

**“Financial Market Cycles, Globalization,
and the Current Banking Crisis”**

Graeme Wheeler, Managing Director, The World Bank

**Lunchtime Address: Sovereign Debt Management Forum
Policy Challenges for the Financial Sector
October 27, 2008, Washington, D.C.**

I am conscious of George Bernard Shaw’s comment that, “If all the economists were laid end to end, they would never reach a conclusion.”

So I will try to be more one-handed and make 5 points about the financial crisis that is sweeping the globe.

They are:

- We have seen this before, but not on this scale – the financial market behavior is not new;
- Economic and financial cycles are becoming more complex;
- The current crisis originated in the US and the crisis still has a long way to go;
- Sovereign debt managers have prevented a bigger crisis, but have much to do;
- The World Bank is ready to help.

We have seen this before

What do the current banking crisis and the Tulipmania frenzy in Amsterdam of the 1630s have in common? Quite a lot in fact. Tulipmania is an interesting example of how speculative behavior can lead to financial market panic and recession. During the tulipmania frenzy, the market for rare tulip bulbs boomed for twelve years before collapsing in 1636. At the height of its activity, prices for the rarest bulbs ranged

from 6 to 20 times the annual income of artisans, and twice the amount that Rembrandt received for painting “The Night Watch” in 1639.

Even in those days, foreign buyers were active in the tulip market and fraudulent practices developed as ordinary tulip bulbs contaminated the rare tulip bulb market. There were shady derivative trades involving tulip bulb offshoots, widespread default, and, in the aftermath, a vigorous debate over regulation. The Dutch economy went into a deep recession, the number of bankruptcies doubled and property prices on the Herengracht fell by 40 per cent. (No doubt also due to the wave of bubonic plague which spread across northern Europe and killed 15 per cent of Amsterdam’s population in 1636.)

But, note the similarities with the analysis in the policy statement of the US President’s Working Group on Financial Markets produced back in March – nearly 400 years later. It saw the principal causes of the recent financial market turmoil as "the breakdown in underwriting standards, a significant erosion of market discipline, risk management weaknesses, and the failure of regulatory policies to offset them."

We are familiar with how these cycles begin. Reductions in the cost of financing encourage credit creation, carry trades and leverage, and fuel asset prices. Investors take on greater risk in the search for higher yield and in doing so, significantly lower risk premia. Dominant institutional investors placing similar bets, share similar benchmarks, and have similar pricing and risk management platforms. All face the pressure of meeting short-term profit goals, and outperforming peers.

We saw this pattern in the lead-up to the Argentinean crisis in the late 1990s. Investors continued to provide bond financing to Argentina – often at declining spreads – fearful of missing out on returns captured by those who preceded them. Argentina came to represent nearly one quarter of the emerging market bond index.

Rather than requiring higher risk premiums from an increasingly leveraged borrower, investment managers benchmarked to the emerging market bond index felt obliged to buy at the going price. Eventually, policy signals or business failures increase investor caution and lead to elevated risk premiums and lower asset values, and this promotes the liquidation of the debt underpinning the assets.

Globalization is making economic and financial cycles more difficult to manage.

One might hope that the frequency and amplitude of financial cycles would diminish as governments improve their economic management – through initiatives such as medium term financial strategies, fiscal responsibility rules, more independent central banks, flexible exchange rates, and more prudent management of their balance sheets.

One might hope, but one should not be confident.

Most OECD countries have had low rates of underlying inflation for 25 years or more. Many had declining debt ratios for much of this period. But governments have not been able to protect their economies from repeated asset price bubbles. We have seen several such bubbles since the Asia crisis in the late 1990s (e.g. high tech, public and private equity, real estate, commodities, emerging market equities and fixed income). Risk capital moves rapidly from one asset class to another as each cycle plays out. These bubbles have now demonstrated the power to generate macro instability at the global level.

International capital flows increasingly dominate our cycles of industrial production. These flows, and the complex financial engineering which accompanies them, are overpowering the traditional instruments of monetary policy and the regulatory architecture.

The Current Cycle still has a long way to go.

The crisis has demonstrated how all of the elements that will form the Basle II pillars, can fail in a G7 economy, including market discipline.

Many factors contributed to the crisis, including greed, badly designed compensation structures, and failures in risk management.

