The sub-prime crisis has its roots in international payment imbalances, made worse by capital markets imprudence, which in turn became endemic because of regulatory failures.

The United States sub-prime mortgage crisis has occasioned a deep economic winter. How did it come about? The crisis is related to international payment imbalances and US economic policies. After the bursting of the dot.com bubble, the US Federal Reserve ran a loose monetary policy for several years. The Fed fund rate, for instance, dropped from 5.25 per cent in January 2001 to 1.75 per cent in January 2002, and stayed in that neighbourhood till the end of 2005. Easy credit fueled US consumption, reduced savings and created high current account deficits.

The world, especially Asia, absorbed the US inflationary pressure partly by producing more. Also, Asian countries used their savings to purchase US securities to support the dollar so that they could avoid revaluing their currencies. When capital markets are informed and rational, international imbalances can be self-correcting. A review of the events that led to the current crisis would help us understand why it wasn’t so in this case.

The US government encouraged home ownership. That is generally good public policy. But in this instance, it led to the extension of mortgage lending to people who did not meet prime credit quality requirements – hence the term “sub-prime” mortgages.

Moreover, the mortgages were “securitised” – that is, bundled and sold as financial instruments to investors for immediate cash. This created an incentive problem: The institutions that originated the mortgages – commercial banks, savings and loans, etc – did not end up holding the mortgages. This led to excessive and irresponsible mortgage lending.

The investment banks that repackaged and sold the “expected” mortgage payments as securities were able to do so because they enjoyed high credit ratings. Their activity appeared to be old-fashioned financial intermediation, but it was not.

The problem was that US rating agencies assigned ratings based on the investment banks’ histories. But the instruments the banks were peddling – mortgage payments from lower-quality borrowers – were new. They carried credit ratings that did not reflect their high underlying default risks. Investment banks could not resist the temptation to make a quick buck. They made a quick buck aggressively.

Additionally, high savings from China and other countries continued to flood US markets. Foreign savers could not realise the lure of apparently safe US returns better than in their own markets. Foreigners did not necessarily invest in sub-prime instruments. But their investments increased liquidity nevertheless in US financial markets.

This translated to more money for Americans for sub-prime mortgages and other kinds of consumption. And investment banks found the profits from derivatives like mortgage-backed securities even more irresistible because they could get cheap credit to repackage. The delinquency risks of low-grade instruments were temporarily camouflaged by high liquidity.

The bubble had to burst. Because of inflation worries caused by high energy prices, the Federal Reserve raised interest rates in 2006. Some households had difficulties meeting their mortgage and other payments. The bubble was burst.

Fears set in and investment banks could not borrow to meet their payment obligations. There was a liquidity problem. In March this year, Bear Stearns was sold under pressure to JP Morgan Chase. The government-sponsored Freddie Mac and Fannie Mae issued most of the mortgage securities sold in the first half of this year because investors would not trust investment banks anymore. Still, the fears lingered on. On Sept 8, the US government took over Fannie and Freddie in the midst of foreign investors’ concern that the companies’ debt might not be repaid.

The asset values of investment banks continued to plummet. The liquidity crisis turned into a solvency crisis. Lehman Brothers filed for liquidation on Sept 14. After refusing to bail out Lehman, the US government decided to support American International Group. The saga, dotted with such sudden U-turns, is still unfolding. Markets are now worried about a global credit crunch.

The sub-prime crisis has its roots in international payment imbalances, made worse by capital markets imprudence, which in turn became endemic because of regulatory failures. First, investors, particularly foreigners, were swayed by US rating agencies, apparently sound institutions and US economic performance. Getting good returns first made them happy, then made them enthusiastic, and finally made them lose their common sense.

Second, there was a fundamental problem with corporate governance. Wall Street executives enjoyed extremely handsome compensation. Their fiduciary responsibilities to shareholders and investors were pushed to a corner. And third, these common ingredients of manias – blindfolded investors and poor corporate governance – were amplified by a failure of government.

How could such a colossal failure of corporate governance and of rating agencies not have generated early government action? The US authorities’ lack of sensitivity to the warning signs is shocking.

Liquidity was already drying up last year. The US authorities, however, still played the interest rate game, reducing the Fed Fund rate in August and September last year. But by then, the liquidity crisis had turned into a systemic crisis of confidence. Investors did not want to throw more good money at investment banks holding potentially rotten liabilities. Early government action to force them to recognise their mistakes and accept losses might have stemmed the bleeding. Intervention then would have been affordable.

The US likes to lecture others of the need for transparency and good corporate governance. Its failure to apply at home what it preaches abroad is serious. The question is not just whether US taxpayers should or should not bail out fragile financial institutions. It is about admitting regulatory failures, accepting responsibility and rectifying failures in governance.

Apparently, US politicians do not agree. Congress has rejected Treasury Secretary Henry Paulson’s US$700 billion (S$770 billion) bailout package. The world has been denied any sign of relief.

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