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U.S. DEPARTMENT OF THE TREASURY

Press Center

Under Secretary for International Affairs David H. McCormick Remarks to the Better Hong Kong Foundation

10/22/2008

HP-1230

Financial Turmoil and the Global Economy

Hong Kong – These are unprecedented and difficult times for the global economy. The world's financial market conditions are severely strained, and risks to the global growth are significant. The largest advanced economies are feeling this most acutely. In the United States, our financial markets are experiencing unprecedented challenges, and this is adding even greater pressure to our already slowing economy.

These developments are affecting the entire globe. Emerging market countries in recent years, including those in Asia, have made impressive strides in strengthening their fundamentals, accelerating their economic growth and cushioning themselves against external shocks. Nevertheless, as the events of the past several weeks have shown, emerging markets like China are not immune from the global financial stress. Even financial markets with little direct exposure to mortgage-related assets risk becoming destabilized by diminishing market confidence and slowing export growth. Because we are all affected by this crisis, we must work together to address this instability and restore the health of the world economy.

Over the past two weeks, we have witnessed an unprecedented international response to this financial turmoil. The Group of Seven industrialized countries have announced and are implementing a coordinated action plan to stabilize financial markets and restore the flow of credit. Others around the world, from Hong Kong to Denmark, have adopted similar approaches. Together these countries are taking steps to provide liquidity to markets, strengthen financial institutions, prevent failures that pose systemic risk, protect depositors, and enhance confidence in financial institutions. While financial markets have responded positively in some ways to these unprecedented efforts, much work remains.

Today, I would like to share my views on how we arrived at this place, what the United States is doing to address the turmoil and suggest some possible early lessons for both the United States and China.

Root Causes of the Market Turmoil

How did we get to this point? The story begins with a decade of benign economic conditions marked by low interest rates, low inflation, and less volatile asset markets, leading many to ignore the "risk" half of the risk-reward equation at the heart of financial markets. Investors around the world, who in preceding years had enjoyed above-historical returns on most assets, continued reaching for ever-higher gains. In response, the financial-services industry created a variety of complicated new financial products to meet this demand, and regulators and investors alike showed a growing complacency toward risk. These factors, blended together, created underlying conditions ripe for instability.

The imbalance between risk and reward was most evident in the U.S. housing market, where lenders significantly loosened credit standards, particularly for a new generation of adjustable-rate mortgages. Last summer, these vulnerabilities in our financial system became clear, as looser credit standards in the housing market combined with an end to rapid home-price appreciation led to a significant rise in delinquent mortgages. This in turn contributed to immediate and unexpected losses for investors and a reconsideration of the risk-reward relationship--first in housing, and soon after, across all asset classes. Shaken investor confidence in housing assets had a domino effect throughout world markets, ratcheting up demand for cash and liquidity, and curtailing the pace of the new lending and investment necessary for continued growth.

Actions to Mitigate Risk and Stabilize Markets

Recognizing the risk of the housing downturn to the U.S. economy, the Bush Administration and Congress have taken a number of steps, including a $150 billion stimulus package, to help mitigate the impact on the real economy. Progress in the financial markets has been uneven, and additional challenges clearly lie ahead.

In formulating a response, we initially acted on a case-by-case basis to address deteriorating financial conditions in a number of financial institutions. In March, the Federal Reserve took unprecedented action to ensure an orderly resolution for Bear Stearns, and in September, authorities around the world took steps to mitigate the impact of the bankruptcy of Lehman Brothers, America's fourth largest investment bank. That same week, the Federal Reserve provided funding to American International Group (AIG) to address the systemic risk that would have resulted from a sudden collapse of the firm. Several weeks later, the FDIC facilitated JPMorgan Chase's acquisition of the banking operations of Washington Mutual, one of America's largest retail banks.

In each of these cases, policymakers attempted to strike a careful balance of promoting market discipline while mitigating systemic risk, holding investors and management teams accountable while protecting blameless consumers from collateral damage.

We have sought to achieve a similar balance in the cases of Fannie Mae and Freddie Mac, which are of particular interest to investors around the world, including here in China. These Government Sponsored Enterprises (GSEs) are the largest sources of mortgage finance in the United States, affecting roughly 70 percent of mortgages originated. Not surprisingly, the prolonged housing correction weakened their financial condition, and both institutions faced a loss of investor confidence. Fannie Mae and Freddie Mac are so large and interwoven in our financial system that the failure of either would have far reaching effects on the U.S. and global economies.

