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The Music Stops

By John H. Makin

During a 10:00 a.m. conference call on August 17, 2007, Federal Reserve vice chairman Donald Kohn and New York Federal Reserve president Timothy Geithner were urging Citicorp chief executive Chuck Prince and his fellow big bank CEOs to use the Fed's discount window, which is set up to alleviate liquidity pressures on individual banks or on the banking system as a whole. Prince, the head of the world's largest bank (Or is it the second largest? No one really knows since bank balance sheets are so full of securities that cannot be priced.) may have been wishing that he had not chosen to offer a chillingly clear characterization of the global financial system a little more than five weeks earlier in a *Financial Times* interview on July 9, three weeks before the global credit markets began to seize up.

Prince's comment, which led off last month's *Economic Outlook* and has subsequently been quoted widely, has proved remarkably prescient—no doubt to his dismay and that of the global financial hierarchy. What Prince said was, "When the music stops, in terms of liquidity, things will get complicated. But as long as the music is playing, you've got to get up and dance. We're still dancing." Things have since gotten very complicated indeed.

The painful oscillations of financial markets between denial and panic as credit markets have shut down are recorded in the wild daily gyrations of the major stock markets. The S&P 500 Index rose 3 percent on August 8, the day after the Federal Reserve said it would not ease interest rates and that the economy was fine. Two days later, on August 10, as credit markets continued to collapse

with no funding for mortgage-backed securities, subprime loans, Alt-A loans, and jumbo prime loans, the market was down 3 percent.

The week of August 13–17 saw volatility soar in global stock markets, ending the week with an upward surge of 2.5 percent in U.S. stocks, but a virtual collapse of the Japanese stock market and a rush to safety out of money market funds into Treasury bills. On August 17, the U.S. stock market bounced on the Fed's 50-basis-point cut in the discount rate, largely because most retail investors do not know the difference between the discount rate, a penalty rate at which it lends to commercial banks, which is not so important, and the more important and far more frequently discussed federal funds rate, which was not cut. Moreover, even among savvier market participants, the cut in the discount rate was taken as a strong sign that the fed funds rate would be cut. The noise in stock price volatility has become almost deafening, but the trend is down as of August 24. Since late-July peaks, the S&P 500 Index is down 7 percent, the Nikkei is down 13 percent, the Korean KOSPI is down 12 percent, the Brazilian stock market has fallen 13 percent, and the UK FTSE is down 8 percent. The numbers change rapidly from day to day.

Carry Trade Unwinds

Another aspect of the global financial crisis is the unwinding of the famous "carry trade," wherein Asian and other investors finance themselves in Japan at very low interest rates and invest the funds in higher-yielding securities generated largely by the now-chaotic and collapsing U.S.

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mortgage markets. The U.S. investment banks discovered this great game in 2004: sell to yield-hungry Asians mortgage-backed securities with yields above Treasuries. The Asians specified that the securities should be rated AAA, so Wall Street's financial engineers colluded with rating agencies Moody's and Standard & Poor's to create securities derived from collateralized debt obligations (CDOs) and collateralized loan obligations (CLOs) with a higher yield and a AAA rating. Large pools of money from Asia and oil-exporting countries were eagerly poured into mortgage and related investments, with the capstone being the Chinese government reserve fund's \$3 billion investment in Blackstone's initial public offering for shares that have now dropped in value by more than 30 percent. As these carry trades are unwound, dollars are sold and yen are repurchased to repay the low-interest loans in Japan. The byproduct is a collapse in Asian equity markets and a sharp appreciation of the yen, which in the space of a few weeks rose over 8 percent from 124 to 114 per dollar. It has further to go.

Meanwhile, after watching the Japanese stock market's Nikkei Index collapse from over 18,000 in July to about 16,000 on August 24, and seeing the sharp deflationary surge in the yen along with a report that second quarter growth was only 0.8 percent, the "normalization"-obsessed Bank of Japan grudgingly did not raise interest rates at its August 23 meeting. On August 21, Japan's minister of finance, Koji Omi, had allowed that he expected "the Bank of Japan to take appropriate steps (and not raise interest rates at its August 22–23 meeting) while watching overall conditions." The pretense of the Bank of Japan's independence has been abandoned as Japan's economy continues to slow and its stock market drops, while a rising yen pressures Japan's exporters.

