

The West's financial crisis

Extraordinary measures to restore stability

IN SEPTEMBER AND October 2008, Western governments have taken exceptional measures to prevent the disintegration of their financial systems. It is not yet clear that these will be sufficient to quell the turbulence in money and share markets. A package of official support measures for British banks announced on 8 October was at least as large as the \$700 billion bailout of American banks approved by Congress five days earlier.

At the heart of the panic was a collapse in something usually taken for granted: the mutual trust that enabled banks to lend to each other in the money markets, providing the underpinning for all commerce. Underlining the dearth of market liquidity that was caused by this loss of confidence, the Federal Reserve, the US central bank, said on 7 October that it would begin to provide short-term financing directly to top-rated non-financial companies, whose normal funding routes were being disrupted. The seriousness of the crisis – and its likely impact on the economies of the western world – was also indicated by six central banks' announcement of a coordinated cut in interest rates.

For a year after the troubles began in summer 2007, it had been too easy to dismiss the 'credit crunch' as something that was happening in rather obscure parts of the financial markets. Even though many Americans were in difficulties with home-loan repayments, the problem was somehow seen as one for Wall Street and its equivalents in other countries, and not for the 'real' economy.

All the while, however, banks across the world were struggling to fund themselves on the money markets. In September 2008, these difficulties became unmanageable: because banks could not trust each other's credit, they stopped lending to each other for all but the shortest periods. This forced the weakest banks to the wall, necessitating a series of rescue operations.

The biggest trigger of the chaos was the 15 September bankruptcy of Lehman Brothers, the US investment bank, which the US government chose not to rescue. Lehman Brothers' failure left many institutions exposed to potential losses, and made it even more difficult for them to judge the creditworthiness of others.

Since bank credit is the foundation of all business, the banks' funding problems



A New York trader claps his forehead on 8 October, as shares continued to slide, despite various government rescue packages around the world

were always going to have an impact on the wider world. But this was not at all an accepted fact even as recently as 24 September, when US President George W. Bush urged Congress to support the \$700bn government bail-out of financial institutions. Without the rescue, he said, more banks would fail, share and property prices would plummet, and millions of Americans would be without jobs and access to credit. Many members of Congress, apparently, did not believe him; the House of Representatives' first vote was to reject the package, even after bipartisan negotiation, as politicians balked at spending taxpayers' money to save rich bankers.

By the time Congress passed the legislation on 3 October, rescues had been arranged for more American and European banks. Days later, the possibility that the dominoes could continue to fall led to widespread fears about the safety of savers' deposits, especially in Europe. The potential for the effects to be felt beyond the financial markets had suddenly become obvious to all.

Containment efforts

Until mid September, the general perception was that the crisis was being contained mainly among those who were responsible for originating it, namely unwise borrowers in the American real-estate market and financial institutions exposed to bad property finance. This was a classic boom-and-bust scenario. The long period of economic growth

in the US and elsewhere had fostered expectations that real-estate prices would continue to rise. Money was plentiful because of the huge flow of investment funds into the United States and other strong economies. But the boom in property prices had drawn in many 'subprime' borrowers with poor credit records, and there was bound to be pain when it came to its inevitable end.

What turned a cyclical downturn into a crisis was the fact that the innovators of Wall Street, seeking ways to lend and earn as much as possible and to take advantage of investors' demand for assets, had packaged mortgages into complex financial instruments which were assigned high credit ratings. After US property prices sagged in 2006 and borrowers began to have trouble with repayments, holders of mortgage-backed securities – into which loans of differing quality had been packaged – struck a severe problem: nobody knew how to value their holdings.

Special investment vehicles set up to maximise profits from holding these packaged securities could no longer fund themselves and began to collapse. Banks were suddenly exposed to huge losses, since all holders of mortgage-backed securities had to mark down the value of their portfolios drastically. By August 2008, according to statistics compiled by Bloomberg, banks around the world had written off amounts totalling \$501bn (see table). Many banks raised new equity capital to help cope with the losses.

Investment banks with holdings of troubled mortgage securities were

Top ten bank write-offs

Citigroup	\$55.1bn
Merrill Lynch	\$51.8bn
UBS	\$44.2bn
HSBC	\$27.4bn
Wachovia	\$22.5bn
Bank of America	\$21.2bn
IKB Deutsche Industriebank	\$15.3bn
Royal Bank of Scotland	\$14.9bn
Washington Mutual	\$14.8bn
Morgan Stanley	\$14.4bn

Market total \$501bn

Source: Bloomberg

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particularly vulnerable, since unlike commercial banks they had no base of retail bank deposits to fall back on. In March 2008 came the collapse of the investment bank Bear Stearns, steered by the US authorities into the hands of JP Morgan Chase. From this point on, it became a question of which bank would next come under threat, and which could survive. In spite of US interest-rate cuts and repeated interventions by central banks, the banking markets were in a state of permanent tension.

Series of collapses

This came to a head in September. First, the mortgage-finance companies Fannie Mae and Freddie Mac, which together hold or guarantee \$5 trillion of mortgage debt, were taken over by the US government. Lehman Brothers filed for bankruptcy and its rival, Merrill Lynch, sold itself to Bank of America.

