Big Freeze part 1: How it began

By Gillian Tett
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Just over a year ago, Hiroshi Nakaso, a senior official at the Bank of Japan, started to fear that the global financial system was heading for a jolt. Back then, most American policymakers assumed that the western banking system was extraordinarily strong. Thus while US mortgage defaults were rising, western officials were convinced that such losses would be easily “contained”.

But as Mr Nakaso watched western markets in July 2007, he had a sense of déjà vu. “I see striking similarities in what I see today with the early stages of our own financial crisis [in Japan] more than a decade ago,” he privately warned international contacts shortly after IKB, a German lender, imploded as a result of subprime losses. “Probably we will have to be prepared for more events to come … the crisis management skills of central banks and financial authorities will be truly tested.”

His fears proved well-founded. On August 9 2007, the European Central Bank sent shock waves around world financial capitals when it injected €95bn ($150bn, £75bn) worth of funds into the money markets to prevent borrowing costs from spiralling sharply. The US Federal Reserve soon followed suit. But while the central banks had billed these moves as “pre-emptive” actions to quell incipient market tensions, they did not bring the panic to an end.

On the contrary, as markets that were crucial for raising funds started to dry up last August, a network of financial vehicles slid into crisis, causing the price of many debt securities to collapse. That started a chain reaction that created liquidity and solvency crises at US and European banks – on a scale last seen in Japan almost exactly a decade ago.

A year later, there is still no sign of an end to these problems. Instead, the sense of pressure on western banks has risen so high that by some measures this is now the worst financial crisis seen in the west for 70 years.

What has made this upheaval so shocking is not simply its scale and duration but the fact that almost all western policymakers and bankers were caught unawares. “If you had said a year ago that America could
suffer a banking crisis on the scale of Japan, people would have laughed,” one former senior US regulator admits.

Or as the Bank for International Settlements, which groups central banks, observes in its latest annual report: “The duration of the turmoil, its scope and the growing evidence of effects on the real economy have come as a great surprise to most commentators, private as well as public.”

Adding that it “is essential we understand what is going on”, the BIS points out that the crucial question is: “How could problems with subprime mortgages, being such a small sector of global financial markets, provoke such dislocation?”

The answer to this seeming mystery lies in the slippery concept of financial “faith”. Over the past decade, western banking has experienced an extraordinary burst of innovation, as financiers have discovered ways to slice and dice their loans – such as the now controversial subprime mortgages – and then turn these into securities that can be sold to investors all over the world.

Tracking the scale of this activity with any precision has always been hard, since much of it occurs in private deals. However, industry data suggest that between 2000 and 2006, nominal global issuance of credit instruments rose twelvefold, to $3,000bn (£1,519bn, €1,929bn) a year from $250bn. This activity appears to have become particularly intense from 2004, partly because investors were searching for ways to boost returns after a long period in which central banks had kept interest rates low.

To be sure, ahead of last summer’s crisis some policymakers and investors were uneasy about the scale of this explosion. In particular, there was growing concern that “slicing and dicing” was fuelling a credit bubble, leading to artificially low borrowing costs, spiralling leverage and a collapse in lending standards. When world leaders gathered in Davos for the annual economic forum in January 2007, Jean-Claude Trichet, governor of the ECB, complained about the opacity of some financial innovation and warned that there could soon be some “repricing of credit risk”.

From 2005 onwards, Timothy Geithner, president of the New York Federal Reserve, called on banks to prepare for so-called “fat tails” – a statistical term for extremely negative events which occur more commonly than usual banking models suggest. Behind the scenes, a few bankers and investors also prepared for a crash. Deutsche Bank, for example, started betting on subprime defaults as early as 2006, while JPMorgan Chase placed trades to protect itself from a crash in spring 2007 and asset managers
such as Pimco and BlackRock stopped purchasing many debt instruments in early 2007. Yet most investors, bankers and even regulators did not change their behaviour to any significant degree, owing to a widespread adherence to three big assumptions – or articles of faith – that have stealthily underpinned 21st century finance in recent years.

The first of these was a belief that modern capital markets had become so much more advanced than their predecessors that banks would always be able to trade debt securities. This encouraged banks to keep lowering lending standards, since they assumed they could sell the risk on. “Abundant market liquidity led some firms to overestimate the market’s capacity to absorb risk,” says the Institute of International Finance, a Washington-based lobby group, in a recent report. “The same buoyant environment resulted in market pressure for high returns ... and high levels of competition among financial firms.”

Second, many investors assumed that the credit rating agencies offered an easy and cost-effective compass with which to navigate this ever more complex world. Thus many continued to purchase complex securities throughout the first half of 2007 – even though most investors barely understood these products.

