March 31/April 7, 2008, Volume 13, Issue 28

Confidence Game

A McCain agenda for financial recovery.

BY DAVID M. SMICK

The most dangerous time politically for John McCain is between now and Labor Day, when the GOP convention begins. Democrats, including 527-funded outside groups, will attempt to marginalize him on the domestic front. With the collapse in consumer confidence and the ongoing credit crisis, they will attack the Arizona senator (who admits he "knows nothing" about economics) as, economically speaking, a third term for George W. Bush. The charge will gather credibility as the U.S. economy continues to weaken.

During the Republican primaries, McCain scored points by talking about fiscal responsibility and with attacks on earmarked pork barrel spending. Yet as a general election approaches with the credit system at risk, speeches centering on budgetary bean counting sound strangely irrelevant. When the house is on fire, it isn't the time to do an inventory of the furniture in the front parlor. McCain needs to campaign on a set of bold economic policies.

Arriving at a set of policy solutions, however, won't be easy because the credit crisis has been resistant to conventional policy measures. In recent weeks, the senator has praised the Federal Reserve for its cuts in short-term interest rates, and he supported the bipartisan emergency stimulus package passed in early 2008. Yet these are little more than painkillers. They may lessen the severity of the subprime-related symptoms of the contraction of the credit markets, but they are inadequate in dealing with a problem in the financial system's very architecture. What is at issue for the next president is a problem that was brewing long before the housing bubble burst. At issue is a fundamental and increasing distrust of the asset-backed securities market, one of the main arteries of the global credit system.

For the past decade, the large global financial institutions have flooded the world with asset-backed securities where the "asset" is often a collection of securitized mortgages. Here's how the system works. Senior financial executives lump the mortgages into a pile, divide them into multiple interest-income streams, and for a fee sell them as mortgage-backed securities. The only measure of risk and value of these new securities comes from the credit rating agencies, which measure risk based on sophisticated mathematical models. In this new system, the lender therefore no longer has any connection to the lendee—or the need to worry about whether he or she will pay back a loan. For the bankers and investment bankers, the goal is no longer risk management but risk dispersion. A system of diminished transparency depends on the broader market's confidence that the mortgage-backed securities reflect a viable value. Today there is sudden, widespread distrust of these complicated financial paper assets.

Under normal conditions, the financial system would have relatively easily absorbed a subprime mortgage problem amounting to a mere $200 billion in securitized exposure in a global market worth hundreds of trillions. What the markets couldn't tolerate was the discovery of the legal but dubious system that banks and investment banks set up in the past decade to obscure risk—especially mortgage risk. It is the independent, off-the-balance-sheet vehicles (called conduits or structured investment vehicles) set up by the large financial institutions which triggered the credit crisis.

Why would a bank set up a separate vehicle where the parent bank is not even listed on the balance sheet as a primary beneficiary? One word: greed. The large financial institutions created their own private market—a kind of automatic, legal dumping ground of risk with the added bonus of enormous profits.

David M. Smick is founder of the market advisory firm Johnson Smick International and editor of The International Economy. *His book on financial market turmoil will be published this year by the Portfolio division of Viking Penguin.*

Confidence Game, CONTINUED

The large institutions brazenly encouraged their independent vehicles to buy the parent's mortgage-backed securities, some containing significant amounts of subprime exposure. Using these securities as collateral, the independent vehicles went to the global credit markets and borrowed by issuing commercial paper (unsecured short-term debt that is one of the backbones of the cash-like money market funds). When the housing bubble burst, the sudden strain in the commercial paper market put the independent vehicles in real jeopardy.

The parent banks hadn't counted on the fact that, in a global market, traders don't distinguish between the off-the-balance-sheet vehicles and their big parent banks. With the independent vehicles in trouble, the parent banks were seen as in trouble. Bank stocks collapsed, global credit seized up, and even ultra-safe money market funds were at risk. Investors, fearful of holding paper assets of dubious value, poured into short-term government bond markets and commodities, especially oil and gold, for the comfort of assets whose value can be physically measured.

The Federal Reserve confronted the crisis by trying to stabilize the broader market with preemptive interest rate cuts and other targeted means of channeling liquidity to the banks. Congress passed a stimulus package. But cutting interest rates can't make investors trust debt instruments where there is no connection to the lendee and where mortgage debt exposure is hidden in off-the-balance-sheet vehicles. Fiscal stimuli can't create buyers when confidence in the system of securitizing assets has disappeared. It took a decade for global markets to trust these new financial instruments. Even with reforms, the return of trust will take time. Recovery will be slow.

Last week the Federal Reserve stunned the world by placing the investment bank Bear Stearns and potentially other so-called "nonbank" institutions under the government safety net (allowing them access to the Fed's Discount Window, which was established during the Great Depression to allow banks access to emergency loans regardless of the quality of their collateral). With the Fed appearing to guarantee the entire financial system, not just the banks, we are entering a brave new world. Given the severity of the immediate crisis, it may be that the Fed had no other choice. But whether a blanket guarantee in the long run expands or restricts lending remains to be seen. Today the firms Fannie Mae and Freddie Mac enjoy an implicit government guarantee, yet investors are fleeing in droves. It is also unclear in a government guaranteed financial system what regulatory force can protect the public interest in the distribution of liquidity and the measuring of risk.

This is a treacherous situation, and it gives John McCain the opportunity to lead on the economic front. In today's globalized financial system, capital sweeps across national borders—and today that capital is questioning America's economic future. This is one reason the dollar is collapsing. Bankers have behaved badly. Given his track record, however, the senator will be tempted to demonize the financial sector and support new overregulation (after Enron, he supported the Sarbanes-Oxley legislation which has helped make London the world's financial center at the expense of New York).

Instead, McCain needs to call for a set of surgically precise reforms that avoid threatening the larger financial system as a wealth-creating force. The key is to make sure the United States remains an attractive destination for investment. A McCain policy must lead to greater financial transparency and a better understanding of the nature of market risk and dangerous financial leverage. It must call for the elimination of off-the-balance-sheet financial schemes as well as for a platform for standardizing the pricing of securitized assets.

Recognizing the international nature of America's economic agenda, McCain should call for a global summit to address issues of savings and trade imbalances along with currency relationships—with China, India, and the oil producers as central entities in the multilateral discussions. Most of all, to rebuild confidence in the U.S. economy, McCain needs to strike hard against today's rising protectionist and class warfare policies. During the subprime crisis, the charged political rhetoric calling for reopening of trade agreements and the restriction of capital flows has added psychological kerosene to an already raging fire of global distrust in America. Some of the recent demagoguery threatens the very heart of America's climate of entrepreneurial risk-taking. It borders on insanity.

Today the world economy is at a pivotal point. John McCain, positioning himself as an activist, caring, and imaginative leader on the domestic front, desperately needs to step forward. ◆