While all these developments were extraordinary, perhaps the most breathtaking was the rescue of AIG, the largest US insurance company and an active trader on many markets. Its failure would have caused huge international repercussions. It was given an \$85bn rescue loan by the US government, which also nationalised it by taking an 80% stake.

The two remaining large investment banks, Morgan Stanley and Goldman Sachs, whose share prices were falling as the markets saw them as the next candidates for failure, then turned themselves into commercial banks and received equity injections from new investors; in Goldman's case one was the investment guru Warren Buffett. On 25 September came the failure of the sixth-largest US bank, Washington Mutual, which was seized by regulators and sold. This was swiftly followed by the rescue of the fourth-largest bank, Wachovia.

Banks' difficulties in obtaining money-market funding led to failures and rescues across Europe.

In the United Kingdom, the main casualties were mortgage-lending banks. Northern Rock had suffered a run in 2007 and was nationalised, and Alliance & Leicester was acquired by another bank. In September, Bradford & Bingley was nationalised, and HBOS was rescued by a takeover bid from Lloyds TSB.

In Belgium, the financial conglomerate Fortis was saved by a combination of acquisition by BNP Paribas of France and nationalisation by the Dutch government. In Germany, Hypo Real Estate was rescued by a €50bn credit package from the government and private banks.

Iceland's banking system collapsed, and, amid concerns the country itself might become bankrupt, the government turned to Russia for a loan. Russian markets suffered major disruptions.

As all this was occurring, international money markets remained paralysed. Central banks made hundreds of billions of dollars available to provide liquidity to the money markets.

The bankruptcy of Lehman Brothers disrupted the markets, leaving many institutions exposed to losses. One example was the impact on US money-market mutual funds, seen as a safe and liquid investment and in which many Americans have savings and checking accounts. On 16 September, a \$64bn fund that held \$785 million of Lehman short-term debt said it now had to value this paper at zero, and thus the fund's net asset value fell to 97 cents, below the norm of \$1 that all funds customarily maintained. This was only the second time that this had happened to any fund in the \$3 trillion sector. It suffered a rush of withdrawals. If replicated at other funds, this posed the danger of widespread national panic.

It was in an attempt to contain such fears that US Treasury Secretary Henry Paulson, former head of Goldman Sachs, announced a series of measures on 19 September, including financing to guarantee the value of money-market funds. He proposed a 'troubled asset relief program' to buy up the illiquid, impaired mortgage-related assets that were 'clogging up the financial system'. If this were done, he said, banks could resume normal financing, though they would be subject to new – as yet undetermined – regulations.

The \$700bn bailout posed problems. It was unclear how the Treasury would set the purchase prices for instruments of which the value was unknown. If these were too high, Wall Street firms would be unduly rewarded for poor decisions.

Congress' negative reaction showed the political difficulties involved. After two weeks of frantic exhortation and horse-trading, legislative approval was secured on 3 October. But by then, the crisis of confidence had deepened. Stock markets around the world went into freefall, with sharp share-price declines threatening the viability of what had previously been healthy banks.

On 8 October, the United Kingdom announced a £500bn (\$850m) package to support British banks, including the acquisition of equity stakes. Further national measures in other countries seemed inevitable. It was not possible

to say with confidence that these would halt the turbulence and enable normal financing to resume. The risk of accidents and of large knock-on effects remained.

Broader effects

There have been predictions that the crisis will herald the end of American-style capitalism and the demise of America as a global power. However, such views seem exaggerated. The crisis has demonstrated the extreme importance of Western financial markets to the world economy, and has shown that the authorities can bring to bear huge resources in order to maintain them.

The fact that Japan and China each hold more than half a trillion dollars' worth of US Treasury securities – on top of huge other Asian investments in Western economies – underlines how much the rest of the world has at stake in maintaining the existing global financial system. It is also a reminder that no other country has the broad range of investment instruments, the (normally) deep and liquid markets and the perceived long-term financial security of the United States. The tighter regulation that will now occur will tend to bolster rather than undermine investors' confidence.

The plain truth is that nobody at this stage can predict the full consequences of the crisis, still less who will be the eventual winners and losers. The budgets of countries that are spending heavily on crisis measures will be tighter – and this will affect defence spending. Injections of government funds and cuts in interest rates create a risk of higher inflation, though reduced demand in slowing economies could counteract this.

That economic recession will hit many countries because of the drying up of credit seems a reasonable forecast – this is already occurring in some countries. But the recession's length, depth and geographical extent cannot be known.

The International Monetary Fund, in its annual World Economic Outlook published on 8 October, was relatively sanguine: while the world economy would suffer a 'major downturn', it said, a gradual recovery was expected to begin during 2009. The IMF stressed, however, that international coordination of financial and economic policies was essential.

After a year of crisis, Western leaders seemed finally in October 2008 to have grasped the need for coordinated leadership. As Robert Zoellick, World Bank President, said: 'We have seen the dark side of global connectedness. We need to navigate toward the light.' □ IISS