A put back final

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Expanding money supply is an irresistible temptation. The 'cheap dollar' policy led by the United States in the past ten years boosted the real estate market but unleashed degradation of credit standards. This resulted in hoards of defaulting Americans receiving homes and the world's financial system being hit by a continuous crisis.

Toxic waste crisis

The major instrument to engage the general public in the real estate boom was unconventional debt instruments sold at competitive prices. One of these was negative amortization mortgage whereby debt accumulated but was not repaid or, alternatively, only interest was paid with the principal remaining constant. Extremely low, 'teaser' interest rates were widely used alongside other tools. No wonder many found attractive the opportunity to buy a home in the conditions of soaring house prices; many of those borrowers would never afford a new home in normal conditions however.

The number of defaulting debtors and the aggregate amount of their debts were skyrocketing. The share of Subprime loans soared from 5% in 2001 to 20% in 2006. Mortgage lenders would deliberately ignore solvency evaluation and take high credit risks. They would shift the risks on other financial market players through hedge funds and derivative instruments. Among derivatives, collateralized debt obligations (CDO) played a key role as they allowed piling up heterogeneous mortgage liabilities into a single 'basket'. The 'fly in the ointment' rule was largely ignored at the time. It was considered that the share of non-performing mortgage loans was small; and consolidating of mortgages into a single debt pool ensured diversification of risks and guaranteed profits to end investors. Eventually, there appeared too many 'flies': according to the Credit Swiss estimates, the share of Subprime in backing of the total quantity of CDOs in circulation ($1 trillion) was 50%. No wonder the market of these instruments ceased to exist de facto: turnovers dropped more than 80% by July.

A new type of financial activity produced a host of new financial terms. CDOs, after becoming the most odious end product through the life of a mortgage were dubbed 'toxic waste'. This is reminiscent of another notorious financial term that emerged in the early 1980s – garbage lending. Another finance market-related abbreviation widely used in that time was NINJA, deciphered as 'No Income, No Job or Assets'; this denoted the category of end borrowers who constituted the core of the Subprime segment.

The result was a bit too unsatisfying: a great number of companies operating on the mortgage market – many of which dealt with Subprime instruments – witnessed failures. The most illustrative of those was Countrywide, the United States mortgage lender that was on the verge of bankruptcy although it did not make any direct investments in the potentially defaulting sector; it fell a victim to credit crunch affecting healthier segments. Construction – that largely determines macroeconomic dynamics – was almost halted, although real estate prices tended to grow in the first half of the year). Hopefully, the financial markets are not yet seeing a drastic downturn, what is happening to them is just a liquidity shortage.

Credit crunch

The fact that this crisis occurred in the United States' most developed and advanced financial market points to some serious problems. Liquidity crises are not uncommon in emerging markets where baseless rumor can provoke depositors' runs on banks or trigger off stagnation in interbank lending. We all remember the 2004 summer events that emerged virtually out of nothing. That was absolutely abnormal for a developed financial market, all the more so because fundamentally the economy was performing well. As a matter of fact, the real sector of the US economy has no deep problems exclusive of the building industry. The main quality shift happened only in the financial market: this year they abruptly turned out volatile. Therefore, it is no surprise a credit crunch set in causing liquidity shortage.

As a result of problems in the Subprime segment, the core of the financial system saw a total re-evaluation of risks, and many market players refused from refinancing mortgage liabilities. Investors preferred to buy liquidity or higher-quality assets (which appeared hard to figure out). Rising volatility forced many market players to reconsider their investment portfolios and attitudes towards exposures. The major lenders including state agencies, pension funds and savings banks had to get rid of securities with depreciated ratings as they were not allowed to hold them under the existing rules.

Besides, the participants had to foresee how events would unfold further and take into account unwanted consequences. The major system risk factor was a possibility of the liquidity crisis growing into a large-scale insolvency crisis that could eventually cause financial markets to crash. In many cases the market was unable to differentiate between good and bad borrowers: it is hard to predict whether a borrower is solvent or not, especially when its true financial standing is veiled by multi-level derivative instruments. On the other hand, insolvency is able to cause chain reaction (at this stage, it would be relevant to recall the 1990s Russia's experience). Besides, a borrower's financial state depends on relative asset and liability prices. What is a sound borrower today can turn out a bankrupt tomorrow should prices slump.

Therefore, the resulting panics that overwhelmed financial markets in July were expoundable. The panics illustrated the negative reaction of stock quotes that followed adequate actions undertaken by monetary authorities. When, for instance, the European Central Bank released liquidity, the market players interpreted it as a sign of a coming recession rather than an upturn.

