

Special Feature C

Financial Sector Dynamics and Post-crisis Challenges for Asia

by Michael Spence¹

Introduction

*"If we worked on the assumption that what is accepted as true really is true, then there would be little hope for advance."
- Orville Wright, pioneer in powered flight.*

The crisis we are in brought down the global economy and nearly produced a depression. The latter was avoided by rapid and unconventional actions by central banks (mainly) to restart and sometimes replace frozen credit channels.

At its origin and core, the crisis was a massive failure of the advanced country financial sectors. It originated in balance sheets (financial and household) and their interconnectedness. To nearly all participants, regulators, analysts and observers, it came as a shock and a complete surprise. That is perhaps its most worrying feature. The conceptual frameworks and models that we use to understand the dynamics of the financial sector are evidently incomplete.

Core Instability

At one level, both the instability and the power of the negative dynamics are traceable to excess asset values supported by high and rising, and ultimately, destabilising amounts of leverage. When asset prices faltered and risk spreads shot up, the downward spiral accelerated and swept into the real economy as balance sheet destruction (housing, pensions and other savings) led to reduced employment, consumption and business investment, and with a very short lag, international trade. The interaction and negative feedback loops from balance sheets to income statements and back produced a much more violent global contraction than in even fairly serious recessions.²

Normally leverage is constrained in part by regulation, primarily, of banking – an inherently leveraged sector with a claim on the public purse in adverse circumstances. But it is also constrained by the investors' perception of risk and volatility, a familiar concept in private equity where leverage is constrained by the volatility of cash flows. In the present case, excessive leverage resulted in large part from the absence of regulatory constraints in the shadow banking system (the system of credit provision outside the traditional banking channel) combined with a failure to accurately perceive and react to rising systemic risk. The self-defence and self-regulatory brakes were not applied.³

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² I have called this a double downward spiral elsewhere.

³ The evidence for this is that the most sophisticated financial institutions all suffered serious balance sheet damage. The rising systemic risk was not anticipated and defensive action not taken.

What hindered risk assessment was the way financial markets developed a network-like structure via balance sheet linkages – one entity’s assets are another’s liabilities. Although the data at present are far from sufficient for either research or systemic risk assessment purposes, it is fairly clear that the structure was evolving with the growth of complex securitised assets along with derivative, insurance and risk-spreading instruments. The pattern of interconnectedness within the financial sector shifted steadily but far from transparently. Notional assets and liabilities were and still are much larger than the balance sheets show. As a result, the failure of a large financial institution had the potential to bring down all the others and the whole system, the more so the higher the leverage levels. Because the connectedness lacks transparency, uncertainty and fear contributed to the negative dynamics. Recently we hear often the term “too big to fail”. More accurate would be “too big and too interconnected to fail”.

Because of large informational gaps and resultant opacity of the connections, it is not surprising that risk assessment procedures had trouble with systemic risk assessment. While leverage is probably the proximate cause of fragility and instability, the underlying reason was the inability to track risk.

These misperceptions of risk included pretty much every category of interested parties: market participants (including the most sophisticated ones), central banks, other regulators, and with notable exceptions, market analysts and economists.⁴

How did that much risk get hidden from view? It is a question that requires and deserves the attention of the economics profession. The current models seem to me not up to the task. There is a wide divergence between the micro and macro perspectives. At the macro level, leverage in relation to flow variables like GDP was rising and should have been sending out warning signals. But in the microeconomic shrubbery, risk was

apparently being redistributed via increasingly complex (and leveraged) assets and derivative insurance contracts. The microeconomic story was not alarming, and therein lies the challenge. Financial innovation had reduced the risks. With the benefit of hindsight, systemic risk was not being reduced; it just dangerously disappeared from view until it was too late. The lightly regulated model with a hefty dose of presumed self-regulation turned out to be dynamically unstable and failed.

Two agendas stand out as part of the required response. One is to rebuild the models of the financial sector so that the potential sources of instability become visible, understandable and detectable with available data. The second in the shorter run, without the benefit of those rebuilt models (this will take time, serious research and humility), is to re-regulate so as to reduce the likelihood of rising systemic risk and a sudden failure to function.

On the more immediate regulatory response, the most obvious step is to restrict leverage at the microeconomic level via reserve, capital and margin requirements, and to monitor leverage at the macroeconomic level. Asset bubbles with origins in human psychology are a recurring phenomenon and most would agree, pretty much inevitable. But they do not have to be turbocharged with debt. Central banks (or other designated entities – the issue is still being debated) in pursuit of stability will have to pay attention to balance sheet variables and they will require more instruments than short-term interest rates if they are going to manage inflation, asset bubbles, excessive leverage, unrealistically compressed risk spreads, naïve investor behaviour, and excessive liquidity resulting from global imbalances. Judgments, at times second guessing the markets, and mistakes will go with this broader mandate. It will feel uncomfortable and probably expose these institutions to more external pressure with some potential threat to their autonomy.

