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Recent International Financial Markets Turmoil is a Wakeup Call: Dr Akhtar

Dr Shamshad Akhtar, Governor, State Bank of Pakistan said today that the recent turmoil in the global financial markets is a wake up call for leading financial market centers to reassess their legal and regulatory framework.

Delivering her keynote address on 'Reflections on Global Economic and Financial Developments' at the 57th Annual General Meeting of the Institute of Bankers, Pakistan (IBP) in Karachi, Dr Akhtar said there is now a broad consensus that this financial turmoil stemmed from a liquidity crunch and has sharpened financial vulnerabilities globally. She said given the intensity of financial market turmoil, there have been concerns regarding its implications for inducing economic slowdown particularly in the U.S. markets where housing slowdown is estimated to have already chopped off close to half or quarter of US GDP growth.

The SBP Governor said the Federal Reserve took the extraordinary step to reduce its key discount rate by 50 basis points. Although markets responded to this positively with stock markets indexes registering growth, the easing of interest rates will boost world economy with a laggard effect, she added.

Dr Akhtar said 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 worldwide accompanied by financial engineering and innovation in the area of structured finance,' she added.

She said the 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 higher risk taking cross border, the Governor added.

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

Notwithstanding, concerns have been echoed regarding global economic and financial vulnerabilities, she said and added 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 also raised several questions.

The SBP Governor said that in order to promote global economic stability and an orderly unwinding of these imbalances, the International Monetary Fund has now launched a Multilateral Surveillance Mechanism while strengthening the bilateral surveillance process with special focus on exchange rate surveillance.

Initially, there has been a debate whether the explosion of "Alternatives" defined to include commodities, hedge funds, real estate and private equity, estimated by JP Morgan to be close to $3 trillion as of 2006, would be creating the next bubble? Aside from this, it has to be recognized that thus far signs of a bubble emerging appear in energy commodities, she added.

The SBP Governor said since 2006, concerns have 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 in 2007, but it eventually burst 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 and leveraging and quality of regulation prevailing,' she added.

Mortgage market has now come under deep scrutiny given the approaches adapted to structure tranches of loans and packages in accordance with the type and nature of risks associated, she added.

The SBP Governor said the origins of sub-prime mortgage crisis lay in the housing boom when sub-prime 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 while with the tightening of credit markets and impending rate-setting, the problem surfaced more visibly in sub-prime mortgage as delinquencies rose to 13.5 % in June 2007 (though 5.5% for the fixed interest rate subprime mortgages) – double the level of 2005, she added.

Dr Akhtar said the sub-prime problem is largely external to Asia, but Asian asset prices have been seriously affected by the global financial markets turmoil through the following channels:

- Some Asian institutions have exposure to subprime mortgage-backed assets and other Collateralized Debt Obligations (CDOs).
- Re-pricing of corporate risks in the US probably caused some normalization of risk premiums
- Tighter liquidity conditions in the US and Europe may affect capital flows to and from Asia.

While concluding her speech, Dr Akhtar outlined some of the lessons to be learnt from this recent financial turmoil.

- There are clear limits of excessive leveraging and excessive off balance sheet transactions come to eventually haunt the financial institutions which have to either take over or assume losses of special vehicles or to provide for requisite liquidity support.
- While spreading of risks cross borders help in diffusion of risks, it has serious implications for global financial markets which have wider consequences across developed and developing countries.
- Role of rating agencies and investors excessive trust in the ratings. Evidence suggests that rating methodology for corporate credit is fundamentally different from that used for structured finance and yet ratings are placed on same scale.
- 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.

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