Yeni Finans Düzensizliği
Finans Krizine Dair Asyalı Bir Görüş

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ÖZET

Hong Kong Hisse Senetleri ve Vadeli İşlemler Komisyonu Eski Başkanı Andrew Sheng'in kapsamlı makalesinde, Asyalı bir finans uzmanının bakış açısıyla krizin makro ve mikro sebepleri, krizden çıkarılacak dersler ve krizin dünya finans sisteminde yol açabileceği değişikler konu alınmaktadır.

Makalede, mevcut krizin, küresel model olarak "Amerikan rüyası"yla ilgili soru işaretlerine yol açtığı, dünya nüfusunun yüzde beşinin yaşadığı ABD'nin küresel hasılanın yüzde 25'ine sahip olduğu, halihazır gelişme hızları devam ettiği takdirde, Asya'nın dünya ekonomisindeki payının 2030 'da ABD ve Avrupa'nın toplamından daha büyük olacağı, ancak Asya finans piyasasının henüz bu rolü oynamaya hazır olmadığı belirtilmektedir.

Krizin makro ve mikro sebeplerinin analiz edildiği makalede, 1990'lı yıllarda ortaya çıkan Japonya'daki kriz sonrasında Japonya'nın uyguladığı düşük faiz politikaları, finansal mühendisliğin ağırlık kazanması, küresel sermaye hareketleri üzerindeki denetimin asgariye indirilmesi, Soğuk Savaşın sona erişinin ardından planlı ekonomilerde ortaya çıkan işgücü arzının ürettiği ucuz işgücü ve düşük enflasyon, olası makro sebepler olarak değerlendirilirken, mikro düzeyde ise, finansal yaratıcılık ve finansal türev ürünler üzerindeki denetim eksikliği, yatırım bankalarındaki risk yönetimindeki zaafiyet gibi bankacılık sisteminin işleyişindeki yapısal sorunlar ele alınmaktadır.

Makalenin son bölümünde yazar Sheng, Asya'nın bu krizden çıkaracağı birçok ders bulunduğunu, reel ekonomiye herzaman finans sektöründen daha fazla ağırlık verilmesi gerçeğinin anlaşıldığını, finans sistemleriyle ilgili düzenlemelerin maliyet artışı getirdiğini, ancak finans krizlerinin çok daha yüksek maliyetler yarattığını vurgulamaktadır.

The New Financial Disorder* An Asian View of the Financial Crisis

Andrew SHENG**

The years 2007 and 2008 marked an important turning point for the global market economy. Did we witness the peak of global capitalism as well?

One thing is certain: The crisis put a question mark on the American dream as a world model. Americans comprise less than 5 percent of the world population, account for 25 percent of global GDP, and consume annually external resources equivalent to 6 percent of global GDP. For the average Chinese and Indian, who together number 37 percent of world's population, the American goal is impossible for the global natural resources to sustain.

As India and China each grow at more than 8 percent per year, compared to less than 2 percent for the United States, Europe and Japan, the relative balance of power between mature economies and emerging markets will change dramatically. Economist Angus Maddison has projected that by 2018, China will overtake the United States as the largest economy in the world, with India ranked No. 3. By 2030, he estimates, Asia including Japan would account for 53 percent of world GDP, while the United States and Europe would account for 33 percent. If this happens, the global financial architecture would be significantly different from the present.

Asia now accounts for 67 percent of global currency reserves, 55 percent of the world's population and 24.5 percent of world GDP, but only 16 percent of International Monetary Fund quotas, equivalent to its voting power in the Bretton Woods institutions.

My calculations suggest Asian financial markets will be the largest in the world in the next 10 years, assuming financial deepening in Asia continues to improve and Asian currencies appreciate relative to the U.S. dollar and euro. This means that either one Asian currency or Asian currencies as a group will very likely play a role as a global reserve currency by that time.

