The financial contagion now spreading worldwide

The financial crisis that started in the US with the sale of unsuitable mortgages to unsuitable people has spread to Europe and the rest of the developed world. Former Austrian Finance Minister Hannes Androsch, warns that the world may be heading for a decade of severe Japanese-style deflation

Ever since President George W. Bush's administration came to power in 2000, many Europeans have viewed its policy with a degree of scepticism not witnessed since the Vietnam war. It began with the presidential election itself and the impression that commercial and political interests, rather than democratic principles, dictated how technical irregularities in voting procedures were dealt with. It continued with the controversial and divisive wars that followed the attacks on the World Trade Centre.

Not since the presidencies of Johnson and Nixon has the United States attempted to pursue such extensive foreign and domestic policies without reference to domestic taxes and savings. The policy exuberance of the earlier administrations was a major contributor to the global financial instability of the 1970s. There are some who fear that the present financial and economic downturn may be a result of politicians having failed to learn the lessons of history, or having ignored them. And, with greatly enhanced economic integration, the global economy has fewer defensive mechanisms in its armoury.

Not since the time of the industrial revolution have the geo-political and economic changes of the past quarter century been more rapid and of greater consequence. In the long-term, the benefits will predominate; in the short-term, the pain of transition will be acutely felt.

Already, the stresses of transition are beginning to show. Newly-created wealth is unevenly distributed. In developed countries the newly unemployed cannot comprehend why their highly-profitable former employers have simply upped and departed for greener pastures in low-wage economies. In their wake, they have left behind a predominance of part-time or casual employment which is hailed as labour-market "flexibility".

In the emerging economic superpowers of the future, China and India, the atrocious conditions that workers are forced to tolerate, the disregard for public health, worker safety, education or the environment, all suggest that prosperity has yet to touch the lives of the average worker, or citizen. Globalisation has reasserted the pre-eminence of capital as a factor of production.

American enterprise and innovation have deservedly earned the admiration of the world. For the past century innovation has been primarily scientific and technological in character, increasing productivity and lowering costs. But its success has produced a mentality which ordains that obstacles to innovation should be cleared unceremoniously out of the path of progress. This is a dangerous development, encouraging a disregard of advance warnings of impending catastrophe in the pursuit of short-term gain.

The most notable innovations of the past two decades have been largely financial in character. Financial innovation is neither new nor undesirable. It represents the perpetual search for greater efficiency. Like technological innovation, financial innovation is concerned with cost reduction; in this case, the cost of transferring funds from savers to investors. Cost reductions that represent a net benefit to society can be regarded favourably. But where financial innovation is designed to circumvent regulation, either prudential or taxation, we need to be much more circumspect.

The finance revolution of the past 15 years or so has been rent-seeking rather than welfare-enhancing in character. It has been based on eliminating, or at least reducing, two important cost elements in banking operations. One is the need for a bank or other financial institution that acquires short-term creditor funds to hold liquid reserves. The less liquid the bank's assets, the greater the need for such reserves. But their yield is small, and economising on them is profitable. The UK's Northern Rock debacle last year will long remain an example of how not to manage such risk. The other precautionary element is to hold adequate capital as a cushion against risky investments.

Increasing leverage can be very profitable when the return on investments exceeds the cost of funding. But statutory capital requirements, the subject of Basel I and Basel II, ordain a capital-asset ratio of about 8%. If adhered to, reckless expansion of the balance sheet in pursuit of profit is kept in check. Many financial companies ignored this restriction, to their cost: The Carlyle Capital Corporation, a subsidiary of the US-based Carlyle Group, had leveraged up to 32 times, i.e. held one dollar of capital for 32 dollars of assets, before market developments wiped out the company.

Avoiding prudential requirements is at the core of the present financial crisis, exacerbating the collapse of confidence in a system based on trust. The end of the boom is now exposing the fragility of the banking system, including quasi-banking institutions, as revealed by Bears Sterns and other US investment banks, and in Europe by Northern Rock, UBS, WestLB and many more.

Perhaps the most tragic aspect of this story is the human exploitation involved in the so-called sub-prime mortgage crisis. What we are talking about is a variable-rate mortgage offered to customers with a low credit rating. (In the United States, unlike Europe, mortgages to prime borrowers tend to be at a fixed rate, and include an option to refinance should market rates decline). In this case, "variable rate" is a misnomer – they were mortgages with artificially low interest rates initially, pre-programmed to include a significant interest-rate hike after a couple of years. Thereafter, these rates would rise with market rates, but never fall when market rates declined. This structure could only have been devised to suck in as many customers as possible with scant regard for the longer-term consequences.

These mortgages were affordable to low-income households, at least in the initial low-interest phase. A mortgagee did not have to save for a deposit as they were