But two factors dominate others – the rapid growth in global liquidity and the permissive regulatory environment. Real interest rates were very low in the first half of the decade, and there was little regulation around complex products such as collateralized debt obligations and credit default swaps.

When the credit crisis intensified, policy mistakes were made. Bail out packages never got ahead of the markets, and many have suggested that the way in which the Lehman's collapse was handled led to a breakdown in trust among financial intermediaries. From that point onwards, the challenge became how to prevent a collapse of the global financial system and deep recession.

The speed with which the crisis is affecting economic activity around the world is staggering. Most OECD economies are already in recession and growth in Asia is arguably slowing more rapidly than at any other time since 1990. Coming after the rise in food and energy prices, many developing countries are now being hit extremely hard. It is a dramatic shift from a year ago when we were experiencing the strongest period of global growth in 40 years.

The changes in household wealth taking place are unprecedented. Some estimates put the decline in household wealth in the US at around \$9 trillion. About a quarter of US households with mortgages – about 12 million homes – currently have negative equity and in about half of these, the negative equity is above 20 percent. Many analysts suggest that US real estate prices have another 10-15% to fall – assuming that the market

does not overshoot. And we see commodity prices almost in freefall. Brent crude is trading at below \$60 this morning, copper prices have fallen by 50% since the beginning of September, and last Friday, wheat futures for December delivery were 62% below their peak in February.

As the Bank of England Deputy Governor Charlie Bean recently said “This is a once-in-a-lifetime crisis, and possibly the largest financial crisis of its kind in history.”

Prudent sovereign debt management has prevented an even more difficult situation.

Thankfully, sovereign debt management has been excellent in many countries over the past decade. Government debt managers took advantage of the abundant liquidity and low yield environment to reduce their refinancing risk and increase the duration of their portfolios.

Over the past 5 years, many developing countries refinanced their foreign currency debt with 10 year maturities and lengthened their domestic yield curves. Debt managers increased their risk modeling capabilities and their coordination with central banks to better separate debt management liquidity operations from monetary policy. At the same time, many governments strengthened their balance sheets by building up their foreign currency reserves, privatizing assets, and improving the management of their fiscal positions and contingent liabilities.

But debt managers will face real challenges in the current environment. For many developing countries, access to international markets has closed or is available only at significantly higher cost, and for smaller amounts and shorter maturities. Today the EMBI spread is 840, well up from 300 at the end of August. Foreign investors are pulling back from riskier foreign assets, unwinding carry trades and are currently investing in yen and dollar denominated government securities. Fiscal and current account positions will be more difficult and expensive to finance. And policy makers in developing countries remain very concerned about capital flight – particularly given the

unprecedented guarantees that OECD countries have introduced on their banking systems.

Fortunately, there is good news. As a result of the extensive foreign currency refinancing in recent years, emerging market sovereigns only have about \$30 billion of foreign currency refinancing to do over the next 15 months. More worrying is the fact that the corporate sector has \$80 billion in foreign currency bond amortizations between now and end-2009, and many countries have sizable levels of cross border corporate bank debt.

In OECD countries, sovereign debt managers will have to design borrowing programs to finance the enormous fiscal support being given to the banking sector. They will need to help governments think through the management of the huge contingent obligations they have entered into, and help monitor and advise governments on their new ownership interests in banks and insurance companies.

The World Bank is ready to partner

In the financial sector, developing countries are likely to face many challenges – such as how to deal with capital flight, how to handle insolvent financial intermediaries, how to protect domestic banking systems, how to manage their pension funds, and how to finance their fiscal positions.

The Bank will partner with countries by providing lending, advice, and helping to build capacity. In a typical year, the Bank lends around \$13 billion to middle-income countries. Over the next two years, the annual lending program will expand rapidly – perhaps to around \$30-\$35 billion a year.

The Bank and the IFC, its private sector arm, will assist Governments with crisis management and help manage work outs with domestic banks and other financial institutions. The Bank will help governments strengthen their crisis preparedness and

financial stability arrangements, and is working closely with the IMF and the Financial Stability Forum on crisis measures.

The Bank will also vigorously extend its support and advice to sovereign debt managers around the world – both on a one-on-one basis and through important fora such as this week’s conferences.