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Emilio Gullini
Editor

ECONOMIC CRISES AS A RESULT OF DISTRUST

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ECONOMIC CRISES AS A RESULT OF DISTRUST

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PREFACE

A large and relatively unimpeded flow of credit through healthy financial markets is a salient attribute of the U.S. economy and any well functioning modern economy. Banks and other financial institutions channel the economy's savings toward a variety of current productive uses. By borrowing short-term and lending long-term, these institutions create a flow of credit that passes liquidity from savers to investors, and transforms liquid short-run assets into less liquid long-term assets. But lending in credit markets requires confidence in the borrowers' ability to repay the debt (principal and interest) in full and on schedule. The current turmoil in U.S. financial markets is the result of a breakdown in that necessary confidence. In an environment of distrust, financial institutions are far less willing and able to lend long-term. This book examines the monetary policy and macro-economic supply factors in U.S. credit markets that contributed to the credit expansion. This book also defines credit default swaps, explains their use by banks for risk management, and discusses the potential for systemic risk. This book consists of public documents which have been located, gathered, combined, reformatted, and enhanced with a subject index, selectively edited and bound to provide easy access.

Chapter 1 - For a decade prior to 2005, the People's Republic of China (PRC) pegged its currency, the renminbi, to the U.S. dollar. On July 21 of that year, the PRC finally broke this peg. However, the PRC has continued to intervene heavily in foreign exchange markets to limit the subsequent appreciation of the renminbi. Governments in other Asian economies have sought to limit the appreciation of their currencies against both the renminbi and the U.S. dollar to maintain the price competitiveness of their manufactured exports with their Chinese rivals in North American and European markets. Shadowing the PRC's exchange rate policy, other Asian governments have also intervened heavily in foreign exchange markets. From 2001 to 2007, the PRC, India, Indonesia, Japan, South Korea, Malaysia, Taiwan, and Thailand have collectively added \$2.7 trillion to their foreign exchange reserves. About 2/3 of these reserves have been invested in U.S. dollar-denominated assets, primarily U.S. Treasury and agency debt securities.

Since 2000, the PRC's exchange rate policy and the shadow policies of other Asian governments slowed the depreciation of the U.S. dollar and lowered interest rates, particularly at the long end of the yield curve. By distorting market price signals, these policies have exacerbated a number of economic problems not only in the United States but also around the world:

Chapter 2 - Chile experienced a banking crisis from 1981-84 that in relative terms had a cost comparable in size to that perhaps facing the United States today. The Chilean Central Bank acted quickly and decisively in three ways to restore faith in the credit markets. It restructured firm and household loans, purchased nonperforming loans temporarily, and facilitated the sale or liquidation of insolvent financial institutions. These three measures increased liquidity in the credit markets and restored the balance sheets of the viable financial institutions. The Central Bank required banks to repurchase the nonperforming loans when provision for their loss could be made and prohibited distribution of profits until they had all been retired. Although the private sector remained engaged throughout the resolution of this crisis, the fiscal costs were, nonetheless, very high.

The U.S. Congress is contemplating a $700 billion government assistance package to arrest the financial crisis in the United States. President Bush argued that failure to enact legislation quickly could result in a wholesale failure of the U.S. financial sector. As discussion of the Administration's plan unfolded, however, questions in Congress arose over issues of magnitude and management of the "bailout," the need for oversight, and the possibility that less costly and perhaps more effective alternatives might be available.

In this light, Chile's response to its 1981-84 systemic banking crisis has been held up as one example. The cost was comparable relative to the size of its economy to that facing the U.S. Government today. In 1985, Central Bank losses to rescue financially distressed financial institutions were estimated to be 7.8% of GDP[1] (equivalent to approximately $1 trillion in the United States today). The policy options Chile chose had similarities as well as differences from those contemplated in the United States today. Their relevance is debatable, but they do highlight an approach that succeeded in eventually stabilizing and returning the Chilean banking sector to health, while keeping the credit markets functioning throughout the crisis.

