

Learning from the Global Economic Crisis: Lessons for the International Financial Architecture

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1.0 Background

1.1 Soon after the Asian crisis

Two of the questions in Asia with respect to the recent global financial crisis were: first, how it could have happened since we had labored hard at fixing the roots of the Asian financial crisis; and, second, how could it happen so soon after the Asian crisis. In response to the Asian financial crisis we were focused on controlling our foreign indebtedness and our fiscal deficits to remove the causes of the Asian financial crisis 10 years ago and the Latin American debt crisis 25 years ago. However, this time it was our credits (not debts) and investments abroad that had an immediate adverse impact. It only became much deeper because export markets contracted due asset losses in importing countries. The second question is partially answered by the mini-crises that have happened over the last 25 years since the increase in financial liberalization. As a side effect of increased global financial integration, the interaction among financial markets had increased across borders. Because the size of the market has increased tremendously, volatility was much stronger and what would have previously been minor fluctuations becoming larger than individual countries could absorb or mitigate on their own. While prudential structures were designed, the exact form of vulnerability had not been fully specified so preventive mechanisms were difficult

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to design.

By almost all accounts this was the worst financial crisis since the Great Depression because of the depth and breadth of its effects. It affected several of the most economically and financially important countries. By of February 2009, the United Kingdom, Japan, and the United States have suffered absolute declines of -0.50%, -11%, and -1.5%, respectively, in their gross domestic product. And China's rapid growth rate will decelerate to 6.5% from a high of 11% at one time. Other countries have suffered similar if not worse fortunes. There are indications that things will get worse before they get better. For a crisis of such depth, length and breadth we may have to go back to the 1930's to look for close parallels.

1.2 New causes

When the crisis finally arrived it came from the general direction that had been broadly anticipated but in a form that had not been visualized. The two main components were the financial intermediaries like banks and insurance and financial markets. Because of its role in previous domestic financial crises, financial intermediaries had always been closely regulated by domestic rules. In recent years, the Basel Committee in Switzerland had formulated an evolving set of international standards that acted as an informal system regulated by business practice and domestic regulators to put more order in the global banking system. However, financial markets had previously been more loosely regulated based on the belief that market participants were higher-value, more sophisticated investors. The main regulators of the financial markets were the Securities and Exchange Commission's of countries. Their main objectives were the prevention of fraud and maintenance of an orderly market. Prevention of systemic failures was not an explicit function of these watchdogs. Greenspan admitted in an interview that he underestimated the risky lending (i.e. subprime credits) on the broader economy (Davies, 2007). In post-crisis interviews he has also observed that he may have overestimated the self-correcting ability of the financial markets. In this context, several weaknesses appear from hindsight.

1.3 Roots of vulnerability

Subsequent analysis indicates that some areas of the international of domestic and international financial systems were vulnerable to the enormous expansion of essentially un-hedged credit risks. Perversely, some of the system's prudential features facilitated this dangerous buildup. One of the other root causes may have been the over-consumption of developed economies especially the United States, capitalizing on the cost competitiveness of newly emerging economies like China and India. This combination of mature economies, efficient production by new producers and the increasing integration of global product markets became apparent about a quarter of a century ago, manifested by the tremendous growth in trade volumes in the last decades of the 20th century. As the flow of goods from these newly-industrializing economies accelerated, it caused a continuing flow of funds trade deficit to surplus countries.

Overconsumption and the resulting recycling problem of foreign currency by the exporting countries set the grounds for the tremendous explosion of credit and the enhanced use of subprime credits in the financial markets. This provided

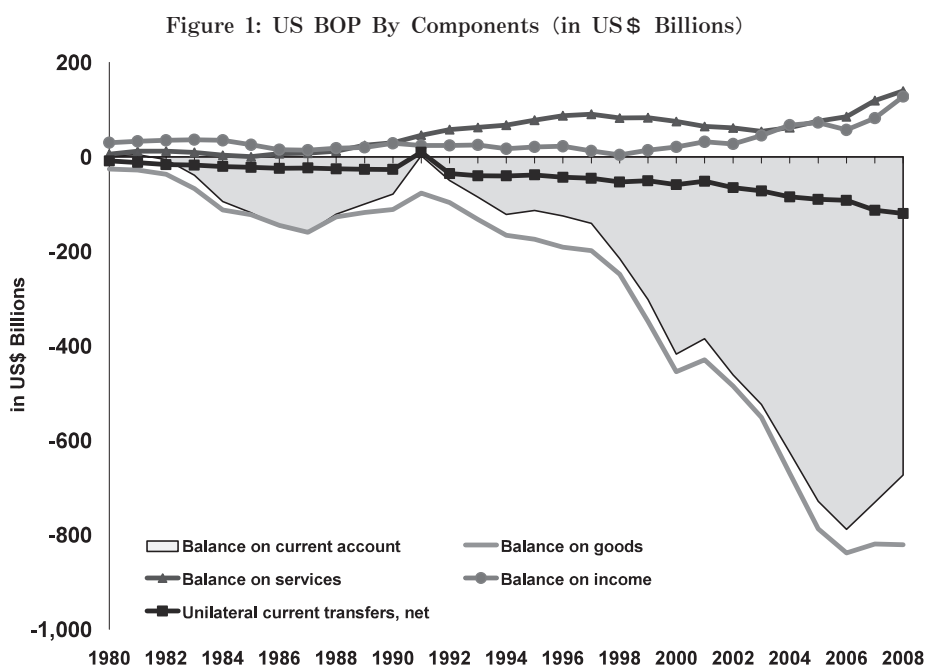
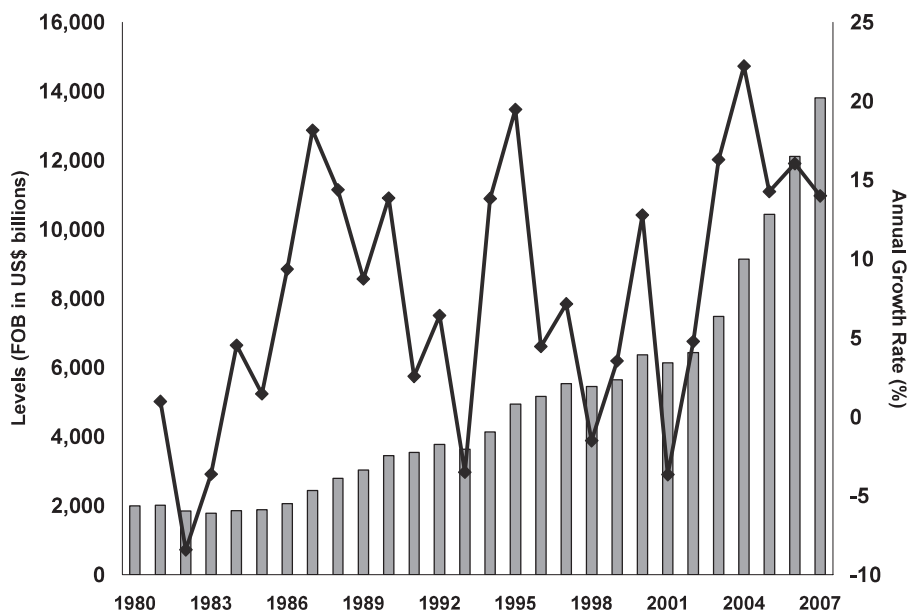
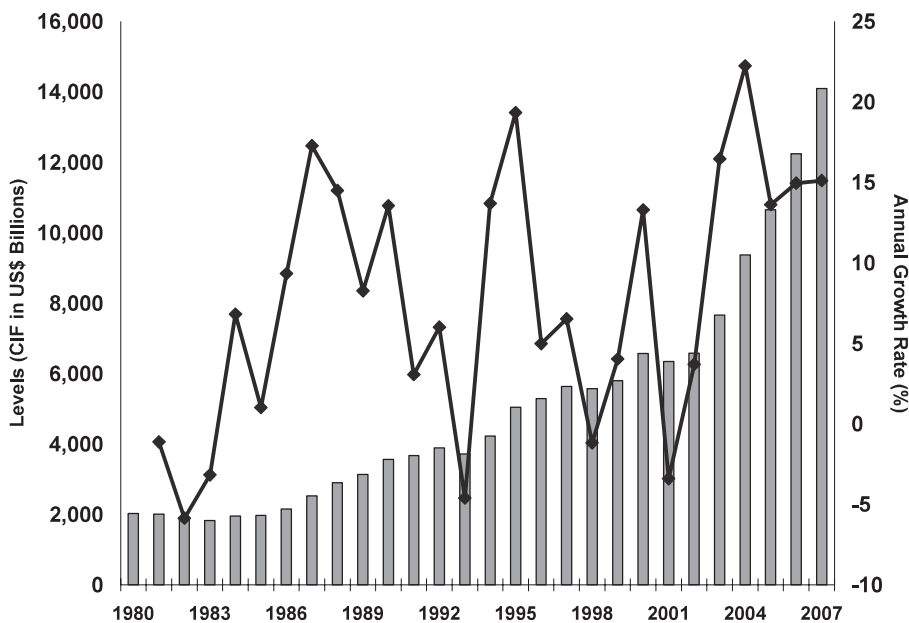