But third, and perhaps most crucially, there was a widespread assumption that the process of “slicing and dicing” debt had made the financial system more stable. Policymakers thought that because the pain of any potential credit defaults was spread among millions of investors, rather than concentrated in particular banks, it would be much easier for the system to absorb shocks than in the past. “People had looked at what had happened to the Japanese banks and said, ‘this simply cannot happen here’, because the banks were no longer holding all the credit risk,” one senior European policymaker recalls.

In private, some central bank officials harboured doubts about this new creed. From 2003, senior officials at the BIS in Basel, for example, repeatedly warned that risk dispersion might not always be benign. However, such warnings were largely kept out of public view, partly because the US Federal Reserve was convinced that financial innovation had changed the system in a fundamentally beneficial way.

Consequently, no attempt was made to force banks to boost their capital reserves to offset exploding debt issuance; instead, regulatory rules permitted banks to cut their capital levels sharply, which they duly did. “People really believed that the world was different,” recalls Larry Fink, head of BlackRock investment group. “There was this huge trust in the intellectual capital of Wall Street – and that appeared to be supported by the fact that banks were making so much money.”

As a result, when high rates of subprime default emerged in late 2006, there was initially a widespread assumption that the system would absorb the pain relatively smoothly. After all, the system had easily weathered shocks earlier in the decade, such as the attacks of September 11 2001 or the collapse of the Amaranth hedge fund in 2006. Moreover, the US government initially estimated that subprime losses would be just $50bn-$100bn – a tiny fraction of the total capital of western banks or assets held by global investment funds.

In fact, the subprime losses started to hit the financial system in the early summer of 2007 in unexpected ways, triggering unforeseen events such as the implosion of IKB. And as the surprise spread, the three pillars of faith that had supported the credit boom started to crumble.

First, it became clear to investors that it was dangerous to use the ratings agencies as a guide for complex debt securities. In the summer of 2007, the agencies started downgrading billions of dollars of supposedly “ultra-safe” debt – causing prices to crumble. Last week, for example, Merrill Lynch sold a portfolio of complex debt at 22 per cent of its face value, even though this had carried the top-notch triple-A rating.

Then, as bewildered investors lost faith in ratings, many stopped buying complex instruments altogether. That created an immediate funding crisis at many investment vehicles, since most had funded themselves by issuing notes in the asset-backed commercial paper market. It also meant that banks were no longer able to turn assets such as mortgages into subprime bonds and sell these on. That in turn meant the second key assumption that had underpinned 21st-century finance – that the capital markets would always stay liquid – was overturned. Worse still, the third pillar of faith – that banks would be better protected from
a crisis because of risk dispersion – also cracked. As investment vehicles lost their ability to raise finance, they turned to their banks for help. That squeezed the banks’ balance sheets at the very moment that they were facing their own losses on debt securities and finding it impossible to sell on loans.

As a result, western banks found themselves running out of capital in a way that no regulator or banker had ever foreseen. Peter Fisher, a managing director of BlackRock and former US Treasury undersecretary, wrote in a recent paper: “It seems clear that risk dispersion did not work as expected. Major financial institutions did not succeed in shedding risks so much as transferring them among their own business lines.”

Banks started hoarding cash and stopped lending to each other as financiers lost faith in their ability to judge the health of other institutions – or even their own. “Firms became reluctant to participate in money markets ... as a result subprime credit problems turned into a systemic liquidity crunch,” says the IIF.

Then a vicious deleveraging spiral got under way. As banks scurried to improve their balance sheets, they began selling assets and cutting loans to hedge funds. But that hit asset prices, hurting those balance sheets once again. What made this “feedback loop” doubly intense was that the introduction of mark-to-market accounting earlier this decade forced banks to readjust their books after every panicky price drop – in contrast to the pattern seen in the 1990s Japanese banking crisis, or the Latin American debt debacle of the 1980s.

At several points over the past year, policymakers have hoped that this vicious cycle might be coming to an end. Last autumn, for example, conditions briefly improved; early this year brought another respite when central banks pumped more liquidity into the system. Similarly, when the Fed stepped in to prevent the implosion of Bear Stearns in March, sentiment stabilised for a period.

However, in practical terms, the real challenge for financiers and policymakers now – as in Japan a decade ago – is how to build a new sense of trust in finance. In the medium term, regulators are preparing reforms that aim to make the system look credible, even in a world where the benefits of risk dispersion are no longer taken as a creed. These would force banks to hold more capital and ensure that the securitisation process is more transparent. Separately, groups such as the IIF are trying to introduce measures that could rebuild confidence in complex financial instruments.

More immediately, the banks are trying to rekindle investor trust by replenishing their capital bases. The IIF calculates that in the year to June, banks made $476bn in credit writedowns, as debt prices plunged in the panic (although tangible credit losses are hitherto just $50bn). However, they have also raised $354bn in capital. Financiers are also trying to restart trading in frozen debt markets. Experience from earlier financial crises suggests that this will only occur when investors are convinced that they have seen true “clearing prices”. Events such as Merrill Lynch’s recent fire sale of its CDO portfolio may be a step in this direction.

