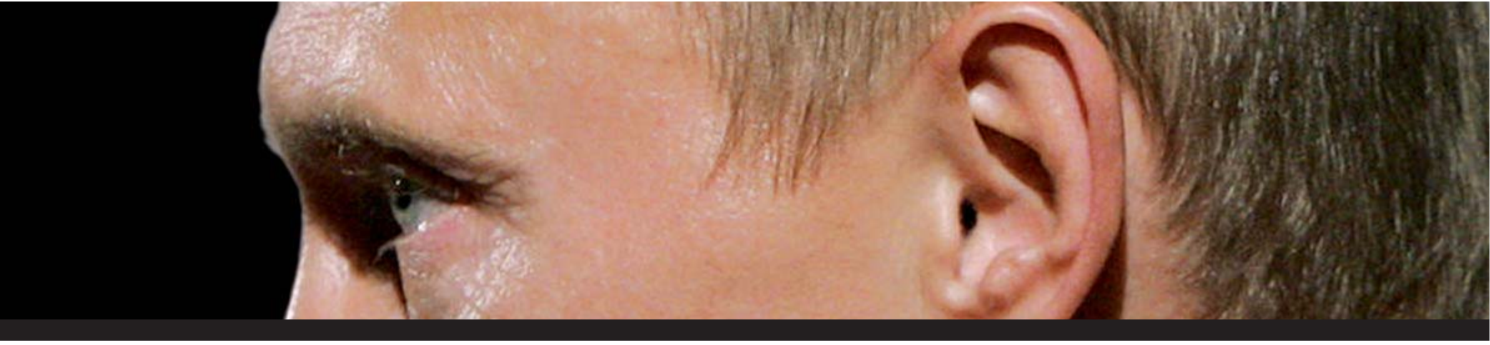
by Alessandro Profumo

EDITORIAL

The serious financial turbulence which hit markets in August has invited comparisons to previous ones such as the stock market crash of 1987 and the 1998 crisis triggered by the default of Russia and the failure of the Long Term Capital Management hedge fund. I believe the current crisis is just as serious, but fundamentally different in some important respects, and understanding its nature can help us imagine what might lie ahead.
The roots of the current turmoil lie in the unprecedented liquidity growth of the last few years. In response to the shocks of 2000-01, central banks in the major industrial countries brought real interest rates to historically low levels for a prolonged period of time. As the Fed and then the ECB gradually raised policy rates towards normal levels, their policy tightening was offset by the strong accumulation of FX reserves in major emerging countries, and by an acceleration of leverage in the financial sector, so that monetary and credit aggregates kept rising fast, and started decelerating only at the beginning of this year. Market rates declined, and spreads on risky and corporate assets narrowed sharply across the board – in some cases this also reflected stronger fundamentals, but in others, risk was clearly mispriced.
The US subprime mortgage market is a case in point: the relaxation of lending standards of the last couple of years was a risky bet on a sustained increase in house prices. The bet went wrong, and default rates increased, undermining the performance of securities backed by subprime mortgages. The subprime debacle was predictable. What was completely unexpected, however, was the way in which it quickly snowballed into a widespread confidence and liquidity crisis. Investors suddenly lost confidence in the credit quality of most categories of asset backed securities, even those with no exposure to subprime; financing deals were put on hold; trading on a



range of risky assets became paralyzed; and activity in the interbank market declined sharply as financial institutions increased their precautionary holdings of liquidity. This in turn has raised concerns that the dislocation in financial markets might turn into a credit crunch for consumers and corporates alike, which would seriously undermine the growth outlook.

There is no doubt that these developments have posed a material risk to the world economy and a serious challenge to policymakers. It is important to realize, however, that in situations like this markets always tend to overreact: just as risk was mispriced prior to the crisis, so the flight to safety we have observed seems out of line with the underlying fundamentals. This is first and foremost a crisis of confidence. Investors have lost

_The financial crisis triggered by the American subprimes had the world holding its breath for a few weeks. The markets subsequently reacted very positively to the decision by Ben Bernanke, Chairman of the Federal Reserve, to cut the cost of money by a half percentage point to counter the trend towards recession. In the meantime, the finger was pointed at ratings companies, which had failed to point out the risks of the subprimes in time

faith in large parts of the structured credit market, the credibility of rating agencies has suffered, and uncertainty over financial institutions' exposure to the subprime sector has held back interbank lending. But, beyond the US subprime mortgage market, default rates had not risen significantly as of early September. The near-paralysis observed in several asset markets seems at odds with still solid fundamentals, and discriminating investors are already looking with some interest at the current valuations.

A correction was necessary, and I see a need for some deleveraging and risk repricing to take place – as central bankers have also pointed out, this would be a welcome development, a step towards a more sustainable equilibrium in the world financial system. And financial institutions will keep working with central bankers and regulators to identify potential measures to strengthen the financial sector further and, where appropriate, introduce additional safeguards – as is already being discussed in the case of US subprime lending. This crisis should indeed be taken as an opportunity to further strengthen the institutional fabric of financial systems. But it is important to keep in mind that the financial innovation of the last few years has also played a very positive role, providing better risk management tools for financial institutions and corporates alike, and facilitating the increased globalization of financial flows – which in turn has gone hand in hand with a long period of record high global economic growth. Progress and innovation always proceed in fits and starts – in retrospect, the current crisis will be seen as an important but temporary setback in our progress towards a stronger and more stable global economy. The risks should of course not be underestimated, as a confidence crisis can become self-fulfilling. As I mentioned above, there is a danger that if uncertainty and lack of confidence persist for too long, the financial crisis might trigger a credit crunch and spill over into the real economy. Luckily, though, this crisis has found the global economy in very good health, with growth robust and geographically balanced: Europe's upswing has surpassed expectations, emerging markets display remarkable dynamism, and even the US economy has so far proved reasonably resilient to the housing sector slowdown. This provides an important cushion, which should allow monetary authorities to continue reacting with targeted measures to restore the orderly functioning of financial markets while limiting the impact on the real economy – possibly with some recourse to monetary easing. Uncertainty is very high, but there are reasons to be optimistic that the crisis will not precipitate, and that this painful adjustment will restore more sustainable conditions in financial markets and support continued robust global growth.

It is also encouraging to note that emerging markets have weathered the crisis relatively well so far; this is perhaps particularly noteworthy in the case of central and eastern European countries which, with notable exceptions like Russia and Kazakhstan, do not benefit from high commodity prices.This resilience is an important testimony to the progress made by these countries in strengthening their economies, their institutions, and their balance sheets. It is also an encouraging sign of discriminating behaviour and attention to quality on the part of investors. CEE markets would of course not be immune if the crisis were to deepen, but they have already shown that the progress made is being recognized and is paying off in terms of enhanced stability.