Figure 2: World Exports Value, 1980- 2007 (in US\$ billions)



Source: International Monetary Fund (IMF)

Figure 3: World Imports Value, 1980- 2007 (in US\$ billions)



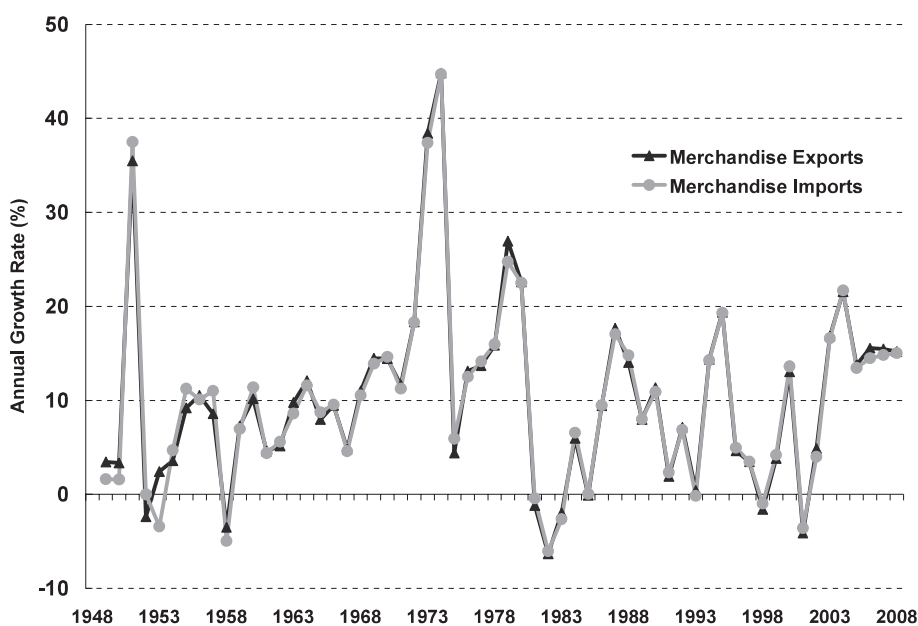
Source: IMF

the fuel for the continued expansion of international finance and the inflated asset prices that became the trigger for the global collapse. This added dimension implies additional reforms that have to be addressed as the world recovers from the crisis.

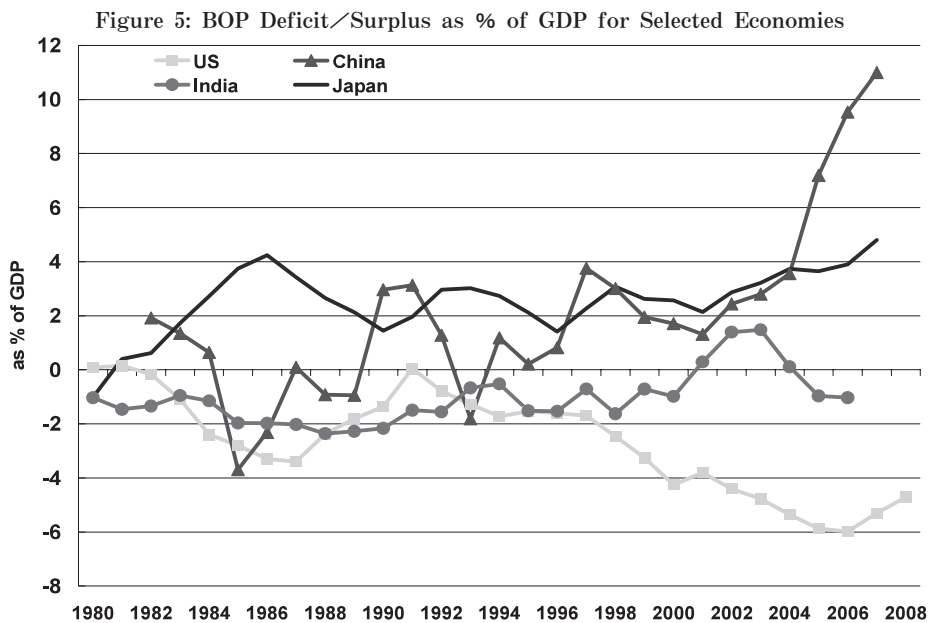
The production and trade imbalance created a re-cycling problem for the main exporters that needed either currency realignment or a remedial capital flow from surplus countries. To maintain their cost competitiveness, surplus economies chose the latter, shipping several trillion dollars of funds to purchase earning assets from deficit countries. While we use China to illustrate how the process took hold, this phenomenon came out of a strategy rooted in development lessons of the last half-century and was part of a major push for economic growth by emerging economies.

For the United States, the supplier of the de facto global currency, this was masked by the need to produce a moderate balance of payments deficit in order to supply liquidity needed by the rapidly expanding volume of world trade. This cover was extended when the collapse of the socialist economies created several

