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The current international financial crisis cannot be blamed on a single underlying cause but on the interaction of many different factors, which alone could not have caused the crisis but together, they reinforced each other, creating a domino effect. Among them, I note the rapid rise in housing prices and their post-2006 decline, the relentless expansion of subprime mortgage lending through the “originate-to-distribute” incentives, securitization and the creation of a multiplicity of non transparent layers of derivative securities, the optimistic grading given by the Rating Agencies on some of those security tranches, greed and the quest for yield by investors, who underestimated the downside risk (i.e., an inverse of the well-known peso problem), and perhaps, most important of all, the high leverage of non-bank financial institutions that was based particularly on short-term borrowing and led to its quick deconstruction.

While the causes of the crisis will be debated for some time to come, the crisis itself is still unfolding and we have to understand why. Three elements lie behind this stubborn continuity: Lack of liquidity, insolvency and de-leveraging. The liquidity problem never went away despite heavy and innovative interventions by central banks that continue to provide ample amounts of cash on demand. Banks hoard cash and are unwilling to lend to other banks, as they distrust each other and are afraid of hidden skeletons, an item which is puzzling to be present in the market 14 months since the beginning of the crisis. Interbank spreads, say, over equivalent government borrowing maturities, have gone up in the US and Europe, and more so in the US, and are presently the highest ever. They have driven up the cost of funding for banks, leading to higher lending rates and a restriction in credit availability, thus hurting consumption and investment and pushing global economic growth lower. The year 2009 is expected to fair worse than 2008, which was already worse than 2007.

Insolvency, the second element behind the crisis’ continuity, comes from losses originally incurred by the earlier unwise investments on the so-called “toxic” assets, which have reduced Financial Institutions’ capital base to low levels, sometimes even to less than zero.

Write downs from past losses are a lot larger than new capital increases, creating a dangerous gap in the books of banks that closes through forced buy outs, capital infusions by governments and/or individuals, or through bankruptcy (e.g. Lehman Brothers). US fiscal authorities were quick to respond to the insolvency crisis on a case-by-case basis. On an aggregate level, the Bush administration tax package averted a US deep recession in 2008, while the recently voted TARP, despite its shortcomings – I would have liked to see more emphasis on recapitalizations, is a tool for jump starting many markets of the financial sector.

In Europe, a common approach to tackle the unraveling crisis is still missing and it is possible that countries will follow their own separate paths. Europeans seem to agree on how to install better fire extinguishers in order to prevent a future fire – a future crisis – via road maps and other bureaucratic processes, but are slow as a group to respond and extinguish the actual fire today, i.e., the current crisis. Incentives, apparently, differ substantially across the countries.

De-leveraging, the third element, is perhaps the main culprit for the prolongation of the crisis and its transfer to the real economy because the lost capital forces banks to sell assets or restrict credit by a multiple amount. Bank capital supports a multiple amount of assets, 10 times more in the US and 20 times more in Europe, thus the effect of its loss is multiplicative. The future restriction of credit is estimated to be equivalent to a year of stagnation in European bank lending and two years in US bank lending and it may not be an extreme scenario. This reduction in credit growth is bound to keep the economies of US and Europe sluggish in 2009 and perhaps longer. Commentators, of course, differ on how long the crisis will last or how severe it will continue to be. Some argue the worst will be over once housing
prices in the US stabilize. Others are more pessimistic and expect its intensity to rise arguing that hedge funds and/or private equity funds, both heavily levered, may be hit next.

We should keep in mind that this crisis, despite its severity, does not compare even remotely with the Great Depression, when industrial production fell by more than 50%, economic output by 30%, prices by anywhere from 37% to 52%, depending on the index, and the unemployment rate went up to 25%. The differences between the two periods are stark, as back then the gold standard acted as a major restraining device, US was a bigger economic center than it is now with Asian economic power absent, US government officials did not intervene, and there was little regulation, like deposit insurance or regulatory capital requirements.

This is a reminder against many commentators who, influenced by the current interventionist policies, have hurriedly stretched the power of government intervention even further, claiming that we have now entered a new era of higher central authority and less market freedom, exactly as it happened after the Great Depression. They may be partly right and only time will tell. But it will not be because of a repetition of the post-Depression policies.

In the current negative market environment, regulators ought to avoid following a pro-cyclical strict policy on capital requirements. If they insist on banks quickly raising their capital base, they would simply aggravate the crisis, as they would force a quicker pace of de-leveraging, loan reduction and a deeper recession. Yet, regulatory broadening and deepening would be the most likely long-run outcome of the present crisis. Broadening is essential in order to avoid regulatory arbitrage and the potential of instability generated by financial players that operate on the fringes of regulation and undo the regulatory restrictions on mainstream players.

Regulatory deepening will probably steal the attention in the intermediate run as regulators are likely to first tackle the obvious gaps in the existing regulation. Event risk will be reassessed with stricter capital standards. Securitization, credit derivatives and the transfer of risk will be reexamined. Illiquidity of assets and transparency will come to the forefront. Issues of corporate governance, Pillar II of the current Basel regulation, will be emphasized more. Mature economists, instead of only smart physicists and mathematicians that develop fancy statistical models, would be called upon to assess overall risk.

Amidst the new regulatory fervor, one should not lose sight of the fact that capital is costly and that financial crises of the magnitude and intensity we presently observe only happen in advanced and stable economies once in a lifetime. Regulators should not impose onerous restrictions in order to cover the possibility of a bad state occurring once in 100 times. They should not underestimate the ability of the private sector to always be one step ahead of them in finding ways around regulatory restrictions when those restrictions impose too much cost. The right balance of broader, deeper and less costly regulation should be found, one that reduces conflicting incentives, is not pro-cyclical, takes into account the positive and negative externalities imposed from one FI (financial institution) to the others, and minimizes the probability of a crisis and its costs to the economy.