# A Temporary Lapse of Economic Reason
**A reflection on the financial crisis**

By

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## Introduction

For many years to come analysts and economists will write extensively about the collapse of an entire international financial system and how it all began. The Harvard Business School is already using existing scenarios to write case studies for their bright students to examine and analyze.
Authors and publishers will line up to print multiple volumes and examine the causes and fall-outs of what occurred.
In this brief publication, I want to share my opinion and comments on where and how it began and also what we can learn from it.
When financial disasters like this happen, they can only occur within a pre-set environment of perfect conditions that were put in place well before the occurrence. We have seen this happen many times during our written and documented history.
So let us examine how such conditions were created and what gave rise to the collapse.

## The first condition: The Start of Globalization

It may seem bizarre that I want to go back this far, but we will have to in order to understand the simple foundation that was laid.
When Keynes introduced Roosevelt to his new economic principle of government capital injection to create new economic markets that then afterwards would benefit the economy through the replacement of such by private and corporate capital, a seed was planted.
Nobody really knew how the seed would grow and what it would turn into, at least not back then.
It initially gave rise to many great things that should certainly not be ignored. The primary seed for Europe was called the Marshall Plan.
It indirectly stimulated the creation of BENELUX, the EGKS and the EEG. Foreign capital flowed in and we ultimately saw the rise of the EMU. The unification of a

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continent had begun and started to take shape. Not only that, it laid the foundation for the creation of a non-tradable currency: the ECU.

Each legacy currency of the participating members would have to trade within a specified bandwidth and national governments were responsible to defend their currencies within the required limits.
With the continued expansion of globalization we also created a new condition whereby vulnerability existed within a new system.
Such gave rise to the first sign of what could come and happen and became the second condition. Most economists or politicians did not react to it, nor did they feel the need to strengthen the foundation of the growing global economy to prohibit such condition to occur.

## The second condition: Currency Exposure

With the expansion of the global economy also came an exponential growth in the inter-currency markets and with that more carry trades, more speculation and more exposure to international parties.
The parties involved were not only companies that protected their exports or foreign revenue, but also financial companies and more specifically the new kids on the block.
We saw the rise of hedge funds that promised a very high return on investment for the wealthy people that could afford to invest millions at a time.
The hedge funds did not hedge their portfolios, they started speculating with large amounts of cash to increase their revenue stream and therefore their management fee.
The first sign of such market activity could be seen in 1993 when a NY based hedge fund betted heavily against the GBP and the ITL to such an extent and with so many contracts that the central banks of both the UK and Italy could no longer keep their respective currencies within the prescribed ECU bandwidth and were forced to withdraw from the system, al least temporarily.
This was the first time we saw private capital go against public or government capital and be able to out beat them.
The situation corrected itself ultimately but nobody took it as a warning sign of the fragility of our system and what would become the second cornerstone of a financial crisis afterwards.
In 1997/1998, the same event happened in Asia, only this time it was not created by hedge funds but by the globalization itself. The number of transactions, the size of the contracts and the growth in carry trades caused the small Asian currencies to collapse due to the inability of Governments to support their currencies.

They did not have access to sufficient flexible reserves and did not have access to sufficient USD to support  the exchange rates in the market.
The result was a collapse of the foreign exchange market with a large impact on the STCM (Short Term Capital Market) and the LTCM (Long Term Capital Market).
Interest rates in the Asian money markets went through the roof and reversed repo contracts as well as swaps were abundant. The returns were unheard of and the revenue stream worked in favor of the institutions that had free access to USD or DEM at the time.
But in essence these innovative and seemingly complicated strategies actually helped to stabilize the regional financial crisis.
It was another warning sign that was widely overlooked and ignored.

## The third condition: The Dot.Com Collapse

With the technology industry booming and investors being eager to grab a piece of the pie, the IPOs were just flying of the shelves like cookies on sale.
Nobody could get enough of it because every offering was sure to become the next corporate success story. Investors, and primarily new and inexperienced ones, did not pay attention to the prospectus of such companies and did not base their decision on earnings or revenue. Instead, promised and future earnings without any substantiation blinded them.
The NASDAQ became the new Las Vegas. A loss of rationality and a hunger for opportunity led to the now famously framed term of “irrational exuberance” by Greenspan.
But what this condition also did was create a piece of the foundation for the next condition, which was for more reaching and much more influential: a change in monetary policy.