Monetary challenge

The United States monetary authorities whose monetary policies favored financial booms were blamed for that crisis squeeze mess. However, those policies mitigated the consequences of the stock market downturn that was caused by the 2000 new economy bubble.

Low basic interest affected long-term rates thus unleashing an economic growth fueled by consumer demand. The issue of balances between incomes and expenditure was put off, but there was no reason to tighten the monetary policy. The period of the 'easy money' was short – it lasted from October 2001 to October 2004.

The strategy of connivance to soap bubbles, led by the Federal Reserve Service's head Alan Greenspan and his successor Ben Bernanke, ran into criticism. Critics rest on an assumption that monetary instruments are ineffective for strangling growth of asset costs by the market and suggest that it is better to relieve the consequences of financial market crashes rather than prevent them. It is highly probable that the United States monetary authorities will have to relieve such consequences another time, and there are such aftereffect policies are historically preconditioned - we will tackle it later. The present situation at the financial markets has no precedents and is probably more complicated than crises that occurred back in the 1980s and 1990s (related to real estate and new economy bubble failures). Two factors are paramount – transformation of financial markets that took place recently and globalization. The range of participants and instruments is now much wider than in the case of usual runs on liquidity. Non-financial companies engaged in lending operations are directly related to what is happening on this market. A growth in corporate spreads that illustrates problems in debt-refinancing also signifies the snowballing failures in this segment.

Spreading of derivative instruments complicated the life of both the market players and regulating bodies. Assessing of the quality of financial institutions' assets has become much more difficult because credit risks, including Subprime exposures, are hidden in derivatives. Regulating agencies are losing controls: even the banking system failed to bypass a range of restrictions of the prudential monitoring and uses absolutely different risk parameters than earlier. With hedge funds, credit risks are differentiated not only by the market segments, but by countries as well. On the one hand, their concentration in the United States has become weaker and this is good for the world's economy; on the other, the threat of crisis expansion is looming.

The developed countries' monetary authorities have to overcome all these difficulties. At present, their top objective is to halt the panics. Adequate and timely measures may be crucial for normalizing the situation, but mistakes (or inaction) will sharply exacerbate it. The classical example is the beginning of the Great Depression in 1929 when monetary authorities failed to prevent the catastrophic money contraction. The Russia's 1998 crisis was so painful because of the authorities' reluctance to allow devaluation of the ruble and helplessness in public debt management.

Fighting with bubbles

Let us tackle these two historical examples as they prompt us interesting analogies with the current situation. The main cause of the Great Depression was FRS' ignoring the stock market's interests. Let us start with the stock market downturn that happened in October 1929.

The pre-crisis key indicators of the United States economy were quite good, and the economy saw a continued growth in the post-war decade. The stock market however was overheated, but it only illustrated the general 1920s optimistic attitudes. Politics were a factor in the 1929 events: elected in 1928, president Herbert Hoover was an opponent of financial speculations. The fight with the stock bubble was seen as the primary task of the new FRS leadership headed by Adolph Miller who took office one year prior to the crisis. The FRS was given a task – absolutely uncommon for a monetary agency as such – to strangle the growth of the stock market. For that purpose, starting from 1929, the FRS used various techniques to block the main source of the market play – bank loans. The government erroneously thought that the financial sector hit real economy by raising loans as funds were pulled out of it. The government did not understand that the stock market deals did not withdraw any resources. Market players just exchanged stocks for bonds, but to effect transactions they needed liquidity that only the Central Bank could provide. In 1929, the Central Bank repeatedly attempted to halt fund-raising.

When the FRS tightened the money supply, the stock market survived a shock. It first happened in March 1929, after the Fed announced a new course, however the market recovered quite quickly then. The leadership of the Federal Reserve Bank of New York on its own discretion injected liquidity in the banking system for which it ran into criticism later. The financial system was unable to sustain the October 1929 downturn because the Fed appeared consistent in depriving financial markets of liquid assets. The banking industry, households and the corporate sector faced a drastic shortage of liquidity. It all eventually led to deflation and a catastrophic decline of the American and world's economy: GDP dropped 30% by early 1930s and unemployment reached 25%.

The key problem was not the Fed's following populist principles in fighting 'financial speculation'. More importantly, that system did not perform the function of a 'last instance creditor'. This function stipulates an ability to allot as much liquidity as required to mitigate the threat to the financial system. In situations like this the inflation issue is secondary because a liquidity crisis may have much more dangerous consequences. The more competent leaders of the Fed that headed it before 1928 understood that and, when required, took necessary measures on their own discretion.