But while confidence is returning in some areas, it continues to be undermined in others. A decade ago in Japan, the banking woes started with a property slump but later spread when banks were forced to cut their lending – which unexpectedly created more bad loans. Thus far, banks have not yet encountered this “second round” effect on a significant scale.

Though defaults are rising on consumer loans, for example, losses on corporate debt remain modest. However, most bankers and policymakers fear that a second wave is simply a matter of time. That makes it hard to predict when the credit crunch will end, how big the total losses may eventually be or even whether the banks are adequately capitalised yet.

“What we learnt in Japan is that banks have a tendency to underestimate how their assets could deteriorate due to the feedback problems,” Mr Nakaso recalls.
A year into the credit crisis, in other words, trust remains a rare commodity in the banking world. It will take years, not months, to restore that crucial ingredient – particularly given that so many of the assumptions underlying 21st-century finance have turned out to be so dangerously wrong.

The writer, the FT’s capital markets editor, is on sabbatical writing a book about the credit crisis. Her first book, on Japan’s banking crisis, was published in 2003 as ‘Saving the Sun’

The chaos in the US housing market and structured finance rippled into the wholesale markets in which banks raise short-term finance. Trust evaporated as financial institutions hoarded cash and withdrew credit from others. The London interbank offered rate, the main measure of interbank lending rates, rose sharply.

The effect was devastating. Six weeks later, Northern Rock, the mortgage lender that relied on interbank funding, was rescued by the UK government after other institutions refused to lend to it. Seven months after Mr Molinaro’s warning, Bear Stearns itself succumbed to the market crisis. It was given emergency funding by the Federal Reserve and forced to sell itself to JPMorgan Chase for $2.1bn (€1.3bn, £1.1bn), paying the ultimate price for the market’s loss of confidence.
Financial institutions are still fighting to restore stability. Banks such as Citigroup, UBS and Merrill Lynch have made billions of dollars worth of asset writedowns, forced out chief executives and repeatedly raised new capital. Lehman Brothers has fought to persuade investors that it is more stable than Bear Stearns.

It is impossible yet to know the full damage from the credit crisis. Bank writedowns are estimated at $476bn by the International Institute of Finance. This is still less than the $600bn of US bank failures in the savings and loans crisis of the early 1990s but $1,600bn has been cut from the global market capitalisation of banks.

Many bankers think the eventual bill will top the S&L crisis, although it may cause less financial harm than the Scandinavian and Japanese banking crises of the 1990s. But, whatever the ultimate bill, the impact on investment banking and financial regulation will be profound. “This has been a very deep and unusual crisis that involves the unwinding of a decade of excess. The impact on the financial sector has been seven on the Richter scale [a “major” earthquake], as dramatic as anything for 25 years,” says Bill Winters, co-head of the investment bank at JPMorgan Chase, which has navigated the crisis better than most.

The crisis has called into question the existence of independent investment banks, the institutions that have been among the biggest winners of the past three decades of financial and trade liberalisation. Investment banks led by Goldman Sachs have grown rapidly and rewarded their employees lavishly: Wall Street banks paid bonuses of $33bn last year.

But many analysts think that the crisis has shifted power in the direction of “universal” banks – those with retail as well as investment banking arms – and away from broker-dealers such as Goldman and Morgan Stanley. The latter may find it hard to keep on operating with small, highly leveraged balance sheets, relying on wholesale markets for funding. “It is pretty clear that retail deposit-taking institutions are in a stronger position . . . I think the business model will change significantly and there will be fewer independent investment banks,” says James Wiener, a partner in Oliver Wyman, the financial consultancy.
Not surprisingly, the universal banks that have expanded into investment banking in the past decade – many by investing heavily in bond operations – agree with this. They think the crisis will give them an opportunity to grab business from the independents, or acquire them.

"Stand-alone investment banks will struggle to operate in anything like the way they were before the crisis," says the head of investment banking at one commercial bank. "They are not going to be able to operate with the same degree of flexibility and leverage."

Investment banks have two challenges. One is to reassure investors that they are financially stable. Bear Stearns collapsed while it was making money and had, theoretically at least, a sound balance sheet. Its former leaders still complain that short-selling hedge funds spread false rumours to bring their institution down.

While they argue this point, however, the four remaining big investment banks have rushed to reduce their leverage and raise their capital reserves. Goldman Sachs, the strongest of them, now holds $90bn in cash and liquid assets and its balance sheet debt has an average maturity of eight years. This makes them safer but it adds to their second challenge of making enough money to satisfy shareholders and keep their most highly valued employees from joining hedge funds or private equity groups.

