**Reflections on Global Economic and Financial Developments**
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Financial globalization – marked by growing cross border flows and strengthening of financial inter-linkages -- has been on the rise. This has been supported by wave of financial and capital account liberalization world-wide accompanied by significant growth in financial engineering and innovation particularly in the area of structured finance. Process of financial globalization and integration in the last few years has further deepened as capital flows grew across the globe. Capital flow direction and dynamics changed as country's capacity to accumulate wealth grew. This was supported by the high savings rates in Asia and rise in revenues generated from oil and high export earnings that together resulted in substantial build up of the high Asian reserves.

Process of financial globalization has fostered economic growth and efficiency as capital mobility has allowed flexibility to countries to meet their financing requirements. At the same time, it allows investors with surplus capital to benefit from international risk sharing opportunities and enjoying higher returns as a reward for taking cross border risk. These developments nurtured global economic prosperity and the World now for some years has enjoyed benign global environment backed by a fair degree of macroeconomic stability. World economic growth in 2006 was cruising at 5.4%[1] powered by surge in consumption spending and was projected at 5.2% for 2007 and 2008 by IMF in July 2007.

Central bankers have played a crucial role in maintenance of macroeconomic stability through effective monetary tightening, while nurturing healthy domestic financial markets along with enhanced global monitoring and vigilance. This has helped keep the global financial markets fairly robust and stable.

Notwithstanding, concerns have been echoed regarding global economic and financial vulnerabilities. These concerns stemmed partly from the continuous widening of global economic imbalances now for almost five years whereby burgeoning US external current account deficit has raised following questions: whether U.S will face soft or hard landing? And whether the rest of the World is going to decouple from the United States slowdown? At the same time, there have been debates on how sustainable is it for U.S to continue financing its current account deficits from Asia's surpluses bulk of which are invested in US Treasuries. Aside from the significant

[1] IMF: *World Economic Outlook.* April 2007

dependence of US on Asia's investments in US Treasuries, an equally concerning factor is the sizeable economic interdependence of Asia on U.S consumption demand which has contributed to Asia export earnings.

To promote global economic stability and an orderly unwinding of these imbalances IMF has now launched Multilateral and Bilateral Surveillance Mechanism to assess the macroeconomic and of exchange rate vulnerabilities. IMF's Multilateral Consultation on Global Imbalances of five major countries [2] issued earlier in the year (prior to the financial market turmoil) concluded "that imbalances are now showing some signs of stabilizing, albeit at high levels……….as United States non-oil trade deficit narrowed by ¼ % of GDP in 2006 facilitated by some re-balancing of domestic demand – particularly strong growth in Europe, Saudi Arabia and weaker demand growth in the United States -- and the lagged effects of past dollar depreciation." It was expected that falling oil prices earlier in 2007 would simultaneously reduce excessive build up of reserves in oil producing economies but the process has been interrupted with the prices again on the rise.

In parallel to the economic vulnerabilities induced by global economic imbalances, analysts have raised concerns regarding growing financial vulnerabilities. This has been fuelled by a number of factors such as expansion in financial innovation backed by weaknesses in the scoring and rating mechanism, under pricing of risks and easy credit conditions in financial markets which together have raised risk appetite and exposures of financial industry. Furthermore, the spreading of risks through securitization and packaging of tranches of asset backed and mortgage backed securities and offloading these to investors through off-balance sheet transactions, CDO structures, and special vehicles such as hedge funds has encouraged excessive leveraging. Given the attractive returns on riskier assets investors have drifted into such investment without adequate assessments of the probability of defaults. In today's financially integrated world, a financial crisis or crunch in one segment of financial market has wider global consequences and could often lead to a contagion effect.

Initially, there has been a debate whether the explosion of "Alternatives" [3] defined to include commodities, hedge funds, real estate and private equity, estimated by JP Morgan 2006 paper to be close to $3 trillion as of 2006, would be creating the next bubble? While rapidly expanding and significant, JP Morgan study highlights that these alternatives constitute only 5% of the $60 trillion capitalization of the conventional asset classes ($38 trillion in global equities and $22 trillion of global fixed income). Aside from this, it pointed out that that thus far there were signs of an emerging bubble in energy commodities. It further states that US commercial real estate witnessed high prices and expensive valuations, but not enough speculative activity to completely

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[2] IMF: *Staff Report on the Multilateral Consultation on Global Imbalances with the United States, China, the Euro, Japan and Saudi Arabia*. 29 June 2007.

[3] Alternate to cash, bonds and equities.

qualify as a bubble. Meanwhile, there were strong inflows of private equity inflows and Investments in hedge funds as returns remained high, and the source of return is increasingly from beta exposures. Yet, alpha remains significant showing that return opportunities are still reasonable.

