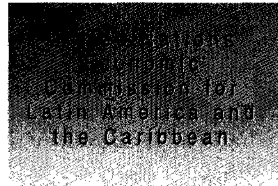

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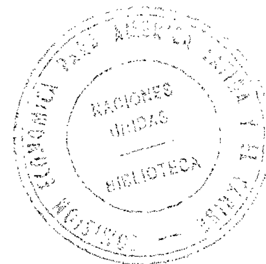
Confusion and Uncertainty in Credit Markets



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Confusion and Uncertainty in Credit Markets

"...But that very uncertainty is the biggest issue of all. For what is most pernicious about the current credit storm is that the climate of confusion is so high that nobody quite knows what to believe anymore...The reason for this uncertainty, as this paper has repeatedly noted in recent days, is that this decade's frenetic financial innovation has scattered subprime losses around the financial system to a degree never seen before."

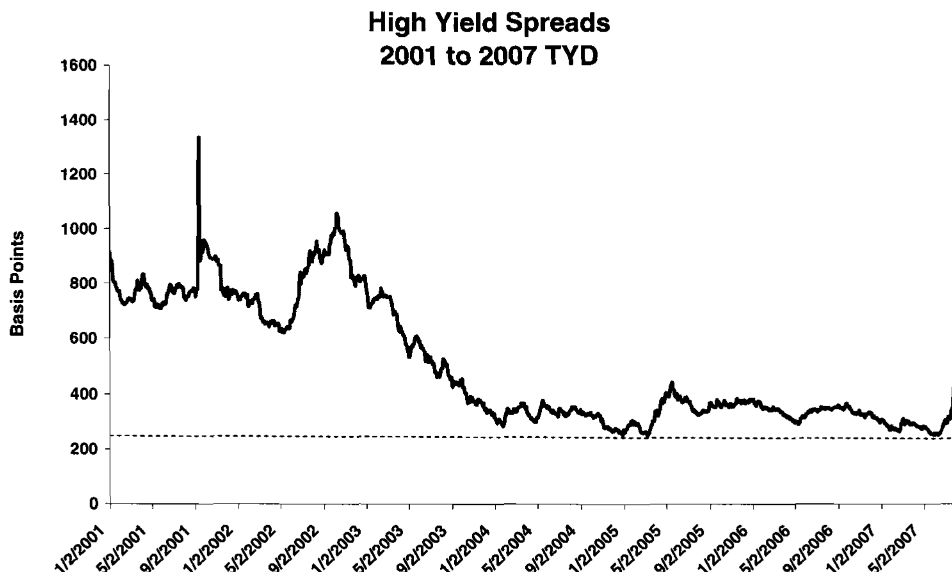
"Credit compass fails to work" by Gillian Tett, August 19 2007, Financial Times.

Credit concerns have dominated global financial markets in recent weeks. The spillover from the crisis in the U.S. mortgage and structured markets has been fueling a global move towards risk aversion, and a variety of asset classes has been hurt in this process.

A crisis of confidence

The existing degree of leverage in credit markets was built over a number of years. The process started with the Federal Reserve's easing in 2003-04, when the Fed's federal funds rate was cut to 1%. The low interest rate environment encouraged financial innovation and the use of leverage to improve returns, sparking an asset allocation shift into real estate and alternative assets such as hedge funds and private equity. The result was an extremely benign economic environment.

The strong and stable global economy lulled investors into a sense of false security, who began to behave as if volatility had all but disappeared. In early 2001, the average junk bond yielded around 900 basis points more than the ten-year Treasury bond. In May 2007, the spread had dropped to a 20-year low of 260 basis points.



Source: ECLAC, on the basis of data from Merrill Lynch U.S. High-Yield Master II Index (H0A0).

During this period, Wall Street investment banks generated substantial fees by underwriting big volumes of mortgages, and the loans and high-yield bonds that funded leveraged buyouts (Box 1).

BOX 1: Underwriting debt and dispersing risk

Underwriting is a way of placing a newly issued security, such as stocks or bonds, with investors. The underwriter assembles a pool of mortgages and divides them into "tranches" (slices), with different degrees of risks and returns. Each security is a slice of the deal's risk. The original debt is thus sliced into collateralized debt obligations (CDOs) and collateralized loans obligations (CLOs), as well as other products.[1] The various tranches are graded by rating agencies, and are then sold to hedge funds, pension funds, mutual funds and other investors. Foreign investors tend to buy the paper with the highest ratings, that is, the bonds that have first claim on the cash flows and collateral backing the loans. Hedge funds trying to offer clients market-beating returns tend to buy the lower-rated but higher-yielding paper, often using money loaned to them by the prime brokerage arm of the same investment banks that underwrote these loans in the first place.

