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TACKLING THE ASYMMETRY IN FINANCIAL MARKETS

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Tackling the asymmetry in financial markets

By Joergen Oerstroem Moeller, For The Straits Times

LAST week's turmoil in global financial markets reiterated a number of lessons from economic history. The first is that the only thing new under the sun is human forgetfulness. Though the current crisis has its own specifics, previous financial crises are all too easily recalled.

Financial institutions entered into too-risky investments, not because they wanted to, but because of too lavish liquidity. Under normal circumstances, they would not have touched a significant part of the current loans even with a barge pole. As the market is now, however, banks with a more prudent investment policy could lose customers and market share.

Market watchers, and probably also central banks and financial institutions, comforted themselves by saying that globalisation would spread the risks. No one would succumb if debtors defaulted, as lending was shared by a number of institutions. Financial institutions in many countries could help one another out, minimising the individual risk.

It turned out the other way around. Knowing that many financial institutions carried a part of the risk, each and every one assumed a larger burden than sound judgment would have dictated. When the bubble burst, risk spread like a prairie fire around the globe. Instead of rallying to the rescue of those in trouble, financial institutions tightened their screws and clamped down on lending.

Yes, globalisation means capital moves in enormous quantities within a few seconds. We had a live demonstration of what this means last week.

In pre-globalisation days, the losses within that small segment of the market, sub-prime housing in the United States, would have been confined to that sector. But not so now.

Financial institutions were caught off-guard because competition had pushed them to disperse investment over several sectors, sometimes outside their normal branches of activities. Not only did the credit squeeze spread globally among institutions involved in sub-prime housing, but it also jumped to other parts of the global financial market.

The next sector to be hit had similarly exposed itself to too-high risks. Mergers & acquisitions (M&A) have grown explosively recently. 'Predators' bought at overvalued prices, reckoning that global growth in the vicinity of 5per cent would continue for years to come. The assumption was plausible, even likely, but it was not a given.

In the first half of 2007, M&A reached an estimated value of US$3 trillion (S$4.5 trillion) globally. But the financial institutions that had been quick to finance them just as quickly passed the burden - and the risks - to other investors by issuing bonds. These institutions functioned, shall we say, as intermediaries offering bridging loans.

This worked only for a time. Believing the ultimate creditor to be some other party, banks did not feel exposed to much risk. But when the sub-prime market imploded and investors pulled in their horns, the banks were suddenly left with huge amounts of unsold bonds. All at once they were converted from intermediary to ultimate creditor, a role they had never wanted and were not prepared for.

The paradox in the crisis is that, almost overnight, the world moved from having too much money and chasing too few investment opportunities to having too many debtors screaming for money to pay off their debts.

What next? In plain and unpleasant words, there will be losses for a number of financial institutions, companies and individuals. Some of them will default under this burden.

This will happen whether we like it or not. The pain will stop only when bad debt has been worn down to a sustainable level.

The game is about whom, how much and for how long.

Globalised world or not, the anatomy of a financial crisis has not changed. Bad debt has to be flushed out through a painful process, the sooner the better.

Globalised world or not, private financial institutions were simply doing what they have always done: pursuing profit and increasing market share. They used globalisation for these purposes. It was entirely predictable. No one can blame them for what they did.

The potential risks to the economy, and even more the global economy, are not part of the equation guiding the behaviour of market players.

This is where the Asian financial crisis of 1997-98 and the sub-prime housing crisis are similar.

The virtues of the free market are praised by many. All too often, however, it is forgotten that unless a suitable regulatory framework is in place, what former Federal Reserve chairman Alan Greenspan called 'irrational exuberance' will tempt financial institutions into deep water.

Time after time, events have shown that financial institutions pursue their own interests. They do not see why they should take the burden and responsibility of stabilising the market off the shoulders of central banks and the monetary authorities.

When you factor in globalisation, the dilemma becomes starker. Markets work globally; globalisation fosters stronger and harsher competition, pushing financial institutions towards riskier investments.

Monetary authorities, and their financial supervision and control mechanisms, are still predominantly national.

Unless this asymmetry is addressed by policymakers, last week's crisis will not have been a singular event, but an omen of a series of crises harassing future globalisation.

The US Federal Reserve was apparently caught by surprise, but acted quickly to prevent the market from imploding. It would, however, be unwise to count upon similar luck or adeptness every time in the future.

Strengthening international institutions and regulatory frameworks, taking into account what globalisation means for international financial markets and capital movements, looks a better bet.

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IMBALANCE IN THE SYSTEM

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