TAIPEI TIMES • SATURDAY, OCTOBER 4, 2008

Global markets brought down by risky innovations

BY **HANNES ANDROSCH**

The most notable innovations of the past two decades have been financial. Like technological innovation, financial innovation is concerned with the perpetual search for greater efficiency — in this case, reducing the cost of transferring funds from savers to investors. Cost reductions that represent a net benefit to society should be regarded favorably. But as the current financial crisis demonstrates, where financial innovation is designed to circumvent regulation or taxation, we need to be more circumspect.

Sadly, the financial revolution has been mostly rent-seeking rather than welfare-enhancing in character. It has been based on eliminating, or at least reducing, two key elements of banking costs closely associated with prudential arrangements.

One is the need for banks and other financial institutions to hold liquid reserves. The less liquid a bank's assets, the greater the need for such reserves. But the yield on such reserves is small, so economizing on them is profitable. Last year's Northern Rock debacle in the UK will long remain an example of how not to manage such risk.

Moreover, increasing a bank's leverage can be very profitable when returns on investments exceed the cost of funding. Reckless balance-sheet expansion in pursuit of profit is kept in check if financial firms adhere to statutory capital requirements, which mandate a capital-asset ratio of about 8 percent. But many have sought to ignore this restriction, to their cost: The Carlyle Capital Corp, a subsidiary of the US-based Carlyle Group, was leveraged up to 32 times before adverse market developments wiped out the company.

Avoidance of prudential requirements is at the core of today's financial crisis, exacerbated by the collapse of confidence in a system based on trust. This has exposed the fragility of the banking system, including quasi-banking institutions, as revealed by Bears Sterns, Lehman Brothers and other US investment banks, and in Europe by Northern Rock, UBS and many more.

Perhaps the most tragic aspect of this story is the exploitation of low-income families involved in the subprime mortgage crisis, whereby variable-rate mortgages were offered to customers with a low credit rating. In fact, "variable rate" is a misnomer, since these mortgages' artificially low initial interest rates were preprogrammed to include a big rate hike after a couple of years. Thereafter, 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 long-term consequences.

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

The rude awakening came when property values began to decline. For those without an equity cushion, refinancing was not a possibility and rising interest rates have led to default, foreclosure and homelessness.

Now we hear that subprime mortgage holders have only themselves to blame. No one talks of the bank manager, under pressure to sell "financial products" and eager to sign up customers, even if the products were not in a customer's best interest.

It is astonishing that subprime mortgages and their like were repackaged and resold in securitized form. That these collateralized mortgage obligations (CMOs, or bonds backed by a pool of mortgages) found a ready market, both in the US and abroad, reflects failure on several fronts.

The nature of these 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 favorable risk-yield characteristics of CMOs can be accused of having fallen for Milton Friedman's "free lunch."

In a world where capital is free to flow across international boundaries, the crisis in the US has spread to Europe. This is a new form of contagion, which transcends national boundaries and is amplified by an international crisis of confidence. This is why the global problem today is many times greater than the savings and loan crisis of the 1980s and 1990s, which cost US taxpayers an estimated US$150 billion to clean up.

Today, the global integration of financial markets means that problems can pop up anywhere, at any time. Central banks are currently attempting to plug one leak as the next appears. But if the financial system's dikes collapse, we may be headed for a decade of severe deflation, rendering expansionar[y] stimulus useless.

When the US Federal Reserve was created in 1913, its most important function was to serve as a lender of last resort to troubled banks. The current crisis suggests that this is no longer enough. Central banks worldwide are being forced to act as market makers of last resort in securities markets. The signs are already visible.

The European Central Bank (ECB) has also failed to tackle local bubbles in Europe. The justification was that the ECB is concerned with inflation, not relative price adjustments. This means that monetary policy is geared toward the needs of large countries, like Germany. But, given the scale of the threat to Europe's economy from a full-blown financial crisis, this apologia for inactivity has outlived its usefulness.

Hannes Androsch is a former finance minister and vice chancellor of Austria.

COPYRIGHT: PROJECT SYNDICATE/EUROPE'S WORLD