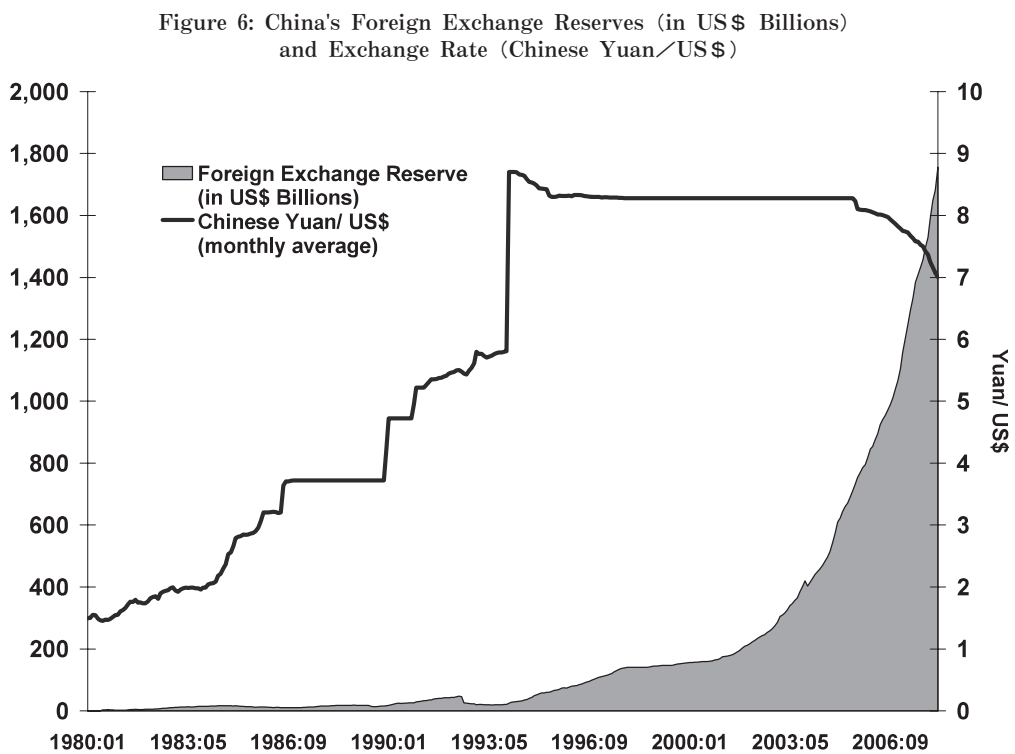
Figure 4: World Merchandise Trade, 1948-2008



Source: World Trade Organization

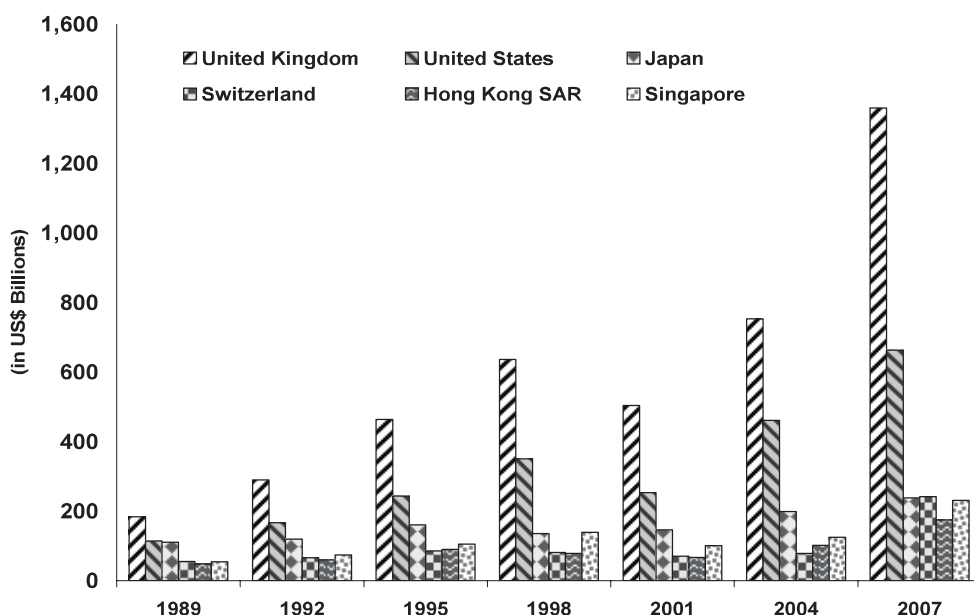


Source: IMF



Source: IMF

Figure 7: Daily Global Foreign Exchange Turnover,
By Major Markets (in US\$ Billions)



Source: Bank for International Settlements

new capitalist economies with central banks that loaded up in foreign exchange reserves to support their entry into the world trading system.

These flows of cheap goods and funds had two salient results in the recipient countries. First, the inflow of cheap goods reduced their inflation rates, strengthening their currencies and, thereby, harming their manufacturing sectors. Second, the flow of funds inflated asset prices and reduced the return on investments. When the dot-com bubble burst in 2000, the low-inflation environment allowed the central banks, led by the US Federal Reserve, to reduce interest rates to avoid recession, further enhancing the asset price bubble and aggravating the already low returns on investments, inciting a frantic search for higher-yielding alternative investments. They found the solution in subprime credits and inflation hedges like minerals and agricultural commodities.

Subprime credits became the centerpiece of a (financial) market-wide effort to stem the decline in investment returns and to extend the reach of the financial markets to the rest of the world. This unlocked a huge reservoir of capital that spawned a spiral of financial activity. This was facilitated by financial innovations

allowing the securitization of subprime mortgage loans into collateralized debt obligations (CDO's) and the "originate and distribute" business model of selling these assets. In 1999, the United States repealed the insulating restrictions between banking and other financial services like insurance, increasing the size of the financial market and the market players at the same time that it allowed the increased exposure of banks to the volatility of the financial markets.

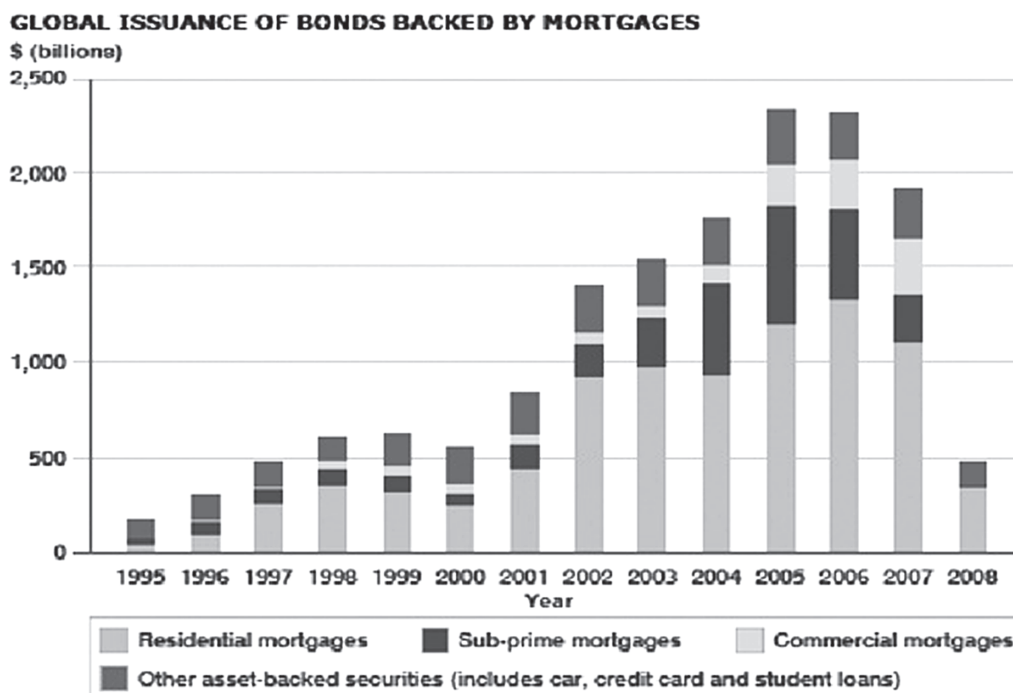
2.0 Business rationality and market myopia

Among the puzzles of the crisis is how regulators could have missed the signals and how they could have allowed the problem to get so large. One of the reasons is that the crisis started in the financial markets rather than among banks. It was "market liquidity" that froze when the rapidly dropping asset prices caused funds to flee financial markets, rather than "funding liquidity" with banks running out of funds as depositors withdrew their funds.