Banks enjoyed a run from 1998 onwards (with a brief interruption after the September 11 2001 attacks) of rising profits and high ratings. They had been valued at one to 1.5 times their book value because of their earnings

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**US investment banks**

Share prices (in $)

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<tr>
<th>Year</th>
<th>Goldman Sachs</th>
<th>Merrill Lynch</th>
<th>Morgan Stanley</th>
<th>Bear Stearns</th>
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**Wall Street bonuses**

New York securities industry bonuses ($bn)

- **2007**: $33.2bn
- **2008**: $23.2bn (latest forecast)

**Global CDO issuance**

Quarterly totals ($bn)

- 2004: $0
- 2005: $20
- 2006: $100
- 2007: $150
- 2008: $200

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**Writedowns since beginning of 2007**

- **Citi**: $54.6bn
- **Merrill Lynch**: $51.8bn
- **Morgan Stanley**: $14.4bn
- **JP Morgan**: $12.8bn
- **Goldman Sachs**: $3.8bn
- **Bear Stearns**: $3.2bn
volatility but their share prices rose as they persuaded investors that they had learnt how to manage risk.

Few people believe that now and banks’ share prices have fallen abruptly. Not only are their earnings back to being rated as they were before, but the banks have to find ways to replace the huge revenues from bond financing over the past decade.

The optimists point to the industry’s history of migrating from one business to another. The chief executive of one bank says that investment banks often lose 70 per cent of their revenues in financial crises and replace them with new ones. “Investment banks have shown an amazing ability to reinvent themselves,” says Mr Wiener.

Indeed, Scott Sprinzen, an S&P analyst, says investment bank revenues have held up well so far, although results have been hurt by writedowns. Their troubles have even brought them some business – they have earned fees raising capital for each other.

But their longer-term outlook is clouded. The credit crisis has brought home once again the need for investment banks to have diverse earnings streams so that mishaps in one area can be offset elsewhere. In practice, only Goldman Sachs has had sufficient depth and breadth to ride out this crisis reasonably unscathed.

Before the crisis, others were trying to mimic Goldman’s expertise in hedge funds and trading. Bear Stearns was trying to build its fund management arm, Merrill was continuing a long push to transcend its roots as a retail broker and Lehman was expanding outside fixed income. But Bear has gone and others have been set back.

Their capacity to bounce back is constrained by new limits on their balance sheets and freedom of manoeuvre. The market is imposing its own disciplines and regulators are likely to impose others. Bear Stearns’ near-collapse prompted the biggest government intervention in the financial system since the splitting of banks and investment banks and the setting up of the Securities and Exchange Commission in the wake of the Great Depression.

The Federal Reserve has long provided a funding back-stop to banks that took retail deposits through its discount window, but investment banks were not given the same explicit backing. That policy changed during Bear’s rescue, when the Treasury and the Fed judged that it was too central to the US financial system to be allowed to fail.

The Fed gave investment banks temporary access to the discount window and has since extended the guarantee. Even if it eventually closes off access, the precedent has been clearly established: in times of financial distress, the Fed will give financial backing to investment banks.

In return, the Fed will demand much closer oversight. Reforms to the regulatory system await the next president and Congress but the Fed is very likely to gain some oversight of investment banks as well as large retail banks.

Indeed, officials hope that the Bear rescue, which was carried out on terms that involved the bank’s shareholders and executives suffering heavy losses, will serve as a warning. “Investment banks should have a deep interest in making the Fed comfortable. They will not want it to escalate late [launch emergency action in response to a funding crisis],” says one banker.

Fed oversight of investment banks, instead of them being supervised mostly by the SEC, would come at a cost. “A government back-stop would reduce the risks of the business but it could also take away some of the profit potential,” says Mr Sprinzen of S&P.
When there was no implicit government guarantee, investment banks could run highly leveraged balance sheets, carry out a lot of proprietary trading and lend to hedge funds and private equity groups. Now they face scrutiny of, and perhaps curbs on, their most profitable activities.

Some investment bankers remain sanguine, arguing that the past few years was an era of super-profitability that is not likely to return in a hurry. They say that investment banks will be able to adapt after a year or two and resume as normal, albeit with lower revenues and share prices.

But the fear is that investment banks' advantages over their universal bank rivals have been eroded by this crisis. There are not many independents in any case. The disappearance of Bear leaves only Goldman, Morgan Stanley, Merrill Lynch and Lehman Brothers as big broker-dealers.

It may be that merchant banks such as Lazard, private equity groups such as Kohlberg Kravis Roberts, or hedge funds such as Citadel or Fortress will expand to fill the gap left by Bear. Consolidation in financial services has often prompted the rise of new players.

But there is another possibility: that investment banks such as Lehman and Merrill will give up the unequal struggle to match Goldman and be swallowed up into universal banks. Partners at Goldman, who have traditionally worried about being outsmarted by Morgan Stanley and others, now have another concern.