Since 2006, concerns had mounted regarding the housing sector and the sub-prime mortgage market and its adverse consequences on the local and world economy. This bubble did emerge in headlines early on in 2007, but problem eventually surfaced more blatantly in July 2007. Now for two months the markets have been in financial turmoil, albeit at different degrees depending on the level and nature of exposures, leveraging and quality of prevailing regulation. .

Mortgage market has now come under deep scrutiny given the approaches adapted to structure tranches of loans and packaging these in accordance with the type and nature of risks associated. Subprime mortgages, as the term implies, refers to residential loans that have lower expected probability of full repayment but carry high returns given associated high risks. Alt-A loans are flexible alternative to prime loans with former meeting by and large the credit scores, debt-service income ratios and loan to value ratios but lacking income documentation.

Development of U.S. mortgage markets is a milestone in financial history and its growth supported by several incentives including tax deductibility of interest payments, flexibility regarding down payments, adjustable rate mortgages, automated underwriting and securitization which helped disperse risks while offering investors high yield products etc. Supported by these incentives and trends in house prices, there was growth in nonprime and Alt-A mortgages. Nonprime mortgages were about 19-21% and Alt-A about 25% of the total mortgage market of close to $3 trillion.

The origins of sub-prime mortgage crisis lay in the housing boom when subprime market supported more aggressive borrowings. Since mid 2005, with rising interest rate and softening of house prices, home owners booked mortgage more and more on adjustable interest rate resets. Both home sales and residential construction slowed down. With the tightening of credit markets and impending rate-setting, the problem surfaced more visibly in sub-prime mortgage as delinquencies rose to 13 ½ % in June 2007 (though 5 ½ % for the fixed interest rate subprime mortgages)– double the level of 2005.

Disrupting the housing finance markets, subprime mortgage markets and their rising delinquencies generated a significant panic and liquidity crunch which initially impacted asset re-pricing in subprime adjustable rate mortgages, and quickly spread to other asset backed commercial paper, collateralized debt obligations and unsecured commercial paper. These developments triggered a number of events:

(i) Premature foreclosure of homes rising to 300,000 in each of the first two quarters of this year and consequent displacement of home owners since they could not secure financing;
(ii) Flight to quality caused surges in the demand for short dated Treasury bills plummeting its yields down to 2.5%;
(iii) Credit rating agencies downgraded some issues and kept others on watch for downgrading;
(iv) Credit spreads widened for low rated securities including sovereigns; and
(v) Stock markets were volatile both within US and other international markets even jolting Asian markets; and some Asian markets even witnessed exchange rate gyrations.

Of the two main transmitters of the contagion, the structured finance market which repackaged the subprime loans into CDO tranches and sold it to institutional investors globally, particularly the US investors and European investors, had greater responsibility for the current problems. The second, which is the asset backed commercial paper, was more consequential in nature, as the continuous asset re-pricing did not sustain the tight surveillance tests under the Special Investment Vehicle (SIV) – large holders of securitized pools of subprime mortgages. Denied short term funding SIVs resorted to drawing backstop liquidity facilities from its sponsors, typically investment banks. The sudden huge demands on sponsor's liquidity was however not sustainable; and commercial and investment banks had to either seek alternate recourse to funding, subsume their off balance transaction, or force sell program assets to meet the liabilities as it became due, and some SIV/SIV Lites are being put up for an eventual wind down state.

The problem exacerbated with the collapse of some high profile hedge funds, the sizeable losses registered by a mid size German bank, , liquidity crunch at one of US largest mortgage lenders Country Wide Financial holdings which then received a capital injection, and later by the depositors discomfort with the Northern Rock in the United Kingdom. The market uncertainties magnified the risk aversion. As a result, institutions faced difficulty in raising the desired level of funding from the market and turned to central banks and other alternatives or shirked away from holding riskier assets or demanded higher price for risk.

The growing downside risks prompted a wide-spread policy response from central banks. The key tool used was discount window to allow banks/financial institution to draw liquidity. In United States, the discount window rate for refinancing was reduced initially by half a percentage point to 5.75% and then to 5.25% at the U.S Federal Reserve meetings. US and European central banks have injected significant liquidity. Greasing of international money markets was welcomed particularly as it helped stabilized the credit spreads. However, the rescue of Northern Star – fifth largest mortgage finance house in United Kingdom did raise complications in UK financial markets because of moral hazard concerns.

**Impact of Asia:**

The subprime problem is largely external to Asia, but Asian asset prices have been seriously affected by the global financial market turmoil through the following channels:

- some Asian institutions have exposure to subprime mortgage-backed assets and other CDOs;
- re-pricing of corporate risks in the US probably caused some normalization of risk premiums; and
- tighter liquidity conditions in the US and Europe may affect capital flows to and from Asia

Most Asian financial institutions do not have relatively high CDO exposure, let alone high exposure to subprime mortgage-backed credits in the US. The only exceptions could include a few Singapore, China and Korea banks and some Taiwan insurance companies. According to analysts at this stage, it is difficult to figure out the total amount of losses in those institutions' asset values. Some believe that while the overall exposure may not be particularly large, relative to their assets, much of the assets belonged to low tranches of credit ratings.