The sale of underwritten debt takes place through complex chains. The debt is sold to structured investment vehicles (SIV), a class of big, mainly bank-run programs, designed to profit from the difference between short-term borrowing rates and longer-term returns from structured product investments. These programs typically invest in credit market instruments, such as mortgage-backed bonds and collateralized debt obligations (CDOs), and fund their purchases with short-term borrowings in which interest and principal payments are backed by financial assets. An "asset-backed commercial paper" (ABCP), which lasts for anything between a few days and a few months before needing to be refunded, is issued in exchange for short-term financing.

[1] CDOs and CLOs are derivatives backed by pools of credits: CDOs comprise bonds, including high-yield and mortgage-backed securities, while CLOs consist of corporate loans, including those used to finance buyouts.

The Fed tried to reduce liquidity by raising short-term interest rates from 1% in 2003-04 to 5.25% by mid-2006. Higher interest rates meant higher mortgage costs and a reduction in home sales, as well as in the number of home loans to underwrite, which would likely diminish leveraged buyouts. In response, investment banks loosened their credit standards, agreeing to purchase lower-quality loans. Leveraged buyout financing also followed more relaxed rules, with deals becoming riskier, and with bigger companies being bought. Lowering standards worked out for a while: in 2006, investment banks collected almost 60% more from underwriting mortgages and other loans than in 2003.

The origins of the current market turmoil can be traced to rising delinquencies in the U.S. subprime mortgage market and the impact on the securities backed by these mortgages. From the macro standpoint, the nominal value of subprime mortgages is small, and potential losses are not large. However, the securities backed by these mortgages are hard to value. A typical mortgage-backed product contains thousands of mortgages, all of varying quality and proportions. In addition, holdings are widely dispersed, thus market participants do not know the scale of losses and where those losses now sit.

Defaults and delinquencies began to rise in mid-2006. In February 2007, specialist lenders began to report losses for the fourth quarter of 2006, starting with the largest, Nova Star, a leading lender in nonconforming residential mortgage loans. The second-largest lender, New Century Financial Corporation, facing liquidity problems, had trading of its shares suspended by the New York Stock Exchange over concerns about its ability to stay in business. By April 2 it declared

bankruptcy. In May, UBS announced that it was closing its in-house hedge fund, Dillon Read Capital Management, folding it back into its investment banking arm less than two years after it was set up. In June, Bears and Stearns announced problems at two of its hedge funds. The news was followed by a number of other funds reporting significant losses in similar debts. In July, financing for the Alliance Boots and Chrysler buyouts, two of the biggest private equity-backed deals in the markets ran into serious difficulties, intensifying fears about the possibility of a sharp credit crunch.

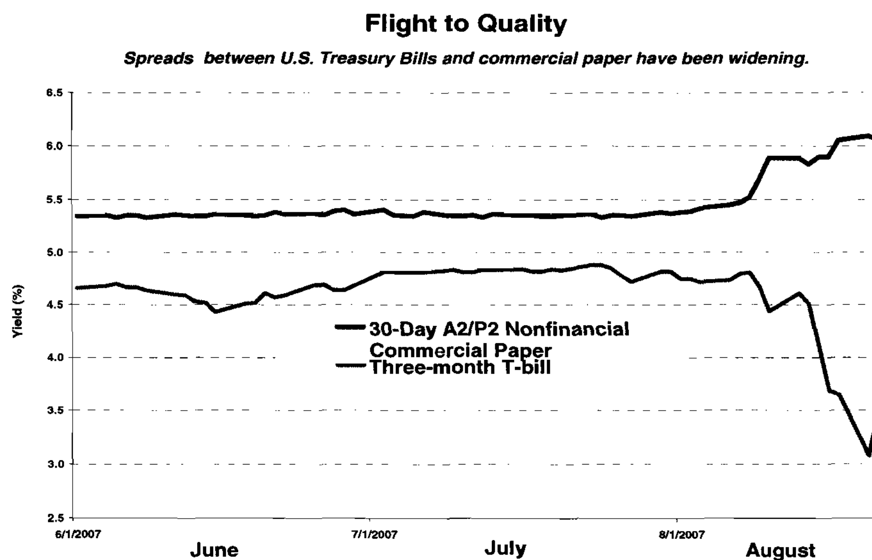
Volatility spiked in July and August, with problems spreading to equities and to quantitative hedge funds that thrive on volatility but come unstuck when there are sudden changes in trading patterns. These problems became clear when Goldman Sachs was forced to pay US$ 2 billion of its own money to rescue its Global Equities Opportunities fund, after admitting that its highly regarded computerized fund failed to predict market turbulence. Fears about the U.S. subprime exposure also spread beyond the U.S. banks and small specialized lenders. BNP Paribas was forced to suspend activity of three funds holding asset-backed securities. Problems at German bank IKB resulted in a bail-out by local banks on August 2, and interbank interest rates in the overnight lending markets shot up as a result. The European Central Bank and later the Federal Reserve, the Bank of Japan, the Russian Central Bank and the Bank of Canada were forced to take action, supplying markets with short-term funding so that they could continue to function.