⁴ To a first approximation, risks were believed to be largely exogenous to the system, stationary and uncorrelated enough to permit the diversification and insurance models to work. This misperception and the attendant increase in leverage caused the risks to be endogenous, non-stationary, rising and increasingly correlated, in turn causing the diversification, insurance and asset allocation models to fail as risk mitigating devices.

Lessons for Asia

What does all this suggest for developing Asian economies?⁵

The short version would be caution in moving toward advanced country models that are in a major transition and poorly defined, and a focus on developing circuit breakers and augmenting resilience in the face of external shocks.

One lesson that we have a distressing habit of learning and forgetting is that the financial sector has large external effects on the real economy and on government finances. These contingent liabilities have to be constrained by regulation: self-regulation will not do it. The financial system by itself does not internalise these broader risks and as it evolves, the regulatory structures have to evolve with it.

In the short and medium term, prudence would suggest avoiding instability by restricting not just leverage but also exercising caution over the pace of introduction of relatively complex financial instruments whose macroeconomic characteristics are not fully understood. By this I do not mean preventing the development of a properly regulated shadow banking system with relatively simple securitized assets as a way to finance investment and spread risk. But for now, simplicity, transparency and gradualism have a lot of merit.

The financial and economic turmoil in the advanced countries spread to the rest of the global economy via two main channels: the rapid withdrawal of capital to shore up badly damaged balance sheets at home and a consequent very sudden tightening of credit, and the sharp reduction of aggregate demand (consumption and investment) which produced a sharp drop in growth and set in motion recessionary dynamics.

Asian economies, though certainly not insulated, were relatively well-positioned generally and that holds important lessons for others. In part as a result of the 1997-98 Asian Financial Crisis, financial sector institutions were better regulated and quite healthy. Importantly, holdings of toxic assets were negligible. Reserves were accumulated to defend against volatility in exchange rates and international capital flows, and were used in the present case partially to reverse the outbound capital flows. These reserves were augmented by China's huge reserves to add stability via swap facilities and similar arrangements.

A significant fraction of the financial institutions in Asia remained domestically-owned and were able to work with central banks to restore credit to various important sectors of the economy. Domestic ownership turns out to be crucial. Large advanced country financial institutions with almost no exceptions were in distress, had their focus elsewhere, and were partially taken over by their governments and central banks with consequences for their priorities and behaviour. This crisis dramatises the prudential limits to financial globalisation in the absence of reliable and authoritative global governance institutions.

Generally, savings rates were high relative to investment, making the Asian economies less dependent on foreign financing to sustain domestic private and public sector investment, and hence less vulnerable to the advanced countries' financial distress. External debt denominated in foreign currencies was reduced and greater control over exchange rates further mitigated the potential adverse balance sheet effects of the external shock and resulting outflow of capital. More flexible managed exchange rates (post 1997-98) combined with reserves to contain excess volatility have served the region well in the crisis and in more normal periods.

⁵ Here I rely on a slightly longer essay published on the PIMCO website, "*Emerging Markets after the Global Financial Crisis*" (URL <http://www.pimco.com/LeftNav/Viewpoints/2009/Emerging+Financial+Markets+Spence+August.htm>).

The sharp reduction in global aggregate demand and the downward spike in trade were less easy to defend against, the more so the more open the economy. It is no coincidence that Singapore, probably the most open economy in the world in terms of trade and financial flows, was badly hit by the contraction of external demand which followed in the wake of the credit crisis. As in advanced countries, fiscal stimulus is an imperfect and impermanent substitute for domestic and

external demand. But it helps. Countries vary considerably in their capacity for fiscal stimulus without running risks with intertemporal fiscal balance and aggregate debt levels.

The relatively rapid restoration of growth in China and to some extent in India has also proved to be crucial to a relatively rapid rebound in the region and has broader positive effects globally.

Sum-up

In important respects, the crisis is not a mean-reverting event. It will trigger change. Global growth is likely to be slower for structural reasons: extended deleveraging, higher risk spreads and costs of capital, the need to restore fiscal balance after the emergency responses are over, and the effects of the eventual removal of liquidity from the banking system as central banks contract their balance sheets. While there is no substitute for the global economy as a source of knowledge, demand and growth for developing countries in the Asian region, maximising the potential of the domestic economy for growth deserves a high priority, as do policies that increase resilience to external shocks.

Advanced country financial systems are in the early stages of being re-regulated and rebuilt. Their structures are already transformed. We do not yet know the outcome of that process and it will take time to acquire experience with and confidence in the new systems. The balance clearly needs to shift back towards the essential functions of the financial system: safe savings channels, credit provision to various sectors of the economy, allocating capital to investment and risk spreading.