

US Crisis in the Eyes of Thai Experts

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The US economy goes through a cycle of upturn and downturn. In each downturn, since the Great Depression of 1930s, the US financial system could, more or less, prove to have enough resilience to withstand the adverse environment. But in this round of down turn, the US financial system is teetering on the edge of a complete breakdown and is now being put on a life's support system by the Federal Reserve and Federal government.

Most people are now blaming capitalism or deregulation as the culprits of the US financial system collapse. But there is nothing wrong with US capital or deregulation. The problem has more to do with the US's failure of macroeconomic reading and US's failure of microeconomic management.

Thirachai Phuvanat-naranubala, the secretary-general of the Securities and Exchange Commission, explains that mismanagement at both the macroeconomic and microeconomic levels have brought about the US financial crisis. At the macroeconomic level, the US government has been stuck in the overconsumption mode for several decades since the Reagan years.

Macroeconomic misreading

Reaganomics – still now being subscribed by hard-core Republicans – prescribes tax cuts for across the board in order to put spending in the hands of the corporates or the families. Once the private sector spends the money for investment and consumption, it would help drive the economy. In turn, the government would pick up more tax than the revenue loss of tax cuts it had undertaken.



Reaganomics is dead.

The virtuous cycle of Reaganomics has never been realised. As a result, the Federal government has been running budget deficit all along because it can't collect enough tax to meet the spending obligations.

The Federal government has therefore automatically been pushed into the overconsumption mode, spending future money beyond its tax collection ability.

On the US consumers' side, there is also overconsumption. Thirachai explains further that the emergence of China has exerted enormous impact on the global economy unseen over the past 100 years.

China has become the world's manufacturing base by the sheer size of its economy of scale.

"China's opening up its economy has an impact of once in one hundred years, similar to the US impact to the world's economy in the 19th century," Thirachai said.



Thirachai: Super Bubble

Most US economists and policy-makers have underestimated the China factor, which has been flooding the world's markets with cheap manufactured goods and products. China had been a closed economy for a long time. It only started to open up in 1979.

With a population of more than one billion mostly living under poverty, it has been able to continue to keep low wage for a sustained period because there is new labour going into the market all the time.

US retail and department stores are locked up with Made in China products, which have in turn caused a huge black hole in the US trade balance.

Since the Chinese-made products are cheap, they help to keep the global inflation and the US inflation artificially low. Alan Greenspan, the former US Federal Reserve chairman, attributed the US low inflation to higher US productivity when in fact it was the China factor that helped artificially contain US inflation. Greenspan went on to engineer a low interest rate environment, in spite of bubbles in the hi-tech industry and housing industry.

The US consumers also went into top gear of spending, made possible by the availability of cheap credit. The housing prices had gone up sharply for over a decade.

About six years ago, Paul Krugman, the Nobel Prize laureate, came over to Thailand to speak about the global economy. He said then that the US housing was facing a bubble. "It's going to burst one day. But I don't know when?" he said.

The US financial institutions started to become complacent with easy credit. They had become overleveraged. The financial bubble took shape and waited to burst out.

When the US Federal government's overconsumption, the US consumers' overconsumption and US financial institutions' overleverage were combined, we could only witness a Super Bubble unseen since when God created this planet.

Lax management of the financial institutions

Apart from the macroeconomic misreading, the US also suffered badly at the mismanagement of the financial institutions. The problem stems from poor regulation in the mortgage loans that eventually spilled over into the financial system. There are now about 20 million homes facing mortgage problems.

First, borrowers were entitled to 100 per cent mortgage loan to buy new houses without having to put down any instalments.

Second, lending institutions introduced teasing rates to attract borrowers. In this respect, borrowers were charged very low interest rates in the first few years of the mortgage loan contract before the mortgage rates were brought up later. Many could not pay when the rates started to go up to reflect the market rates.

Third, there was no due diligence. The borrowers' financial backgrounds were not cross-checked by the lending institutions, who allowed the borrowers a free hand to declare their assets and incomes. Subprime borrowers came to the scene.

Fourth, the home-builders also extended the loans. This was a conflict of interest. Since they built the homes, they were more inclined to sell and give out the mortgage loans quickly.

All of these factors happened when housing prices had been rising sharply for over a decade. This created a feel-good factor among the borrowers, the lenders, the investment bankers, the credit rating agencies that even if the borrowers could not pay the mortgage, the houses could be foreclosed at higher prices.

The investment banks or the like of Lehman Brothers stepped in to make money in a crazy way. From the housing loans, they bundled them into mortgage-backed securities to help carve out the risk of the mortgage lenders.

From mortgage-backed securities came Collateralised Debt Obligations (CDOs). The CDOs are complex financial products designed as a structure on top of a structure. They were very popular in the last four years because they were offered as an AAA rating and higher yield than that offered by other AAA

products. The CDOs appealed to the banks and investment funds.

The mortgage-backed securities are originally assigned with different ratings from Triple A, Double A, A, to Triple B as well as equity feature. Then they are bundled together with features of notes, cash, interest and principal into CDO tranches. These CDO tranches come with Class A, Class B, Class C, Class D, Class E and Equity (not rated).

The US investment banks sold the CDOs world-wide, while the rating agencies mixed the rating of these instruments similar to the ratings of the US treasuries. The selling point was that high-grade CDOs would face less chance of defaults against lower-grade CDOs because they were structured like a condominium unit. When the fire started, it would burn the basement first before damaging the higher floor.

When investors or banks were not confident with the risk of the CDOs, institutions such as AIG came up with Credit Default Swaps, which guaranteed the defaults of these complex instruments. Most European banks are now having high exposure to the Credit Default Swaps, whose volume total about US\$55 trillion. The European banks have to be bailed out by their respective governments because they have exposure to Lehman Brothers and also to the credit default swaps.

But with the economic downturn, most borrowers are finding that their debts are higher than their equity.

This means that even if they can sell their houses, they can't get enough money to pay for the mortgage loans. The defaults of the home borrowers have brought about the collapse of the entire financial house of cards. All the ratings mean nothing.

The US investment banks were doing business with overleverage. Banks

normally can leverage only 12 times against their capital. But the US investment banks were leveraging more than 30 times. They had been making filthy money in good time and paying top bonuses to executives. But when the markets turned the other way, the leveraged financial institutions were falling like dominoes. That has resulted in a collapse of the interbank market.

Pongsak Hoontrakul, Senior Research Fellow at Chulalongkorn University's Sasin, warned that the vulnerability of the global financial institutions has created credit risk as they are facing forced sell.

This would further lead to stock market fall, tighter credit market and recession.



Dr Pongsak: Not liquidity crisis alone, but credit crisis

"Although the Thai banks do not have significant exposure to the US financial instruments, we also stand to get hit as some banks have already started to tighten their lending. Going forward, we need to stimulate domestic growth to keep the economy afloat while the world is going through the financial storm,"

he said.

Asian banks are less vulnerable to the global financial crisis because they have less exposure to the toxic financial products sold by US investment banks. Japanese banks, in particular, have moved to adopt Basel II banking regulation, making them cautious in risking their capital with the US financial instruments. European banks have yet to move to Basel II banking regulation. That's why they are most vulnerable now, with daily announcements of government intervention.

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