If their rivals cannot bounce back from the credit crisis of 2007, Goldman could end up as an industry of one.

Sources for charts: Thomson Datastream; Office of the New York State Comptroller; Sifma

How risk refused to be sliced and diced

Last week, after a year of continuous, shocking writedowns of banking balance sheets, Merrill Lynch sold a $30bn portfolio of structured securities based on US mortgages for 22 cents on the dollar.

The portfolio was made up of collateralised debt obligations, the structured finance vehicles that lay at the heart of the credit crisis that broke out a year ago. It was described by William Tanona, a Goldman Sachs analyst, as a “capitulation trade” that was painful but necessary.

John Thain (below), Merrill’s chief executive, clearly wanted to draw a line on the past year and move on. But the irony is that CDOs were designed to relieve banks of the necessity to hold loan risks on their balance sheets at all.

The Merrill trade is a sad epitaph for a period in which banks thought they had transformed themselves from lenders to intermediaries in credit markets, and investment banks believed they could lend money as effectively as commercial banks.

In practice, it did not work out that way. When the credit markets froze in August last year, many banks had not yet passed on the risk to others. Many were holding asset-backed securities in “warehouses” and were working on splicing them up into CDOs, getting them rated by a credit agency such as Moody’s or Standard & Poor’s.

This version of banking had developed over two decades with the evolution of credit derivatives and structured finance. Instead of a bank making loans and then either holding them on its balance sheet or syndicating them to others, it structured them into new securities.
This opened up the market for credit to all kinds of investors. The cashflow from a portfolio of mortgages could be spliced into a variety of securities with different interest rates, appealing to a wide range of buyers. Hedge funds and insurance companies became the holders of mortgage loans.

The collapse of the CDO market and recriminations among bankers, credit agencies, investors and regulators has called all of this into question. If the CDO market was riddled with such flawed assumptions and lax calculations, what does that say about the theory behind it?

Few believe the CDO debacle will cause a return to old ways. “We are not going back to the days when banks made loans and kept them all on their books. We have seen that movie and we know what happens in the end,” says one senior banker.

Indeed, the reason why banks moved first to loan syndication and then to securitisation was that they suffered so badly in past banking crises when the borrowers defaulted. Although CDOs failed to protect them, that was not entirely the fault of structured finance techniques.

For one thing, several banks were caught out not only because it took time to structure the securities but because they deliberately held on to what they regarded as “safe” tranches of loans. UBS was badly damaged by retaining “super-senior” CDO debt.

But banks will be a lot warier about treating structured finance as the cure-all for lending risk in future. They are unlikely to be given much choice: investors in such securities will demand more transparency and may well require an originating bank to keep some exposure.

The ultimate lesson of the CDO collapse is that technology does not obviate the need to assess a borrower carefully. Neither banks nor credit agencies did this well enough on behalf of investors and it proved a painful experience for everyone.

Part 3: Fed under pressure

By Krishna Guha
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The US economy remains in limbo: neither pulling away from nor succumbing to pressure from the credit squeeze, falling house values and high oil prices. With only one quarter of negative growth – the final one of 2007 – the jury is still out on whether the US has had or will have a recession. Growth in the first half of this year was weak but positive, boosted by tax rebates, though there are renewed concerns about a double-dip downturn around the turn of the year.

The absence of a full-blown recession owes much to strong support from trade – which has contributed on average 1.6 per cent to annualised growth in each of the past five quarters – and rapid gains in productivity, which have mitigated the oil shock. But most economists believe the Federal Reserve also deserves credit for navigating some difficult trade-offs between growth and inflation – not perfectly, but without making a big mistake on either front.

When the subprime crisis metastasized into the credit crisis in August 2007, the questions were how big an impact this financial disruption would have on the US economy and what tools should be used to address it. Ben Bernanke resolved that the Fed should accommodate a shift in the private sector’s demand for liquidity through enhanced liquidity operations. But implementing this proved difficult. The Fed discovered its liquidity tools were out of date and carried too much stigma to be effective. Tim Geithner,
the president of the New York Fed, was forced to improvise an entire new suite of tools, deployed from December onwards.

Mr Bernanke decided rate cuts were also needed, setting the Fed on a different course to the ECB, which did not face a domestic housing slump and falling household wealth. This brought substantial depreciation of the dollar against the euro and some other floating currencies – the Fed had wanted some depreciation but was edgy about the possibility that this could become disorderly.

The US central bank began cutting rates before there was any tangible evidence of a slowdown in the economy. But it did not move fast enough for many in the markets. At its policy meeting in October, the US central bank blundered by signalling that it thought it had done enough. Tensions with the market were aggravated by outspoken comments from hawkish regional Fed presidents.