This past summer, investors began to express growing concerns over the stability of Fannie and Freddie and the ambiguity over the scope and certainty of government support for these institutions. In response, Secretary Paulson asked Congress for certain authorities regarding Fannie Mae and Freddie Mac in order to help stabilize and support our financial and housing markets. Congressional leaders acted promptly and decisively with the needed legislation. In the days and weeks that followed, the FHFA, the government regulator responsible for overseeing these institutions – placed both of Fannie and Freddie under temporary government control to allow for needed changes at both institutions.

In a complementary step, Treasury established contractual Preferred Stock Purchase Agreements with both institutions, committing up to $100 billion per institution to ensure that each GSE maintains a positive net worth, thereby protecting debt holders. These Preferred Stock Purchase Agreements are intended to address the underlying ambiguities surrounding the GSEs by explicitly demonstrating to the holders of Fannie Mae and Freddie Mac debt that the U.S. government will stand behind and protect their investments.

A Comprehensive Policy Response

Despite the hardening of the government's support for Fannie Mae and Freddie Mac, and the decisive resolutions of Bear Stearns, Lehman Brothers, AIG, Washington Mutual, and Wachovia, investors have become increasingly concerned over the possibility of other failing financial institutions. This has made them increasingly reluctant to extend credit and has resulted in the further tightening of our credit markets.

Sharp increases in the cost of credit for financial and non-financial companies, in the United States and globally, have increased the risk that corporations will be unable to roll over maturing debt. Given this fragile environment, U.S. authorities decided there was a need to act decisively and comprehensively to stabilize the markets and address the underlying sources of uncertainty. The four part plan rolled out by earlier this month seeks to achieve these goals.

First, central banks from around the world have acted together in recent months to provide additional liquidity for financial institutions. The Federal Reserve has established swap lines with a number of central banks to reduce pressures in global short-term U.S. dollar markets. Moreover, to further increase access to funding for businesses in all sectors of our economy, the Federal Reserve launched a Commercial Paper Funding Facility (CPFF), which provides a broad backstop for the commercial paper market by funding purchases of commercial paper of three month maturity from high-quality issuers.

Additionally, in early October, Treasury implemented a temporary guaranty program for the U.S. money market mutual fund industry, which had experienced funding problems. This temporary $50 billion guaranty program offers government insurance to address concerns about whether these money market investments are safe and accessible.

Second, we have taken steps to improve market operations and market integrity. For example, the Securities and Exchange Commission took temporary emergency action to prohibit short selling in financial companies to protect the integrity and quality of the securities market and strengthen investor confidence. The SEC's exceptional actions were joined by regulators in the UK, France, Germany, and other countries who also imposed restrictions on short selling. In addition, the SEC is aggressively pursuing enforcement action against market manipulation that may have occurred in previous months.

Third, with the support of Treasury and the Federal Reserve, the FDIC has temporarily guaranteed the senior debt of all FDIC insured institutions and their holding companies, as well as deposits in non-interest bearing deposit transaction accounts. These actions are specifically designed to unlock interbank lending by mitigating counterparty risk. Regulators will implement an enhanced supervisory framework to assure appropriate use of this new guarantee. This important action, combined with the increase in the FDIC's deposit insurance from $100,000 to $250,000, will provide confidence in the banking system and avert destabilizing capital flows between banks in the United States.

Finally, and perhaps most important, Treasury is acting to provide much-needed capital to address one of the root causes of the current stress in our financial system – the ongoing housing correction and the consequent buildup of illiquid mortgage-related assets. These troubled assets remain frozen on the balance sheets of banks and other financial institutions, constraining the flow of credit that is so vitally important to our economic growth. The failure to address this would mean that every aspect of our financial and funding markets, ranging from consumer credit to money market funds, would remain impaired.

On October 3, Congress passed and President Bush signed into law the bipartisan Emergency Economic Stabilization Act of 2008. The law gives the Treasury Secretary broad and flexible authority to purchase and insure mortgage assets, as well as equity securities, as needed to stabilize our financial markets. The law empowers Treasury to design and deploy numerous tools to fill the capital hole created by illiquid troubled assets.

