FROM SUB-PRIME TO SUBLIME DISASTER: IMPLICATIONS FOR THE CARIBBEAN REGION OF THE CURRENT FINANCIAL CRISIS IN THE USA / BY DR. MAURICE ODLE, ECONOMIC ADVISER TO THE SECRETARY-GENERAL, CARIBBEAN COMMUNITY SECRETARIAT, 18 SEPTEMBER 2008, GEORGETOWN, GUYANA

OVERVIEW/STRUCTURE

When I was given this assignment yesterday, I assumed that, despite the title, I would be expected to take into account financial market developments in other areas of the world besides the USA. My presentation will therefore take the following form:

• Origins of the Crisis

• The Meltdown and Regulatory Response

• Global Contagion Effect and Recession Tendencies; and

• Impact on the Caribbean's Financial and Non-Financial Sectors.

ORIGINS OF THE CRISIS

The financial crisis can be said to have resulted from a constellation of factors but the four main reasons were the spate of reckless borrowing; a perverse resort to predatory lending; an ignoring of the firewall between commercial banking and investment banking; and a very lax regulatory environment.

Home ownership has always been regarded as integral part of the American Dream, from the point of view of both psychic and physical satisfaction/comfort and the fact that it is a forced form of saving with a significant capital gain expected in later years. However, borrowing to accomplish these objectives was taken to an excessive level in the face of an aggressive promotion campaign by commercial banks, brokers and social activists, particularly in Latino, Afro-American and low income white neighbourhood areas. In the euphoria of "keeping up with the Joneses", there was considerable falsification of income in order to qualify for a loan to purchase homes whose prices had already escalated almost out of reach as a result of the housing boom.

As expected, low income earners would experience difficulty in making mortgage repayments. Some others, after a few years borrowed on the equity accruing on the house for consumption purposes. With the onset of the crisis and the plummeting in home prices, personal mortgage debt sometimes exceeded the value of the houses and many occupants found it rational, though painful, to default and walk away from their assets.

The phenomenon of predatory lending was an even greater contributory factor than reckless borrowing. Commercial banks and their broker agents decided that they would satisfy the pent-up demand in the low income communities (who were deemed to possess low credit worthiness scores) by offering adjustable or variable interest loans. Thus the lender would entice the borrower with both a meager down payment requirement and a low starting interest rate.

Unknown or not very transparent to many borrowers was the fact that the interest rate would explode upwards after a couple of years. While in hindsight this strategy was a risky one, the lenders obviously felt that the borrowers would do everything possible to retain possession of their homes and that, in the final analysis, the government would save the day. There was an inevitably high foreclosure rate and burst of the housing bubble.

The breaching of the firewall between commercial banks (to which governments have a 'lender of last resort' obligation) and investment banks (whose more risky role is that of underwriter, in addition to being asset manager and adviser) also contributed to the making of the crisis. Mortgage loans by the commercial banks were packaged in the form of mortgage backed securities and sold to the investment banks that further re-packaged and sold some of this to financial institutions in Europe and Asia. Thus the "credit default swap" type risk, a form of derivative, was being transferred down the line. The financial regulators seemed oblivious of the dangerous nature of this commercial bank-investment bank nexus and woke up too late. When foreclosures multiplied and the crisis escalated the investment banks found themselves burdened with depreciating assets and the threat of bankruptcy.

The lax nature of the regulatory regime in the financial sector, particularly with respect to the investment banking wizards in Wall Street, is a fundamental underlying factor which permitted the crisis to unfold. The paradigm that the market knows best and will always adjust and correct itself, with little need for rules and heavy handed corporate governance, is one continually preached by the vested interests (some of whom receive enormous salaries, bonuses and retirement/severance benefits) and their lobbyists and this is reflected in a spate of de-regulation beginning in the 1990s, along with the exercise of little oversight. The close and interlocking nature of the relationship between Washington and Wall Street is also reflected in the fact that President Clinton's Treasury Secretary, Robert Rubin, and President Bush's Treasury Secretary, Hank Paulson, were both CEOs of Goldman Sachs, the most prestigious investment bank on Wall Street.

Free reign was given to financial innovation (bordering on speculation) leading to a dizzying array of financial products which are complex and mesmerizing even for the regulators, who are continuously playing "catch-up".

