Capitalism in convulsion
John Plender

Toxic assets head towards the public balance sheet

After a period of wild market swings in which trust was at times wholly absent, governments face having to socialise the mistakes of an entire industry in order to restore confidence, writes John Plender

In the space of just two momentous weeks, the landscape of global finance has een dramatically transformed. President George W. Bush's administration has mounted a multi-billion-dollar rescue of the financial system at the cost of inflicting severe damage on the US model of free-market capitalism.

Heavy costs will be inflicted on the American taxpayer, who is now subsidising Wall Street -and indeed financial institutions around the world - in a bail-out of unprecedented size.

The sequence of events that led to this extraordinary socialisation of finance began with the de facto nationalisation of Fannie Mae and Freddie Mac, the bankrupt government-sponsored mortgage lenders at the heart of the US housing finance system. There followed a rise in the cost of insuring against default in the world's most powerful economy. On some independent estimates, the overall response to crisis could take the outstanding US public sector debt from readily manageable status to a level comparable with such fiscally stretched countries as Italy and Japan.

Concern about the creditworthiness of the US is nonsensical, according to Charles Goodhart of the London School of Economics. It has nonetheless surfaced, along with worried punditry about the dollar's role as a reserve currency.

Then came the absorption of Merrill Lynch by Bank of America and a bold decision by Hank Paulson, US Treasury secretary, to allow Lehman Brothers, the fourth largest US investment bank, to go to the wall. This constrasted with the government orchestrated rescue of the smaller Bear Stearns by JPMorgan Chase earlier this year.

The disappearance of these two Wall Street securities giants raised questions about the durability of the independent model of investment banking. Shares in the two independent survivors, Morgan Stanley and Goldman Sachs, were quickly savaged by short-sellers. In the UK, such short-selling is alleged to have been what pushed HBOS, the country's biggest mortgage lender, into its shotgun marriage with Lloyds TSB.

Still more startling was news that the Federal Reserve was advancing $85bn (€59bn, £47bn) of taxpayers' money to AIG, the world's biggest private insurer. Thanks to its role in the global market for credit insurance, AIG was so interconnected with other financial institutions that its bankruptcy would have been catastrophic for the whole system.

Yet despite the rescue, the festering lack of trust that has dogged the banking system since August last year worsened after this move. On Wednesday, the interest rate on one-month US Treasury bills turned negative, bearing the astonishing message that investors would rather lose money on government paper where repayment was certain than invest in money market funds. The climactic point had been reached where nobody trusted any credit other than the government's.

In such circumstances, experience teaches that central banks have to lend freely. In the event, the Federal Reserve injected $180bn into the markets, while other leading central banks said they were taking co-ordinated measures to help short-term dollar markets.

To round off the week, Mr Paulson announced discussions with political leaders to create a government-sponsored vehicle to take on toxic assets created during the bubble, prompting a manic stock market bounce.

The paradox in this remarkable tale is that extreme illiquidity exists in a world awash with the excess savings of Asia and the petro-economies. Russia illustrates the point. Thanks to the oil windfall, it sports high economic growth, the third largest foreign exchange reserves in the world and low public sector debt. Yet Moscow stocks are collapsing and trust in the financial system has eroded to the point where overstretched Russian investment banks are starved of funds and threatened with bankruptcy. This is what happens when an overleveraged global financial system unwinds. Borrowing is being forcibly reduced across the world after the greatest credit bubble in history. It amounts, says David Roche of Independent Strategy, a research boutique, to a "tectonic shift from leverage to thrift as the means of financing growth and the concomitant dramatic reduction in global imbalances such as the US current account deficit".

The reality is that the financial system has been operating as if it were an off-balance-sheet vehicle of the government. Private-sector companies and individual bankers have been making huge profits in the bubble. Their risk appetite has been enhanced by previous bail-outs and, in the case of Fannie and Freddie, by the government's implicit guarantee. Yet their market pricing does not reflect the potential cost to the system of their own collapse.

This inability to handle externalities has again been apparent in the markets over the past two weeks as speculators have engaged in short-selling strategies against AIG and the investment banks in the US and HBOS in the UK. This threatens the financial system because the rating agencies respond to the consequent falls in share prices by cutting credit ratings, so jeopardising the victims' ability to fund the business.

Once again, property has been at the heart of a financial debacle, in spite of the assurances of central bankers that a nationwide fall in US house prices was an impossibility. Yet the peculiarity this time lies in property being wrapped in complex financial products that few could understand.

When investors go outside their areas of competence, trouble follows. Walter Bagehot, the 19th-century economist who defined the rules for central bank management of financial crises in his book Lombard Street, said: "Common sense teaches that booksellers should not speculate in hops, or bankers in turpentine; that railways should not be promoted by maiden ladies, or canals by beneficed clergymen ... in the name of common sense, let there be common sense."

The twist in the current decade is that even bank boards and bank executives have failed to understand complex mortgage-backed banking products, as have central bankers, regulators and credit rating agencies.

In this off-balance sheet Alice in Wonderland world, the most absurd feature has been a reward system that has granted huge bonuses to those who peddled toxic mortgage-related products and does not permit much of the money to be clawed back now that the going is bad. Almost as absurd has been the degree of leverage racked up by investment banks.

As Michael Lewitt, the Florida-based money manager, puts it: "Allowing investment banks to be leveraged to the tune of 30 to 1 is the equivalent of playing Russian roulette with five of the six chambers of the gun loaded. If one adds the off-balance-sheet liabilities to this leverage, you might as well fill the sixth chamber with a bullet and pull the trigger."

So what stage in the the crisis have we reached? Bagehot quoted the banker Lord Over-stone's description of the progress of an unstable cycle thus: "quiescence, improvement, confidence, prosperity, excitement, overtrading, CONVULSION [Bagehot's capitals], pressure, stagnation, ending again in quiescence".

Over the past two weeks we have experienced convulsion. Yet it ought to be possible to avoid stagnation, because the authorities are following the prescriptions of Hyman Minsky, the economist whose work Stabilizing An Unstable Economy best explains the dynamics of this crisis.

Minsky saw fiscal activism by big government, alongside last-resort lending by central banks, as the modern way of coping with financial distress. That is now taking place. In effect, the US government is replicating what happened in the private banking system earlier in the crisis, when institutions were obliged to take entities they had created, such as structured investment vehicles and conduits, back on to their balance sheets as funding dried up.

Having implicitly guaranteed Fannie and Freddie and underpinned the operations of irresponsible bankers at AIG and elsewhere, the US government is putting bankrupt institutions back on to the public sector balance sheet via nationalisation. Now, Mr Paulson's proposal for the system's toxic assets has the makings of a turning point.

What will the banking landscape look like after this saga? Much depends on the regulatory response. At the very least, tougher capital requirements will be imposed, which could mean the banking system reverts to a lower-risk, utility-like function. Yet one of the most important questions concerns the independence of central banks.

If central banks have to be recapitalised, as seems likely, politicians may want to extract a price that diminishes their operational independence. That could have damaging consequences. For a central point of Minsky's thesis is that fiscal activism and last-resort lending set the stage for serious inflation.

That, together with an increased burden on future generations of taxpayers, could be the cost of the last two weeks' frantic efforts to stave off deflation and keep some semblance of the Anglo-American model of capitalism afloat.

Fonte: Financial Times, London, September 20 e 21 2008, Primeiro Caderno, p. 10.