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PUT WARNING BELLS ON WORLD FINANCE

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If a tropical storm begins to gather hurricane-level strength off the coast of Florida, FEMA warns us. If a ballistic missile is launched somewhere in the Middle East, shared early-warning systems immediately alert affected nations while that missile is still airborne. If a global economic crisis is lurking around a corner . . . nothing happens. Instead of a triggered warning that allows for avoiding catastrophic consequences, the crisis simply hits, taking national economies and countless individuals' livelihoods with it.

If the recent global financial crisis has taught us anything, it is that we need an international financial Early Warning System (EWS) that can alert policymakers to pending financial crises. In large part, the failure of our global financial institutions to sound alarm bells well before economic collapse is the result of a flawed mind-set. In their recently published book, Carmen Reinhart and Kenneth Rogoff aptly refer to this as the "this time is different syndrome." Failing to give credence to the commonalities of financial crises, economists and institutions of this mind-set instead conclude that we cannot predict crises because a different, exceptional factor is in play each time. That has left the International Monetary Fund and other organizations reacting to, rather than trying to avert, crises.

In contrast, many economists and institutions have been able to predict and warn of recent economic crises. Those of us at the U.S. Pacific Command in 2007, for example, published a rather alarmist Asia Pacific Economic Update 2007 (Vols. 1 and 2). Our alarm flowed from our use of what Reinhart and Rogoff term a "signals approach." We looked at numerous financial crises in the past 2 decades and saw disturbing early signs of financial vulnerability common to all of them. Most importantly, we saw many of these same financial risks threatening an overborrowed U.S. economy.

The same Early Warning System that we recommended in our APEU 2007 is even more urgently needed now. Fortunately, the IMF has taken a step in the right direction by conducting early warning exercises. But a much greater shift toward a signals approach and toward a more comprehensive EWS is needed.

First, a financial EWS would monitor economic indicators that history reveals to be precursors of economic collapse. Some of the most important indicators have been

overvalued foreign exchange rates and high current account deficits. In early 1994, for example, the Mexican economy exhibited numerous warnings signs of financial vulnerability, including a 30 to 40 percent overvalued currency, an alarming current account deficit of 8 percent of GDP, and a rigid currency regime. This resulted in a run on the Mexican peso, soaring foreign debt as the peso collapsed, and a costly financial bailout. Thailand's economy followed a similar story line in 2006-07, and the U.S. financial crisis of 2008 was similarly preceded by a large and unsustainable U.S. current account deficit.

Second, an EWS would take into account extenuating economic circumstances and political factors that affect financial risk. Qatar's large public borrowing requirements, for instance, would be considered a dangerous economic indicator if we did not also factor in the Qatari government's investment in doubling the production and export of liquid natural gas. Likewise, an understanding of political factors inside the United Kingdom—most importantly, the high unemployment that made the United Kingdom's attempt to raise interest rates unsustainable—could have shed early light on the impending Black Wednesday of September 16, 1992.

By accounting for all these indicators and factors, an EWS would identify a coherent story line of rising financial vulnerability, where appropriate. Each economy's circumstance is different, but there are commonalities that allow us to be more effective in predicting crises. By communicating simple but comprehensive story lines to policymakers, an EWS would do more than simply ring alarm bells. Economies generally crash in the same fashion as dominos fall. By identifying key factors and decision points along the way as economic trends unfold, an EWS would provide guidance—allowing policymakers to change the alignment of dominos, as it were, and avert financial crises.

We have the historical knowledge needed to implement a financial EWS—most logically at the IMF. But we need economists who know their financial history and who are committed to a “signals approach” rather than economists who keep saying “this time is different.” Nothing short of a wholesale culture change in our global financial institutions is required, one that recognizes that the urgency of the times demands early warning of financial crises—and that we are capable of providing it.

The views expressed in this paper are those of the author and do not necessarily reflect the official policy or position of the Department of the Army, the Department of Defense, or the U.S. Government.