Chapter 3 - In the early 1990s, Sweden faced a banking and exchange rate crisis that led it to rescue banks that had experienced large losses on their balance sheets and that threatened a collapse of the banking system. Some analysts and others argue that Sweden's experience could provide useful lessons for the execution and implementation of the Emergency Economic Stabilization Act of 2008[1]. The banking crisis facing the United States is unique, so there are no exact parallels from which to draw templates. Sweden's experience, however, represents a case study in how a systemicbankingcrisis was resolved in a developed country with democratic institutions. The Swedish central bank separated out good assets, which it left to the banks to oversee from bad assets, which it placed in a separate agency with broad authority to work out debt problems or to liquidate assets. Four lessons that emerged form Sweden's experience are: 1) the process must be transparent; 2) the resolution agency must be politically and financially independent; 3) market discipline must be maintained; and 4) there must be a plan to jump-start credit flows in the financial system. This chapter provides an overview of the Swedish banking crisis and an explanation of the measures Sweden used to restore its banking system to health.

Chapter 4 - A large and relatively unimpeded flow of credit through healthy financial markets is a salient attribute of the U.S. economy and any well functioning modern economy. Banks and other financial institutions channel the economy's savings toward a variety of current productive uses. By borrowing short-term and lending long-term, these institutions create a flow of credit that passes liquidity from savers to investors, and transforms liquid short-run assets into less liquid long-term assets. These long-term assets are created by credit-financed, current spending by households on housing, consumer durables, and education, and by, current spending by businesses on new plant and equipment. But lending in credit markets requires confidence in the borrowers' ability to repay the debt (principal and interest) in full and on schedule. The current turmoil in U.S. financial markets is the result of a breakdown in that necessary confidence. In an environment of distrust, financial institutions are far less willing and able to lend long-term. The move toward short-term lending diminishes the flow of long-term credit to the non-financial economy and dampens the economic activities of households and businesses that are dependent on borrowing. Economic policy may be needed to get credit flowing smoothly again and to mitigate the damage incurred by households and non-financial businesses. A number of indicators have pointed to a substantial rise in the cost of credit and a decrease in the flow of credit to the broader economy.

A reduced flow of credit will likely dampen economic activity that is dependent on such borrowing as residential investment spending (purchasing new homes) by households, business investment spending (purchasing new plant and equipment) and consumer spending (purchasing autos, appliances, and higher education) by households. Residential investment spending has fallen over 40%

between the fourth quarter of 2005 and the third quarter of 2008, and has on average subtracted about 1.0 percentage point from real GDP growth in each of those six quarters. Non-residential investment spending continued to increase in 2007 and the first half of 2008, but the pace fell steadily, and in the third quarter of 2008 it declined 0.1%. Consumption expenditures had been increasing, but at a decelerating rate in 2007 and the first half of 2008. However, in the third quarter of 2008 consumer spending fell 3.1%. A recent study estimates that the decrement to the U.S. economy's supply of credit is about $1 trillion, leading to a potential drag on real GDP of about 1.8 percentage points for two years.

There are three types of policy response, applied separately or in combination as the severity of the problem warrants. The first type is the conventional macroeconomic policy tools of monetary and fiscal policy, used with the aim of broadly supporting bank liquidity and aggregate spending. Monetary policy, having greater flexibility than fiscal policy, will usually play the prominent role. The second type of policy for responding to a credit crisis is the Fed's traditional role of "lender of last resort," typically involving some expanded use of the Fed's discount window, the facility the Fed uses to make short term loans to banks that need to bridge a short-run shortage of liquidity. These policies will be more narrowly focused on the needs of troubled institutions. The third type of policy response is the use of "extraordinary measures" involving direct interventions by the federal government to restore confidence in financial markets, forcing credit to flow broadly and at greater volume.

Chapter 5 - During the week of September 13-20, 2008, the United States confronted the worst global financial crisis in almost a century. Credit markets, which are the circulatory system of the U.S. economy, seized up. The Federal Reserve was unable to revive credit markets through massive liquidity injections. Share prices plummeted, and a run began on money market mutual funds.

Federal Reserve Chairman Ben Bernanke and Secretary of the Treasury Henry Paulson determined that the *ad hoc* approach that the federal government had been taking to resolve this crisis was not working. Instead, the federal government needed a comprehensive plan that would resolve the uncertainty about value of impaired mortgage- related financial assets and the solvency of financial institutions holding these assets.