Uncertainty about losses has led to an abrupt drying up of liquidity in the three-month interbank and commercial paper markets. The U.S. commercial paper market experienced record outflows in past weeks, and asset-backed commercial paper programs faced increasing liquidity risks, with institutional investors in particular making a big switch from commercial paper to government securities, causing Treasury yields to decline.

Banks have refused to lend to other banks, partly because of the lack of transparency on their commitments to ABCP structures. Some banks are carrying off-balance-sheet risks, and this has caused uncertainty about what risks a counterparty institution might be bearing and has contributed to the drying up of liquidity in parts of the market. Although some signs of normalization have emerged after the Federal Reserve cut its discount rate (the rate at which it lends to banks) on August 17, Treasury yields are still far from their levels prior to this financial turmoil.

Flight to Quality

Spreads between U.S. Treasury Bills and commercial paper have been widening.



Source: Federal Reserve.
Latest information: August 21.

If an ABCP program is unable to rollover or extend commercial paper coming due, it must attain some sort of short-term financing or close and sell the underlying assets. In the week of August 13, only 11% of asset-backed commercial paper coming due was rolled successfully, largely as a result of market concerns about underlying mortgage-related exposure. Spreads on ABCP paper have widened dramatically compared with non-asset-backed commercial paper. In Europe, companies continued to face problems raising funds in the ABCP market, which is a key source of funding for financial companies. According to data from Dealogic, companies failed to refinance more than 80% of ABCP paper that matured on Monday, August 20. Thus Central Banks around the world are taking measures to provide markets with enough liquidity to complete short-term transactions.

Investors have also lost confidence in their ability to value complex structured credit products that include some exposure to subprime bundled up with exposure to other underlying assets, thus there is enormous uncertainty regarding the credit quality of their assets. If investors do not know how to value a security, the classic process by which sellers and buyers settle on a new equilibrium price may not work properly, thus markets for complex structured derivatives and some asset-backed securities could remain closed for some time.

Will the turmoil hit the real economy?

The current market turbulence originated with a "real" economic trouble, when some financially stretched U.S. households failed to make mortgage payments. However, this summer it spread into the structured finance world, affecting the asset-backed commercial paper and the collateralized debt obligation markets, or the so-called sector of structured investment vehicles (SIVs). It remains uncertain whether the financial crisis will hit the wider economy or whether it will be contained.

There are two channels through which transmission of the recent financial turmoil to the real economy could take place. The first is consumption. Property and equity prices have buoyed household spending across the world in recent years. If the U.S. housing crisis gets worse, and markets continue to be weak, consumption growth will slow. The depressed wealth effect that comes from lower home and equity prices will reduce the pace of consumer spending. Consumer defaults on credit card payments in the U.S. seem to be already on the rise. Credit card companies were forced to write off close to 5% of payments as uncollectible in the first half of 2007, almost 30% higher year-on-year. Late payments also rose, and the quarterly payment rate – a measure of cardholders' willingness and ability to repay their debt – fell for the first time in more than four years.

The second channel is the effect that rising borrowing costs will have on business spending and hiring. Widening credit spreads should hurt business investment. Global business spending has been supported by record cash flows, as well as by debt-funded investment. The corporate bond market has slowed to levels not seen since the recession of the early 1990s, as rising defaults among mortgage borrowers are causing lenders to question loans going to companies as well. Without healthy bond markets, there is no access to capital. Capital expenditure may slow gradually as companies adapt to a scenario of lower liquidity, and there is already some evidence that software and equipment spending is softening in the United States. Moreover, employment

could be affected as a result of lower business spending, which would lead to slower real disposable income growth and, in turn, lower consumption.

There has been widespread "deleveraging" as a result of the current turmoil, meaning that investors have been forced to cut their debt in a hurry by selling assets. Funds have been rushing from assets backed by mortgages, triggering selling in other markets. In the current episode of deleveraging there have been signs that problems are spreading from hedge funds to banks. One link between the markets and the banks is via the SIV or conduit, a vehicle that funds itself in the short-term money markets and thus does not appear on the banks' balance sheets. Many of these vehicles have arranged emergency credit lines with banks in case their normal funding sources dry up. Countrywide Financial Corp., U.S.'s biggest mortgage lender, announced it was drawing down US$ 11.5 billion in credit lines to bolster its cash position, a sign that it was unable to raise money in financial markets as it had been. The fear is that banks will soon be forced to bail out other vehicles, which could place bank balance sheets under huge strain. Stress on the banks might cause them to call back lines of credit to the real economy, reducing business investment and growth, as has occurred in previous banking crisis.

