OpinionAsia 31 August 2007.

Markets in Disarray? Don't sweat over the fever, cure the disease

Joergen Oerstroem Moeller31 Aug 2007
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# Markets in Disarray? Don't sweat over the fever, cure the disease

**Joergen Oerstroem Moeller | 31 Aug 2007**

A unanimous chorus over the last two weeks has blamed subprime housing for the turmoil in the international financial markets. It would however be a grave mistake to mix up cause and effect, and neglect the factors that have given rise to jitters the world over.

The real cause for the tension can be identified within three fundamental weaknesses in the global economy: the growing imbalances in the US economy, the central banks' illusion that inflation targeting is a workable policy, and the asymmetry between global economic forces and the institutional frameworks that determine rules and regulations. Steps by central banks and monetary authorities to help stabilise markets may alleviate the temperature, but sweeping measures are needed to cure the patient.

One fundamental sources of market chaos has been US overspending over many years. Deficits on the public budget, and on the balance of payments have been financed by the rest of the world. The US consumer sets sail in a sea of debt, heading into the well-known danger zone of dis-savings. Such state of affairs was always going to be untenable over an extended period.

Curiously enough, no real action had been envisaged, even though many market-watchers realise something was going to give way. Creditors were more than ready to accumulate US assets fearing the negative effects on global growth should they stop doing so. After all, the US consumer was the locomotive pulling the rest of the global economy along. For many years it was difficult to see what should fill a vacuum left by lower US consumption. The rest of the world acquiesced and the US itself saw no reason to act.

The going was good, or as some said - what's the problem? If there was one, it might be solved down the road. The political fallout from what may have appeared as a premature intervention to adjust the domestic economy seemed too costly. In the US' perspective, foreigners, in particular China, was welcome to dump its dollars on the currency markets. An appreciation of foreign currencies, principally the yuan, which had been item number one on the US wish list for a long time, would take place.

And so, the global economy lived with a strange equilibrium: the US over-consumed, China over-produced, the Federal Reserve System and Japan's central bank oversupplied the world with money, and the show was financed by Asia.

This tenuous equilibrium was never going to be sustainable, and the subprime housing crisis whatever technical reasons lie behind, has acted as the whistleblower. Its message to policymakers is simple. Redress these imbalances, if not, the market will. The current crisis may be solved and the wounds plastered over, but the respite will be short.

The quandary is not over whether the US balance of payments will be righted - they will, eventually. The issue is whether policymakers will allow for such a course of action to be implemented in an orderly and organised manner with costs spread over a number of years, so as to be politically manageable. Or if the market, as it has signalled, will do it in a brusque and pitiless way, without any consideration for the political consequences.

Central banks have over the last 15 years been seduced by inflation targeting. They pursued a policy of not more than about 2% inflation per year. All major countries have achieved that target and central banks claimed credit even though they had very little to do it with it. The main reason has been singularly down to the low-cost of production in China.

Convinced about the efficacy of their own diagnosis, the central banks looked at the low inflation figures convinced that everything was fine and kept printing money. As the money supply was too lavish, asset prices started to rise, stocks, property, minerals, and gold – you name it. There was nothing else to use the money for.

The world moved into a strange zone of low inflation rates for goods and services while hosting tremendous asset price rises. Consumers mortgaged their properties and spent the money on consumption. In normal circumstances prices would rise, but not this time. China was capable of delivering an endless stream of goods at low prices. The carousel kept running and yet, central banks did not sense that something could be amiss.

The same central banks and primarily the Fed stoked the growing imbalances because they pursued inflation targeting instead of looking at the whole state of the economy. Looking back, monetary policy should have been tightened earlier than summer 2004 when the Fed started to raise interest rates.

The policy of inflation targeting is understandable to some extent as central banks always have two eyes on price stability, but in one of the strange paradoxes of economics, it allowed the serious and threatening economic imbalance to run wild distorting the US economy.

Globalisation is a fantastic growth machine. Trade in goods and services, capital movements and investments all move across the world without noticing the lines on the map detailing which national boundaries they operate within.

Financial institutions lived happily with this model. They knew that risks were growing, but took comfort in the belief that a large number of financial institutions shared the risk. One key sentence frequently heard was that globalisation made it possible to spread risks making the financial system more stable and secure. But this philosophy backfired.

Risk spreading did not work to calm nerves in the preliminary stages of the recent crisis; it spread anxiety to a large number of financial institutions around the world. When it dawned upon them that a crisis was brewing, all of them opted to get out of risky assets, triggering off a storm instead of dousing the fire.

This is where one would expect international institutions to act, but they proved to be little more than paper tigers. Little has been done to put up the firewalls, ready to be activated if or when financial turmoil arose. The international community proved toothless when confronted by market forces.

The institution which should rise to the occasion, the International Monetary Fund, was in the midst of changing its managing director and has been absent from the stage even though it was the incumbent for the lead role. The European Union and other countries have pointed to the obvious need to act, especially since well-known credit rating agencies apparently got it completely wrong in explaining the aforementioned omissions or mistakes. The European Union, however, is only one player in the global concert.

Unless financial institutions, central bankers and politicians address these problems, subprime housing is only a bad omen for a series of financial crises to come - these in the long run may threaten the present version of economic globalisation.

*This article is an extension of a letter published by the International Herald Tribune on 25 Aug 2007.*

*Joergen Oerstroem Moeller is a Visiting Senior Research Fellow at the Institute of Southeast Asian Studies, and an Adjunct Professor at the Copenhagen Business School.*