As part of a carefully defined capital injection plan, nine major financial institutions, which comprise more than 50 percent of all U.S. deposits and assets, have already agreed to participate and will receive a combined $125 billion of capital and will grant the U.S. government minority stakes in return. These healthy institutions are taking these steps to strengthen their own positions and to enhance the overall performance of the U.S. economy. By participating in this program, these banks, along with others that will be identified in the future, will have enhanced capacity to perform their vital function of lending to U.S. consumers and businesses and promoting economic growth. These nine banks have also committed to continued aggressive actions to prevent unnecessary foreclosures and preserve homeownership.

We are also developing plans to add additional capital to reduce market uncertainty and encourage private investors by purchasing mortgage backed securities and whole loans off the balance sheets of U.S.-based financial institutions.

Together, these four steps significantly strengthen the capital positions and funding ability of U.S. financial institutions, enabling them to perform their role of underpinning overall economic growth. These actions demonstrate to market participants around the world that the United States is committed to taking all necessary steps to unlock our credit markets, minimize the impact of the current instability on the U.S. economy, and restore the health of the global financial system.

Much of this action is being coordinated internationally. The steps being undertaken in the United States are consistent with the efforts undertaken around the globe by others to provide liquidity, strengthen financial institutions, prevent failures that pose systemic risk, protect savers, and enforce investor protections. We welcome the policy decisions announced by European countries, Japan, Australia, and other nations around the world to stabilize their markets and ensure the health of their institutions.

Lessons for the Future

Since we are very much in the eye of the storm, it is difficult and premature to draw definitive lessons. Let me suggest four emerging themes that may be worth considering.

First, we have undoubtedly learned that our own financial system is in need of reform. To help rebuild the strength and confidence in our markets, the United States has worked to implement the findings of international experts in the Financial Stability Forum (FSF) and U.S. experts in the President's Working Group on Financial Markets (PWG). These bodies concluded that we must increase transparency, prudential regulation, risk management, and market discipline. Additional reforms of our regulations, regulatory structure, and international institutions will most certainly follow.

The Financial Stability Forum recommendations are applicable to the financial markets around the world, and my country is committed to implementing them in full. China can and should benefit from the lessons the United States and other countries have learned from the challenges in our financial markets, and we are happy to share them. It would be unfortunate if, as a result of this turmoil, policymakers in China mistakenly abandon their pursuit of financial sector innovation that has been so important to supporting China's growth in productivity and macroeconomic stability.

Second, it is clear that the current turmoil has exacerbated macroeconomic policy challenges the United States and China already faced as a result of structural imbalances in both economies. For the United States, this has made efficient management of fiscal policy an even more critical challenge. China's extraordinary growth has relied on exports and investment to fuel the economy, but this strategy may no longer be tenable in the face of a global economic slowdown.

As China's leaders recognize, their current growth model has created growing internal and external imbalances that need to be addressed. Strong domestic demand growth – with robust contributions from consumption and the services sector – provides the surest guarantee of both macroeconomic stability and sustained economic growth in the face of negative external shocks. Achieving strong demand-led growth is no small policy challenge. However, market-based pricing, including for interest rates and exchange rates, must play a central role in the process of allocating resources towards production for the domestic market.

Third, we have learned that our growth and prosperity is more dependent on one another than at any time in our respective histories. Openness to international trade and investment has been and will continue to be the linchpin of economic growth for the global economy. Policy makers around the world must therefore remain vigilant to guard against the inevitable short-sighted appeals for protectionism during this period of global financial stress. A central task for policymakers in both the United States and Asia is to embrace the aggregate benefits of openness to trade and investment while taking measures to ensure that opportunities to benefit from that openness are widely shared.

Finally, the recent crisis has highlighted the importance of continued cooperation among major economies through such fora as the G-20, the Financial Stability Forum, and the International Monetary Fund. As recent developments have demonstrated, the market turmoil is a global event. Governments around the world have taken actions to address financial market developments, and international cooperation and coordination has been robust. It is critical for governments to continue to take individual and collective actions to provide much-needed liquidity, strengthen financial institutions, enhance market stability, and develop a comprehensive regulatory response. We must closely coordinate our efforts within a common framework so that the action of one country does not come at the expense of others or the stability of the system as a whole.

Conclusion

Ladies and gentlemen, the interdependence of our global economy makes our current challenges more complex. It also makes our work with international counterparts to promote growth and financial stability all the more important. We should take faith from the fact that leaders in America and around the world are rising to this pressing challenge. In the United States we have faced and overcome enormous economic challenges like this before. From this crisis, too, I'm confident we will emerge stronger and wiser.

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