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Is Asia ready to play that role? Not by far. In the past, emerging markets were dependent on advanced economies for markets and financing. Asia's surplus role has been too recent for that fact to sink in. Asia had to put its excess savings in the West precisely because its own financial system is not ready to intermediate such savings. Its regulatory structure is still evolving, and Asian bureaucrats are neither internationally minded nor prepared psychologically to act in the international monetary order. There are hardly any think tanks in Asia dedicated to the international financial order.

Macro Questions

Four mega-trends preceded the crisis. The first trend was the appearance in 1989 of a labor force with 3 billion people from previous planned economies after the Cold War that provided the world with cheap goods and low inflation for nearly two decades.

The second can be found in the monetary policy responses to the Japanese bubble and deflation since 1990, which gave rise to more than two decades of almost interest-free yen loans globally, creating the famous yen carry trade. Recent estimates of the global carry trade -- essentially the arbitraging of differences in national interest rates and exchange rates -- amounted to $2 trillion, of which about half involves the yen carry trade. The supply of almost interest-free funding effectively subsidized the rise of financial engineering, which was first applied with great effect in the Asian crisis. The success of such carry trades were then applied and magnified through leverage and derivatives -- a hallmark of the new class of investment banks and hedge funds.

The third force was the emergence of financial engineers, a trend evident after Cold War scientists were laid off and then applied their skills to financial markets. These engineers created financial models to manage risks and staffed the business schools, investment banks and hedge funds that dominated markets. Underlying their sophisticated models, however, was a fatal flaw: They believed the world of risk was a bell-shaped curve that ignored the long-tailed black swan risk. This underestimation of once-in-400-year risks was their undoing.

The fourth trend was the phase of global deregulation for markets. These included tariff reductions under the World Trade Organization, the removal of capital controls under the IMF, and the philosophy that minimal intervention and letting markets determine prices and competition would create global efficiency. Such philosophy permeated textbooks and the international bureaucracy. Essentially, these mega-trends were four arbitrages that created converging globalization – wage arbitrage, financial arbitrage, knowledge arbitrage and regulatory arbitrage.

At the policy level, the failure of state planning also saw the ebb-tide of Keynesian economics, which called for greater government intervention in the economy. The dominance of Friedman-ite free market capitalism unfortunately overemphasized the use of monetary policy tools and the importance of central banks. Fiscal policy was relegated to minimizing fiscal deficits, while elegant monetary targeting theories were propounded based on consumer prices that ignored the crucial role of asset prices. It was a grave intellectual blind spot that the entry of cheap labor into the world economy deluded many Western central bankers into thinking that their monetary policy was working wonders on global inflation.

But that blind spot was minor compared to ignoring the bubble in real estate prices. The naive belief that widespread house ownership benefited long-term social stability, irrespective of affordability and supply constraints, had the unintended consequence of creating social expectations that house prices would rise and never fall. Real estate accounts for the bulk of assets of households and is certainly the most important collateral asset of the banking system.

In many countries, the desire for greater housing was not backed by sufficient supply, so more lending for housing simply created self-fulfilling upward price pressures. In the United States, house prices rose almost non-stop from 1991 to 2006, with total private sector real estate rising to 225 percent of GDP. Between 2003 and 2007, real estate assets of U.S. households rose by US$ 6 trillion, but household liabilities increased by US$ 4.5 trillion, implying that households consumed a large part of the increase in house prices.

This was made possible because the financial system pushed loans to the consumer sector. Mortgage loan to value (LTV) ratios rose to 90 percent for house buyers and credit evaluation deteriorated by lending to no-income, no job assets (NINJA) subprime borrowers. These subprime mortgages were then sliced and diced into packaged derivatives by financial engineers without supervision by regulators and sold to investors hungry for yields during the low interest environment of 2003-07.

Micro Origins

The above macroeconomic background is crucial to understanding the current world crisis. It was the ability to finance external deficits that was the basis for the emergence of the current “originate to distribute” structure of the U.S. banking system. In other words, the U.S. and European banking system evolved from the traditional retail

deposit-bank lending model to the new wholesale banking model, because they were no longer constrained by domestic savings but could draw on global savings through securitization.

