

# Why the credit squeeze is a turning point for the world

By Martin Wolf

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These are historic moments for the world economy. I felt the same during the emerging market financial crises of 1997 and 1998 and the bubble in technology stocks that burst in 2000. This “credit crunch” may, I believe, be an equally important turning point for financial markets and the world economy. Why do I believe this? Let me count the ways.

First and most important, what is happening in credit markets today is a huge blow to the credibility of the Anglo-Saxon model of transactions-orientated financial capitalism. A mixture of crony capitalism and gross incompetence has been on display in the core financial markets of New York and London. From the “ninja” (no-income, no-job, no-asset) subprime lending to the placing (and favourable rating) of assets that turn out to be almost impossible to understand, value or sell, these activities have been riddled with conflicts of interest and incompetence. In the subsequent era of “revulsion”, core financial markets have seized up (see charts).

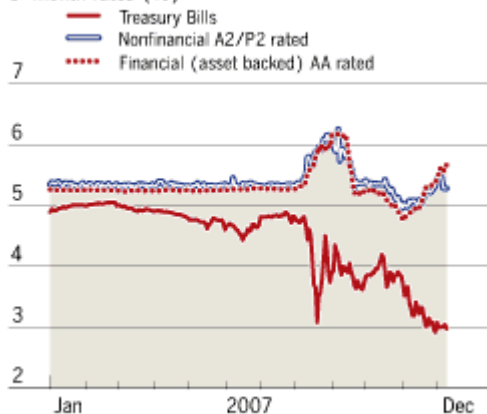
Second, these events have called into question the workability of securitised lending, at least in its current form. The argument for this change – one, I admit, I accepted – was that it would shift the risk of term-transformation (borrowing short to lend long) out of the fragile banking system on to the shoulders of those best able to bear it. What happened, instead, was the shifting of the risk on to the shoulders of those least able to understand it. What also occurred was a multiplication of leverage and term-transformation, not least through the banks’ “special investment vehicles”, which proved to be only notionally off balance sheet. What we see today, as a result, is a rapid shrinkage of markets in asset-backed paper (see chart).

Third, the crisis has opened up big questions about the roles of both central banks and regulators. How far, for example, do the responsibilities of central banks as “lender-of-last-resort” during crises stretch? Should they, as some argue, be market-makers-of-last resort in credit markets? What, more precisely, should a central bank do when liquidity dries up in important markets? Equally, the crisis suggests that liquidity has been significantly underpriced.

Does this mean that the regulatory framework for banks is fundamentally flawed? What is left of the idea that we can rely on financial institutions to manage risk through their own models? What, moreover, can reasonably be expected of the rating agencies? A market in US mortgages is hardly terra incognita. If banks and rating agencies got this wrong, what else must be brought into question?

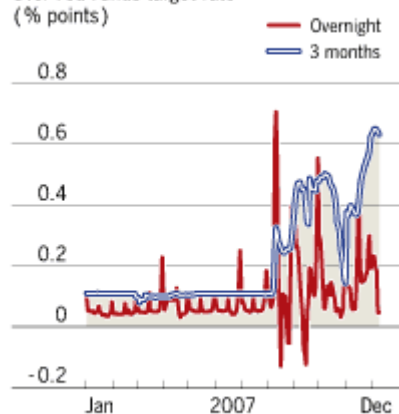
### US commercial paper and Treasury bills

3-month rates (%)



### Dollar libor spreads

Over Fed Funds target rate  
(% points)



Fourth, do you remember the lecturing by US officials, not least to the Japanese, about the importance of letting asset prices reach equilibrium and transparency enter markets as soon as possible? That, however, was in a far-off country. Now we see Hank Paulson, US Treasury secretary, trying to organise a cartel of holders of toxic securitised assets in the “superSIV”. More importantly, we see the US Treasury intervene directly in the rate-setting process on mortgages, in an attempt to shore up the housing market. Either, or both, of these ideas might be good ones (though I strongly doubt it). But they are at odds with what the US has historically recommended to other countries in a similar plight. Not for a long time will people listen to US officials lecture on the virtues of free financial markets with a straight face.

Fifth (and here we start to move from the questions about the workings of the financial system to global macro-economic implications), the crisis signals a necessary re-rating of risk. It turns out that it also represents a move towards holding more transparent and liquid assets, as one would expect. This correction is altogether desirable. It has, moreover, been selective. It is a striking feature of what has happened that emerging markets have emerged as a safe haven as investors run away from US households. For those in emerging economies, this must be sweet revenge. They should not cheer too soon. Today’s favourites may be brutally discarded tomorrow.

Sixth, this event may well mark the limits to the US role as consumer of last resort in the world economy. As the Organisation for Economic Co-operation and Development notes in its latest Economic Outlook, the correction is well under way. In 2007, it forecasts, US final domestic demand will grow by just 1.9 per cent, down from 2.9 per cent in 2006. It forecasts a further decline, to growth of 1.4 per cent, next year. In both years, net exports will make a positive contribution to growth: 0.5 percentage points in 2007 and 0.4 percentage points in 2008, as the trade deficit shrinks in real terms. In this way, the US is re-importing the stimulus it exported to the rest of the world in previous years. The credit crunch is quite likely to accelerate this process. So the US needs strong growth of net exports. For this reason, policymakers are relaxed about the dollar’s fall, provided it does not awaken fears of rapidly rising inflation.

Seventh, a US recession is possible. Whether it happens depends overwhelmingly on consumers. The principal counterpart of the external deficits has been the excess of spending over income by households. That has meant negligible savings and a big jump in household debt: mortgage debt jumped from 63 per cent of disposable incomes in 1995 to 98 per cent in 2005. This rising trend is unlikely to continue in a falling housing market. Unwillingness (or inability) to borrow on such a scale will, in turn, hamper the effectiveness of US monetary policy. That, in turn, makes a weak dollar and strong export growth yet more important.

Last but not least, this event also has big significance for the game of “pass-the-external-deficits” that has characterised the world economy for several decades. It has proved virtually impossible for emerging market economies to run large deficits, without running into crises.

Over the past decade, the US filled the (growing) gap as ever-larger borrower of last resort. This epoch has probably now ended. But the surpluses being run by China and Japan, by oil exporters and, within the European Union, by Germany continue to grow. If we are to enjoy global macro-economic stability, a creditworthy set of countervailing borrowers must emerge. If the US ceases to increase its absorption of the growing savings surpluses being generated elsewhere, which countries will be able and willing to do so?

Experience teaches that big financial shocks affect patterns of lending and spending across the world. Originating, as it does, at the core of the world economy, this one will do so, too. The question is how stable and dynamic the world economy that emerges will be.

[martin.wolf@ft.com](mailto:martin.wolf@ft.com)

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