Credit Flows Ceasing

While this turmoil was unfolding, the market that really matters—the asset-backed commercial paper market (ABCP), the main artery in the network of credit flows that have fed a liquidity-driven real estate equity and financial boom—has been struggling. On Friday, August 17, while U.S. stocks were celebrating the Fed's discount rate cut, commercial paper rates rose another 28 basis points,

the largest jump in the entire crisis period. By August 21, the ABCP rate had reached 6.5 percent, with few takers on the lending side. At one point, professional money managers were prepared to give up 450 basis points of yield in the major commercial paper market for the safety of 2 percent yields in the absolute safety of four-week Treasury bills. Meanwhile, on the same day, "Fed sources" were described by Fed watcher Steve Beckner as seeing crisis talk as "overblown." "You can still borrow, you just have to pay a little more," opined one insouciant Fed source.

The global financial crisis and its impact on the global economy, which already is bad, will get considerably worse. Although a lot of damage has been done, recorded global wealth losses are probably approaching \$5 trillion from mid-July to mid-August alone. Add to that a huge jump in volatility and it is easy to predict the rapid disappearance of the risk appetite that had been driving global markets

through mid-July. Reduced risk appetite is desirable; no appetite whatsoever is not. It will starve credit flows.

The Fed, while increasingly aware of problems in global financial markets and their implications for the world economy, may have failed to appreciate the speed at which financial crises can emerge. Still, by Fed standards, it has moved with extraordinary rapidity to acknowledge problems and to begin to act. In the space of just ten days from its regular August 7 Federal Open Market Committee Meeting to its unprecedented inter-meeting change on August 17, the Fed went from describing the economy as "likely to continue to expand at a moderate pace over coming quarters, supported by solid growth in employment and incomes and a robust global economy" to stating on August 17, "The Federal Open Market Committee judges that the downside risks to growth have increased appreciably. The Committee is monitoring the situation and is prepared to act as needed to mitigate the adverse effects on the economy arising from the disruptions in financial markets."

In only ten days, the Fed went from a view that financial markets were orderly—there would be no negative feedback on the real economy, which was likely to continue to grow at a moderate pace—to acknowledging that financial market turbulence could harm the economy because disruptions in financial markets were serious enough to bring about that result.

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That said, the Fed is still moving at a maddeningly slow pace in the view of some market participants, although it may be doing so by design. By moving at a stately pace, strictly by the book, to respond to a rapidly emerging financial crisis, the Fed is signaling a desire thoroughly to crush the appetite for risk that has led to a housing bubble in the United States and apparently to bubbles in the market for asset-backed securities and other financial instruments. The Fed's first response to turmoil in financial markets, as a number of markets for asset-backed securities collapsed and Countrywide Financial, the country's largest mortgage lender, teetered on the edge of bankruptcy, was to reassure the banking system that it would provide ample liquidity through the federal funds market. Daily injections of additional funds temporarily stabilized markets early in August.

The Discount Window

As early as August 15 and 16, however, evidence of extreme distress and absolute liquidity preference emerged, as the rate on short-term Treasury securities fell close to 3.75 percent—a full 2 percentage points below the Fed's target fed funds rate for overnight money. This could only occur as households and firms, panicked about the severity of the financial crisis being widely reported in the press, withdrew money from money market mutual funds and shifted them to the absolute safety of short-term government securities. That sign of acute fear prompted the Fed to cut the discount rate from 6.25 percent to 5.75 percent, still representing a penalty versus the Fed funds rate of 5.25 percent. In effect, the Fed offered the banks something they would not want. Access to the discount rate at 5.75 percent is the Fed saying to the commercial banks something they do not want to hear: do your job, evaluate the riskiness of alternative borrowers, and then, if illiquidity problems arise in connection with providing credit to riskier borrowers, we at the Fed will lend to you, through the discount window, large amounts of funds once you set a value on the riskier claims on potential borrowers.

There is a big problem for the banks in accepting the Fed's offer to use the discount window, notwithstanding some limited (thus far) and apparently largely symbolic use of the window by a few major banks. The problem is tied to the word "discount." If Citibank, JPMorgan Chase, or

Bank of America elects to use the discount window extensively, they must establish a value for the loans they wish to "discount" at the discount window. This is problematic for two reasons. For bundles of loans like special investment vehicles (SIVs), the bundle may include derivative products (CDOs and CLOs) for which no value has been established, largely because no one wants to acknowledge the fact that the value is well below par (less than 100 cents on the face value of the loan). Doing that would raise a solvency problem.