MELTDOWN AND REGULATORY RESPONSE

For over a year, the federal authorities failed to recognize that a serious crisis was looming and merely encouraged lenders to delay taking foreclosure action, without offering direct assistance to those threatened with a loss of their homes. However, as the crisis escalated, the authorities were faced with something of a Hobson's Choice: they could do nothing and risk a deepening of the crisis and possible total collapse or they could risk intervention by the Treasury and the Federal Reserve Bank, with the taxpayer picking up the huge tab. However, the latter action involved an element of 'moral hazard' in that a financial firm which is bailed out is likely not to heed the lesson and may be prone to repeat the same irresponsible practices in the future.

When the USA authorities did intervene, they did so in a big way as is seen from the following:

• In March 2008, the Federal Reserve Bank provided funds and guarantees for J.P. Morgan Chase to purchase Bear Sterns, a prominent investment bank.

• In July 2008, the assets of Indy Mac Bank, the largest mortgage lender were taken over by the Fed

• In September 2008, the US$5 trillion colossus institutions, Fannie Mae and Freddie Mac, the backbone of the mortgage market with more than half of all holdings or guarantees, were largely nationalized

• Whereas the investment bank, Lehman Brothers, was allowed to go under, being mired in debt beyond the stage of redemption, American International Group (AIG) was given a $85 billion collateralized loan by the State (at 11.3% interest) since it was deemed too big to be allowed to fail, given its critical world-wide insurance role.

What is critical to note from a regulatory point of view, is that for the first time a Central Bank (the Fed) had become a 'lender of last resort' to investment banks, in addition to its more traditional role of lending to the less risk taking commercial banking sector.

The crisis has therefore so far resulted in three of the five largest Wall Street investment banks going under (the third investment bank, Merrill Lynch, was actually taken over by Bank of America for US$50 billion) and a total outlay of about US$800 billion to rescue the financial system. An equal sum might be required to be further disbursed by the State before confidence returns to the market. The experience is a very sobering one for both the risk taking financial firms and the role of the State and only the future will tell whether we will continue to witness a situation of 'privatized profits but socialized losses'.

GLOBAL CONTAGION EFFECTS AND RECESSION TENDENCIES

The packaging and re-packaging of the sub-prime debt (in "derivatives' style) and sale to financial institutions around the world was the original medium of international transmission of the crisis. Those adversely affected included Northern Rock in the UK, BNP Paribus in France, Credit Swisse and UBS in Switzerland, Deutsche Bank in Germany, Banca Marco in Spain, Bank of China, and a number of financial companies in South Korea, Australia and New Zealand (where 23 companies have so far filed for bankruptcy). Halifax Bank of Scotland, Britain's biggest mortgage lender, is currently in talks with Lloyd’s TBS, the country’s fifth-largest bank, on either a merger or an acquisition deal.

The crisis in the financial system and the general loss of confidence inevitably spilled over into the real sector which suffered from a drying up of credit. This drying up of credit first hit the housing construction sector and then impacted on producers of household appliances, furniture and electronic equipment in a typical multiplier effect, inter alia, thus exacerbating the effects of the energy crisis and high oil prices, with unemployment rising beyond 6%. The woes of Main Street began to rival those of Wall Street.

The economies in the more developed parts of the outside world were also faltering badly. For example, in Japan, exports in June declined for the first time in about five years. In South Korea, auto exports fell, as did home appliances, and in Taiwan exports of electronic products declined. The less industrialized of the developing countries tended to be much less directly affected.

IMPACT ON THE CARIBBEAN'S FINANCIAL AND NON-FINANCIAL SECTORS

Given the inter-dependent nature of the global economy, it would be surprising if the Caribbean were not in some way affected by the crisis. The intensity of such an impact would tend to vary considerably from sector to sector.

(i) Financial Sector

The financial sector in the Caribbean is fairly insulated from the current global crisis, partly because it is small and underdeveloped and so mortgage backed securities were not dumped onto their market by the USA investment banks. But in the case of AIG there can be said to be a direct connection, since that firm has insurance and re-insurance coverage for a number of products and services in Jamaica and Trinidad and Tobago, inter alia. However, the massive loan by the USA Government may serve to keep AIG afloat, although customers may be asked to pay a higher premium. Also Merrill Lynch is known to be the manager of certain Caribbean pension funds (e.g. that of the CARICOM Secretariat) which prompts the question as to whether the ‘minimum local assets ratio’ regulation, a requirement for both prudential and regional capital market development purposes, is still being respected by the institutional investors (including insurance companies) in the non-commercial banking sector.