Secretary Paulson asked Congress to authorize the Treasury to purchase and liquidate up to $700 billion of impaired financial assets from financial institutions. Both credit and equity markets had a favorable initial response, but the subsequent reaction was less positive.

Chapter 6 - Macroeconomic and microeconomic policy blunders by both the U.S. government and foreign governments inflated an unsustainable housing bubble in the United States and other developed economies. When this bubble inevitably popped, a global financial crisis ensued. Although misaligned private incentives, methodological errors in rating structured credit products, and the recklessness of some private financial institutions and investors did play a contributory role in the recent financial turmoil, individuals and firms could not have created and sustained such a large housing bubble over so long a time without major macroeconomic and microeconomic policy mistakes.

Chapter 7 - The popping of the housing bubble, the subsequent increases in residential mortgage loan delinquency and foreclosure rates, and the recent failures of commercial and investment banks have prompted some Americans to suggest that current economic policies are similar to Herbert Hoover's.

To assess the validity of this assertion, one must first understand what Hoover's economic policies actually were. There is a widespread misconception that under Hoover the federal government remained idle as the economy contracted. In reality, Hoover aggressively pursued bad economic policies that transformed what could have been at worst a short recession into the worst depression in U.S. history.

Although Hoover did not understand banking, finance, and monetary policy, his success as an engineer, entrepreneur, and government official prior to his inauguration convinced him that he did not require economic advice. Hoover thought that he already knew everything that there was to know about economics. Hoover's arrogance proved disastrous. Hoover repeatedly ignored sound advice from prominent economists to pursue relentlessly bad economic policies based on his wrong-headed notions, his quirky morality, and his anti-bank, anti-Wall Street prejudices.

Chapter 8 - An unprecedented U.S. housing bubble began to inflate in the first quarter of 1998 and then popped in the second quarter of 2006. The subsequent deflation of housing prices has caused the delinquency and foreclosure rates for subprime residential mortgage loans to soar. Investors grew uncertain about the value of the residential mortgage-backed securities (RMBS) and the collateralized mortgage obligations (CMOs) into which many subprime residential mortgage loans had been placed. Consequently, the market liquidity for these subprime-related derivative securities shriveled.

Chapter 9 - This chapter explains how weakness in the U.S. housing sector morphed into a global financial crisis that began last August. Using the framework for analyzing asset bubbles that was introduced in a previous report,[1] this chapter examines stage two – credit expansion (microeconomic factors related to financial services) and stage six – financial panic and crisis management.

Chapter 10 - We are all familiar with the numerous ways in which we use credit. Credit finances the smaller purchases we make when we use our credit cards, and the larger purchases that are fundamental to our lives – the cars we drive, the homes we live in, the colleges where we send our children. Credit is also crucial for the needs of businesses, and for state and local governments.

Chapter 11 - Japan experienced large asset price bubbles in its stock and commercial real estate markets during the second half of the 1980s. These bubbles peaked in 1989 and 1990, respectively. Subsequently, both Japanese share prices and land values fell, surrendering all of their gains during the bubble years by 1993 and 2000, respectively.

After these bubbles popped, real GDP growth slowed abruptly. However, a series of fiscal and monetary blunders by the Japanese government transformed the inevitable post-bubble recession into a "lost decade" of deflation and stagnation. U.S. policymakers can learn valuable lessons of what to do and not to do by studying these blunders.

Chapter 12 - Credit default swaps are contracts that provide protection against default by third parties, similar to insurance. These financial derivatives are used by banks and other financial institutions to manage risk. The rapid growth of the derivatives market, the potential for widespread credit defaults (such as defaults for subprime mortgages), and operational problems in the over-the-counter (OTC) market where credit default swaps are traded, have led some policymakers to inquire if credit default swaps are a danger to the financial system and the economy. For example, the establishment of a conservatorship for the government sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, in September 2008 potentially triggered credit default swap contracts with notional value exceeding $1.2 trillion. Processing and covering these commitments may be difficult. This chapter defines credit default swaps, explains their use by banks for risk management, and discusses the potential for systemic risk.