Among the main factors identified in the market freeze are new financial structures called structured investment vehicles (SIV's) that made substantial use of financial innovations including collateralized debt obligations (CDO's). Structured investment vehicles were handy financial structures to exploit the availability of funds provided by the recycling of funds from surplus economies and to avoid the low investment returns (and parallel asset bubbles) in the face of growing liquidity. These were set up to mop up market liquidity by issuing short-term instruments and turn around to buy higher-yielding longer-term notes, part of a practice known as the carry trade. This type of operation carried the inherent danger posed by "a term mismatch" where short-term borrowings finance long-term assets. If short-term rates were to suddenly rise, these activities could result in substantial losses. Using short-term fund sources also created uncertainty about the stability of the financing.

The activities of SIV's were facilitated by the increasing availability of securitized sub-prime credit instruments (CDO's) essentially based on homebuilding loans that were supported by the Federal National Mortgage Association (FNMA, hence Fannie Mae) and the Federal Home Loan Mortgage Corporation (FHLMC, hence Freddie Mac). The presence of a vigorous secondary market allowed the

Figure 8: Global Issuance of Mortgage-Backed Bonds (in US\$ Billions)



Source: Fitzgerald, V. *The Global Financial Crisis & Developing Economies*.
University of Oxford. 22 September 2008.

tranching of these securities, producing highly-rated instruments that allowed the market to attain much higher volumes of financing.

Unfortunately, increasing profits by using these instruments was too tempting and the market expanded, among others, by re-securitizing these securities a few more times. As the original loans were packaged and repackaged through increasing levels of securitization, their underlying credit weakness became submerged and the market forgot how poor the credit basis was.

This phenomenon was facilitated by a financial institution meant to strengthen the credit process: credit rating. Credit rating is one of the main pillars of modern financial markets, acting as an instrument for controlling risk. To control risky taking by investment and credit managers, provide more information for investment and credit decisions, and protect the public, Securities and Exchange Commissions (SEC's) require that public issues of bonds and other

credit instruments be rated by accredited credit rating agencies (CRA's). To encourage prudent lending and portfolio decisions, central banks have increasingly implemented the Basel accords that require risk weighting for banks' risk (earning) assets. Risk-weighted assets are used to compute the minimum amount of capital to support bank lending in order to minimize the chances of bank failure due to unexpected losses (i.e. over and above the allowance for bad debt losses).

The SEC requirement ensures that investors unable to afford their own individual credit investigation efforts have enough information to guide their investment and lending decisions. Since the issuance of debt to the general public has tremendously raised the amount at risk, credit rating has become armor against wholesale losses by investors in the financial markets. The central bank rule is meant to ensure that banks are insulated against failure and, therefore, safe counterparties in the credit business. If individual banks cannot survive loan defaults, then they also create trouble for the next bank in the chain of lenders and that bank to the next bank and so on. This kind of systemic failure is minimized as risk weighting and capital cover allow the banks and other lending entities to absorb unexpected losses at their turn, thereby stopping the contagion mentioned above.

Credit rating (and other risk mitigating methods) failed to prevent the financial meltdown. In fact, some features of the credit rating system — coupled with other innovations like the securitization of subprime mortgages and deregulation (e.g. repeal of Glass-Steagall) that allowed the fusion of the banking and financial services industries — may have allowed the underestimation of risk and even amplified the overall danger, individually for lenders and collectively for the market as a whole. The rating process typically involves assessing the issuer of the instrument. In the case of the collateralized debt obligations (CDO's) where debt servicing ultimately rests with the original borrowers (i.e. the mortgagors of the properties) of the underlying contracts, the rating would focus on the issuers of the bonds (perhaps real estate investment trusts or REITs) or the guarantor. By slicing CDO's into varying tranches of seniority, REITs and similar funds are able to issue instruments rated AAA even though based on underlying

subprime instruments. When the issuers are highly rated or the issue is guaranteed by highly-rated entities (like Lehman Brothers), the assets are carried at higher value (risk weights are low). Given the high interest rates that subprime credits carried, these instruments were very attractive to investors.

Somehow lost in the shuffle was the fact that ability of the mortgagors (with low ability to pay) to service the underlying debt was very sensitive to market shifts such as changes in interest rates. When interest rates rose, the original mortgagors started defaulting and even AAA rated paper were not protected by the *tranche* feature. Something similar had happened about a decade earlier when a market shift blindsided the Long Term Capital Management Fund (LTCM).

The credit rating process became an unwitting partner of the magnification of the risk because it lent a (falsely) reassuring tone to the acceptance of what were essentially risky instruments. A frequent rule in guidelines for pension funds, investment and similar committees include rules that investments “must be AAA rated” or “must be investment grade,” etc. Disciplined boards and committees could rest assured that they had done their fiduciary responsibilities by adhering to the rules of prudent investing. After all, they had followed all the rules of financial prudence. This phenomenon is a variant of the market failure traceable to “moral hazard” similar to the loss of market discipline if deposit insurance (especially if subsidized) is too high. Just because the instruments are credit rated, decision makers become careless in ensuring that default risks are minimized.

While individual responsibility may have been practiced, unknown to most participants in the financial markets, a dangerous mixture of highly combustible risk was building up. Paradoxically, the comfort provided by high credit ratings may have abetted this hazard. Reassured by the use of credit ratings risk managers, credit committees and similar bodies contentedly allowed their investment managers to continue investing in this type of instruments. Business rationality and market myopia were combining into a highly dangerous recipe for disaster.

The beginning of the end came when the extraordinary demand for dollars finally came to an end. The large balance of payments deficit finally translated

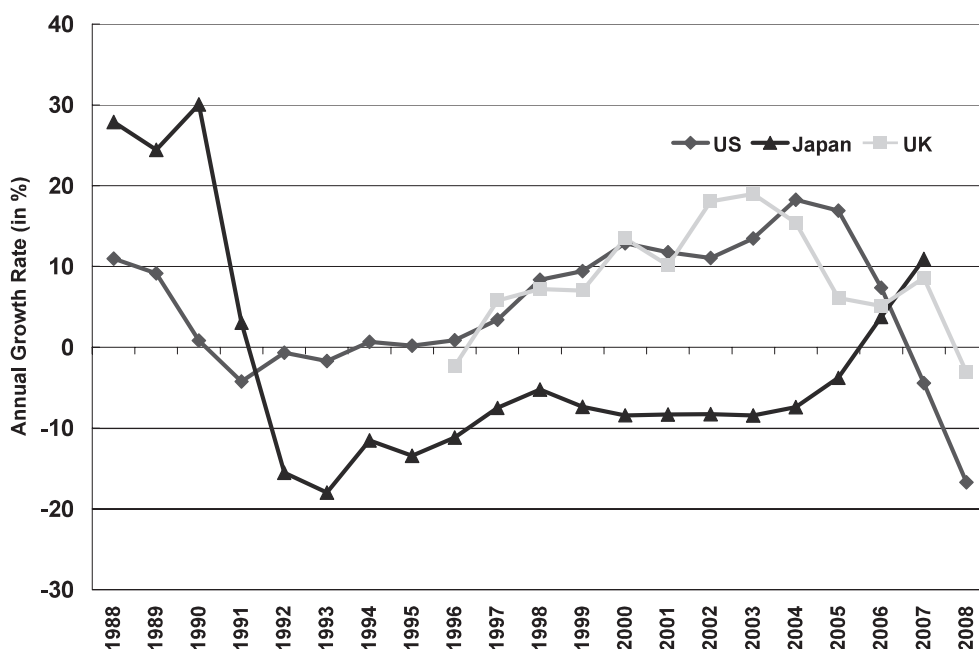
into a weakening US dollar. Around this time, increased militancy by OPEC also led to rising oil prices and, connected to this, increasing prices of minerals and other commodities. This led to accelerating inflation that induced central banks to raise interest rates. Higher interest rates resulted in rapidly declining asset values, especially the value of houses. Declining house prices exposed the inherent inconsistency in subprime credits — the borrowers could not afford to service their debts especially with higher interest rates — and the defaults started. The resulting decline in asset values led to losses that squeezed the credit markets in a crisis of market liquidity. When the credit markets froze, the absence of operating capital and short-term funds led to higher interest costs and shutdowns in the real economy, leading to losses, layoffs and the general economic malaise.