The commercial banking sector in the Caribbean is fairly tightly regulated, particularly since the occurrence of the debacle in Jamaica in the 1990s. Also, the managers tend to be rather risk averse. So far, they have not sounded any alarms partly because the USA correspondent banks that handle their day-to-day dollar transactions, being commercial banks rather than investment banks, are on the periphery of the crisis. However, it would be well if the regulators in the Caribbean region follow the example of Jamaica and

Trinidad and Tobago and decree that commercial banks hold deposit insurance, moral hazard not withstanding.

(ii) Foreign Exchange Reserves

The Caribbean Central Banks have about US$20 billion invested abroad as foreign exchange reserves. These “sovereign wealth funds” earn income when invested in government bonds, corporate bonds or equity and earnings would therefore have fallen as a result of the crisis. In the case of Trinidad and Tobago, the reserves are said to be managed by a subsidiary of Lehman Brothers, which is a USA investment bank that has filed for Chapter 11 bankruptcy protection.

The crisis will probably prompt a review of the Caribbean foreign exchange reserves holdings strategy. First, should all of a country’s foreign exchange reserves be managed by one overseas investment bank or be denominated in one international currency? Second, are the foreign exchange reserves adequate in a world that continues to be rattled by recurring financial crises? After the 1997-98 S.E. Asian financial crisis, the Central Banks in the Caribbean region made a conscious attempt to increase their foreign exchange holdings above the traditional three (3) months import cover figure and some now have over five (5) months import cover. Trinidad and Tobago, for its part, has also placed US$9 billion of its petroleum and gas earnings into a Heritage and Stabilization Fund.

(iii) Cost of Borrowing

There is a credit crunch in the markets of the developed countries as loans are either not available or available at a rather high rate of interest. Caribbean entities, whether government or corporate, that attempt to tap the international market, will therefore experience some difficulty at this time, even for those with a very good credit rating.

However, in recent years, Caribbean Governments and corporate entities have been securing financing for an increasing proportion of their debt from the surplus economy of Trinidad and Tobago, where the rate of interest, moreover, tends to be lower than the international rate.

(iv) Flow of Remittances

With rising unemployment, falling house values and depreciation of other asset holdings, remittance flows to the Caribbean are expected to fall significantly as a result of the financial crisis.

In 2007 remittances from the USA alone were cited as Jamaica US$1.9 billion, Haiti US$1.8 billion, Guyana US$424 million, Trinidad and Tobago US$125 million, Suriname US$115 million and Belize US$105 million. Remittances have become a crucial source of income for some of the Caribbean countries. For example, in Guyana they represented 43% of the GNP, and in Haiti 35% and Jamaica 18%. These figures are likely to fall considerably for 2008 and the poor and most vulnerable segments of the Caribbean population are likely to be severely impacted. Retail establishments and related consumption sectors will accordingly experience a decline of activity.

(v) Tourist Arrivals

The energy crisis and related high oil prices continue to cause serious air-lift problems for the Caribbean tourism sector as a result of a collapse of certain airlines, elimination of certain destinations, reduction in the frequency of flights and increases in airfares. In addition, there is the adverse effect of a reduction in the baggage allowance. The situation is now further aggravated by the financial crisis with fewer persons being able to afford holidays abroad. This coming winter season is therefore expected to be a rather bleak one for the hotel and entertainment industries.

A double whammy is that the increasing trouble for the tourism industry will come on top of the adverse impact of the spate of natural disasters that some Caribbean countries have been experiencing this hurricane season. Those who contribute the least to global warming are the ones most adversely affected and the time has come for the setting up of a World Bank Grant Disbursing Facility for disaster relief purposes.