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Chapter 1

CHINESE FOREIGN EXCHANGE INTERVENTIONS

Jim Saxton

EXECUTIVE SUMMARY

For a decade prior to 2005, the People's Republic of China (PRC) pegged its currency, the renminbi, to the U.S. dollar. On July 21 of that year, the PRC finally broke this peg. However, the PRC has continued to intervene heavily in foreign exchange markets to limit the subsequent appreciation of the renminbi. Governments in other Asian economies have sought to limit the appreciation of their currencies against both the renminbi and the U.S. dollar to maintain the price competitiveness of their manufactured exports with their Chinese rivals in North American and European markets. Shadowing the PRC's exchange rate policy, other Asian governments have also intervened heavily in foreign exchange markets. From 2001 to 2007, the PRC, India, Indonesia, Japan, South Korea, Malaysia, Taiwan, and Thailand have collectively added $2.7 trillion to their foreign exchange reserves. About 2/3 of these reserves have been invested in U.S. dollar-denominated assets, primarily U.S. Treasury and agency debt securities.

Since 2000, the PRC's exchange rate policy and the shadow policies of other Asian governments slowed the depreciation of the U.S. dollar and lowered interest rates, particularly at the long end of the yield curve. By distorting market price signals, these policies have exacerbated a number of economic problems not only in the United States but also around the world:

- These policies have contributed to the growth of unsustainable imbalances in the international accounts of both the PRC and the United States.
- The PRC's massive accumulation of foreign exchange reserves is stoking rapidly rising inflation in China.
- Low long-term interest rates contributed to the housing price bubble during the first half of this decade. As the bubble approached its peak, reckless lending became rampant.
- The bursting of this bubble revealed significant overinvestment and malinvestment in housing in the United States as well as significant speculative excesses in credit markets around the world.
- The inevitable unwinding of these imbalances, the liquidation of overinvestment and malinvestment in housing, and the restoration of confidence in credit markets may slow real GDP growth in the United States for several years.

I. INTRODUCTION

During the 1980s and 1990s, the foreign exchange value of the U.S. dollar was largely determined by the market-based, wealth-maximizing decisions of households and firms both here and abroad. Since 2000, however, the strategic interventions by central banks in foreign exchange markets have played a far larger role in determining the foreign exchange value of the U.S. dollar than during the two previous decades. In the last five years, the value of the U.S..dollar has declined (see Graph 1).

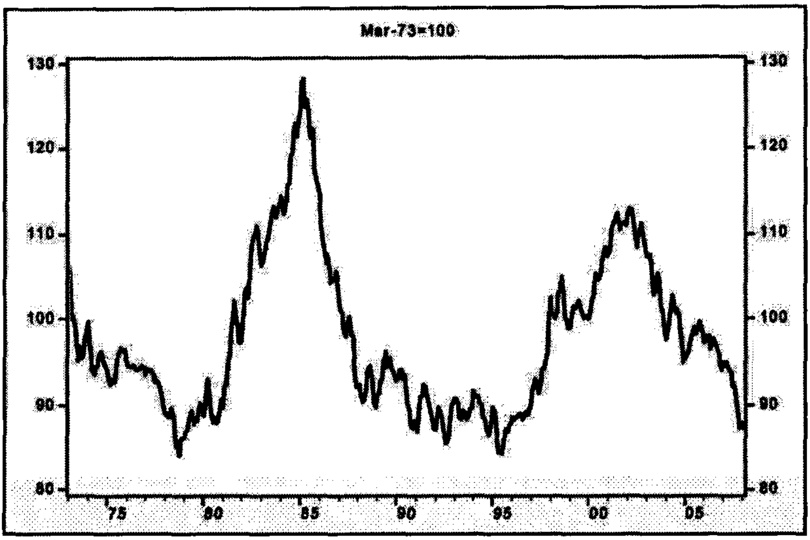
For a decade prior to 2005, the People's Republic of China (PRC) pegged its currency, the renminbi,[1] to the U.S. dollar. On July 21 of that year, the PRC broke this peg and finally allowed the value of its currency to rise, but not to a market-determined level. The People's Bank of China (PBC) continued to intervene heavily in foreign exchange markets to limit the subsequent appreciation of the renminbi. Governments in other developing and newly industrializing economies in northeast, southeast, and south Asia feared that significant appreciations of their currencies would cause their manufactured exports to lose their price competitiveness with their Chinese rivals in North American and European markets. Consequently, these governments have sought to limit the appreciation of their currencies against both the renminbi and the U.S. dollar.