Unlike the 1997 Asian crisis -- a traditional retail banking and currency crisis -- the present crunch was truly a wholesale banking phenomenon with derivative amplification. Because the Asian crisis was a crisis at the periphery, its network effect was limited. But the present crisis is at the center of global finance and is amplified from the United States and Europe to the emerging markets. Therefore, it was significantly larger and deeper.

Excessively loose monetary policies, low interest rates and carry trades made speculation and a "search for yield" the driving motivation for financial innovation. Improvements in telecommunications and computing gave dynamic trading a superior advantage over the conservative "buy and hold" retail investors and pension funds. Hedge funds and investment banks could trade at speed and arbitrage price differentials across markets and products. To satisfy the search for yield, new securitized products evolved to suit investor tastes.

Four elements of financial innovation and deregulation merged to create the toxic products at the root of the current crisis. The first was the plain vanilla mortgage securitized into mortgage-backed paper by government mortgage institutions such as Fannie Mae and Freddie Mac. Securitization meant assets could be moved off-balance sheet into unregulated special investment vehicles (SIVs) that did not require capital. Then accounting and regulatory standards permitted moving such potential liabilities off balance sheet so banks benefited from "capital efficiency," letting leverage increase with the same capital level.

The third was the use of insurance companies and newly evolved credit default swap (CDS) markets to enhance credit quality of the underlying paper. If underlying assets looked weak, a CDS sold by triple-A insurers such as AIG enhanced credit quality. The fourth sweetener was the willingness of the credit rating agencies to give these products triple-A ratings, for a fee.

By slicing traditional mortgages into different tranches of credit quality, collateralizing each tranche with guarantees or assets, the financial engineers "structured" credit debt obligations (CDOs) that smelled like safe triple-A products with higher yields than

government treasury bonds. What investors did not realize was that these products carried embedded leverage that could unravel. By collecting origination fees up front, investment banks, rating agencies and mortgage originators profited without regulation. To assure investors who feared these assets had no liquidity, the issuing banks gave liquidity "conduits" to structured products that were contingent buy-back guarantees. All these were conveniently off-balance sheet commitments.

It looked too good to be true, even to regulators. But they were reassured as the market grew. Time and again, former Federal Reserve Chairman Alan Greenspan and others commented on potential risks, but also said risks were being distributed outside the banking system.

This "black hole" in regulation was in practice the over-the-counter (OTC) market that originated from bilateral transactions between banks and their clients. The largest and most successful OTC market is the foreign exchange market. The advantage of the OTC market is that it is opaque to outsiders, including regulators, but if the product is well understood, it can be a highly liquid market. Derivatives in foreign exchange and interest rate derivatives were supported by central banks because many thought their evolution would enhance monetary policy instruments, as well as enable banks and their clients to hedge market risks.

That protection was so strong that even when Hong Kong, South Africa, Malaysia and others protested during the Asian financial crises that illiquid foreign exchange markets in emerging markets were often manipulated, these charges were dismissed. Too many vested interests were at stake. Emerging market supervisors were too weak to change this bastion of non-regulation, because the winners of superior financial innovation were Western banks.

This "originate to distribute" banking model, plus the OTC market, formed what Bill Gross of fund manager Pimco called a "shadow banking" system. Tim Geithner, the New York Federal Reserve president tapped for U.S. treasury secretary, estimated that this dynamic shadow banking system could be as large as $10.5 trillion, comprising $4 trillion worth of assets with big investment banks, $2.5 trillion in overnight repos, $2.2 trillion in SIVs, and $1.8 trillion in hedge fund assets. This compares with $10 trillion in assets for the entire, conventional U.S. banking system, which means system leverage was at least double what was reported.