Re-pricing of credit in the US has already generated important impacts in Asian markets. During the past month, for instance, Asian share prices went lower, bond spreads grew wider and Asian currencies became weaker. If the credit crunch turns into a global problem, then financial conditions could tighten significantly and economic activities could suffer more seriously.

Asian asset markets have already suffered serious damage, with share prices falling by 16.3% on average and currencies declining by 1.9% during the past months. Analysts expect Asian currencies to show further weakening in the near term and more Asian central banks to shift to easing mood. The only economies in Asia where policy rates could still rise are probably China and Taiwan.

The quandary faced by central bankers was illustrated nowhere better than in South Korea. After raising interest rates on Aug 07 in an attempt to discourage excessive lending by bankers, Korean central bankers few days later were reportedly attending crisis meetings on how to handle fears of a liquidity crunch.

Asian currencies generally weakened against the US dollar in recent weeks amid the market volatilities. This is probably a result of uncertainty. However, Asian currencies are likely to continue their paths of appreciation in the near term, at least against the dollar. Their relative moves against other currencies such as the Euro, British Pound and Australian Dollar may be more limited. Even if Asia were to weather heavier subprime storms, it is believed that they are likely come out in better shape than most other emerging market economies.

Emerging market growth and prospects remain generally solid. In recent months, consensus forecasts have continued to rise for emerging market growth in Eastern Europe, Asia and Latin America. Even so, forecasts for those regions remain above consensus. Moreover, improved current account positions, ongoing FDI inflows, shrinking external debts, high FX reserves, plus better monetary and fiscal positions (in aggregate) have greatly reduced the vulnerability of many emerging markets to "sudden stops," triggered by US slowdowns or credit market distress. However, not all countries are in the same position. Those most leveraged to US growth, facing external imbalances or with little scope to adjust policy due to inflation or fiscal pressures will likely see economic and market performance suffer more than average.

On account of generally robust conditions, emerging market spreads have widened fairly modestly relative to previous episodes of market turmoil, and they remain low by historical norms. In turn, a lack of severe financial market stress has allowed emerging market monetary policies to remain focused on their own medium-term inflation and economic-stability goals. As with the industrial countries, the central banks that are still expected to tighten will do so because growth is strong and as a precautionary move against future inflation risks, rather than in response to currency or funding crises.

Although Gulf banks have postponed some debt issues in recent weeks due to tightening market conditions, these deals are likely to close successfully after summer, given the region's bright outlook. Economic growth is set to remain sound in the context of record-high oil prices. The financial profiles of these banks are strong, with good asset quality, high profitability, and robust capitalization.

S&P's recent survey assessed the exposure of about 20 of the largest banks they rated in the Gulf to U.S. subprime mortgage-related instruments. Their main finding was that the vast majority of banks have no or insignificant exposures to U.S. subprime instruments.

**Lessons Learnt from 2007 Subprime debacle:**

Although the disruptions caused to financial markets and controversy surrounding some policy responses has not as yet settled, the subprime debacle has been a wakeup call and is leading financial market centers to reassess their legal and regulatory frameworks. Risk premiums are now beginning to revert to normal levels, but markets are playing their normal role to re-price risks.

There is now a broad consensus that this episode stems from a liquidity crunch and has sharpened financial vulnerabilities. Given the intensity of financial market turmoil, there have been concerns regarding its implications for inducing economic slowdown particularly in US markets where housing slowdown is estimated to have already impacted United States -GDP growth. In view of this, Federal Reserve took the

extraordinary step to reduce the federal funds rate and more recently the policy rate. Markets responded to this positively with stock markets indices registering growth. However, the easing of interest rates will boost world economy with a lagged effect and carries inherent dangers of reviving inflationary pressures.

Few key lessons to be learnt from this recent financial turmoil are multifold.

- There are clear limits of excessive leveraging and off balance sheet transactions come to eventually haunt the financial institutions which have to either take over or assume losses of these special vehicles or to provide for requisite liquidity support.

- While spreading of risks across borders help in diffusion of risks, it has serious implications for global financial markets which have wider consequences for developed and developing countries.

- Role of rating agencies and investors excessive trust in the ratings. Evidence suggests that ratings methodology for corporate credit is fundamentally different from that used for structured finance and yet ratings are placed on same scale.

- Weaknesses of regulatory and supervisory models and the lack of oversight of off-balance sheet transactions and securitized products etc.

- The sub-prime debacle has served as catalyst for a general reassessment and re-pricing of risk across financial markets. This should augur well for future of structured finance products.