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Why there's a crisis—and how to stop it

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Special to CNN

Editor's Note: David Smick, a global strategic adviser, is author of the new book, The World Is Curved: Hidden Dangers to the Global Economy *(Penguin Portfolio). He is chief executive of Johnson Smick International, a financial market advisory firm based in Washington. It publishes* The International Economy *magazine.*

WASHINGTON (CNN)—At this point in the credit crisis, at least one thing is certain: most policymakers lack a clue of what is really at stake. Those with some knowledge are driving policy looking through the rearview mirror.

Begin with the U.S. Treasury's $700 billion bailout package. This was presented as some magic pill which, if gulped down, would quickly restore financial stability.

The "shock and awe" of the sheer size of the taxpayer-funded bailout would somehow restore confidence. Instead, stock markets collapsed and credit markets remained frozen.

This is because the credit crisis reflects something more fundamental than a serious problem of mortgage defaults. Global investors, now on the sidelines, have declared a buyers' strike against the sophisticated paper assets of securitization that financial institutions use to measure and offload risk.

In recent years, our banks, borrowing to maximize the leverage of their assets at unheard-of levels, produced mountains of financial paper instruments (called asset-backed securities) with little means of measuring their value. Incredibly, these paper instruments were insured by more dubious paper instruments.

Therefore, the housing crisis was a mere trigger for a collapse of trust in paper, followed by a de-leveraging of the entire global financial system. As a result, we are experiencing the painful downward reappraisal of the value of virtually every asset in the world.

So what are these paper instruments, these asset-backed or mortgage-backed securities? I like to use a salad analogy. Before the last decade, bankers simply lent in the form of syndicated loans. But with the huge expansion of the global economy in the 1990s, which produced an ocean of new capital, the bankers came up with an idea called securitization.

Instead of making simple loans and holding them until maturity, a bank collected all its loans together, then diced and sliced them up into a big, beautiful tossed salad.

The idea was to sell (for huge fees) individual servings of diversified financial salad around the world.

The only problem: under an occasional piece of lettuce was a speck of toxic waste in the form of a defaulting subprime mortgage.

Eat that piece of salad, and you're dead. The overall salad looked delicious, but suddenly global investors were no longer ordering salad. No one knew the location of the toxic waste. This distrust heightened when global interest rates began to rise.

So what does this salad boycott mean for the future and why have financial markets collapsed so brutally? The markets are telling us the world will face a serious credit crunch in 2009 regardless of how much money government spends to remove the toxic salad from bank balance sheets.

Policymakers have no means of forcing the banks to start lending short of nationalizing the entire financial system. After all, the U.S. banks alone so far during the crisis have lost upwards of $2 trillion from their collective asset base.

Most banks are leveraged by more than 10 to 1. Translation: The U.S. financial system will have a whopping $15 trillion to $20 trillion less credit available next year than was around a year and a half before. The cost of money is rising and the availability shrinking.

True, the banks will still lend—but the fear is they will do it only to people such as Warren Buffett, who don't need loans. What is uncertain is the amount of lending to borrowers engaged in entrepreneurial risk, the center of business reinvention and job creation.

Apart from the economic pain resulting from shrinking credit markets, we are about to see an earthquake in the relationship between government and financial markets. The great uncertainty is whether government has the power to rescue the financial system in times of crisis. It seems doubtful.

In the United Kingdom, for example, the collected assets of the major banks are four times the nation's gross domestic product (GDP). A similar situation exists in many Euro zone countries. This means government cannot bail out the system even if it wanted to. Given such massive exposure, government guarantees in a time of crisis become meaningless.

Yet because of the interconnected web of global financial relationships, we are all vulnerable to the threat. The collapse of, say, a major European bank would hardly leave American workers immune.

Our policy leaders in Washington are thinking domestically when the solution to the credit crisis will be global. It is not that the world lacks money; it is that the world's money is sitting on the sidelines—more than $6 trillion in idle global money markets alone.

The challenge will be to reform our financial system quickly to draw that global capital back into more productive uses. The first step should be efforts to make the market for future asset-backed paper more transparent and credible.

We need a private/public global bank clearing facility. The bankers don't trust each other. The central banks, working with the private institutions in providing enhanced data, need to begin to refashion the world's financial architecture.

And while that is happening, the major governments of the world, including the Chinese, should begin major fiscal efforts to stimulate their weakening economies.