The U.S. as an Emerging Market
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Economists continue to search for useful historical analogies for the unprecedented financial crisis in the United States. Is the right analogy the 1930s, when prices collapsed, half of all U.S. banks failed and houses lost a third of their value? Or is it the 1970s, when inflation accelerated despite a stagnant economy?

While both analogies have featured in the financial press, neither is on the mark. There have been a handful of spectacular investment- and commercial-bank failures, from Bear Stearns to IndyMac Bank and – in the UK – Northern Rock, but they remain far fewer and their economic repercussions have been less severe than in the 1930s. Mindful of that history, Chairman Bernanke's Fed has been quick to grant access to the Fed's credit facilities to virtually any financial institution in need. Consequently there has been no collapse of commodity prices or economic activity like that of the 1930s.

But neither has there been inflation comparable to the 1970s. As soon as indications surfaced this summer that inflation might become unanchored, the Fed signaled that there would be no further easing of interest rates. U.S. unemployment may have broken through 6 per cent., but this remains a pale shadow of the double-digit unemployment experienced in the late 1970s and early 1980s, much less the 25 per cent rate reached at the depths of the 'Thirties Depression.

The best analogy, both for thinking about how we got here and imagining the future, is neither the 1930s nor the 1970s but the Asian financial crisis of 1997-8. Bizarre as it may seem to suggest that the United States, with its high incomes and sophisticated financial markets, is just another emerging economy, the parallels are clear.

The Asian crisis was first and foremost a crisis of inadequate transparency. Few Asian banks provided up-to-date estimates of their nonperforming loans. Few firms published accurate quarterly statements. In the run-up to the crisis, investors poured money into loss-making banks and firms without knowledge of their true condition. Hence when stories began to circulate about insolvent banks and firms, those rumors took on a self-fulfilling quality. The Subprime Crisis in the U.S. is similarly a crisis of inadequate transparency. Financial engineers concocted the most opaque imaginable instruments, slicing and dicing the cash flow from residential mortgages into CDOs, CDOs squared and worse, to the point where no one had the slightest idea as to the credit quality of the underlying claims. Thus when questions arose about the worth of those instruments, the race to sell was on.

The Asian crisis was also the result of lax bank regulation leading to excessive leverage. Thai and Korean banks bet borrowed money, rather than money of their own. When doubts arose about their condition, the ability to borrow evaporated, and a devastating deleveraging occurred. The problem in the U.S. has also been one of excessive leverage, with investment banks leveraging their capital 24 times on average and Fannie Mae and Freddie Mac leveraging their capital an astounding 60 times. This allowed them to place bigger bets. That they were gambling other people's money encouraged them to take more risk. And once the process moved into reverse, deleveraging had devastating consequences for the economy.

The Asian crisis was also a crisis of crony capitalism and connected lending, where the politically influential enjoyed privileged access to borrowed funds. In the U.S., Freddie and Fannie similarly enjoyed privileged access to the money market as a result of their political connections. The GSEs were famous for employing the most effective lobbyists on Capitol Hill. If this is not connected lending, then what is?

Another element in the Asian crisis was implicit government guarantees which convinced banks that they were too well connected to fail and encouraged them to take still greater risks. The parallel with Freddie and Fannie is too obvious to belabor.

The stage for the Asian crisis was also set by an overly accommodating monetary policy that fed a credit boom. The credit boom was allowed to spill into the construction sector, which left in its wake the unfinished high-rises dotting the skyline of Bangkok. In the U.S., cheap credit financed unfinished residential subdivisions rather than unfinished office buildings, but the underlying economics were the same.

A final element in the Asian crisis was that local savings did not keep pace with local investment. The Asian countries as a group relied on borrowing from the rest of the world. This exposed them to capital-flow reversals when confidence was disturbed. The U.S. has similarly relied on borrowed funds. The question now is whether the foreign money will keep flowing given that the U.S. is no longer seen as a producer of high-quality financial assets.