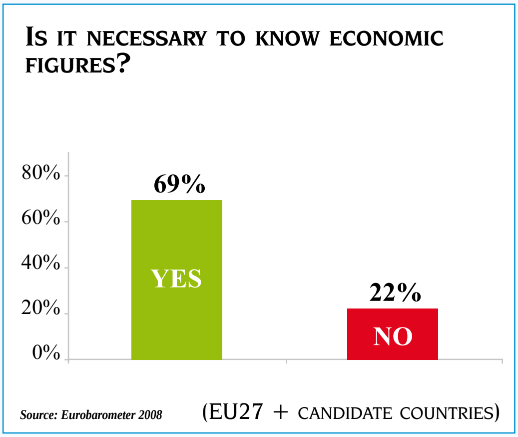
MATTERS OF OPINION

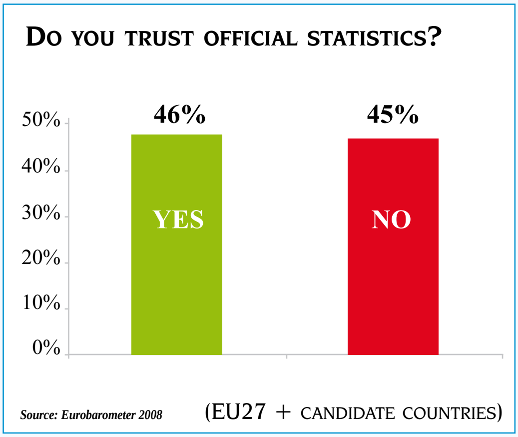
Europeans don't know and don't trust statistics

Europeans think it is important to know statistical information relating to their country's economy, such as GDP growth, although only a minority are familiar with this data. At the same time, fewer than one in two people say they actually trust official statistics.

Over half the people questioned in a recent Eurobarometer survey answered "don't know" when asked to give their country's growth or inflation rates. In a separate question, some 69% agreed that they ought to know the economic figures. Of the EU27 plus candidate countries Croatia and Turkey, Cypriots were the most likely to believe that it was important to know the data. In contrast, the Dutch were broadly knowledgeable about economic figures compared to other Europeans, but placed least importance on the need to know them.

The Dutch also had the most confidence in official statistics (77% said they "tend to trust" them), followed by Danes and Finns. The people with the least confidence in government-supplied figures were the French (60% said they did not trust statistics), the Britons and the Hungarians.





usually for 100% of the purchase price. With the property market booming, prospective capital gains promised undreamt of wealth. And most mortgage holders probably expected to refinance their mortgages before the rising interest-rate trebled or quadrupled their monthly repayments. Another hoped-for benefit was that capital gains could be converted into home equity loans, thus boosting the living standard of homeowners.

The rude awakening came when property values began to decline. For those without an equity cushion, refinancing was no longer a possibility. Rising interest rates led to inevitable default, foreclosure, homelessness. The spiral of human misery changed up a gear. Now we hear that the sub-prime mortgage holders have only themselves to blame, that they entered into contractual obligations of their own free will. No one talks of the bank manager, under pressure to sell "financial products", eager to sign up customers and acquire signatures, even if the products were not in a customer's best interest. And no one questions a financial culture, or bonus system which favours one year of super profits followed by bankruptcy, in preference to two years of moderate results.

It is astonishing that variable-rate, or sub-prime, mortgages should be repackaged and resold in securitised form. That these securities, CMOs (collateralised mortgage obligations, bonds backed by a pool of mortgages), should find a ready market, both in the United States and abroad, reflects a failure on several fronts. The Federal Reserve Board and its then chairman Alan Greenspan ignored early warnings that unsuitable financial products were being sold to unsuitable customers. The warnings date back to the second half of the 1990s. At the time, as now, most countries were preoccupied with avoiding recession and were reluctant to fix something that was not obviously broken.

The rating agencies offered triple as to the upper tranches of portfolios of sub-prime mortgages, thus making them acceptable investment outlets for even the most sensitive of financial institutions. This failure must surely rank alongside that of the auditing industry in the wake of the Enron disaster.

Finally, I would argue that the nature of CMOs should have been apparent to risk managers. Any financially literate fund manager knows that risk and return are positively correlated. Any fund manager who claims to have been deluded by the apparently favourable risk-yield characteristics of those CMOs, or related credit instruments, can at the very least be accused of having fallen for Milton Friedman's "free lunch". Risk models do not justify abandoning one's natural sense of incredulity.

In a world where capital is free to flow across international boundaries, the crisis in the United States is one of truly international dimension. Some European banks, including the Swiss-based UBS, Northern Rock in the UK and the Landesbank Sachsen in Germany, to name but three of many, have felt the icy exposure that comes from international linkages. This is a new form of contagion, which transcends national boundaries and is amplified by an international crisis of confidence. This is why the potential global problem today is many times greater than the Savings & Loans crisis of the 1980s and 90s, which cost the American taxpayer an estimated $150bn.

If the dykes of the financial system collapse, we may be heading for a decade of severe deflation, as in Japan when the economy simply refused to respond to any expansionary stimulus

The tight network of financial markets means that problems can pop up anywhere and at any time. Many countries have been affected by the US sub-prime crisis. Some countries have created sub-prime problems of their own – 120% mortgages or interest-only mortgages. The full story has still to be told.

At present central banks are attempting to plug one leak before the next appears. If the dykes of the financial system collapse, we may be heading for a decade of severe deflation, as was experienced in Japan. During that time, the Japanese economy simply refused to respond to any expansionary stimulus.

When the Federal Reserve was created in 1913, its most important function was as a lender of last resort to troubled banks, providing emergency liquidity via the discount facility. The present crisis suggests that this is no longer enough and that central banks worldwide may soon be forced to act as market makers of last resort in securities markets. The signs are already there.

The European Central Bank has also failed to tackle local bubbles in Europe. The justification was that the ECB is concerned with inflation, but not relative price adjustments. This means that monetary policy is geared towards the needs of Germany, because of its weight, but not to those of, say, Belgium. This apologia for inactivity has outlived its usefulness. □

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