A new check-and-balance order

Headlines: A New Check-And-Balance Order
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WHEN the dust eventually settles, the origins of the 2008 financial crisis will probably be linked to two key developments in the global economy since 2000.

The first was its rapid growth. The world economy grew by an average of 5 per cent per annum from 2000 to 2007. Growth was supported by relatively low interest rates and easy access to credit. This was especially true in the United States, where sophisticated financial instruments made it easy to use illiquid housing wealth to support consumption.

Economic growth was even higher in emerging markets. Rising global demand for resources, together with ill-advised petrol subsidies and government-sponsored food-to-energy programmes in industrialised nations, fanned a commodity price boom. Food prices nearly doubled between 2000 and mid-2008, and crude oil prices reached a record high of US$146 in June 2008. The invisible outcome was higher inflation.

The second development was the emergence of significant macroeconomic imbalances between the US, on the one hand, and Asia and oil exporting nations, on the other. The US current account deficit averaged more than 5 per cent of its GDP in the 2001-2008 period, against only 1.5 per cent during the 1980s.

Excess savings in emerging markets and an insatiable demand for its assets enabled the US to finance its current account deficit without significant upward pressure on interest rates.

The potential for adverse effects of these two developments coming together - high growth and global macroeconomic imbalance - became apparent in early 2006. Cheaper credit contributed to US housing prices increasing by 25 per cent from 2003 to 2006. Low initial interest rates, together with the irrational expectations of housing price continuing to rise, encouraged sub-prime borrowers to obtain available mortgage credits that would be difficult to service once interest rates rose.

And rise they did. For the Federal Reserve gradually raised its federal funds rate from a low of 1 per cent in May 2004 to 5.25 per cent in June 2006. It did so, just as much to prick the housing bubble, as to stem inflationary pressures. Rates remained high until August last year, when the sub-prime mortgage crisis first surfaced. The US housing bubble would have burst anyway, but the Fed's actions merely hastened the inevitable.

What was so special about this housing boom and bust cycle? Cycles in housing markets are not uncommon events. But what made the recent US housing cycle stand out, however, was the systematic failure of market participants to appreciate the financial risks they faced should house prices fall.

The securitisation of mortgages in the US had enabled more investors to purchase shares in shaky housing loans. Cred- it default swaps (CDSs) - which are essentially insurance derivatives - transferred the risk of default from holders of mortgage-backed securities (MBSs) to CDS providers. But the CDS market itself, being unregulated and undercapitalised, added to the systemic risk.

Investment banks, aided by a 2004 Securities and Exchange Commission ruling that allowed them to almost double their debt-capital ratio to 3:1, also helped multiply the volume of MBS holdings and broaden their sales worldwide. Who would have imagined that securitised products - such as Lehman's Mibonds and Merrill Lynch's Jumbo Notes - would end up being sold to retirees in Singapore?

Securitisation of sound mortgages clearly has desirable effects because they spread the underlying risks across many investors. This crisis was caused by the systemic failure of market participants to appreciate the size of the default risk. Moral hazard, imperfect corporate governance and regulatory failures were largely to blame.

By March this year, an estimated 8.8 million homeowners in the US had zero or negative equity in their homes. The growing risk of MBS default sent shad- dows through the financial system. Even financial institutions without MBS holdings became wary, because they had made loans to institutions with MBS hold- ings. When several major financial institutions failed last month, perceptions of risk escalated and caused credit markets - the blood line of the global economy - to seize.

Having a financial crisis with failing banks is bad enough; having one along with rapidly eroding borrower and lender confidence and a credit squeeze is a recipe for a global recession.

Why? Most countries are linked by an elaborate web of international capital flows and trade linkages to the US, the world's biggest economy and its most im- portant financial centre. Through the fi- nancial linkages, a major financial crisis in the US quickly becomes a global crisis. And because of trade linkages, a global economic slowdown reduces world trade, further constraining growth in a vicious downward cycle.

Indeed, the Great Depression of the 1930s, which started in the US, lasted sev- eral years after the initial stock market crash, largely because of competitive pro- tectionism or beggar-thy-neighbour trade policies. But that period also left policy makers with many hard-earned lessons on what needs to be done to contain a major financial crisis.

First, central banks must expand rather than contract the money supply. Sec- ond, strong national leadership is re- quired to prevent bank runs and to re- store confidence in the banking system. And third, strong world leadership is re- quired, with countries from poorest to richest pooling resources to address the problem.

All three actions were lacking in the 1930s. Fortunately, they were taken in the current global financial crisis. In response to the credit market freeze, central banks pumped liquidity into the system. When this step failed to restore confidence, govern- ments announced plans to use public money to remove toxic assets from finan- cial balance sheets and even to recapital- ise banks.

At the international level, there was co- ordination among the major central banks to slash interest rates, rescue banks that needed capital as well as to guarantee inter- bank loans, thereby removing counter- party risk. Notwithstanding stock market meltdowns, all these actions appear to have improved confidence in the financial system.

That said, damage has already been in- flicted on the real economy by the global stock market meltdown. There are al- ready signs of declining growth and rising unemployment in many countries, and commodity prices are easing. The risk of negative feedback between the real and the financial sectors remains high, though manageable provided confidence in the financial system is restored.

More can be done to minimise damage to the real economy. It is time for na- tional governments to consider fiscal fiscal measures. In this respect, Asian economies have an advantage over Europe because of their high savings rates and large accumulated surpluses. In- dustrialisation in Asia would also narrow existing current account im- balances in the global economy.

Last but not least, attention must be di- rected to the regulatory system. The prime objective of the financial sec- tor is to serve the real economy by channeling capital and liquidity to its most productive use. Financial markets need to be better regulated to avoid the build up of excesses that can damage the real economy. But over-regulation must not go too far so as to be so constricting as to hamper the effi- cient workings of the financial system.

It is indeed a challenge to design a regu- latory framework that balances these two competing needs.

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