation, and whether or not President Bush vetoes such new proposals, the amplified Congressional debate will sensitize government regulators, at both federal and state levels, and encourage them towards greater scrutiny and tougher interpretations of existing law. At least for this year and next, there is clear danger of an increasingly business-unfriendly environment in the day-to-day government policies in the United States.

In this atmosphere, one could envisage growing warfare between financial and corporate risk takers, on the one side, and well-intentioned "guardians of the public interest," including regulators, prosecutors, and politicians, on the other.

ANTI-GLOBALIZATION WAVE ACROSS THE WORLD

The United States is not alone in being subject to growing "government risk." The ongoing struggles between the EU Commission and the governments of the EU member states pose an endless number of potential risks. The EU Commission is continuously engaged in an effort to utilize the drafting of new regulations to assert EU authority over the divergent regulations of the member states, and the member states continue to fight back. In the background, in much of the European Union, there is an underlying anti-globalization wave emanating from both city streets and rural villages.

National governments in many other countries are now trying to deal with a rising political fear of globalization, and its threat to "sovereignty." Governments everywhere are increasingly under pressure to shield domestic economies from "foreign" influences imposed by "vulture funds" and multinational giants. In many countries, international hedge funds and private equity investors are portrayed as the bogey men of the new century. In other words, the risks of anti-globalization backlash and disruptive government responses to financial market volatility are not unique to America.

One conclusion is that although the global financial market seems to have spread risks widely and thinly, neither the enterprises which manage capital flows, nor their regulators in every nation, are as knowledgeable about the real extent of leveraging and the ultimate location of risk as they would need to be during events of "adverse liquidity." Central bankers in particular will most likely need to give far greater attention to increasingly sophisticated and technically complicated financial innovations, the intention of which is to shift risk continuously from one party to other parties, while relying upon leverage to lubricate risk transfer and generate profits.

Henceforth, markets will be more jittery than before the Shanghai shock—and there is good reason for the underlying apprehension. The single financial global marketplace will have a powerful, pervasive influence on every national economy—and challenge every effort by central banks, governments, and politicians to manage and direct the consequences of global capital flows. ◆