World economy: Financial crisis exposes market myths

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In the wake of the Asian financial crisis of 1997-98, there was much talk in financial and political circles of the need for a new "global financial architecture" and greater "transparency" in order to prevent a recurrence of the crisis that hit global markets.

Almost a decade on, plans for a new financial structure remain unfulfilled. While the demand for transparency was partially met with increased reporting by financial authorities, the basic irrationality of the market-system has now re-emerged with devastating force.

One of the chief arguments advanced by the defenders of the market and its "wisdom"—it was a favourite of former Federal Reserve Board chief Alan Greenspan—is that no other "information system" could possibly take its place in the organisation of a complex global economy.

This mythology has once again been blown apart by the latest crisis, which has its origins in the lack of information about the murky processes taking place in the very heart of the global financial system, above all in the American market.

One of the chief factors behind the credit crunch, which brought about the near seizure of financial markets earlier this month, was that it was virtually impossible to ascertain to what extent major banks and financial institutions were caught up in risky trades involving so-called subprime mortgage debt. Consequently, there was a freeze in the market for commercial paper—the debts issued by large firms and financial corporations by which they obtain short-term funds necessary for their day-to-day operations.

This meant that, while the subprime mortgages constitute a relative small proportion of financial markets, the uncertainty over which hedge funds and bank-backed investment arms might be holding them caused the whole market to start to seize up.

Now the extent of at least some of the involvement by major banks and other financial institutions is starting to come to light.

The major British bank Barclays is under scrutiny over its links to SachsenLB, the failed German state bank that was heavily involved in risky US subprime debt. Last May Barclays set up a fund on Sachsen's behalf—Sachsen Funding 1—which had assets of about $3 billion, the majority of which was invested in securities based on prime and subprime US mortgages. According to a report in the *Financial Times*, Barclays exposure is in the "low hundreds of millions of dollars."

In the US, *Fortune* has reported on an unusual operation by the Federal Reserve to bend key banking regulations to assist Citigroup and Bank of America. The article cited two letters from the Fed written on August 20 in which it agreed to "exempt both banks from rules that effectively limit the amount of lending that ... federally-insured banks can do with their brokerage affiliates." According to the report, Citigroup and Bank of America requested the exemptions to "provide liquidity to those holding mortgage loans, mortgage-backed securities, and other securities."

On August 22, Citibank and Bank of America were among four banks that accessed $500 million each in 30-day financing from the Fed's discount window. The move was described at the time as being aimed at encouraging banks to use the credit facility, thereby removing the stigma generally attached to such borrowing.

Commenting on the Fed exemption, a Bank of America spokesman said it was just a "technicality" to "enable us to use our regular channels of business with funds from the Fed's discount window."

In the case of Citigroup, the Fed said it had made the exemption to allow the bank to get liquidity to its brokerage arm in "the most rapid and cost effective manner possible."

The granting of the exemptions has raised questions about the effect of the liquidity crunch on the major banks and their offshoots. As the *Fortune* article noted: "At the time, the gloss put on the discount window advances was that they were orderly and almost symbolic in nature. But if that were the case, why the need to use these exemptions to rush the funds to the brokerages?"

No doubt further questions will arise as details about extent of the credit crunch come to light. Meanwhile, the impact of one of the underlying factors—the decline in the US housing market—shows no sign of easing.

The latest data show that the supply of unsold homes in the US rose to a 16-year high last month with economists predicting that the downturn would worsen as the July figures only reflected conditions in May and June, before the tightening of credit.

And the problems in the housing market are having flow-on effects. Figures released this week show that defaults on credit cards are increasing. Credit card companies were forced to write off 4.58 percent of payments as uncollectible in the first half of 2007, an increase of almost 30 percent compared to the same period last year. One of the factors is the tightening of housing credit which means that it is more difficult to draw down on home mortgages to pay credit card debt.

One of the most significant features of the present crisis is the utter perplexity of the media commentators who seek to explain the workings of the global capitalist economy and who insist that, whatever its faults may be, it is the only possible form of economic organisation.

The *Washington Post* economics correspondent Robert Samuelson, writing in *Newsweek* on August 22, recalled the experience of the Great Depression and then noted that today's global economy undeniably faced "some big, potentially destabilising threats" of which global finance was one. However, anyone claiming to understand today's world financial system was either "delusional or dishonest."

Not wishing to go too far, Samuelson left unexplored the implications of his own comments: that the lives and well-being of tens, hundreds of millions of people, are threatened with devastation by an economic system, which the powers that be cannot even understand, let alone control.

Stephen Roach, head of Morgan Stanley Asia and the group's former chief economist, put the crisis down to a failure of central banking. Pursuing an easy money policy, the central banks set in motion a chain of events that allowed one financial bubble to beget another—from equities, to housing, to credit.

Roach, who has consistently pointed to the implications of the imbalances in the global economy, warned that the world could not "lurch from one bubble to another" and that the cost of neglect was "an ever-mounting systemic risk that could pose a grave threat to an increasingly integrated global economy." But he had no answers to the crisis, apart from a call for a "major overhaul" in the art and science of central banking "before it's too late."

The *Financial Times* economic commentator, Martin Wolf, in a column published on August 21, wrote that while the Fed could be accused of being a "serial bubble-blower" this was not because it was being managed by incompetents. Rather, its actions were the response of competent people to "exceptional circumstances."

Under conditions where massive current account surpluses—the excess of savings over investments—were being accumulated in other parts of the world, notably China and East Asia, the US has necessarily functioned as the world's spender and borrower of last resort. And under conditions where businesses were failing to invest in the US economy, this meant that the Fed has had to pursue a policy "capable of producing a huge and unprecedented financial deficit among US households." Unless it did so, the economy would plunge into recession.

"Today's credit crisis," he concluded, "... is far more than a symptom of a defective financial system. It is also a symptom of an unbalanced global economy. The world economy may no longer be able to depend on the willingness of US households to spend more than they earn. Who will take their place?"

Wolf chose to leave his analysis there because to pursue it further would raise troubling questions about the viability of a system that can only continue to function by creating the conditions for an economic disaster.