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The Macro Market Environment Behind the Financial Crisis and Monetary Policy Trends

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Reinhart and Rogoff's 2008 study of financial crises over the past two centuries underlines the frequency of such events. In my two decades as a central banker we dealt with five major crises: the Latin American debt crisis of the 1980s, the US savings & loan crisis and the Scandinavian banking crisis of the early 1990s, and the Asian currency crisis and Japanese financial crisis of the late 1990s.

With each event regulatory authorities, central banks, and market participants learned new lessons and introduced a host of new measures to monitor, regulate, and manage risk at financial institutions. It is not as if nations fell repeatedly into the same trap; the key players and the affected regions and markets differed in each case.

Nonetheless, the process involved was often similar. Extremely bullish market participants would build up investment positions to levels not justified by the economic fundamentals and ultimately find themselves unable to maintain those positions.

After the fact, people ask whence the bullishness came and whether it could have been brought under control before it prompted a crisis. In this report I reconsider these questions in light of current events with a focus on the market environment and monetary policy.

Market environment from 2003 to the crisis

Many practitioners see 2003 as an important threshold in the lead-up to the current crisis. It was then that the United States finally recovered from the collapse of the IT bubble, growth rose around potential, and Japan's response to the earlier financial crisis concluded with the nationalization of a major bank. Growth in the market for securitized assets accelerated, principally in the US, and US and European investors began to snap up Japanese and Asian equities. At the same time, Asian and Middle Eastern countries flush with foreign reserves boosted their purchases of US Treasury securities. The price of gold, oil, copper, and other commodities also surged on capital inflows from institutional investors and strong growth in emerging economies.

From then until the beginning of 2007, when signs of a change in the US housing market became increasingly evident, the world financial and economic environment was extremely favorable. Growth rates in Japan, Europe, and the US remained solidly above potential, and inflation fell. The "great moderation" in macroeconomic conditions that emerged simultaneously in the advanced economies helped mitigate financial market volatility via reduced risk premia and stable long-term interest rates.

It is hardly surprising that declining market volatility and a low cost of capital bolstered investors' appetite for risk. Hedge funds and private equity funds were joined by traditional institutional investors expanding their investment frontiers in search of wider spreads and higher returns. Nor did the "search for yield" stop at domestic borders. As the home bias weakened, investors in advanced economies stepped up their purchases of emerging market assets.

A variety of hypotheses were offered to rationalize the market euphoria. Some argued that the use of credit scoring models and securitization had broadened the boundaries of mortgage lending to include low-income US households, others that the BRICs would post faster growth than the advanced economies. Yet others predicted that outward investments by the Japanese would pick up amid concerns about the aging population and national pension program. These arguments pointed to the possibility of structural changes in the economy and financial markets and were used to rationalize new benchmarks for the ratings of securitized assets fashioned from subprime loans, the P/E ratios of emerging market equities, and the Sharpe ratios of yen carry trades.

The problem with these hypotheses—and the reason why they were accepted by professional investors—is that they were more than just ground-less theorizing or investors talking their books. Each contained a kernel of truth. Moreover, advances in information technology made it possible for large groups of investors to obtain the same information and establish the same positions at very low cost. Consequently, investors around the world—including retail participants like the so-called Mrs. Watanabes of Japan—built up crowded positions that could never be justified by the few grains of fundamental truth contained in the aforementioned hypotheses. Moreover, they did so on a global scale, in markets ranging from equities and credit to forex and commodities.

Factors that prevented market excess from being reined in

Even before the euphoria ended, some market participants understood that excessive investment would eventually lead to a financial crisis. For many of them, however, it was simply not feasible to leave the market at a time when competitors—whether other investors or financial institutions—were still making money. This reality was crystallized in former Citigroup chairman Charles Prince's famous remark that "As long as the music is playing, you've got to get up and dance."

If the hands of private investors were tied, what about the central banks? Central bankers in the advanced economies naturally surmised that markets had overshot. As the search for yield compressed spreads between risky and risk-free assets, many investors sought to boost returns by employing leverage. Central bankers were aware that investors were using the repo market and the re-securitization market to lever up. They also knew that investors had built up so-called crowded positions in specific markets based on specific hypotheses.

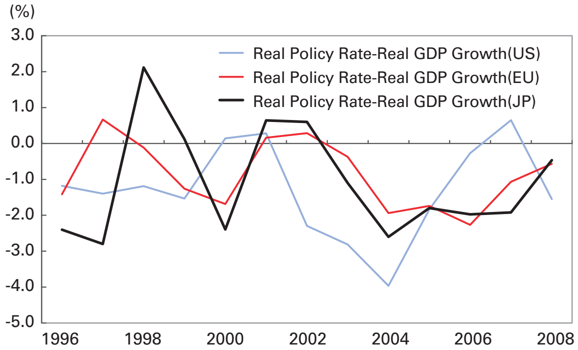
Did they simply look the other way, much as authorities are said to have done in the case of the massive investment fraud that recently came to light? I do not think so. In my view, central banks' monitoring of financial markets and institutions was not sufficiently broad or precise to enable them to formulate a concrete response.