If this diagnosis is accurate – that the causes of the Subprime Crisis resemble the causes of the Asian financial crisis – then what implications follow for the future? First, it is naïve and ultimately dangerous to pretend that, by careful analysis and hard work, policy makers can eliminate the threat of financial instability. Financial markets are fragile and unstable by nature. They are unstable because they are markets in information, and information is intrinsically asymmetric and incomplete. Investors – including even big institutions with positions in residential-mortgage-backed securities and collateralized debt obligations – understand only imperfectly the risks of their portfolios. When they see other investors scrambling out of particular assets, they fear the worst and scramble out themselves. Unfortunately, just as in the case where someone yells “fire” in a crowded theatre, not everyone can exit at the same time.

The idea that central banks and governments can eliminate this kind of erratic behavior by committing to price stability, regulating banks more rigorously, and requiring greater corporate and financial transparency flies in the face of centuries of human experience. Financial markets may be continuously improving their capacity to acquire and process information, but the information environment in which they operate is becoming ever more complex. Uncertainty, herd behavior, sharp corrections and, in the worst case, panic will always be with us, no matter how hard we push ahead with reform. The reforms that follow the current crisis, however useful, will not make the crisis problem disappear.

Second, the analogy with the Asian crisis suggests that we are more likely to see incremental than radical reform. Following the 1997-8 crisis, which was a devastating shock to a set of Asian economies accustomed to miracle growth, pundits forecast radical changes in the international financial architecture. Hedge funds, they predicted, would be reined in or abolished. Controls on capital flows would be re-imposed. A new global exchange rate system would be established. Of course, none of this came about. The existing system was simply too deeply embedded to be ripped out root and branch. Its components were too interconnected to replace any one without also replacing the others, something that proved beyond the grasp of even the most ambitious reformers.

What followed instead was a series of incremental changes. Emerging markets enhanced the independence of their central banks. They adopted somewhat more flexible exchange rates. They sought to strengthen corporate governance and financial transparency. They upgraded supervision of their banks. They invested in developing local bond markets. They chose to run their economies under less pressure of demand in order to accumulate international reserves. That these were incremental reforms is not to denigrate their importance. These steps are part of what has insulated Asia so successfully from the Subprime Crisis. But they fall far short of the kind of revolutionary changes predicted by some critics of the global architecture.

This experience suggests that we will now once again see incremental rather than radical reform. U.S. officials will tighten their oversight of mortgage brokers. Investment banks will be brought into the supervisory net. The credit rating agencies will be scrutinized more intensely – as Andrew Cuomo, attorney general of New York State, the rating agencies' home base, has already begun to do. But we will not see radical changes. Existing arrangements are simply too deeply embedded to be ripped out root and branch.

Third, we will see, starting in roughly 2010, a reasonably robust economic recovery in the United States. Asia, following its crisis, experienced a v-shaped recovery, with output rising strongly from its 1998 trough. While there were deep problems in the financial system still to be resolved, Asia also had a great deal of idle productive capacity as a result of its recession, capacity that could now be put back to work. And the fundamentals that had long supported economic growth – low-cost labor, high savings and competitive exchange rates, among others – remained in place. The U.S. similarly hasn't lost the flexible labor markets, well-developed venture capital industry, and close university-business collaboration that have powered its growth in recent years. It too will bounce back.

But U.S. growth in the longer run may be somewhat slower than that to which we have grown accustomed. A lesson drawn by Asian governments from their 1997-8 crisis was the importance of following more prudent policies to prevent financial instability from recurring. Governments forced their banks to hold more capital and exercise more caution when lending. They sought to limit current account deficits. As a result, investment and growth rates in Asia have been lower than before the crisis – except in China, of course, which was not one of the casualties of the Asian crisis and, as always, is a special case. It is likely that the U.S. now will similarly keep a tighter rein on its banks. Finance will therefore be harder to come by, and American firms will have to pay more when borrowing. As a result, investment and growth rates may slow relative to the halcyon days of the second half of the 1990s and the first half of the current decade.

Finally, the U.S. will stop preaching about the superiority of its financial system, as it did so self-righteously after the Asian crisis. The U.S. financial system in fact suffers from many of the same weaknesses as emerging financial systems, although these may not be as dramatic and clearly evident to the naked eye. The U.S. would do better to fix the problems with its own system before again seeking to export it to the rest of the world.

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