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Markets’ resilience to terror is no reason to relax

You might think that during the five years since the terrorist bombings of the World Trade Center and the Pentagon, financial markets would have shown signs of extreme anxiety. This is especially true since the attacks on the US were followed by others in Indonesia, Spain, Saudi Arabia, Egypt, England, India and Turkey. Many commentators, including me, predicted that governments, citing national security, would go down the road of market-smothering financial regulation. Some of us also believed that the prospect of random violence against critical infrastructure would have created exactly the kind of uncertainty that Wall Street usually abhors. But not only did traders and investors weather the terrorist activities, they thrived; not because of terrorism, of course, but in spite of it. Whether they will continue to do so is another matter.

The US stock market recovered from September 11 2001 within six weeks. After every other major bombing they bounced back much faster. Since 9/11, financial organisations as diverse as HSBC, Goldman Sachs, the Blackstone Group and the London Stock Exchange all prospered. The overall financial system facilitated exceptional annual global economic growth of 4 per cent to 5 per cent, including buoyant trade expansion of more than 6 per cent a year and record flows of foreign direct investment.

What accounts for this good news? First, in the immediate aftermath of 9/11, the US Federal Reserve, other central banks and securities regulators showed exceptional skill and coordination in calming markets, adding to confidence that they could do it again if necessary. At the same time – and less related to terrorism than to general global economic conditions – central banks flooded the world with cheap money and key governments turned on the fiscal spigots by running large deficits. Banks and securities firms used this highly liquid world economy to deepen and diversify their operations. This added to the sense in the financial community that an ever more robust cushion for the capital markets was being established over which to spread multiple risks, including those relating to terrorist attacks.

A snapshot of how global markets evolved tells all: between 2001 and 2004, daily foreign exchange turnover rose to $1,900bn, a 57 per cent increase, while daily trading in derivatives reached $2,400bn, an increase of 74 per cent. Today, private equity firms control some $800bn in capital, 500 per cent more than five years ago. Hedge funds now manage over $1,000bn, compared with about half that in 2001.

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Financial institutions also deepened cross-border collaboration, in general and with regard to terrorism in particular. For example, the Basel-based Financial Action Task Force, comprised of senior financial officials from dozens of key countries, has worked to clamp down on terrorists’ money laundering. Individual companies made progress in ensuring business resilience after a disaster. For example: Lehman Brothers has bolstered its operations in New York, London and Tokyo with spare trading floors away from its primary locations. It has established storage capabilities for redundant data for its 10,000 servers. It can now communicate with all its employees in the event of terrorist mayhem.

But no one should think that the past is necessarily prologue. The global economic picture is becoming less accommodating with rising interest rates, slowing US growth and mushrooming trade imbalances that threaten to unleash protectionist policies. While financiers and traders may now be better able to cope with aircraft and train bombings, there is no telling how they would react to a nuclear device that explodes in a cargo container, bringing global commerce to a halt as port operators everywhere shut down their operations to re-examine their own security.

There is no predicting what would happen if terrorists mounted a successful attack on the global cyber-infrastructure, leading to the collapse of the payments system on which global banking transactions depend. Or if terrorists sabotaged a Saudi petroleum field, sending oil prices to $150 a barrel. Or if they bombed the overseas subsidiaries of a number of multinational companies, causing foreign investors to panic.

Perhaps the biggest unknown is that the financial system has not been stress-tested for some time. True, only a big financial crisis can do that. But the very factors that may make the system more stable – the gargantuan size, the exponential growth, the mind-boggling array of high-tech instruments – could cause it to implode if, in a panic, everyone tried to sell assets at the same time. The truth is, the system has become too big and too complex for anyone truly to understand it, let alone know how it would perform in the next major crisis.

Put another way, five years on, the financial markets have done a great job. But no one should exhale.

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