Regarding leverage, not even central banks in the advanced economies could know with any degree of accuracy how big the problems were, whether locally or globally, or to what extent financial institutions were involved, at least until the crisis broke. Nor could they fully appreciate the extent to which risk had proliferated via securitization and derivatives. Central banks may have underestimated the size of crowded positions because liquidity conditions would have appeared favorable as long as fund inflows continued. In other words, I suspect that central bankers first became aware of the global scale and considerable depth of such positions only after the crisis erupted and massive fund outflows sent asset prices hurtling lower.

In this regard it is interesting to ponder whether central bankers in the advanced economies would have maintained accommodative monetary policies as long as they did given a more timely and accurate understanding of market conditions.

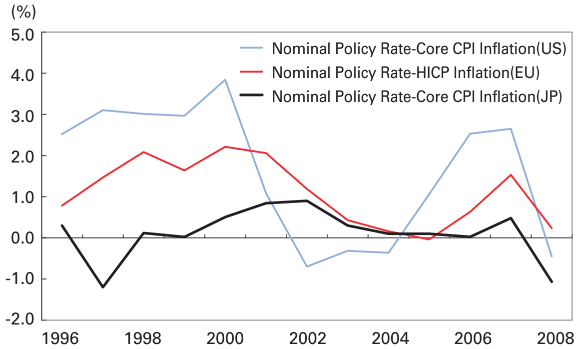
Prior to the current crisis a substantial amount of research had been published on Japan's post late-1990s financial crisis. There was a shared global understanding that, as BOJ Governor Toshihiko Fukui pointed out on numerous occasions, bad things can happen when market participants come to expect that interest rates will be kept at extremely low levels for an extended period of time. Nonetheless, central banks in the advanced economies were reluctant to tighten monetary policy. Although policy rates were low in absolute terms, it was thought that policy was not excessively accommodative given the lower inflation rates and inflation expectations of the time. Accordingly, central banks took their time in normalizing monetary policy after the collapse of the IT bubble (e.g., the Fed's "measured pace" of tightening).

Exhibit 1. Economic growth and policy rates: Japan, Europe, and US



Source: NRI

Exhibit 2. Inflation vs policy rate: Japan, Europe, and US



Source: NRI

In short, even if central banks in the advanced economies had been able to monitor the markets with a high degree of precision, it is uncertain whether they would have moved to end the accommodative conditions fostered after the IT bubble burst. After all, there was—and is—no consensus on whether banks should tighten policy in response to sharp increases in asset prices. At the risk of generalizing, the ECB was open to the idea of preemptive tightening, whereas the Fed was opposed to such action and argued that all the central bank need do is ease aggressively after the bubble collapses. This view was based on the argument that it is impossible to identify a bubble until it bursts—in other words, that even central banks cannot know until the very end whether the kinds of hypotheses noted above are true.

Also contributing to the crisis was the fact that central banks in emerging economies in Asia and elsewhere fostered accommodative monetary conditions similar to those in the US by selling their currencies against the falling dollar. Local real estate and stock prices surged as a result, only to collapse after the crisis hit.

Implications for the future

Finally, I would like to raise a few points that may contribute the discussion for the prevention of future crises.

First, central banks need to be able to monitor risk aggregation and concentration in the financial markets in a timely manner with greater precision and broader coverage. Given the increasingly cross-border nature of financial transactions, cooperation between global central banks is critical in this regard. This is simply another way of expressing the importance of macro-prudential policy. That said, we should be careful before deciding to regulate all markets and players, a proposal now being discussed in various countries. An a priori assumption that regulation is good can have the side-effect of hindering spontaneous technical innovation in the market. We should not forget that there are meaningful intermediate stages—surveillance and dialogue with the markets—on the road to regulation.

Second, central banks should take care when administering monetary policy not to provide excessive support for financial transactions. Although inflationary pressures have been subdued for some time, a sharp rise in asset prices has the potential to spark high inflation via excessive consumption or investment. Similarly, the collapse of an asset price bubble can cause a sharp decline in inflation. Fluctuations in asset prices are therefore closely linked to future inflation and to deflation—even though great uncertainty surrounds the transmission mechanisms and time lag—and hence to the price stability that central banks are mandated to maintain. Presented with the different approaches of the US and Europe, I find myself drawn more towards the European view.

Finally, it is important that emerging market nations maintain flexible exchange rates. When advanced economies are easing monetary policy, emerging economies with exchange rate flexibility can avoid importing accommodative policy by not intervening on the forex markets to devalue their currencies. To that extent, these countries need to overcome their fears of currency appreciation.

Conclusion

Regulation of financial institutions and markets and risk management at financial institutions are critical to the prevention of financial crises. But inasmuch as monetary conditions can play a key role in generating such crises, current events reaffirm that we should place greater emphasis on how these crises unfold when discussing monetary policy.

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