3.0 How the crisis evolved

In early 2008 Paul Krugman of Princeton University said that “\$1 trillion of losses on mortgage securities [will be] showing up somewhere.” (That turned out to be a gross underestimate with recent subsequent estimates being in the 3-4 trillion dollar range). He also said that the financial impact “looks like a combination of 1990 and 2001, and probably bigger than both combined” and continued that “if the recession started in January 2008, then that would mean that July 2010 is the first month we have anything that feels like a recovery” and he “wouldn’t be surprised if it goes longer than that.” In mid-2008, Professor Nouriel Roubini of the New York University wrote in his *Global EconoMonitor*, “The worst is ahead of us rather than behind us in terms of the housing recession and its economic and financial implications.” The numbers have since gone in the general direction they had pointed out. The US economy has since declined by 0.9% in 2008, UK has grown minimally by 1.1%, and Japan has contracted by 0.6%.

The housing markets in the United States, United Kingdom and Spain fell precipitously. At one point about 20 million people, accounting for about a fourth of US homes, were saddled with paying for more than their houses are worth. House prices continued to decline and the US housing sector and its impact on consumer spending weighed heavily on the economy. Tighter credit conditions

Figure 9: Housing Price Trends for Selected Countries



Source: S&P, Japan Real Estate Institute, and UK Land Registry

added to these woes. Lenders undertook a mass freezing of home-equity credit lines. Continued risk aversion by lenders was heightened by rising delinquency rates in auto loans and credit card payments. The delinquency rate on indirect auto loans—which buyers get from dealers themselves—and credit card delinquencies rose to their highest levels in several decades. Various business and consumer confidence indices declined drastically.

These dire numbers have been repeated in various ways in other developed countries that served as major export markets for the Philippines.

4.0 How it reached the Philippines and other emerging economies

Impact on the Philippines

Many people wonder what and how much the impact of the US recession on us has been. Most developing nations rely on America as their largest export market, not only for goods, but also for services. US companies have investments

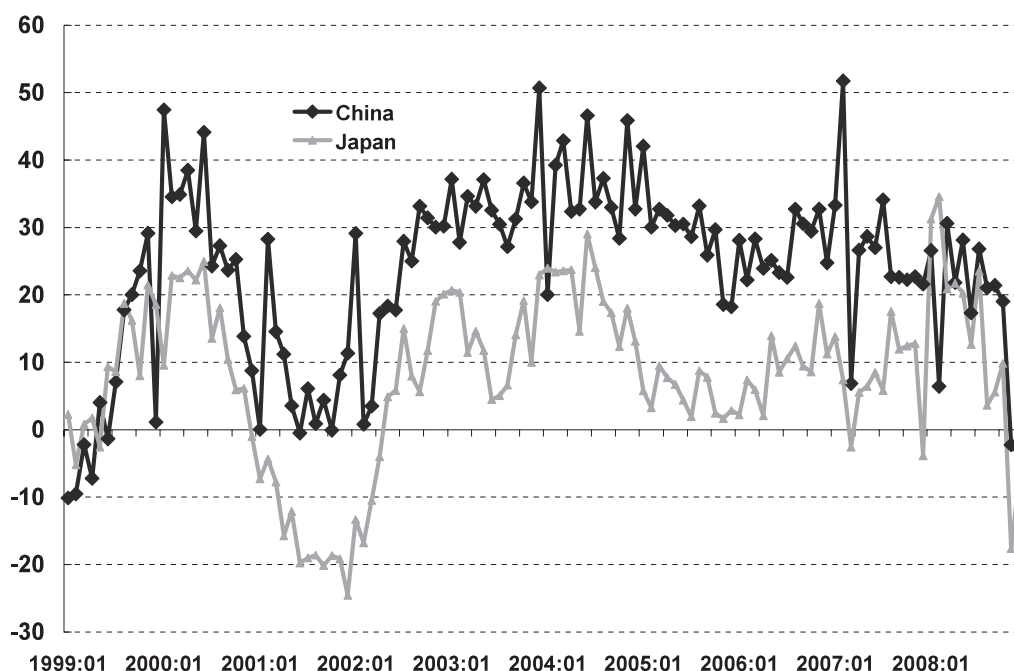
and subsidiaries in Asian countries, which provide employment and spur growth in investments. US investors have also included emerging market stocks in their portfolios to diversify; some invest in riskier assets in Asia for higher potential returns. Volumes of domestic assets are held by US investors, and the reverse is also true. These interrelationships make a lot of countries vulnerable to the US economic situation.

A lot of discussion has been on the degree of “decoupling”, or whether other economies have reduced their dependence on the US economy to such an extent that the adverse impacts of downturns in the latter are diminished. This concept is not new. When the US went through a recession in 2001, China’s growth only fell by less than a percentage point to grow at 7.3%, as strong domestic demand helped cushion the huge decline in exports. In 2007, Asian countries enjoyed healthy growth while the US housing sector slumped and the sub-prime mortgage crisis exploded. Local currencies strengthened against a weakening US dollar, while stock markets rallied.

There are two views. One says that developing Asia is still strongly affected by the US recession, and developing nations have not decoupled from US. As the recent declines in the stock indices of Asian countries show, the sub-prime mortgage crisis has had spillover effects on markets outside the US. US investors fled from risky assets to safer ones, and the sell-off led to declines in Asian stock markets. The drastic reductions in exports of export-oriented Asian countries also confirm this. And financial markets all over the world, including Asian institutions that do not have substantial exposures to soured CDOs and mortgage-backed assets, have been strongly affected by movements in developed economies.

The other view says that these countries are somehow insulated from the impact of the US recession. Some private forecasters share this view. According to some quarters, forecasted growth of emerging markets in Asia, though slower than their previous year’s, are more than twice that of developed countries. This conjectured insulation is puzzling in an era of globalization. Economies of developed and developing nations would have more interrelationships with each other. Then again, globalization and decoupling may not be totally opposite each other.

Figure 10: Monthly Export Growth Rate for China & Japan, 1999:01-2009:01



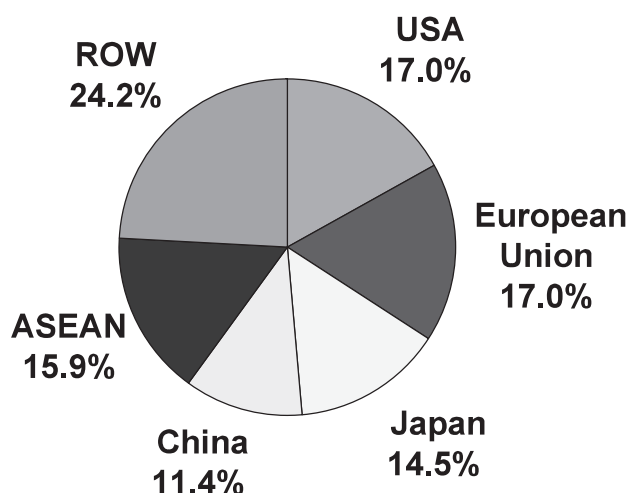
Source: IMF

The two forces can co-exist. In the past, emerging economies were more coupled with developed countries, especially the US, and less with the rest of the world. Now emerging countries have become more globalized — that is, they have expanded their relationships to other economies, especially with neighboring countries.