(vi) Other Export Earnings

The intensification of the crisis adversely affects USA demand for Caribbean manufactured goods whether these enjoy preferential market access (CBI/CBTPA) or not. The Caribbean dollar tends to be tied to the USA dollar and so when the latter fell in the early stages of the crisis Euro and Pound earnings from commodity (and tourism) sales to Europe partially compensated; however, now that there is tending to be a currency realignment, this is no longer the case. In any event, if the deepening of the crisis is prolonged, European demand for our traditional exports (bananas, sugar, rice, etc) will fall, as well as demand by China, Russia, etc for bauxite resources. Two other commodities worth mentioning are petroleum and gas, and gold; Trinidad and Tobago’s earnings have fallen from the dizzling heights reached during the energy crisis, whereas, Guyana and Suriname would have benefited from a rise in the price of gold, a commodity to which speculators gravitate in times of financial crisis.

One other export adversely affected is that of capital. For decades, there has been an unspoken low intensity flight of capital (‘reverse remittances’) to mainly the USA, Canada and Britain by businessmen and individuals wishing to hedge their bets against socio-economic and political instability in the Caribbean. Such holdings of stocks, bonds and real estate would have experienced a drop in earnings during the crisis, although these assets are typically held for the long haul and should eventually recover in value. Whether the capital flight slows down is left to be seen.

(vii) Foreign Direct Investment

The year 2008 is expected to show a decline in foreign direct investment (FDI) as occurred after the 9/11 event in 2001, particularly since the USA accounts for a large share of FDI in the Caribbean. Because of the credit crunch (and fall in the level of economic activity) investors would not have the level of capital or business confidence that would be required to engage in large projects of a natural resource or hotel construction and infrastructure nature. One exception would be exploration and drilling activity in the area of petroleum and natural gas. Accordingly, FDI in the Caribbean in 2008 is likely to be less than the 2007 estimate of US$4.5 billion or the actual 2006 figure of US$3.8 billion.

Although FDI per capita has been relatively high in the Caribbean, there is now need for a redoubling of investment promotion efforts and greater geographical diversification of the sources of investment inflows. In addition, intra-Caribbean investment should be more vigorously encouraged.

(viii) Growth Rate

Because of the abovementioned factors, economic growth in the Caribbean is likely to be significantly lower than what it was in 2007. For the year 2007, the Caribbean Development Bank (CDB) had reported that economic growth slowed in nine (9) territories and accelerated in only four (4). For the Caribbean as a whole, therefore, economic growth fell from 6.9% in 2006 to 3.9% in 2007 as a result of rising oil and commodity prices, slower growth by major trading partners, depreciation of the USA dollar and the high cost of intra-regional travel. When we factor in the worsening global financial and economic woes, the growth rate in 2008 will likely show a 1-2% fall.

CONCLUSION

The current crisis is not the only one that has occurred in the USA in recent memory. In 1989-91 there was the Savings and Loans Crisis and in 1998 there occurred the Long Term Capital Management Crisis which involved hedge funds, another exotic derivative type product. But the current crisis is the first since the 1929-33 Depression to involve simultaneously many countries in the developed world, a product of both globalization and post Bretton Woods regulatory laisser faire.

But it is in the emerging market economies of the semi-developed world that financial crises have been most frequent, yet almost invariably localized. Crises occurred in Mexico in 1982, in Chile in 1985, in Turkey in 1994 (and again in 2000), in Mexico again in 1995, in S.E Asia (starting with Thailand and spreading across the sub-region) in 1997-98, in Russia in 1998 and in Argentina in 2001-2. Almost without exception, a factor contributing to the crisis was the herd like withdrawal by rich country investors of short-term capital (portfolio investment) from these emerging market economies at the first sign of economic instability.

These crises have prompted calls for a New International Financial Architecture but the emphasis by the IMF has been on trying to introduce rules to restrict the economic policy space of decision makers in the emerging market and developing economies (eg. prevention of exchange control on capital account and mandating “tax havens” to have transparency and effective exchange of information) rather than to curb the footloose nature of foreign capital. The systemic weakness of today’s financial system, with its boom and bust propensities, is therefore at two levels – within domestic jurisdictions and cross-border.

In the current circumstances, all that the Caribbean can do is to act prudently and defensively, utilize whatever counter cyclical measures are available, explore further avenues for product and market diversification to mitigate external shocks, and deepen the regional integration process so as to both maximize strengths/minimize weaknesses and reduce our excessive exposure to the outside world.

* Presentation made by Dr. Maurice Odle, Economic Adviser to the Secretary-General of CARICOM at a Staff Seminar on Thursday, 18 September 2008, at Turkeyen, Greater Georgetown, Guyana