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ACT NOW TO STOP THE MARKETS' VICIOUS CIRCLE

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The credit crisis has produced an avalanche of problems and also of explanations. Some observers have stressed that it is mainly a solvency crisis; others that it is mainly a liquidity crisis.

It is becoming increasingly clear that it is both. Liquidity and solvency problems are now so much intertwined that trying to decide whether it is one or the other is counterproductive. When a hedge fund today is hit by a withdrawal (a liquidity problem) and is forced to sell assets, the price of its assets declines and a solvency problem is created. The liquidity and solvency problems of that hedge fund in turn are likely to lead other investors to withdraw (again a liquidity problem) leading to further price declines (solvency).

This interconnection between liquidity and solvency problems is embedded in the activities of banks and financial institutions that fund long-term investments with short-term loans. Withdrawals trigger solvency problems, which in turn become signals for further withdrawals, creating liquidity problems. There is a clear market failure here. Markets are fantastic instruments to coordinate economic activities without the need of a planner. Under normal circumstances, markets coordinate these activities towards a 'good' equilibrium that increases welfare. Once in a while they can also coordinate activities towards a 'bad' equilibrium that reduces welfare.

Banks, hedge funds and other financial institutions that borrow short and lend long contribute to welfare when withdrawals are random and independent from each other. The economy is then in a good equilibrium. Occasionally, as a result of bad news, or of foolish behaviour of some of these institutions, lenders withdraw their funds, thereby creating (or aggravating) solvency problems, which in turn lead to further withdrawals. The market then starts to coordinate lenders into massive withdrawals, leading to massive solvency problems at financial institutions that, without the withdrawals, would have been perfectly all right.

This perverse coordination by the market (some will call this a vicious circle) is made worse by the practice of 'marking to market' (the valuing of assets at market rates). The latter forces banks to take a loss in their balance sheets on assets that are caught by the liquidity-solvency spiral. They are forced to do so even if these assets are sound. Thus marking to market today accelerates the downward spiral.

The practice of marking to market, which was generalised as an accounting procedure during the 1990s, was influenced by the idea that financial markets are efficient. In this view, markets provide the best method to put a correct value on the financial assets. Markets are wiser than the judgment of individual bankers or accountants, it was said. That is right under normal circumstances, but not today, when markets are clearly driving towards a bad equilibrium. Markets are not always right. Today the accounting rule of marking to market is driving us at high speed into the abyss.

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A speed limit must be imposed. This can be achieved only by temporarily not allowing financial institutions to mark to market. This will make it possible to keep the assets on their books for a while at their previous values (or historic costs). In so doing, the spiral will be slowed down. Prices of many financial assets would recover because they are fundamentally sound. Their value is artificially pulled down by the liquidity-solvency spiral.

Slowing down the spiral will prevent more innocent bystanders from being caught by the whirlwind. It will, of course, not solve all financial problems. Confidence in the financial system must be restored so that the market can start coordinating again towards a ‘good’ equilibrium. This is not happening today. As a result, financial institutions desperately try to borrow long and to lend short, thereby squeezing liquidity and credit.

The Federal Reserve was right when it recently injected massive amounts of liquidity. It has no other option but to buy distressed assets in an attempt to put a floor on the downward asset valuation spiral that risks getting out of control. But that will not be enough. A massive overhaul of the supervision and regulation of the financial system will be necessary, especially in the US where a religious belief in the infallibility of markets has led the regulatory authorities, especially the Fed under Alan Greenspan’s chairmanship, to abdicate their responsibility to supervise and regulate markets.