The "don't ask, don't tell" market for pricing derivatives arose during the collapse of the Bear Stearns subprime hedge funds, which was precipitated by just such an inability to value derivative securities. They became unsellable because sellers withdrew them from sale once they learned that no one was willing to buy at anything close to par value.

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A Solvency Crisis?

The Fed has been treating the global financial crisis as a liquidity crisis and, by cutting the discount rate and inviting the banks to the window, took the last step that would still be consistent with the notion that a liquidity solution is adequate. It only hinted at the possibility of a solvency crisis by acknowledging on August 17, that "downside risks to growth have increased appreciably." In a solvency crisis, a sharp drop in the value of assets on the balance sheets of banks, corporations, and households could entail systemic risk, either in the form of a failure of financial intermediaries to function or a sharply elevated risk of recession that would exacerbate the solvency problem. A self-reinforcing solvency crisis would virtually guarantee a serious recession.

The Fed appears to be walking the fine line of not acknowledging a solvency or systemic crisis until the last possible minute to ensure that risk appetites are adequately quelled—that is, to be sure that a cut in the fed funds rate does not lead to a resurgence in the prices of risky assets. If such a resurgence occurred, the Fed's concern about inflation would reemerge and it would only have a larger bubble to burst sometime in the future.

The intensity of the financial crisis and its likely negative implications for the global economy are becoming painfully clear—no doubt clear enough to force the Fed to reduce the fed funds rate by at least 50 basis points at or

before its next scheduled meeting on September 18. The crisis in the commercial paper market is more intense and has evolved more rapidly than the crisis that emerged in connection with the failure of Long-Term Capital Management in the late summer and early fall of 1998. Furthermore, the current crisis is far more pervasive. This problem cannot be solved by getting representatives of seventeen banks into a conference room at the New York Fed and asking their cooperation in the bailout of a single hedge fund.

The problems that have emerged are systemic and are tied to a broad-based, rampant underpricing of risk in financial markets. They are global in scope because of the scale reached by the carry trade—financing in Japan or elsewhere at low rates and buying risky mortgage assets in the United States. Asian, British, European, and U.S. banks; investment banks; hedge funds; and sovereign funds are heavily exposed. At this point, a reduction of the fed funds rate by 50 basis points to 4.75 percent, along with abandonment of plans for rate increases by European and Asian central banks, may be enough to contain the crisis, but, arguably, will not be enough to prevent the emergence of a U.S. recession by the end of this year or early next year.

The Fed's cautious approach to what appears to be an intensifying global financial crisis has not, so far, received uniformly high marks in the press. While such views may not be either authoritative or fair, confidence—another word for liquidity in the view of some at the Fed—is not aided by the following August 21 headlines in the world's two leading financial newspapers:

Wall Street Journal: "Fed Fails So Far in Bid to Reassure Anxious Investors"

Financial Times: "Fed Fails to Calm Money Markets"

Pricing Risk Accurately

Ultimately, we are probably experiencing the pain and disruption associated with the need to produce a fundamental change in the markets' perception of the role of central banks. Over the past twenty years, the idea has developed that any financial crisis will cause the Fed or other central banks to run-up the "systemic risk" flag and ride to the rescue. Consequently, the heads of commercial banks, investment banks, mortgage brokers, and virtually every participant in the financial markets have had no choice but to "get up and dance," as Citicorp's Prince so eloquently stated. If the Fed's Open Market Committee members play their cards right in this very tricky game—and they may do so because they know full well what is at stake—we will be able to count ourselves lucky. Investors will learn to price risk accurately and the only cost will be a mild U.S. recession. A better outcome—a mild slowdown like that now envisioned by the Fed—would be almost a miracle, testimony to brilliant crisis management by the Fed. Yet with U.S. growth having averaged barely 2 percent while credit markets continued to function well and stock prices continued to rise through mid-July, we may ask: what growth rate will emerge with credit, at best, considerably more costly for all and, at worst, simply unavailable for those deemed risky borrowers?

A worse outcome—a serious global recession—is possible with some bad luck that might include a financial accident such as the one that almost arose at Countrywide Financial.

A great deal depends on how rapidly global investors abandon their cavalier attitude toward risk. Once again, we can look forward to a wild ride in illiquid, highly volatile financial markets. That environment is not favorable to continued global economic growth.

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