## The fourth condition: The Greenspan Policy

During the trouble caused by the “irrational exuberance” the monetary policy was set to alleviate an economic slowdown and short-term rates started falling. Money was made cheap but that was not the only effect. The duration of low interest rates also changed the landscape in the housing market. During this time, banks were instructed to increase and expand their lending, not just in loans, but credit lines and credit card limits.

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The foundation, or a piece thereof, was paved for a new bubble to burst. At that time the Greenspan policy was viewed as needed and nobody looked towards the long-term consequences.

Behind the scenes sub-prime loans were created in addition to 1YR, 3YR and 5YR ARM loans that were handed out. But other products were invented every day as well that never would have existed if it were not for the monetary policy and the pressure to open the credit markets.

Interest only loans and pay option loans made its way to the market. No down payment and money back at closure became popular. People starting borrowing at 125% of the purchase price, others purchased homes they could not otherwise afford and others purchased more expensive homes because of the cheap and ”special” loan conditions.

This gave rise to innovative techniques within the secondary mortgage market.

## The fifth condition: Structured Products and Synthetic Markets

The boom and innovation in the lending market required not only a change in underwriting, it required a change in the secondary markets as well. First of all, new products had to be created in order to entice buyers and secondly a market had to be created to trade such products.

First things first, we invented structured products in addition to changing how securitization was previously executed.

Such products, which are synthetic by nature, obviously had to be rated in order to find buyers. More about how the rating agencies came into play below.

Secondly, the markets had be created as well or expanded. All of the “new” products found their way to an easy and accessible market: OTC.

There was no regulation, no oversight and no Clearing House to control the pricing, the volume or the counter party risk.

In essence in normal circumstances this may not necessarily present a problem, but it became one of the most important cornerstones in the collapse of what we call the House of Cards.

## The sixth condition: The Rating Agencies

Loans were issued and repackaged at a rapid pace in order to find their way to the secondary RMBS, CMBS, CDO and/or CMO market.

With that came the need to rate newly created structured and securitized products. The products, while based on underlying loans and/or mortgages had to be able to be traded as

a stand-alone product and therefore needed to be rated separately from the underlying content.
The rating agencies put their stamp of approval on all the packages and rated them AAA.
What nobody really wants to talk about is how such rating was achieved.
Did the rating agencies verify the content of the structured package prior to assessing its credit rating? The answer is no.
Then how did they come up with the rating?
The issuers paid the rating agencies for their services in exchange for an AAA rating so their products could be easily traded in a broad market and to a wider public of investors.
US investors such as public and private pension plans, as governed by ERISA law, now found its way to the structured market because of the high rating of the instruments. So did foreign investors and governments alike.
The conditions started to be set for the Big Bang to happen. Only one more condition had to be created to complete the circle.

## The seventh condition: The CDS Market

CDS or Credit Default Swaps have been around for a while but never to the extent we have seen in 2006/2007.
While the instrument is traded in synthetic markets, its goal is to protect the holder of bonds, loans and/or mortgages against any default through the purchase and issuance of an insurance policy: the CDS contract.
However, the contracts started getting a life of their own and started trading individually independent of existing exposure.
Institutions began writing naked CDS contracts (either put or call) without any assets.
A new artificial market was born which very rapidly created an enormous amount of uncovered exposure and contracts, which we now know led to the problems of AIG.

## The circle is round

Now that the dominoes have been put in place, the time is ideal for an explosion to happen in the financial arena. Nobody knows when or where or how, but it was felt by some of us.
It is the same feeling as standing outside knowing that a hurricane is coming. You can sense the outskirts of the first breeze, but you don't know what the eye of the storm will bring.

Nobody knew for sure when it would hit us the hardest, nor did we know how far it would spread, but it was there, waiting for one single event to happen to collapse the entire marketplace.