Towards the end of 2007, Mr Bernanke, his number two Don Kohn, and Mr Geithner pulled more reluctant colleagues along with further rate cuts. But they moved cautiously, concerned about the link between rate cuts, the dollar, rising oil and inflation. Then a sudden weakening in economic data at the turn of the year suggested the Fed had fallen behind the curve. Mr Bernanke took control and cut rates by 125 basis points in eight days in late January 2008 – with another 75 point cut in March. Nothing like this had happened in 18 years of Alan Greenspan’s Fed chairmanship.

The Fed cited two reasons for this dramatic action: the need to buy insurance against the “tail risk” of a very bad outcome on growth, and to offset the widening in risk spreads. It never clarified the relative weight of these factors – which haunts the Fed today, as the debate turns to the conditions for raising rates again.

As the financial markets appeared poised for meltdown with the crisis at Bear Stearns in mid-March, the Fed acted decisively in partnership with the Treasury to support a takeover and ensure other investment banks had access to emergency cash – creating in the process a serious moral hazard problem for the future.

Since then, as headline inflation has risen to 5 per cent, putting pressure on core prices and unsettling inflation expectations, the Fed has begun to worry more about inflation risk. Inside the Fed there is a consensus that the next move in rates is up; the argument is over when and how fast. Fresh concerns about growth could keep the Fed on hold for a while, particularly if it turns out that oil really has peaked. But only if inflation expectations edge lower in response to economic weakness and lower oil. Looking ahead, Fed officials think the moment could come when they can decouple liquidity and interest rate tools, using liquidity tools to support a fragile financial system while recalibrating rates to address macroeconomic forces.

In a series of speeches, Paul Volcker, the former Fed chairman, expressed concern that too much is being asked of the Fed, which is operating at the limit of its mandate and of what its tools can achieve. This sentiment is shared within the current Fed. Policymakers fear the market exaggerates the Fed’s power to shape economic trade-offs as opposed to choose between them. Many Fed officials feel the current policy mix is wrong – that the government should do more, allowing them to do less. But they are sceptical of the merits of a second stimulus, and feel if public funds are deployed, they should be targeted at housing and bank capital instead.
Imagine you had fallen asleep a year ago and had just woken up, wanting to reacquaint yourself with the world economy. You would get quite a shock.

Just as it was last summer, global growth is strong. The International Monetary Fund expects expansion of 4.1 per cent this year, compared with an average of 3.4 per cent since 1990.

Inflation is the real surprise. Last July the IMF predicted price pressures would remain “generally well-contained despite strong global growth”; today, inflation in advanced economies is at its highest rate since 1992, rising from 2.2 per cent in 2007 to an IMF projection of 3.4 per cent in 2008. For emerging and developing countries inflation is up from 6.4 per cent to 9.1 per cent, the fastest since 1999.

On seeing the data alongside high food and oil prices – still way above their levels last year, in spite of recent falls – your immediate historical parallel would not be one that is often drawn, with the early 1930s; it would be the inflation followed by stagnation of the 1970s. The IMF’s forecast of a slowing world economy in the second half of 2008 is entirely consistent with high commodity prices.

You would not have expected US interest rates to have been cut from 5.25 per cent to 2 per cent; for real interest rates across Asia to be negative and for European interest rates to be more or less the same as a year ago.

So, a year into the big freeze in financial markets and the world economy bears all the hallmarks of overheating, not another Great Depression. Yet that global truth is almost entirely lost on policymakers, many of whom talk about rising energy and food prices as if they had nothing to do with them.

Ben Bernanke, the Federal Reserve chairman, told Congress in July that domestic problems had been “compounded by rapid increases in the prices of energy and other commodities”. Jean-Claude Trichet, president of the European Central Bank, complains that the “worrying level of inflation rates results largely from sharp increases in energy and food prices at the global level”. Mervyn King, the Bank of England governor, meanwhile insists that rising UK inflation is the fault of “developments in the global balance of demand and supply for food and energy”.


Such sentiments are shared in the developing world. Speaking after the annual meeting of the Bank for International Settlements, Zhou Xiaochuan, governor of the People’s Bank of China, said: “We know the international price of energy and other commodities, they add additional pressure to inflation in China.”

Each statement is accurate taken in isolation; collectively, they are nonsense. The world cannot import inflation. If every country pursues policies to maintain demand and “look through” a temporary rise in commodities, global demand is likely to continue to exceed supply for some time.

As Mr King, when he was thinking more globally, told British parliamentarians in June: “The biggest challenge for the world economy as a whole is not the oil price as such – I think there are mechanisms that will lead eventually to an equilibrating between demand and supply – but it is trying to ensure a monetary policy framework for the world as a whole that does not build
into it an excess inflationary impetus.” The implication was that the world, but not individual countries, might need the ravages of a credit crisis to slow the rate of global expansion enough to keep inflation under control.