This is certainly true of Asia. Globalization has played a hand in allowing economies to decouple from the US in at least two ways:

One, globalization has resulted in stronger trade relationships among Asian countries. In the Philippines, the current share of exports to the US has declined from 30% to less than 20% since 2000. Demand from other neighboring countries helped offset the decline in exports resulting from sluggish US consumer demand. Also, China has become a rising force in the region's trading activities. BCA Research reports that emerging markets, as a group, now export more to

Figure 11: Major Export Partner, 2007



Source: BSP

China than to the United States. At the same time, the internal growth of China is now hoped to minimize its dependence on exports to the US. This partly explains the expectation of Chinese growth around 6% despite a deep slide in exports.

Two, globalization has helped support the growth of the middle-class. With the growth of industries, higher production and income generation have led to strong consumer spending. This supports the growth of inter-regional trade. More important, it also illustrates that growth in Asian countries are slowly becoming internally driven by domestic consumers. In turn, increased purchasing power helps spur investments and capital growth, as businesses rise to meet domestic demand.

For the Philippines, although the US remains our biggest trading partner, the decline in our export dependence suggests that we are, to a small extent, decoupled from the US. The same may be said for other emerging markets. Although we are unable to fully quantify its effects, we can expect it to continue, especially with the growth of large countries such as China and India. The future degree of this decoupling may ultimately determine how we and other emerging markets will respond to future shocks coming from other parts of the world.

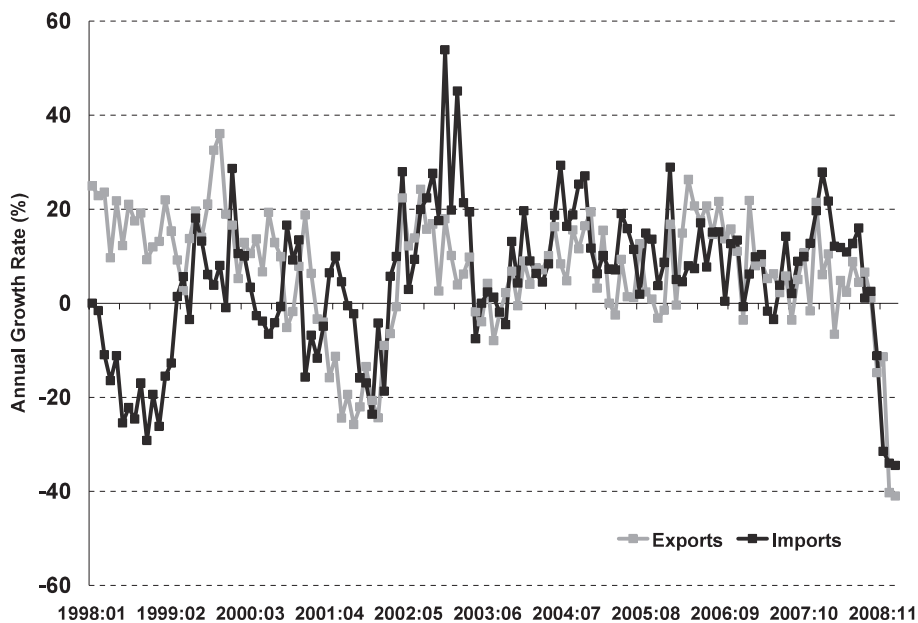
The impact on the Philippines has gone through five channels: First, through the impact on confidence and purchasing power because of the asset losses of higher-spending levels of the population, magnified by the losses suffered by banks. Second, through the added losses to the investing public as portfolio investments flowed out leading to lower asset values in the country, and in turn leading to much more difficult mobilization of investment resources in the equity and credit markets; Third, through the difficulty of raising direct investment capital (FDI) in the developed markets over (to persist over the next few years); Fourth, through the impact on exports as our overseas markets contract (October as large as negative 37%); and, finally, through the feared impact on OFW deployment with the resulting adverse effect on the main engine of Philippine economic growth, OFW remittances. This last impact is still developing and will have to be monitored.