However, one of the characteristics of the frenetic pace of financial innovations is that financial players, and not mainstream companies, are the ones who are heavily indebted. Economic growth over the past four years has not been based on a corporate borrowing binge. On the contrary, aggregate corporate debt has been falling and balance sheets, for the most part, are considered healthy.[1]

Nonetheless, if the turmoil lasts, potential risks to business and consumer sentiment – and the wider economy – will rise. Confidence could be seriously dented if a crisis erupts at a bank, for example. Moreover, growth may slow down if creditworthy investors, such as companies with healthy balance sheets or consumers with good credit history, cannot borrow at reasonable rates.

Will turbulence hit global growth?

The current credit turmoil has raised concerns that the U.S. credit market problems could spread and halt global economic growth. The IMF Managing Director Rodrigo de Rato announced on August 23 that projections for growth in the world economy could be revised downward lightly because of the credit crunch in global markets, "but not in a dramatic manner." The IMF most recent estimates see growth in the global economy at about 5% in 2007 and 2008.

The world economy appears to be steadily "decoupling" from the U.S., with a new engine of growth rising in China and India. This notion seems to be supported by the fact that the United

[1] According to a recent article on the Financial Times by Andrew Smithers, chairman of Smithers, the economic consultancy, it is unwise to assume that corporate balance sheets are in goods shape. This claim is justified by companies' published accounts, which emphasize "marking to market" – reflecting the market value of an asset. However, comparing these published aggregate profit and balance sheets with similar data from earlier years (which did not use the same approach) will give a misleading impression. It is possible to compare today's leverage with that of earlier years by comparing debt with output. Compared with output, U.S. corporate leverage is high and rising. "Although mildly below its peak in 2002, it is well above its long-term and even higher than its post-1990 average levels."

States is at a different point in the economic cycle compared to anywhere else in the developed and developing world.

However, it appears as if there is no such decoupling of world financial markets. On the contrary, on the heels of the latest events, Wall Street seems even more central to the world's capital markets on account of globalization. Standard and Poor's companies increasingly draw revenues and profits from outside the United States. FTSE companies are even more international. For large companies, the countries where they are listed are becoming less relevant to their share price performance.[2]

More importantly, markets themselves are more international, with technology making it easy to trade across asset classes and across continents. According to Authers, it makes less sense to talk about coupled markets than to refer to one homogeneous market. The U.S. still has the world's largest economy, so it will be the major force. Therefore, despite the fact that the sole factor driving world volatility emanates from the U.S., globalized markets have allowed companies in Australia, France or Germany, to share in the losses.

Investors around the world also fear that a U.S. slowdown set off by lower housing prices and tougher lending standards would lead to fewer imports, hurting big exporters in Asia. Emerging Asia's dependence on exports has actually increased in the past decade, and nearly two-thirds of Asia's exports of final goods still end up in the U.S., European Union and Japan.

If Asian countries start to buy less, big commodity producers would be hurt and some large, risky commodity ventures around the world would be at risk. Countries such as Russia, Brazil and Indonesia, for example, would be vulnerable because so much of their growth has been driven by the boom in commodities.

According to John Lipsky, IMF's first deputy managing director, in addition to the possible spillover effects on trade of weaker growth in the United States, other economies would be directly affected by the current turmoil in financial markets. A number of institutions that have been affected have not been U.S.-based. However, he also noted that the world economy has entered this market turbulence in good shape and with strong growth momentum, a large part of which coming from emerging market economies. Emerging markets are better equipped to deal with financial turbulence, their economic performance has been strong, their policies are better, and they have improved the structure of their financial systems.

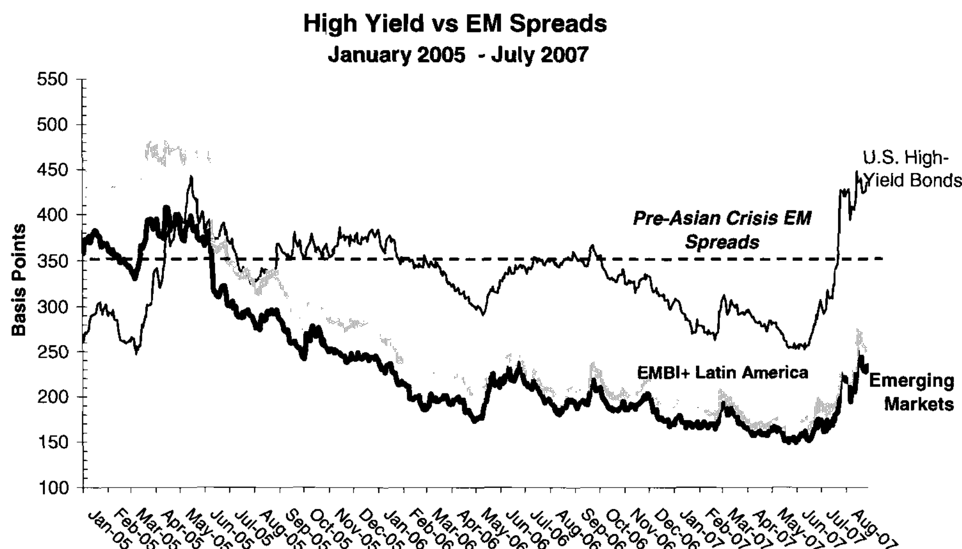
Emerging market countries are now less vulnerable to external shocks, with better debt ratios than developed countries, stronger reserves, low inflation and strong current account and fiscal surpluses. Moreover, emerging market borrowers' needs for external financing are much smaller than they used to be four or five years ago, thus the more adverse global credit market conditions should have a lesser impact on how investors perceive emerging markets underlying solvency.