So how did the global economy get into such a mess? There is little doubt that the immediate cause of both the commodities price boom and the credit crisis has been low global interest rates.

Cheap money encouraged rapid growth: between 2004 and 2007, the world economy expanded at its fastest rate in 30 years. It encouraged investors to search for higher yields and buy into new asset classes. The new money led to easier credit conditions, extending cash to US borrowers with patchy credit histories who previously had been unable to buy property, cars and durable goods.

US expenditure on imports maintained the rapid expansion of production in Asia and in oil exporters, aided by extremely competitive exchange rates and rigid currency ties. Meanwhile, consumption restraint kept capital flowing from poor to rich countries and stopped the world economy overheating.

For a long time, this appeared to be a virtuous circle, dubbed “Bretton Woods II” in reference to the pegged exchange rate system that operated from the end of the second world war until the early 1970s. Most economists thought the 21st century version would prove as unsustainable as its predecessor, relying as it did on ever-greater US trade deficits. Concerns grew over “global imbalances” and predictions abounded that they would finally unwind with a collapse in confidence in the US dollar.

None of the forecasts of doom materialised. Instead, the crucial rupture came when rising defaults among US subprime mortgage-holders undermined the rationale for the expansion of credit, forcing the contraction of financial balance sheets that has stalked the financial world ever since.

Over the past year, meanwhile, rapid global economic growth finally hit capacity constraints. Demand for commodities and food continued to exceed supply, forcing prices sharply higher, raising inflation and further undermining spending power in advanced economies.

Most economists were sanguine when the credit crisis broke last August. A crisis in subprime mortgages would not affect the vast bulk of lending to households and companies, they argued, and the stock of subprime debt was too small to affect the health of the financial sector. Central bankers welcomed what they saw as a desirable repricing of risk.

But as August wore on and the crisis deepened, economic views as well as policy began to change. The European Central Bank and the Federal Reserve offered emergency liquidity support for financial institutions. By mid-September, the Fed had cut its policy rates by half a percentage point and the ECB had postponed a rise it had previously pencilled in. Ever since, the US has been easing monetary and fiscal policy.

Each central bank has a delicate balancing act to perform. Let high inflation become normal in an economy and a wage-price spiral can develop, requiring much more brutal policy action in
the future. But allow the economy to weaken too far and a vicious circle could develop, with more bank defaults leading to further downward pressure on growth.

The conditions are different in every country. As the Bank for International Settlements, the central bankers’ bank, said in its annual report, this should “rule out a ‘one size fits all’ response”.

Gulf, Asian and developing economies are caught between the popular demand for continued rapid growth and the constraint of higher inflation, made all the more damaging by the fact that food and fuel account for a higher proportion of spending in poor countries.

So far, maintaining growth has been the priority. Price rises started in food and energy but have now become widespread, with signs of upward pressure on wages. The Asian Development Bank warned last month of the danger of “repeating the mistakes industrialised nations made prior to the Great Inflation of the 1970s”.

Hardest to deal with is the collective action problem: the right policies for individual economies do not necessarily add up to the right policies for the world. This is where the International Monetary Fund should step forward to break the deadlock. But the IMF’s impotence in securing policy changes from countries that have no need of its finance has been laid bare over the past year.

In its recently updated World Economic Outlook, it noted how the US, the eurozone, Japan, China and Saudi Arabia had agreed “mutually consistent” policies in 2006 to squeeze global imbalances and make the global economy a safer place. Last month, John Lipsky, the Fund’s number two, insisted he still viewed the policy proposals to be relevant. But he was forced to concede that there has been little progress in implementing them.

China’s currency has appreciated against the dollar but not by much on a trade-weighted basis. The US has abandoned budgetary consolidation in favour of stimulus packages. Saudi Arabia’s plans to spend more of its oil revenues on its population have come unstuck as energy prices have risen. Europe and Japan are peripheral to the action and have made little impact on imbalances either way.

Mr Lipsky was forced to conclude: “While the dollar depreciation is helping to reduce the US current account deficit, it has not been sufficient to alleviate imbalances and risks. Rather, new misalignments may be emerging and risks may be shifting.”

So what next for the world economy? If consensus forecasts are to be believed, everything will be fine. The world economy will slow just enough to ensure that the inflationary period is temporary; financial markets will gradually recover; and the world economy will continue to grow at about 4.5 per cent a year indefinitely.

This appears much too rosy and probably suggests a faster sustainable rate of world economic expansion than the evidence of the past few years suggests is plausible. As the BIS annual report concluded: “With inflation a clear and present threat, and with real policy rates in most countries very low by historical standards, a global bias towards monetary tightening would seem appropriate.”
Many central bankers certainly think the consensus is too optimistic. In private, dark humour abounds. They are sure they will make a mistake but have no idea in which direction it will be. And everyone wants someone else to take the really tough decisions.