The causes of Russia's 1998 crisis were different, but it is also illustrative of the role of monetary authorities in crises. At the time, Russia's financial system faced a chronic budgetary deficit, but at the onset of the crisis the fundamental economic parameters were not that bad. The economy started to recover from the 1995 stabilization shock, inflation was driven down to 7% (June 1998 against June 1997), the GDP started to grow first after the reforms were began (up by 0.8% in 1997). The balance of payments in 1997 was next to zero against current accounts (despite plummeting petroleum prices) and positive against capital accounts. The debt burden was heavy, but it was manageable: by the end of 1996, funds to cover external debts were allocated for years ahead, and repayment term for the short-term public debt could be extended.

After the 1997 Asian crisis set in, the government considered refusing from ruble exchange rate fixing as it was pointless after the inflation was curbed. However, monetary authorities were limited in their actions due to the clear political course. After the widely advertised ruble denomination in summer 1997, it was impossible to refuse from fixing the exchange rate and allowing the ruble to depreciate. Besides, the Bank of Russia was afraid of worsening the state of the banking system that had large foreign currency liabilities.

These two motifs explain readiness of the monetary authorities to protect the ruble by all means. In the course of two speculative attacks – in November 1997 and between May and June 1998, the exchange rate regime was preserved at the cost of huge losses in foreign exchange reserves - $6 billion in the first case and $5 billion in the second. Initially, the Central Bank pursued to kill tow birds with one stone – to uphold the ruble exchange rate and prevent a sharp increase in interest rates. When it became clear that the foreign currency reserve was melting, the Central Bank chose a hard monetary policy. The ruble protection led to shock jumps in government bond rates – from 30% to 150% in May 1998. This aggravated the problem of debt repayment that accelerated devaluation and had a shock effect on the banking system by worsening its ruble payables. Besides, the hard monetary policy, instead of ensuring timely devaluation, attracted more international speculators to ruble assets. In August 1998, the ruble had to be devalued – already under the totally different circumstances. The price of surviving the crisis appeared extremely high due to inconsistent and erroneous actions taken by the Bank of Russia.

Searching a way out

Let us again consider the events presently occurring in the global financial markets. The most urgent question is whether monetary authorities should or should not prevent financial company failures observed at the moment. On the one hand, this is a natural process caused by insolvency. The credit crunch revealed a real state of things and will finally aid a revival of the financial system. There is no sense in counteracting to self-destruction of non-performing structures. On the other hand, massive bankruptcies may become unmanageable at a certain stage. A possible collapse of the major market players such as Countrywide can turn out a catastrophe, and it is better to prevent it (like it was done nine years ago with the LTCM hedge fund).

In this regard, monetary authorities have no other choice but to continue to handle liquidity of financial markets. Choosing an optimal policy to strengthen the players' trust in the market is crucial. It is pointless, even harmful, to flood the financial system with liquidity (a vivid illustration is stabilization loans issued to some Russian banks who continued to devaluate the ruble after August 1998).

The pragmatic anti-crisis policy stipulates simultaneous fulfillment of two conditions. Firstly, it is necessary to ensure liquidity be working at banks that are closer to the discount 'window'. Being overcautious, they cut off other players from refinancing. Secondly, there is a need to drop the 'save all by all means' principle. Not limited by anything, supply of liquidity worsens screening of inefficient borrowers and does not improve risk management. Readily available money saved those who created risks that generated a mortgage crisis. This will inevitably cause serious problems in future. Standard techniques from a suite of banking regulation instruments are not apt for fighting the present crisis. New solutions are needed that would ensure diversification and flexibility of liquidity supply channels. For example, the list of securities and participants of repo operations should be enlarged, loan terms – extended, and differentiated discount rates should be used. The Fed outlined these intentions by announcing a reduction in the discount rate recently. Implementation of such measures would ensure a shift towards microeconomic mechanisms of liquidity management and, perhaps, even change of status of central banks as 'last instance creditors' into 'last instance market makers' (which has been repeatedly proposed in the recent time).

It is also very important that the United States and European monetary authorities give an adequate evaluation to system risks and probable scenarios of the crisis progress. This is necessary for undertaking such preventive measures as used to be helpful for settling difficulties. It is also vital to maintain efficient market communication. The FRS leadership statements in the Greenspan epoch would be taken very seriously even if there were ambiguous. The liquidity crisis cast doubts on the quality of this system, which is illustrated by the overall panic. Therefore, monetary authorities should take efforts to secure transparency of their policies for which purpose statements should be made more often and be clearer.