[2] John Authers, *Why the world still waits on Wall Street*, Financial Times, August 11, 2007.

The credit turmoil and the outlook for emerging markets

The volatility radiating from the United States is changing the global backdrop for emerging markets. This change comes after several years when the combination of improvement in country macroeconomic policies and strong risk appetites led to strong flows of new money to the emerging markets asset classes.

The ongoing financial turmoil has affected emerging markets through a series of immediate channels. Global risk appetite has declined significantly and has led to a rise in credit spreads in emerging markets. However, spreads remain at low historic levels, and the current increase in global volatility has put much less stress on emerging markets than it would have four or five years ago. Moreover, emerging market spreads are roughly half of the spreads on junk (high-yield) bonds, and have been under less pressure. Since August 8, the day before BNP Paribas was forced to suspend activity of three funds holding asset-backed securities and the European Central Bank injected liquidity in the money market in response, EMBI+ spreads widened by 34 basis points, its Latin component by 36 bps and the spreads on high-yield bonds widened by 41 basis points.[3]

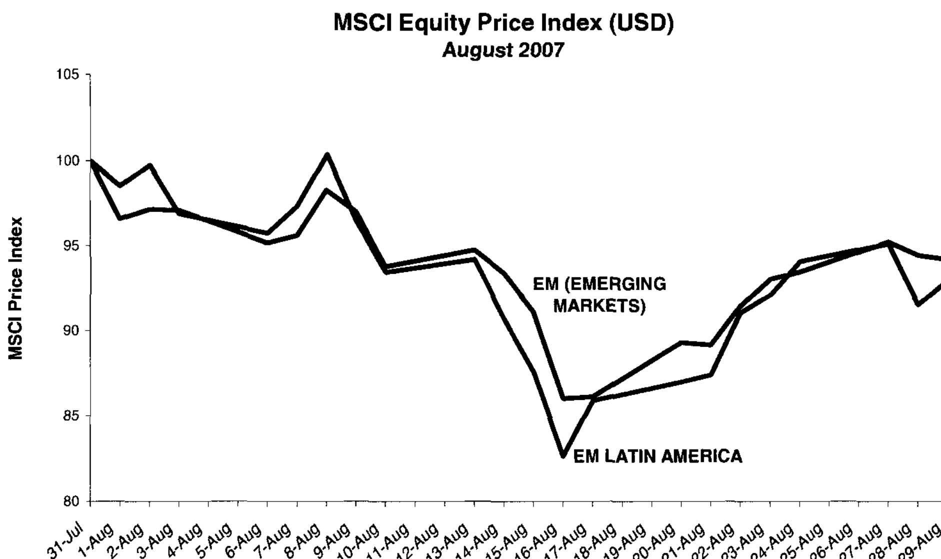


Source: ECLAC, on the basis of data from Merrill Lynch U.S. High-Yield Master II Index (H0A0), and JPMorgan EMBI+.

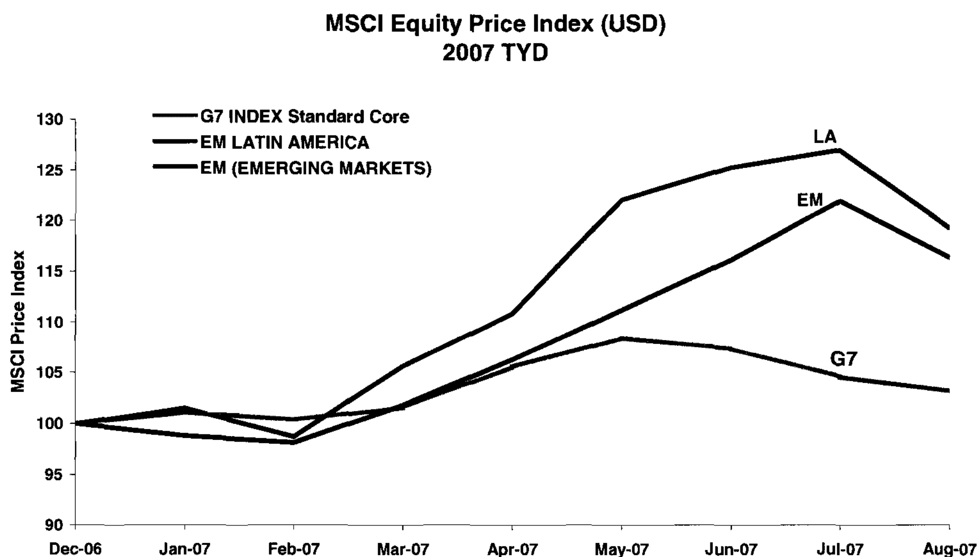
The bonds of countries where investors have concerns about the direction of government economic policy, such as Argentina and Venezuela, are taking large hits, what underscores a degree of market discrimination in recent weeks. These countries have domestic difficulties compounding their international troubles, and their spreads have widened more than spreads in other countries in the region. The EMBI Global in Argentina increased by 196 basis points since May 22, and by 247 basis points in Venezuela, compared to 98 basis points for the region as a whole.

