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Global markets untroubled by world's chaos

By Mark Zandi, July 27, 2014

The world feels especially scary lately. There has been mayhem in the Middle East, Russia seems on the verge of becoming a rogue state, violence in Central America is driving children to make the harrowing trek to the U.S. border, and much of Asia is bickering over Pacific islands and political dominance. Global politics are rarely this unstable.

Global financial markets, by contrast, are sanguine. The U.S. stock market is at record highs, and markets in most of the rest of the world aren't far behind. Investors are willing to buy the bonds of financially challenged companies and countries at record low interest rates. Global commodity prices and most currencies, including the U.S. dollar, are steady.

This disconnect between geopolitics and economics isn't new. Historically, chaos overseas has mattered little to the U.S. economy and financial markets. Barely a ripple was caused by the Soviet Union's invasions of Hungary and Czechoslovakia during the Cold War, or by numerous Israeli-Arab conflicts, or even by the Korean and Vietnam wars. The only obvious exception was the 1973 Arab oil embargo, which caused global oil prices to spike and the economy to tank.

The current round of global troubles appears even less threatening to the economy. This stems partly from the aggressive policies of the Federal Reserve and other central banks. With short-term interest rates at zero, investors seeking higher returns are enticed to accept or overlook the risks to their stocks and bonds.

The troubled parts of the world, moreover, have a relatively small economic footprint. Together, they account for only about a tenth of the world's population and oil production, less than a twentieth of its gross domestic product and trade, and no more than a hundredth of global corporate profits and bank lending.

Moreover, despite the globalization of recent decades, the U.S. economy is still not very global. Most U.S. businesses export little, and those that do have a range of techniques to hedge currency and political risks. We are not an economic island, but no other major global economy is as insulated from what happens outside its borders.

The revival of domestic energy production only reinforces this. Every economic recession since World War II, including the Great Recession, was precipitated partly by a surge in oil prices. We are much less vulnerable to such spikes today, and will be even less so in a few years.

If current trends continue as expected, our only oil imports a decade from now will come from Canada. This doesn't mean it won't hurt when oil prices rise sharply, but it won't be nearly as painful as in the past.

It is helpful that Canada is by far our largest trading partner, as it is arguably one of the most stable global economies. Mexico, our other large trading partner, has had its problems but seems to be getting its act together.

Also cushioning any blow from overseas events is America's status as a haven. When times are tough anywhere, our stable government and legal institutions are overwhelmingly attractive. Money from Russia, the Middle East, Latin America, and China pours into our financial markets when things aren't going well.

Everyone knows that investments in the United States won't be confiscated by a corrupt or capricious government. This helps explain why U.S. cities closely linked to unstable parts of the world, such as Miami, New York, San Francisco, and Seattle, are doing so well. Nervous global money finds a home in their condo towers.

For sure, today's geopolitical hot spots could spiral further out of control. Israel's incursion into Gaza could ignite a broader regional conflict. Russia could send its military into Ukraine. North Korea could do more than loudly thump its chest. But while these would be serious problems, they are likely to be political and military, not economic.

None of this is to say that events outside our borders don't matter to the economy. It wasn't long ago that we were fixated on Europe's battle to bail out Greece and keep the eurozone together. That succeeded, at least so far, but if it hadn't, the fallout for Europe's economy would have been great enough to trigger another recession here.

Also of concern, China's efforts to wean itself off debt-driven growth, reform its unproductive state-owned enterprises, and deflate its real estate bubble may not go well. Each time authorities there have tried, they have had to back away as the economy weakened. China may stumble badly next time, sending the world's second-largest economy into recession. U.S. financial markets wouldn't ignore that.

Furthermore, emerging economies such as Brazil, India, Indonesia, and Turkey, which have been vital sources of global growth, may not rise out of their current funk quickly. The foreign capital they need suddenly became more expensive last year, as global interest rates jumped amid talk that the Federal Reserve would finally wind down its extraordinary stimulus policies. These once-high-flying economies have made adjustments, but more are needed if they are to soar again.

Global events are important to an understanding of where the economy and stock prices are going. But I wouldn't focus too narrowly on today's turmoil-filled front pages. The news is disturbing, but it means little to our economic future.

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