Figure 12: Philippine Economic Growth, 1998:Q1 to 2008:Q4



Source: NSCB

Figure 13: Monthly Merchandise Trade Growth, 1998-2009



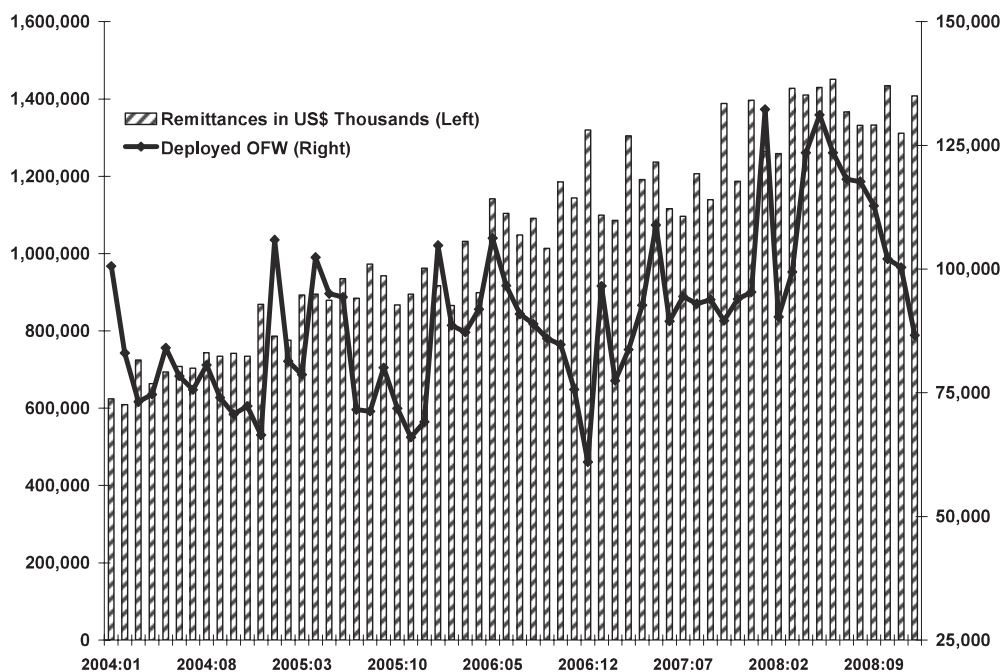
Source: BSP

Figure 14: Philippine Composite Index, 1998-2009



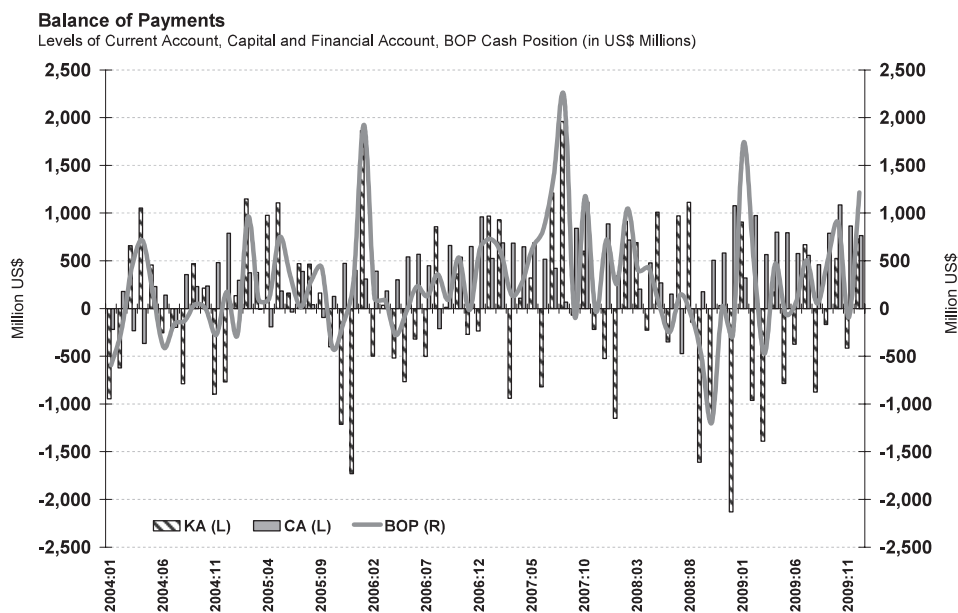
Source: NSCB

Figure 15: OFW Remittances and Deployed OFWs, 2004-2008



Source: BSP

Figure 16: Balance of Payments, 2004-2008

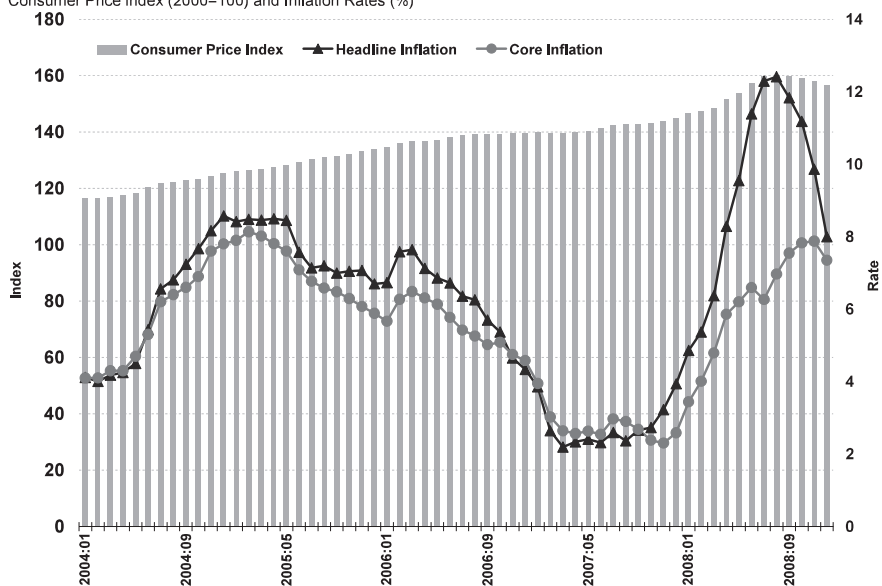


Source: BSP

Figure 17: Consumer Price Index, 2004-2008

Consumer Price Index

Consumer Price index (2000=100) and Inflation Rates (%)

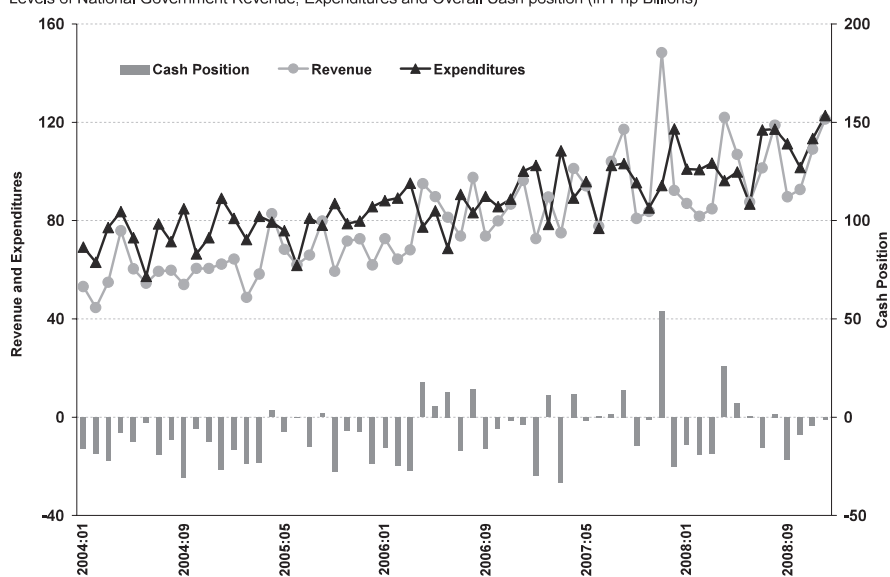


Source: BSP

Figure 18: NG Cash Operations 2004-2008

NG Cash Operations

Levels of National Government Revenue, Expenditures and Overall Cash position (in Php Billions)



Source: BSP

5.0 Lessons learned: some initial issues

5.1 The benefits and costs of decentralized decision making

There are two broad dimensions of the lessons from the global crisis. The first part deals with the changes to the domestic and global financial architectures that need to be introduced in the wake of the global crisis. The second aspect deals with the changes in trade and production patterns that may be needed in order to correct the global imbalances that allowed the crisis. This second aspect is discussed elsewhere. Here we discuss the needed changes in the financial architecture.

The market is double-edged: it has a good side that is also at the same time its dark side. The market's strength comes from its system of rewards and penalties. It breeds innovation, product variety, and good quality products at low prices because it promotes those that provide these and downgrades the others, advancing economic growth and material welfare. The market system's success derives from its economical need for information in directing decentralized decision making. Market Darwinism then just winnows out those who are found wanting.

As such, the decentralized system is subject to overshooting as in the domestic business cycle. Boom periods introduce laxity and excess and the trials of the bust periods squeeze these weaknesses out. Unfortunately, this painful process is an essential component of the informational and operational efficiency of the market system. To completely avoid market ups and downs would also dissipate the system's basic strength. We need to find the (un)happy medium between Schumpeter's "creative destruction" and the externality effectsⁱ on good companies of deep systemic shocks. The key is to prevent these shocks from debilitating the system.

Key features of the current global crisis are evident along four initial areas. Among these are the global character of the crisis that spread with almost instantaneous contagion, the innovative financial vehicles that enlarged the volumes of business but may have served to split capability and responsibility, financial institutions created as safeguards that may have lulled participants into complacency, and new market areas that may have developed without requisite

monitoring and supervision. Finally, for emerging economies like the Philippines, the correction of some global structural imbalances may have unintended effects. We review these issues, not because we are major players in the international markets, but because their resolution will have profound impact on how we do things and may entail major adjustments on our part. Besides, we may need to institute components if not all of these changes inside our own jurisdiction.

5.2 Financial innovation: Credit instruments

Among the proposed culprits in this crisis are the recent financial innovations. Structured credit including structured investment vehicles (SIV's) and collateralized debt obligations (CDO's) have come under increased scrutiny. Securitization had proceeded some time before. These new instruments stretched the boundaries even further.

SIV's, incorporated investment funds set up to issue financial instruments to fund special pools of debt obligations like housing mortgages, have been very useful in mobilizing funds that facilitate certain activities like homebuilding. However, they also serve to separate the organizer of the fund (often an investment bank or fund) from the residual obligation of the pool, thus insulating it from heavy losses of the ultimate borrower. This may have introduced adverse moral hazard by divorcing the authority and the final accountability of credit granting. CDO's, while originally just a method of expanding the sources of funding for housing and other activities, through the techniques of subordination ("*tranches*") and guarantees became a channel for expanding credit to otherwise low-rated and high-cost borrowers. And additional impetus was given by credit default swaps (CDS's) which provided guarantees for buyers of the CDO's. Cohen and Remolona (2008) point to "third-party repos" where another party...often the clearing bank...that knows both original parties guarantees the transaction and holds the collateral. This further facilitated the transactions.

It would seem that any modification of state-of-the-art supervision and regulation would attempt to address these observations. Among the issues that need to be addressed is the separation of origination and residual accountability that is present in recent financial innovations, the moral hazard aspects these

represent, and the safeguard mechanisms and transparency rules needed to address these issues. Recent changes in the United States require originators to retain 10% of the instruments they package. Whether this is enough equity to solve the moral hazard problem will be seen in due time. Parallel changes in related areas may be added with practice.

