Financial Meltdown and Western Hypocrisy

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With the Bear Stearns collapse al-most causing a system-wide meltdown and alarm bells still going off every few days, the Central Banks and financial authorities in the United States and Europe are now studying more radical measures to keep the lid on the financial crisis.

The US Federal Reserve, the European Central Bank and the Bank of England are reportedly studying the possibility of using public funds to purchase bad mortgage-backed securities from troubled financial institutions to save them from further losses and write-downs.

Previously, developing countries facing similar financial crises were ordered by the West-controlled International Monetary Fund not to extend financial assistance to domestic banks in trouble. And even today, as the Western governments put up mounting amounts in subsidized loans to their financial companies, they have been pressurizing developing countries not to extend subsidies to their companies.

The new measures to buy up bad assets from the banks, if carried out, would be a major departure from the "normal" hands-off policy of the central bankers, who proclaim that the institutions should be left to suffer their losses, and the state should not provide a rescue through public money, on the ground that this would create moral hazard.

Moreover, the use of tax-payers' money to rescue financial institutions that got into trouble because of the bankers' greed or ineptitude will be unpopular, and this measure is still only "under consideration". But the fact that the policymakers whose ideology is based on "market fundamentalism" are thinking about it shows the desperate state of affairs.

The Fed's role in facilitating the takeover of Bear Stearns and its other moves on the same weekend of 14-16 March already took it many steps beyond its customary boundary. These included the US$30 billion guarantee it provided to JP Morgan against losses in the latter's takeover of Bear Stearns and the decision to open loans through the discount window to all primary dealers (previously made available only to commercial banks).

If the Central Banks were to purchase the mortgage-backed securities off the commercial banks, investment banks and perhaps even other institutions like hedge funds, they would be taking a giant step up from the recent measures limited to extending credit to mainly the commercial banks to give them much-needed liquidity.

A senior United Nations official, speaking anonymously, remarked today that the Western countries were readily providing different types of subsidies, one larger than the previous, to keep the financial institutions alive and the system afloat, in an increasing nationalization of losses of the private financial institutions. And at the same time, the same developed countries have been pressing developing countries not to provide subsidies to their industrial companies, and even proposing new measures to ban them from using more categories of industrial subsidies at the WTO.

"The hundreds of billions of dollars of subsidies in loans and guarantees, and in future through outright purchase of bad loans and securities used by the Western governments in the current financial crisis, are something way beyond the millions of dollars of subsidies that developing countries' governments could afford for either their financial or industrial firms," said the official, stressing the hypocrisy involved.

On 4 June last year, the US submitted a new proposal in the rules (anti-dumping and subsidies) group under the Doha negotiations to prohibit five new categories of subsidies in the industrial sector. The five types of subsidies are: (1) government payments to companies to cover operating losses; (2) forgiveness of government-held debt; (3) government lending to "uncredit-worthy" companies; (4) government equity investments in "unequity worthy" companies; and (5) other financing, such as "royalty-based" financing that is not commercially available.

At the time this proposal was introduced, US Trade Representative Susan Schwab said that stronger WTO rules will rein in the use of industrial subsidies, and that in an increasingly global economy, foreign government subsidies provide a distinctly unfair competitive advantage. "The subsidies we want to prohibit maintain inefficient production capacity in industries ranging from steel to semiconductors. Stronger rules for these types of subsidies would address significant trade-distorting practices of many of our trading partners that often lead to unfair trade." The US however was quick to stress that the prohibitions would not apply to agriculture.

The proposal generated a storm of protests from many developing countries which argued that such subsidies were necessary for the evolution of domestic firms and were part of the policy tools for development, that the now developed countries themselves had made use of. But these arguments were brushed aside by the US, and its proposal is still on the table.

The US paper proposed the following five types of subsidies to be added to the subsidies that are prohibited in the WTO's Agreement on Subsidies and Countervailing Measures :

(a) the direct transfer of funds to cover operating losses sustained by an enterprise or industry;
(b) forgiveness of debt, i. e. forgiveness of government-held loans or other instruments of indebtedness, and grants to cover repayment of government-held loans or other instruments of indebtedness;
(c) loans and other instruments of indebtedness provided directly to enterprises that are uncredit-worthy;
(d) provision of equity capital where the investment decision is inconsistent with the usual investment practice (including for the provision of risk capital) of private investors in the territory of that Member; and
(e) other financing (i. e., "royalty-based" or "sales-contingent" financing or other similar financing) to an enterprise or project that otherwise would be unlikely to receive such financing from commercial sources.