Shadowing the PRC's exchange rate policy, the central banks in other Asian economies have also intervened heavily in foreign exchange markets since 2000. From 2001 to 2007, central banks in China, India, Indonesia, Japan, South Korea, Malaysia, Taiwan, and Thailand added $2.7 trillion to their foreign exchange reserves. About 2/3 of these reserves have been invested in U.S. dollar-denominated assets, primarily U.S. Treasury and agency debt securities.[2]

Since 2000, the PRC's exchange rate policy and the shadow policies of other Asian governments have kept dollar-denominated interest rates low, particularly at the long end of the yield curve, in the United States and to a lesser extent in Australia, Canada, and Europe. These policies also slowed the depreciation in the foreign exchange value of the U.S. dollar. Without massive interventions by the PRC and other Asian governments, long-term interest rates in the United States would have been significantly higher, and the foreign exchange value of the U.S. dollar would have been even lower.

By distorting market price signals, the PRC's exchange rate policy and the shadow policies of other Asian governments have exacerbated a number of economic problems not only in the United States but also around the world:

- These policies have contributed to the growth of unsustainable imbalances in the international accounts of both the PRC and the United States.[3]
- The PRC's massive accumulation of foreign exchange reserves is stoking rapidly rising inflation in China.
- Low long-term interest rates contributed to a housing price bubble in the United States. As the bubble approached its peak in 2006, reckless lending became rampant.
- The bursting of this bubble revealed significant overinvestment and malinvestment in housing in the United States as well as significant speculative excesses in credit markets around the world [4]
- The inevitable unwinding of these imbalances, the liquidation of overinvestment and malinvestment in housing, and the restoration of confidence in credit markets may slow real GDP growth in the United States for several years.



Source: Feder al Reserve Board /Haver Analytics

Graph 1. Real Broad Trade-Weighted Exchange Value of the US$

II. HOW ECONOMIC FACTORS DETERMINE EXCHANGE RATES AND INTERNATIONAL ACCOUNTS

Under the Bretton Woods system (1945 to 1971), exchange rates were fixed. Current account transactions such as payments for imported goods were generally unregulated, but capital controls restricted both inward and outward investment transactions. International imbalances were resolved mainly through official flows of gold or U.S. dollars among central banks.

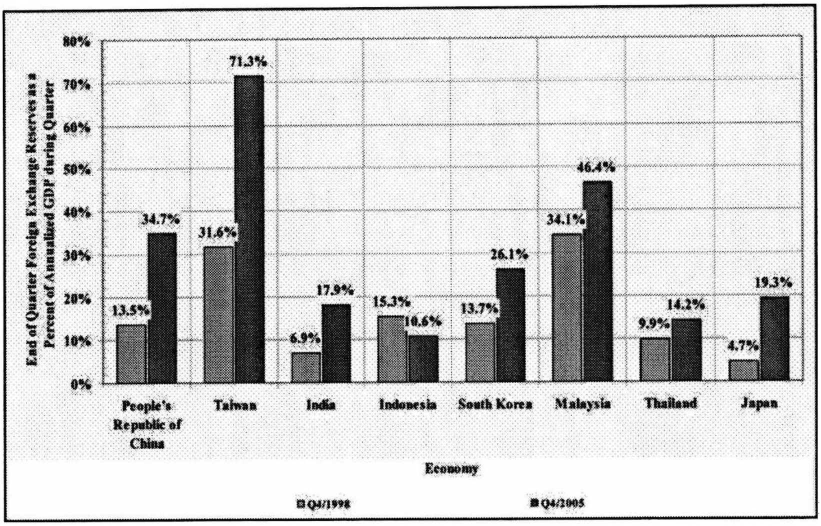
In 1973, the United States and other developed countries allowed market forces to determine the foreign exchange value of their currencies. Economists refer to this system as floating exchange rates. Over the next decade, developed and many developing countries abolished capital controls, freeing their residents to make outward foreign investment and opening their economies to inward foreign investment. In recent decades, international imbalances have been resolved mainly through market-determined changes in exchanges rates. Under floating exchange rates, a government may affect the foreign exchange value of its currency (1) through domestic monetary policy or (2) through its fiscal, regulatory, tax, trade, and other economic policies. Domestic monetary policy determines the supply of money. Changes in this supply relative to international demand affect the exchange rates of one currency with other currencies. Other economic policies affect the international demand for a country's currency by changing market expectations for the risk-adjusted after-tax rate of return. Since foreign residents must exchange their currencies to invest in other countries, policies that increase the expected risk-adjusted after-tax rate of return in one country will increase the foreign exchange value of its currency, and vice versa.