[3] Latest information is for August 29, 2007.

The troubles that began with U.S. mortgages were felt in emerging and Latin American stock markets as well. The MSCI Emerging Markets Index fell by 6% in August, while the Latin America component fell by 7%. A flight to quality, severe volatility and generalized deleveraging caused Latin American stocks to loose almost 15% from August 8 to August 16, erasing more than half of the gains for the region in the first half of 2007. Stocks showed some recovery towards the end of the month, however.



Source:MSCI Equity Indices, http://www.msci.com/equity/index2.html
Note: prices at the end of the month.



Source:MSCI Equity Indices, http://www.msci.com/equity/index2.html
Note: prices at the end of the month.

Another channel through which the ongoing turbulence in credit markets is affecting emerging markets is through the unwinding of carry trades. In recent quarters, vast inflows attracted by higher local interest rates have driven many emerging market currencies up. When investing in

local currency instruments, investors have enjoyed the combination of higher interest rates and foreign exchange appreciation, thus the carry trades have been highly advantageous. The massive and persistent increases in foreign exchange reserves in emerging markets over recent months indicate that carry-trade inflows in emerging markets have been substantial.

For example, Brazil's foreign exchange reserves rose by US$ 70 billion in the first seven months of 2007, and according to U.S. Treasury figures, Brazilian holdings of U.S. Treasuries increased by US$ 41.5 billion to US$ 93.6 billion in the first half of 2007, with Brazil breaking into the top five main international holders of U.S. Treasury bonds and bills as a result. At the end of July, the *real* reached 1.84 to the dollar, although the dollar bounced back by 8% amid the current market turbulence.

There are signs that some of these carry trades could be reversed. Emerging market currency risk and local market interest rates, for example, began to move higher when the recent credit market woes intensified. Some key concerns right now are thus how many of these carry trades will be unwound if the turmoil grows deeper, and how local financial markets will handle this process.

The current turmoil may also affect emerging markets through their holdings of foreign assets and exposure to mortgage-backed securities. There has been a substantial rise in holdings of external assets accumulated by emerging market economies in recent years, in both public and private sectors. According to the Institute of International Finance (IIF), a sample of 54 emerging economies accumulated US$ 575 billion in net external financial assets, US$ 371 billion in the form of official reserves, and US$ 204 billion of other lending flows by both public and private sectors. These assets are for the most part invested in high-grade government securities. However, some countries, especially in Emerging Asia, have recently been diversifying theirs assets into higher-yielding investments. There is a risk that some of these investments may be linked to assets backed by subprime mortgages.

The Bank of China, the Industrial and Commercial Bank of China and the China Construction Bank have recently disclosed their exposures to U.S. subprime-related investments. The total holding of subprime-related ABS and CDO assets is now reported to be US$ 9.7 billion, which exceeds previous market estimates, but is still considered to be a small number. However, it is still not clear what amount of China's foreign exchange reserves has been invested in subprime-related assets, thus the potential losses to official foreign exchange reserves could be bigger.

In the case of Latin American and the Caribbean, banks have minimal or nonexistent exposure to U.S. subprime securities according to Fitch, and will likely weather this downturn with relative ease. According to Fitch, portfolios in the region continue to be concentrated in instruments issued by the local governments, thus despite the recent financial turmoil there should be no change in ratings.

Latin American markets will experience wider sovereign spreads and currency weakening as global risk aversion sets in, but these effects should be manageable given that most countries in the region are not as financially vulnerable as they were ten years ago. The real underlying risk and the relative impact of the current turmoil on the region and on emerging markets as a whole hinge on how events will play out in the United States. The fast increase in foreign reserves and fast economic growth in the region have been supported by an unusually strong commodities boom. If these commodity prices were to weaken, the region's real income would be sharply

