

Financial crisis: Let's get to the root cause

By RIAAN NEL

We are inundated by recriminations and accusations of who is to blame for the current financial crisis. To chart our way out of this malaise, we need to understand the root causes. Failure to understand the origins of this crisis will lead to solutions that might only exacerbate the current situation.

Was it greedy Wall Street that must be regulated more? Was it unscrupulous mortgage brokers who fleeced unsuspecting home buyers? Was it complicated mortgage-backed securities and other derivatives that imploded? Or was it government interference in the free market to increase home ownership? The answer is much simpler — and much more complex!

The root cause of the crisis was an unprecedented increase in the global money supply, in conjunction with the burgeoning of a massive saving surplus in emerging economies. This tsunami of money caused a global credit bubble, and a flood of capital into the rich world. Many complexities, however, did come into play to worsen the severity and magnitude of the crisis, but the calamities we are facing today have their origins in a world where credit-driven excesses went on for too long, and became unsustainable.

How did this occur? In its fervor to increase the money supply in the aftermath of the 2001 recession, the Federal Reserve took the lead globally and slashed the Federal Funds rate too much for too long, and when it started tightening in 2004 the tightening was overly timid. In conjunction with this we had large increases in saving surpluses in the emerging world. The increase in surplus savings in many emerging countries was caused by the shifting of investments away from Asia in the aftermath of the Asian financial crisis; the accelerated increase in the price

of oil, flooding exporting countries with petrodollars; and finally, the currency management system of some countries creating surpluses due to an undervalued exchange rate.

This tsunami of global liquidity fueled the credit boom. Rapid credit expansion usually leads to speculative asset price bubbles, and in many parts of the world real estate experienced a price explosion. Yale University's Robert Schiller, a real estate specialist, pronounced the global real estate bubble as the greatest in history. It has been estimated that more than half of U.S. gross domestic product growth in the first half of 2005 was real estate-related.

It is important to understand that we've had a global real estate bubble. It is ludicrous, though, to argue that greed and government distortions of the market were the root causes. Real estate bubbles occurred in Britain, Australia, Spain, South Africa and elsewhere, due to loose lending standards, fueled by a wave of available money. Also, scant attention has been given to the impact of emerging countries' currency pegging and how it contributed to saving surpluses.

The credit and saving surplus tsunami took place within an increasingly globalized financial system. Tectonic shifts occurred in financial markets during the preceding two decades, intensifying the severity of the crisis. I classify these factors as intervening variables contributing to the current malaise. We've experienced a relentless deregulation drive that started during the Reagan administration, with the negative consequence of shifting lending activities to the purview of nonregulated entities (in 2006 only 25 percent of lending occurred in regulated sectors, down from 80 percent 20 years prior).

We've also experienced a decomposition of mortgage banking, and the innovation of the complicated process of securitization, leading

to the phenomenon of lower quality mortgages marbling their way through the entire world's credit system. We also cannot ignore the government promotion of the ideal of ubiquitous home ownership that exacerbated the evolving crisis over almost two decades.

Predicting the consequences of an unfinished crisis is perilous, to say the least, but the process of global integration, which involves the dominance of markets over governments, is being reversed in three important ways.

First, Western finance will be reregulated to better manage systemic risk; however, we have to be careful not to over-regulate.

Second, the balance between state and market is changing in areas other than finance. We need to guard against over-reaching and erasing the positive consequences of globalization.

Third, America is losing economic clout and intellectual authority. Capital-rich creditor countries, such as China, will increase their influence over the global financial system. U.S. foreign policy will have to become more pragmatic.

What can we do here in the Eugene-Springfield area? One of the consequences of globalization is the erosion of local influence. In this global system speculative excesses will continue to occur. One important defense for local governments is to be cognizant about their use of debt. The lower a city's debt burden, and the more nimble its operations, the more scope it will have to weather the financial storms always brewing somewhere in the new world economy.

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