## The event: The Big Bang

Late 2007, a NY based hedge fund decided to close one of its funds due to their inability to correctly value their assets and calculate their NAV. Investors were not allowed in and existing ones were not allowed to redeem their shares until a valuation could be certified and guaranteed. News like this travels at the speed of light on Wall Street and it started a ripple effect (the first outskirts of the hurricane).

Other firms started looking at their balance sheets and their exposure, primarily the structured products and contracts they had been purchasing before. They were not able to price such realistically either.

Why?

What had changed all of a sudden?

If you trade in synthetic markets, then market confidence and counter party risk become the driving forces of the liquidity in such markets. If the liquidity dries up, then so does the intrinsic value of the product and therefore nobody can set a realistic valuation anymore on their balance sheet.

So, to put this in a very mundane scenario: everybody was forced to open up the glittery Christmas present they had bought, in good confidence and with an AAA rating (i.e. the shiny paper on the outside), only to find that the toy on the inside was not exactly what they thought it would be.

It was not a very merry Christmas and the box was not worth anything anymore. Values dropped down from 100% to 22%.

Nobody wanted to trade in the secondary markets and both liquidity and credit dried up faster than ever.

The effect on a stagnating real estate market, which by the way was known to be over-inflated and ready to burst, didn't just deflate. It completely collapsed under the weight of the secondary mortgage market.

The second thing that happened was FNMA and FMAC.

While both were considered to be government guaranteed agencies, in essence they were and still are GSEs (Government Sponsored Entities), meaning the loans they securitized are not guaranteed at all.

After that we started seeing the collapse of Bear Stearns, Lehman Brothers, Merrill Lynch, WAMU and Wachovia.

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All of a sudden, financial firms were falling like flies while others were trying to hold on as best as they could.

But the biggest impact was still coming. This hurricane was not contained to the US alone. It created a serious financial tsunami across the globe with very serious repercussions because of the exposure international banks had.

The aftermath is that the economies worldwide started to shrink and a recession was born worldwide.

## The aftershock

While the worst may be over, we are still in a period of cleaning up the mess the hurricane left behind and we are not finished yet.

But that is not all. There will come a second wave after the silence: the CMBS market.

The commercial mortgage backed securities market is on the verge of erupting and will cause a second wave in the recession.

This will have a major effect on the liquidity and credit markets for several reasons.

-The size of the commercial loans: all commercial loans are non-conventional and considered “Jumbo Loans”, which need to be refinanced every 36 months even though their amortization schedule is set for 30 years.

-Refinancing for such loans is not influenced by any of the stimulus packages currently available nor does the bond market impact their rate.

-The amount of exposure in the commercial market is about 100 times larger than the residential market.

We already see the first signs of this collapse. The price per square footage has declined steadily and the vacancy rate has gone up (the first smell of the next hurricane)

The second event in the aftershock is the continuing rise in unemployment. While the jobless claims may go down month by month, the bleeding has not stopped yet and will not until at least mid 2010.

## The future

In order for this financial crisis to come to a halt, and this primarily applies to the US, the aftershocks have to take place so that when the dust settles, we can focus on avoiding an inflationary period.

Such period is certainly looming and hanging over our heads.

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The only way to avoid another tough economic climate is by implementing a very well orchestrated exit strategy.
Such is only possible by letting the aftershock run its course and hopefully we will have sufficient time to avoid an inflationary period.

## Conclusion

A very seemingly simple and innocent event can create much damage and carnage, as we have seen throughout history. This crisis has clearly shown that because of our interconnection that such an event can no longer be contained within one continent or within one economy. Throw a rock in a lake and no shore will be spared the wave the rock has created.
I hope that we have all learned a very valuable lesson and will put in motion an international effort to control and regulate the markets in which we work and we are also depending upon. Our behavior, after all is said and done, should focus on how to continue to integrate our economies. Jointly, not individually.
The world may be flat or it may be tilting, but we can all still be part of the solution.
Personally, I call the global economy a sandbox.
On the playground, different children play together to build a sandcastle. As long as they all play well with each other, the mothers are happily conversing with each other on the benches.
When one kid starts acting up in the sandbox, the entire castle comes apart and all mothers get frantic and they pull their children out.
Let's make sure we learn how to respect the sandbox, how to play and how to build a castle….together.

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