5.3 Credit rating

One of the frequently asked questions these days is how subprime credits managed to ensnare so many and at such large volumes as to embroil many countries in the crisis. As we previously mentioned, there was a need for such large volumes of financial instruments because of the tremendous recycling problem. We have also described how market myopia flowed out of financial institutions that had been designed to strengthen the process. Chief among these was the credit rating process. One of the questions raised in this crisis has to do with why the credit rating system gave high ratings for mortgage-backed securities, only to be proven wrong (again) when the subprime crisis finally erupted in the US. Ironically, regulators and investors have asked themselves the same questions after Enron collapsed in 2001. At that time, credit rating agencies (CRA's) also granted high ratings to Enron-issued corporate bonds, only to find itself largely on the defensive and subjected to lawsuits when the company collapsed. Yet, these CRA's would later win over these cases on the grounds that their ratings are no different from an opinion, and are thus protected by the US Constitution's First Amendment. While the legal reasoning that credit ratings are not an excuse for investors to avoid conducting their own due diligence, the question remains as to what use we can really get from them.

Presently, there is general concern among US and EU regulators that the CRA's business model breeds its own conflict-of-interest problems, therefore needing changes to the current mold. This occurs because credit ratings are paid for by the bond issuers and not by the investors who ultimately use the ratings. The underlying claim is that CRA's may be tempted to give higher ratings to clients to attract more clients. This is worsened by their advisory arm which assists bond issuers in packaging and restructuring their financial products in

order to achieve a higher rating. This combination could increase the pressure to give rosy ratings. Even a belief that CRA's have a long-term stake in their reputation (and business sustainability) does not fully dispel at the moment.

The CRA's faulty credit ratings could have resulted from several factors. First, the CRA's rating process may still be overly geared towards single-firm procedures, neglecting the contagion caused by defaulting debtors of counterparties, and may not fully reflect the impact of market-wide shocks on pools of securities. The former deficiency appears in the stress factor used; the second surfaces in the default probabilities of different *tranches* of a pool of securities. Second, CRA's became overly dependent on complex computer models in measuring risk. Aside from its heavy reliance on mathematics which gives it further credibility, it was widely expected to help solve the shortage of skilled workers in the industry. The huge growth of complex debt products overwhelmed the credit rating industry. The complexity made it increasingly difficult to assess each debt product and the seeming precision induced laxity. But the demand for their services remained high. Sound risk management practices suffered in order to meet market demand -- not to mention credibly evaluating whatever result is generated by their computer models. One of the CRA's, for example, admitted to incorrectly rating US\$1-billion worth of complex debt securities due to a computer error. Even if this were an isolated case, it is indicative of the pressure under which the CRA's operated.

Current proposals can be divided into two approaches. The first one proposes to remove the important role played by the CRA's as financial gatekeepers of the system. This means the removal of anything CRA-related from the regulatory requirements. At present, corporate charters of fund institutions often require that they park their funds in assets, rated safe by these CRA's. The aim is to wean off the fund managers and bankers from using the ratings as a crutch and force them to conduct their own due diligence of any investment decision. Unlike CRA's, fund managers can be held accountable for their investment decisions, whether good or bad to the depositors. This is apart from increasing the transparency of the credit rating methods, addressing the conflict of interest issues, and adjusting the rating models and processes to recent financial innovations.

The second approach involves the introduction of government oversight for the industry, effectively introducing a cop guarding their every move. No matter how popular this seems, however, it also raises serious questions since governments are bond-issuers themselves.

5.4 Financial architecture, Supervision and regulation

That the international financial architecture has to be revamped has been a popular proposal, even during the Asian financial crisis in 1997-98. Several proposals were, in fact, put forward at that time such as imposition of very small taxes on cross-border flows (“putting sand on the wheels of global financial flows”) and margin requirements for short-term flows, etc. However, the belief in unimpeded flow of funds and the free market as stimuli for economic activity and conveyor of innovation was so strong that the game-changing proposals were largely forgotten as soon as the immediate crisis passed. That the crisis was largely confined to Asia with a bit of contagion for a few Latin American economies also contributed to the issue’s lack of urgency. Now that the pain is much more widespread and deeper, these questions will certainly be revisited.

In the light of these developments, the repeal of the depression-era Glass-Steagall Act in 1999 has been blamed for enlarging the fire. The change effectively allowed non-banking institutions to perform banking services. The claim is that it allowed volatility in financial markets to invade the highly leveraged banking industry. It may also have given investment banks free rein in the creation of new financial products with both investors and regulators failing to adapt quickly. While our earlier comments about the benefits of the market and its attendant volatility are relevant here, the issue of what can be done to prevent or minimize excesses still arises. Among the issues that would have to be addressed are the market myopia induced by overconfidence induced by some institutions like credit rating, cross-border supervision and monitoring as against harmonization and surveillance, and the scope of financial operations across industries (return of Glass-Steagall?).

Since it is almost impossible to rein in the operations of financial institutions within national boundaries, there is general agreement that cross-border

monitoring scheme should be agreed upon by major economies. How best to implement this is already an issue in itself. The current standards under the Basel 2 accord may have generated pro-cyclical forces and may actually have worsened the downturn. I tend to agree with Dani Rodrik of Harvard University that a single global super-regulator is not warranted at this point. There is too much variation in the legal and business institutions, the socio-economic infrastructure and complementary framework that a one-size fits all model would probably be more counter-productive than helpful. What we need are enough transparency, standards (including accounting procedures), as well as dispute and settlements resolution mechanisms to warrant trust and confidence all over. The ability to gauge the risk of instruments across borders will facilitate financial flows and the transparency and comparability of standards will allow participants to correctly assess the impact of events in other jurisdictions, thus mitigating the panic induced by market uncertainty.

To understand the current turmoil along the lines of regulation vis-à-vis deregulation would be too simplistic and faulty at the least. This becomes more problematic considering that the root of the credit crunch is the housing market which is characterized by government regulation, coupled with pseudo-government entities - namely Freddie Mac and Fannie Mae - characterized the industry. The banking industry, or for that matter, the entire financial industry, essentially depends on confidence for it to operate effectively. Thus, the bankruptcy of one banking institution also weakens other banks and financial institutions where it has serious connection with. Given the importance of the financial system in the broader economy, the health of the banking system is of critical importance and justifies government intervention if warranted.

5.5 Lender of last resort

A final consideration relates to the possibility of a lender of last resort that would serve to support financial institutions and countries during periods of acute market stress. The argument against having one right now is that it would not have an unlimited supply of funds the way a domestic central bank has (because of the fiat power of the government). However, Mishkin (2006),

quoting Stanley Fischer, formerly of the International Monetary Fund, has said that you don't need unlimited liquidity, only enough liquidity. The current global crisis, however, indicates that "enough" can be quite large indeed.

This question is related to the discussion of a global currency. As we discussed earlier, the taste of policy makers over the prudence and size of stimulus and bailout packages may flow out of their varying positions in the world financial order. The US as the supplier of the *de factor* global currency enjoys freedom of action than others. This power will reside with the supplier of that currency. If the sometimes-discussed synthetic global currency is based with the IMF, then it would have this power. However, the conditions for setting up such a currency are best discussed in another venue. Suffice it to say, that the lender of last resort must have some version of this spending power. And at the moment, the US seems to be a somewhat imperfect approximation of that.

Notes

- ⁱ This is the damage done to otherwise good companies by systemic events such as a credit freeze that leads to insolvencies of good companies just because they cannot obtain working capital at crucial periods.

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