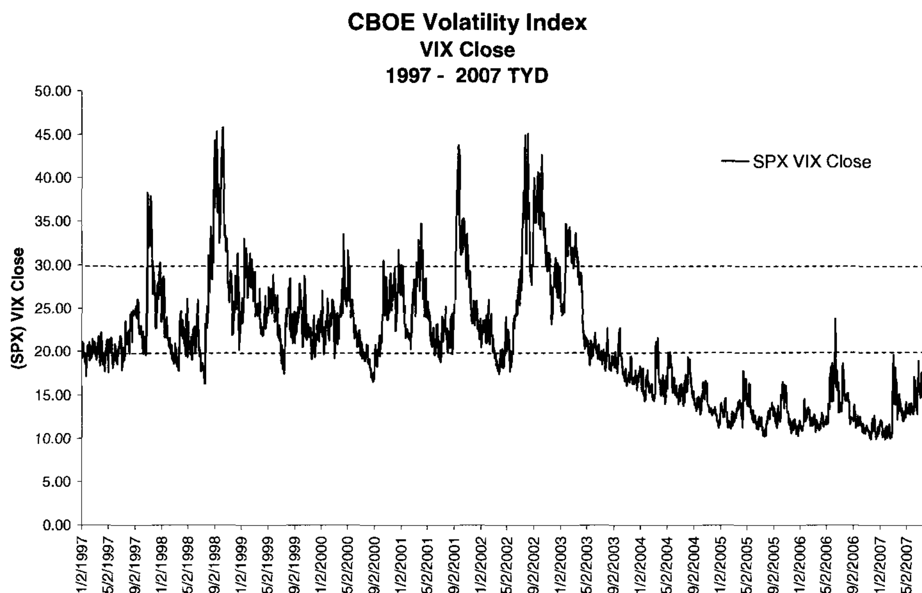
affected, with adverse consequences for budget and external balance positions as a result of less foreign investment and a less favorable export outlook.

Countries in the region have improved their vulnerability to external shocks and should be able to avoid a direct hit from the subprime troubles. However, it remains uncertain whether commodity prices will weaken as a result of the current market turmoil. Weak real commodity prices, low real oil prices in particular, was one of the channels through which the East Asian shock in 1997 was spread around the emerging world in 1998.

Lessons from the past

In order to measure whether the turmoil in credit markets is a short-term correction or a more lasting event, with the potential to hit the real economy, markets are currently looking at past periods of turbulence, seeking for clues of what may happen next. One of these periods is the Long-Term Capital Management (LTCM) crisis in 1998, which followed the Asian crisis in 1997.

There are some similarities between the turmoil in 1998 and the one today. In 1998, credit markets were stirred by the collapse of LTCM, a large hedge fund, while in the current turmoil credit markets have been shaken by the collapse of several financial companies, such as two hedge funds run by Bears Stearns Asset Management, and Goldman Sach's Global Equities Opportunities, among others. As in 1998, there is a great deal of uncertainty about how deep the problems are and which institutions have the most exposure to nonperforming assets, and just as in 1998, credit markets have been roiled by liquidity issues, with a flight to quality causing Treasury yields to decline. The big difference this time around is that turmoil has originated in the credit-heavy U.S. economy, and not in emerging markets, and the U.S. is more likely to be adversely affected by the process of deleveraging that has been taking place in response to the increase in volatility and risk aversion, than emerging markets.



Source:Chicago Board Options Exchange, www.cboe.com/micro/vix/historicai.aspx

Note: VIX values greater than 30 are generally associated with a large amount of volatility, while values below 20 generally correspond to less stressful, even complacent, times in the markets.

The global outlook is much more benign in 2007 than it was in 1998. Emerging market economies are in much better shape this time around, having accumulated ample foreign reserves, having reduced public and foreign debt, as well as short-term financing needs, and having adopted a floating exchange rate in most countries, which reduces the impact of foreign crisis. The robust demand for U.S. exports from some emerging markets have prevented a deeper slowdown in the U.S., and their collective status as net creditors has helped finance the U.S. current account deficit, making emerging markets this time around more part of the solution, rather than part of the problem. On the other hand, the U.S. economy seems more vulnerable today and less equipped to cope with financial trouble than it was in 1998.

Strengthening confidence

Past periods of turmoil can provide insight into the role of Central Banks and the Federal Reserve in particular, which bolstered markets on August 17 by lowering its discount rate by 50 basis points to 5.75%, while keeping the target rate unchanged. The Fed also extended loans for up to 30 days, as opposed to the standard overnight. The move followed a large injection of liquidity in the week before by both the European Central Bank and the Federal Reserve, and aimed to encourage banks to start using the discount window. This time, as in 1998, the Fed is trying to intervene before conditions deteriorate, but unlike in 1998, Chairman Ben Bernanke has taken an approach that markets have called "measured" or "gradual". A cut in the federal-funds rate would translate into a more direct help to small borrowers, but the Fed fears it could also rekindle inflation.