During the last decade, central bankers marveled at the phenomenal growth of the financial derivative markets, which conservative fund manager Warren Buffett called

"financial weapons of mass destruction." By December 2007, data from the Bank for International Settlements (BIS) showed that the notional value of derivative markets had reached $596 trillion. About two-thirds of this was in simple interest-rate derivatives, but nearly $58 trillion was in the rapidly growing CDS market. Exchange traded derivatives totaled $95 trillion. Together, these derivatives were 14 times global GDP, whereas conventional financial assets -- bonds, equities and bank assets -- were only four times GDP. Market traders reassured everyone that the gross market value of such derivatives were actually much smaller, such as $14.5 trillion for OTC derivatives.

What traders did not say was that, despite some bilateral netting between market participants, most transactions remained on a gross basis, since there was no clearinghouse to monitor and clear on a net basis. Gross derivatives clearing and settlement (except where bilateral netting applies) could only function if the wholesale market remained highly liquid.

Because most of these markets are bilateral trades, the OTC market works on a sophisticated and complex system of margin or collateral management. For each derivative trade, the primary dealer calls for margin to protect itself from credit or market risks. In a rising market with narrowing risk spreads and volatility, fewer margins are required, cyclically increasing liquidity. Liquidity begets liquidity, creating a classic network effect.

Unfortunately, it also works the other way, pro-cyclically. If volatility increases, the need to call margin and sell assets to realize liquidity would immediately worsen liquidity, widening risk spreads and creating solvency problems for participants. This was experienced by LTCM in 1998, when it did not have enough liquid assets to meet margin calls. Any stop-loss selling of margin collateral at the highest point of volatility by counterparties would immediately precipitate insolvency for LTCM. But this was not immediately transparent to other market players since no single player is fully aware of market positions in an OTC market. There is no single regulator or clearinghouse to monitor counterparty positions. The opacity of the OTC market is its strength as well as its Achilles' heel.

What also was not widely known was that, instead of distributing derivative risks outside the banking system, much of the risk was concentrated within. According to BIS, only 19 percent of OTC trades were with non-financial customers. In the CDS

market, 2006 British Bankers' Association data said the banks were 16 percent buyers of CDS protection, whereas net protection sellers included insurance companies at 11 percent, hedge funds 3 percent, and pension funds 2 percent. Since hedge funds were never risk holders, they would sell risks back to primary dealers at the first sign of trouble.

We now know that the shadow banking system grossly disguised the true level of leverage, grossly underestimated the liquidity required to support the market, grossly misunderstood network interconnections in global markets, and enabled key players to over-trade with grossly inadequate capital. For example, at the end of 2007, five U.S. investment banks had total assets of $ 4.3 trillion, but only $200 billion in equity, giving them an average leverage ratio of 21.5 times. Their combined notional off-balance liabilities of $17.8 trillion implied further leverage of 88.8 times. They were allowed in 2004 by an SEC rule change to exceed their net capital limits 15 times and start valuing derivatives according to their own risk models, opening up the leverage limit.

Network theory says the hub is robust and efficient so long as the links (network members) continually feed and benefit from the hub. However, if there is any doubt about counter-party risks of the hub, then members are likely to withdraw resources rapidly to protect their own interests. The failure of Lehman Brothers destroyed the myth that any major market maker in global markets was too big to fail.

That failure will go down in history as the trigger that set off the systemic crisis worldwide. Although it had only $620 billion in assets, Lehman had $1.6 trillion in frozen counterparty positions. Since Lehman accounted for nearly 14 percent of trading in equities on the London Stock Exchange and 12 percent of fixed income in New York, and it also managed client assets for hedge funds and investors, the liquidity of its counterparties was immediately impaired on default.

The Lehman bonds default caused money market funds to fall below their $1 par value, so that there were immediate withdrawals from the $3.4 trillion money market sector. If that sector had collapsed, the liquidity crunch in the United States would have been catastrophic. The irony of the Lehman failure was that it was an effort by the high priests of free market fundamentalism to demonstrate to everyone that they were acting against moral hazard, that no investment bank is too large to fail. But in demonstrating that those who practice bad behavior can be allowed to fail, the effect was to tell the market that others may be allowed to fail. So the best strategy is to cut and run.