Exchange rates are also affected by the monetary policy decisions of foreign governments. If a foreign central bank were to increase the money supply of its currency faster than the growth in demand for its currency while the Federal Reserve kept the supply of U.S. dollars in line with the demand for U.S. dollars, then the exchange rate of the U.S. dollar is likely to appreciate against this foreign currency.

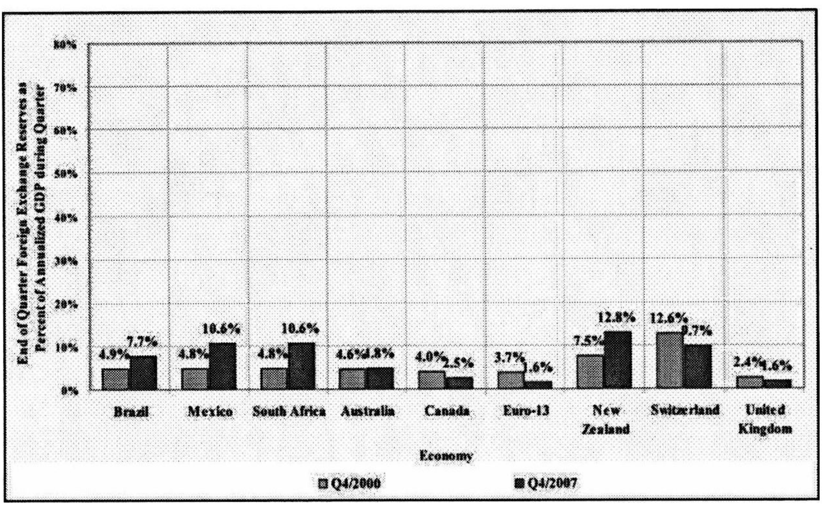
A policy-induced shift in either the supply of a country's currency or its international demand also changes such country's international accounts. An increase in inward foreign direct and portfolio investment will increase a country's capital and financial surplus (or reduce its deficit). This change automatically causes a country's current account deficit to increase (or its surplus to fall). Usually, this occurs through an increase in a country's trade deficit (or a decrease in its surplus) as the higher foreign exchange value of this country's currency simultaneously increases export prices in terms of other currencies and decreases import prices in terms of its own currency.

Between 1973 and 2000, official interventions by the U.S. Treasury and foreign central banks were limited and did not have a sustained influence on exchange rates. Portfolio investors can buy or sell financial assets almost instantaneously with minimal transaction costs to seek higher risk-adjusted after-tax returns, while trade and direct investment transactions often involve long-term contracts and commitments. Consequently, portfolio investment transactions by private households and firms rather than trade transactions or direct investment transactions have generally driven exchange rate fluctuations.

Both the disinflationary monetary policy pursued by the Federal Reserve and the Reagan administration policies of deregulation and marginal tax rate reductions increased expectations for higher risk-adjusted after-tax rates of return on U.S. investments. This drove a surge of inward private foreign investment in the early 1980s that increased the real foreign exchange value of the U.S. dollar. Again in the late 1990s, a high technology boom, trade liberalization, and a capital gains tax reduction drove another surge of inward private foreign investment, boosting the real foreign exchange value of the U.S. dollar. After these portfolio reallocations toward U.S. dollar-denominated assets peaked in 1985 and 2002, the real foreign exchange value of the U.S. dollar fell (see Graph 1).



Graph 2A. Accumulation of Large Foreign Exchange Reserves in Asia



Graph 2B. Moderate Changes in Foreign Exchange Reserves in Major Developed and Developing Economies Outside of Asia