The success of the Fed's measures will be gauged not by the extent to which banks use the discount window, but by whether it bolsters confidence, making banks more willing to take part in the asset-backed commercial paper market. While equity markets have stabilized temporarily in anticipation of policy easing by the Fed, credit markets remain troubled. Troubles have concentrated on short-term funding, financing flows and counterparty risk. As mentioned earlier, in recent years banks have created a profusion of investment funds, structured investment vehicles (SIV) and conduits, which finance themselves through the commercial paper market and invest in asset-backed securities, such as mortgages. More recently, banks have been forcing their counterparties to pay much more to roll the paper over, and it is not clear how fast central-bank injections of liquidity will help to ease the credit squeeze.

The Federal Open Market Committee (FOMC) will meet again on September 18, and markets are largely expecting a cut in interest rates. Some believe that the Fed should avoid the 1998-misstep, when the interest rate cut was not enough in the first time, and led the Fed to intervene two more times. In this view, the Fed should go for a bold move at the next meeting, even if markets stabilize. However, other analysts believe that a rate cut may make the asymmetric information problem in financial markets worse by suggesting that the Fed has more negative information than the market possesses.

Summing up

In the midst of credit market worries and amid the surprise of investors abroad to find that problems with United States homeowners could be felt in their own home markets, participants have been questioning whether the process of securitization is beneficial, or whether it just spreads risks further and increases uncertainty. Many argue that there is nothing wrong with securitization and the problem was that abuses were committed in the U.S. mortgage market when interest rates began to rise.

Some argue that the lack of regulation is a problem. Given the process of slicing up and dispersing risk, some of this risk is bound to end up in areas of the market that are not regulated. The question is how policymakers should address crises that are not centered on regulated institutions. Banks accept much closer supervision in return for access to the Fed's payment systems and discount window. The problem this time, however, is not centered on banks, but on a range of non-regulated institutions that now lack capital or are unable to fund themselves. Whether non-bank institutions should be more regulated is an issue being raised in the light of the recent events in credit markets.

Others argue that the problem was the assessment made by the rating firms, which assigned high credit ratings to mortgages and loans of dubious quality. Many institutional investors and industry observers have blamed the agencies for being slow to downgrade mortgage-backed securities that faced problems and prompted hedge funds to collapse, central banks to intervene and mortgage firms to lay off several employees. Part of the problem, critics say, is that rating firms are paid to rate bonds and other securities issued by banks and other financial institutions by the issuers themselves, what raises a conflict of interest. In addition, it is little understood how the agencies rate more complex securities. All three of the major rating agencies, Moody's, S&P and Fitch have said that they are revising their criteria to assess mortgage-backed securities (MBS) in the light of recent events.

The credit-rating agencies that graded the troubled securities backed by risky mortgage loans now see themselves in trouble too. Their stocks have fallen and members of the U.S. Congress are calling for hearings and more oversight of the rating firms. The agencies have defended themselves saying that they were not slow to react, and that ratings are designed to be stable, and not fluctuate on the basis of market sentiment. The case in point, however, is that the agencies did not help to warn markets about the problems that were about to come, the same way that they did not help in previous financial crises involving Mexico, Asia and Enron. The question is whether increased oversight is the appropriate way to address rating concerns.

The biggest fear right now is that the recent financial disruption becomes a sharp credit crunch, which will trim down consumer and business spending, and significantly reduce economic growth. Given the possibility of an alarming number of home foreclosures beginning this fall, the U.S. Congress is debating whether the government should come to the rescue of overstretched homebuyers. Among discussed measures is the expansion of the activities of the government-sponsored finance companies, Fannie Mae and Freddie Mac. Mortgage liquidity is drying up, and the idea is that Fannie Mae and Freddie Mac could pump new money into the housing finance, buying renegotiated subprime mortgages. The Administration is reluctant to do that, however, and is looking at more limited solutions. For the moment, neither the Congress nor the

Administration has much desire for a big bailout. However, this may change if the current turmoil intensifies, especially as the elections draw nearer.

The Federal Reserve has so far restored some stability to dislocated credit markets without cutting its key interest rate. However, markets are expecting the Fed to cut interest rates on its next scheduled meeting on September 18. Some even believe the Fed might be forced to act before that. The Federal Open Market Committee, however, faces a dilemma. There are good reasons to cut interest rates. Banks have had problems with commercial paper, the short-term debt that supports many transactions. Also, there has been evidence that the economy is slowing. Jobless claims jumped to their highest level in four months, and job cuts in the mortgage-finance sector are poised to increase. Tightening credit markets are also expected to further depress the housing sector, reducing household wealth and adding to economic strains in the second half of the year.

However, expectations are reflecting with a high degree of certainty that the FOMC will cut interest rates, and if it really does, markets may assume that financial distress will always guarantee rate cuts. This creates a moral hazard problem, as it implies that there is no downside for taking irresponsible risks, which is damaging to the Fed's credibility. The Fed governors will have to balance their options and attune their policy response to the competing pressures of the real economy and of a financial sector in distress.