The US and Europe want Asia to tighten policy and revalue currencies to snuff out inflation. Asia, however, insists that its exchange rate policies are its own concern and wants to defend its remarkable growth rates and export-led industries, blaming advanced economies for a home-grown financial crisis. Oil producers hope to be able to ride the energy boom without succumbing either to an inflationary spiral or a sudden worldwide recession, sending oil prices crashing.

For all the disagreements, there is little doubt that the world economy is in trouble, poised between the rock of recession and hard place of overheating. It will take a remarkable resumption in global policy co-ordination and a huge dose of luck to avoid one or the other.

Sources for charts: IMF; Thomson Datastream; Morgan Stanley

A Fed under pressure is forced to push its mandate to the limit

The US economy remains in limbo: neither pulling away from nor succumbing to pressure from the credit squeeze, falling house values and high oil prices. With only one quarter of negative growth – the final one of 2007 – the jury is still out on whether the US has had or will have a recession. Growth in the first half of this year was weak but positive, boosted by tax rebates, though there are renewed concerns about a double-dip downturn around the turn of the year, writes Krishna Guha.

The absence of a full-blown recession owes much to strong support from trade – which has contributed on average 1.6 per cent to annualised growth in each of the past five quarters – and rapid gains in productivity, which have mitigated the oil shock. But most economists believe the Federal Reserve also deserves credit for navigating some difficult trade-offs between growth and inflation – not perfectly, but without making a big mistake on either front.

When the subprime crisis metastasized into the credit crisis in August 2007, the questions were how big an impact this financial disruption would have on the US economy and what tools should be used to address it. Ben Bernanke resolved that the Fed should accommodate a shift in the private sector’s demand for liquidity through enhanced liquidity operations. But implementing this proved difficult. The Fed discovered its liquidity tools were out of date and carried too much stigma to be effective. Tim Geithner, the president of the New York Fed, was forced to improvise an entire new suite of tools, deployed from December onwards.

Mr Bernanke decided rate cuts were also needed, setting the Fed on a different course to the ECB, which did not face a domestic housing slump and falling household wealth. This brought substantial depreciation of the dollar against the euro and some other floating currencies – the Fed had wanted some depreciation but was edgy about the possibility that this could become disorderly.
The US central bank began cutting rates before there was any tangible evidence of a slowdown in the economy. But it did not move fast enough for many in the markets. At its policy meeting in October, the US central bank blundered by signalling that it thought it had done enough. Tensions with the market were aggravated by outspoken comments from hawkish regional Fed presidents.

Towards the end of 2007, Mr Bernanke, his number two Don Kohn, and Mr Geithner pulled more reluctant colleagues along with further rate cuts. But they moved cautiously, concerned about the link between rate cuts, the dollar, rising oil and inflation. Then a sudden weakening in economic data at the turn of the year suggested the Fed had fallen behind the curve. Mr Bernanke took control and cut rates by 125 basis points in eight days in late January 2008 – with another 75 point cut in March. Nothing like this had happened in 18 years of Alan Greenspan’s Fed chairmanship.

The Fed cited two reasons for this dramatic action: the need to buy insurance against the “tail risk” of a very bad outcome on growth, and to offset the widening in risk spreads. It never clarified the relative weight of these factors – which haunts the Fed today, as the debate turns to the conditions for raising rates again.

As the financial markets appeared poised for meltdown with the crisis at Bear Stearns in mid-March, the Fed acted decisively in partnership with the Treasury to support a takeover and ensure other investment banks had access to emergency cash – creating in the process a serious moral hazard problem for the future.

Since then, as headline inflation has risen to 5 per cent, putting pressure on core prices and unsettling inflation expectations, the Fed has begun to worry more about inflation risk. Inside the Fed there is a consensus that the next move in rates is up; the argument is over when and how fast. Fresh concerns about growth could keep the Fed on hold for a while, particularly if it turns out that oil really has peaked. But only if inflation expectations edge lower in response to economic weakness and lower oil. Looking ahead, Fed officials think the moment could come when they can decouple liquidity and interest rate tools, using liquidity tools to support a fragile financial system while recalibrating rates to address macroeconomic forces.

In a series of speeches, Paul Volcker, the former Fed chairman, expressed concern that too much is being asked of the Fed, which is operating at the limit of its mandate and of what its tools can achieve. This sentiment is shared within the current Fed. Policymakers fear the market exaggerates the Fed’s power to shape economic trade-offs as opposed to choose between them. Many Fed officials feel the current policy mix is wrong – that the government should do more, allowing them to do less. But they are sceptical of the merits of a second stimulus, and feel if public funds are deployed, they should be targeted at housing and bank capital instead.

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