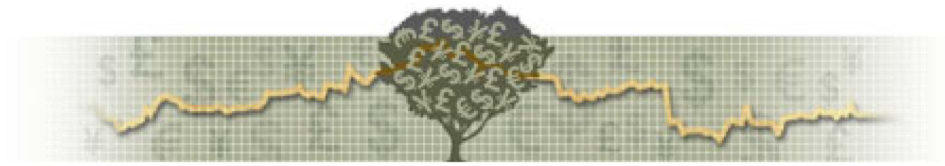
Economist.com GLOBAL AGENDA

Buttonwood

The perfect storm

Sep 6th 2005
From The Economist Global Agenda

It's not just natural disasters that need preparing for



BUTTONWOOD has not been so shocked by anything out of the United States since those photos from the late 1960s that showed tanks dominating the traffic circles of rioting Washington, DC. The images of New Orleans this past week looked like Baghdad on a bad day. But just as shocking were the botched relief effort and the state governor's warning that the National Guardsmen were ready and willing to "shoot and kill" rioters and looters; there are few things as disheartening as an elected government turning firepower on its own people to solve problems largely created by its own neglect.

That said, the rescue operation, however tardy, is now making a difference. Almost everyone has been extracted from the submerged city. Supplies of oil and petrol are being released from emergency stocks, some limited refining is resuming in the Gulf of Mexico, and the price of crude has retreated from last week's record nominal level. The first murmurs from Lloyds of London suggest that insured losses are likely to be manageable, and that the general firming of rates which will follow could be good for business. The betting in the futures markets is that the Fed will raise rates only once more this year, if that. Plenty of people point out that the reconstruction effort will in time produce an upward blip in economic activity. On this reading, the biggest casualty from the worst natural disaster in America's history may prove to be not its economy but its president.

But we cannot rely on this sanguine interpretation of the situation. High oil prices were already beginning to slow growth around the world and now American production has taken a huge hit. Consumers filling their tanks with petrol at $3 a gallon would have begun cutting back on other purchases anyway. Thanks to Katrina, a million of them have reportedly lost their jobs and will hardly be splashing out at Wal-Mart. And as long as the ports of New Orleans is out of action, it will be hard to move grains and soybeans south, and coal and coffee north, along the Mississippi. Risk Management Solutions, a consultancy, estimates that the economic loss from Hurricane Katrina, one way and another, will top $100 billion.

But there's a bigger issue here. If America could be so ill-prepared for a hurricane hitting what has long been called the Hurricane Coast, what else might we be missing? In this apocalyptic frame of mind, your columnist notes that there has been a recent spate of conferences, journal issues and whole volumes examining whether the financial system might be a tad fragile, should disaster strike.

Can that be right? Asset prices are rising and most measures of investor confidence are reasonably robust. Credit markets shook off the turbulence in May caused by the downgrade of General Motors and Ford. Hedge funds, which were thought to have tied themselves in knots with credit derivatives and convertible bonds, did not have to mount massive firesales of their assets and instead saw net inflows from investors in the second quarter. Corporate defaults remain well below their historical average. And stockmarkets stood up to terrorist attack in London in July.

Yet even the unflappable Bank for International Settlements (BIS) seems uneasy. In its quarterly report released on Monday September 5th, it gives warning that “the complexity of some products and the associated risk-management systems, the growing presence of leveraged players in credit markets and the possibility that investment strategies may be less diverse than anticipated make it difficult to predict how credit markets will function under more stressful conditions.”

And the IMF’s economic counsellor, Raghuram Rajan, puts it all too presciently in a new paper. While recent changes in the financial system have made it more stable most of the time, they may also have increased the possibility that it will be excessively unstable in really bad times, as well as increasing the chances that really bad times will occur. We will not know how big the risks are, or what to do to mitigate them, until the system has been tested. “The danger,” he writes, “is that before the economy is stress-tested, it will be hit unexpectedly by a perfect storm.”

The argument is that, over the past three decades, financial markets have changed profoundly under the impact of technology, innovation and deregulation. Banks have given way to markets as the main source of financing. At the recent heart of this process is the rapid growth of credit derivatives such as credit-default swaps, which make it easy for lenders to buy insurance against possible non-payment; and collateralised debt obligations, which allow credits to be bundled together and “tranched” to provide different investors with different risks and returns.

All this is broadly good. Risks are now borne by a bigger pool, with pension funds, insurance companies, mutual and hedge funds and others—in the end, mainly the household sector—taking much of the burden from banks. Because risks can be sliced and diced, they are more likely to end up where they belong. And there are now more sophisticated ways than before of measuring and hedging them. This expansion of the economy’s risk-taking capacity has helped firms and individuals (not to mention governments) to raise record amounts of capital at low cost.

But there may be some negatives to this. There is arguably a drift towards greater risk-taking overall, especially when interest rates are low, so the system has not become any safer and may in fact be less safe. Banks now securitise and flog to third parties their plain vanilla mortgages, keeping on their books the more complicated and less liquid assets that are harder to sell. When interest rates spike upwards, asset prices crash or for any other reason lots of investments have to be unwound in a hurry, banks may be looking for liquidity rather than supplying it to others to keep markets orderly.

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And another point: investment managers’ pay, unlike that of bank managers, is linked to the volume of money they attract. What better way to attract it than to run extra risks to goose up returns—especially long-tail risks that pay handsomely most of the time in exchange for the remote possibility of a cataclysmic wipe-out? That may be particularly true for hedge-fund managers when interest rates are low and they have to provide absolute returns for investors, not just returns that are better than some benchmark. And it is certainly true for managers struggling to fill funding holes in pension schemes. Small wonder that they are exploring the wilder shores of illiquidity these days, investing in private-equity deals, catastrophe insurance, fine art and the like.

Just as fund managers may try to take sneaky extra risks to stand out on the upside, they are famously prone to herding in order to avoid standing out on the downside—ie, underperforming the others. And when credit is cheap, herding can push up asset prices way beyond any fundamental justification, increasing the risk of a subsequent sharp correction.

All this is just conjecture—but it is conjecture that needs to be tested in order to get the regulatory framework right. For all the newish emphasis on “stress-testing”, both of individual firms and of the financial system generally, there are huge gaps: the BIS is not the only one to point this out. If there is one thing to learn from Hurricane Katrina, it is the importance of being prepared.

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