Lessons for Asia

Asians will be hurt significantly through slower world growth and trade, as well as from a weaker dollar. If the U.S. current account deficit adjusts to 3 percent of GDP from roughly 5 percent now, it would cut back $320 billion in annual exports to the United States, meaning a 13.5 percent fall in imports. This would have a negative multiplier effect in Asia. Asians hold a substantial amount of dollar and euro denominated securities in official reserves, so nations also could be hurt by devaluations of those currencies.

The crisis brings everyone back to reality. But there is a short window of opportunity for reform before memory fades and vested interests get in the way. We know derivatives carry leverage and risks that do not disappear when transferred. Not understanding the nature of derivatives is itself a major risk.

Since finance is a derivative of the real economy, no financial structure is strong unless the real economy is strong. Finance must serve the real economy, not drive it. For too long, Wall Street was paid more than Main Street. We must ensure that the incentive structure is even-handed; financial wizardry cannot be rewarded irrespective of performance. There should be no golden parachutes and pay must be aligned with long-term performance.

Emerging markets must understand they cannot mix the culture of investment banking (where risk-taking is key) and commercial banking (where prudence is vital) under one roof. Glass-Steagall was not fundamentally wrong. Nor can the banking system become totally wholesale; the bulk must remain retail, protect depositor interests and serve business, especially small- and medium-sized enterprises that provide mainstream employment in the real economy.

Not all financial innovation is bad. The plain vanilla type of mortgages and mortgage-backed securities are performing relatively well in the United States and markets such as Hong Kong and Malaysia. Asset securitization can become the backbone of a robust corporate bond market in Asia as well as means of reducing the maturity mismatch of the banking system when it finances home ownership. Just as there is a national drug administration to vet and approve new drugs, there is no inherent reason why financial regulators should not examine, approve and exercise proper due diligence on new financial products.

But the whole philosophy of financial regulation needs to be examined. The recent trend toward creating financial super-regulators was due to the concentration and

conglomeration of the industry itself. The present institutional basis of financial regulation created multiple regulators, making the coordination and enforcement of supervision complex, costly and less effective. One of the arguments for super-regulators was that costs to the industry were too high. The answer is now obvious: Higher costs of regulation are still cheaper than the costs of crisis. It is the total social cost that matters.

Financial regulators also need to think strategically about how to regulate effectively through the entire economic cycle. They need to deal with crisis conditions as bubbles emerge. The Europeans did not expect the U.S. subprime crisis would hit them so badly. But it was the weaker regional German banks and British building societies that had to be rescued. Despite massive restructuring of European financial oversight and regulation, the sectors that were local and not subject to clear oversight became the most vulnerable to external shocks.

Emerging markets regulators, central banks and finance ministries are still focused on daily domestic turf battles rather than understanding that the global finance game is changing. Global interconnectivity is reality, but mindsets and social and financial institutions are still local.

If, as I expect, regionalism is the outcome of the current crisis, the global monetary and financial architecture will be radically different in two decades. By then, there will be at least three global reserve currencies contending for hegemony. Notice that I have not specified what the third reserve currency would be. Within Asia, it could be the yen, the yuan, the Indian rupee or even an Asian currency that includes large components of South Korean, Middle East and ASEAN-member currencies. In Latin America, it could be the Brazilian real or Mexican peso. Then, diversified global portfolios will comprise a more equal distribution of assets so investors are not exposed excessively to only one or two major currencies.

Financial crises are ultimately political in nature. Even resolving a crisis is inevitably political because the distribution of losses would be highly arbitrary and controversial. Ultimately, all financial crises are about crises in governance.

The latest financial crisis proves that financial engineering cannot create perpetual prosperity. Financial engineering was based on unrealistic assumptions of neo-classical theory. The present financial crisis has creatively destroyed such out-dated theories. Free-market fundamentalism has truly been marked-to-market.