The recent measures by the US and some European governments in extending credit to troubled banks may well fall under the proposed prohibited subsidy (c), i.e. providing loans and other instruments to enterprises that are "uncreditworthy".

And if the governments purchase or nationalize bank equity (such as the UK government did with respect to Northern Rock bank) or if they purchase bad loans and securities from financial institutions to save them from write-downs of capital (as is now being considered), these may be construed as coming under some of the subsidy categories above, such as provision of equity capital amounting to an "unusual investment practice".

The privatization of profits during booms and the nationalization of private equity and loans gone bad during busts seem to be continuing in the developed countries in new forms during this financial boom-bust cycle.

The turmoil continued following the Bear Stearns episode. On 19 March, Britain's largest mortgage lender and fifth largest bank, Halifax Bank of Scotland (HBOS), came under massive speculative attack and might have collapsed in similar fashion as Bear Stearns but for quick action by the UK financial authorities to scorch false rumours that the bank was in trouble.

HBOS lost 20% of its share value within minutes of the opening of the stock exchange that day on rumours that it had sought emergency funding from the Bank of England. The bank was facing a potential run from depositors, which could have had disastrous effects on the system.

The Bank of England quickly rang up news organizations to deny the rumours, said to be caused by short sellers that profited from the sudden fall in HBOS shares. The London financial authorities then announced that it was investigating market manipulation. By the end of the day, the bank's share was only 7% down.

On 20 March, the Governor of the Bank of England held crisis talks with the chiefs of Britain's five biggest banks, who reportedly pressed him to take more emergency measures. Central bankers in the UK and Europe made available billions of dollars more of liquidity in the financial markets.

As shown in the cases of the UK's Northern Rock bank (which fell when there was a run by depositors on the bank) and Bear Stearns (where investors pulled out their funds), the loss of confidence in a financial institution can cause it to collapse, and suddenly too. Bear Stearns fell and was then taken over in only a few days.

A major problem is that trust has been eroded in the West in its financial institutions, and there is also a lack of openness or clarity in the real standing of these institutions, thereby making them susceptible to rumours that threaten to be self-fulfilling.

Many economists and analysts are now commonly talking about "vicious cycles", for example, how the crises facing banks lead to a squeeze in credit they give out which in turn causes problems for borrowers like house buyers and companies, which in turn worsens the banks' problems as well as the real economy.

A Financial Times article on 13 March quotes Lawrence Summers, former US Treasury Secretary, as describing three vicious cycles going on simultaneously:

H A liquidity vicious cycle, in which asset prices fall, people sell and therefore prices fall more;

H A "Keynesian vicious cycle", where people's incomes go down, so they spend less, so other people's income falls and they spend less; and

H A "credit accelerator", where economic losses cause financial problems that cause more real economy problems.

Meanwhile, estimates of the losses suffered by the banking institutions from the mortgage crisis are mounting. The official estimate is $400 billion, but Summers calls that "substantially optimistic." The economist Nouriel Roubini envisages that loan losses could total $1,000 billion. But the impact of these bank losses on the real economy will be multiple times greater.

This was illustrated by the chief economist of Goldman Sachs Jan Hatzius who was reported by *Financial Times* (19 March) as showing a chart to clients recently, which predicted that major banks and brokers would suffer $200 billion sub-prime-linked losses, but the impact on bank lending would be much greater.

In the calculations, the $200 billion loss would cut bank capital by 12%. If banks shrank their balance sheets by 12%, the implied reduction in overall lending would total $2,300 billion.

This estimation is in line with the "financial accelerator" concept of the Federal Reserve chairman Ben Bernanke (when he was an academic), that losses to banks and declines in the value of their loan collateral cause banks to reduce their lending and thus magnify the scale of an economic downturn, according to the Financial Times article.

Each week brings new twists and turns in the financial crisis saga of the Western countries. The effects of the crisis have not yet been much felt in most developing countries. But it is a matter of time and the big question is how badly or mildly will these effects be. □□□

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