**The Mother of All Emerging Market Crises**
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It is tempting to think of current volatility in U.S. credit markets as the mother of all emerging market crises. The symptoms include panic, illiquidity, a flight to quality, and extraordinary intervention – all classic indications of an emerging market crisis – but on a scale that dwarfs anything seen previously. For aficionados of crises in Latin America and Asia, it is déjà vu all over again.

A number of insights from those earlier Latin American and Asian crises are useful for understanding what is happening in global credit markets. A first such insight is that financial globalization alters the incentives for gathering information. There are fixed costs of gathering and assimilating information about an individual investment, as everyone who has ever contemplated his own investment decisions will understand. Portfolio diversification and the packaging together of individual claims in the form of composite securities mean that even small investors hold tiny amounts of a large number of different obligations. In turn, this tends to discourage them from incurring the costs of gathering information. And in the absence of information, investors will make inferences about the value of their claims on the basis of the actions of other, not necessarily better informed investors. The result will be herd behavior, panic selling in response to bad news, and illiquidity as all agents line up on one side of the market.

This is a fair characterization of what we have seen in U.S. credit markets in recent weeks. Even professional investors have professed ignorance about the risks embedded in the collateralized debt obligations and other derivative securities in which they have positions. Not least among these market participants are cross-border investors, like the German banks which, via investment conduits, have taken significant positions in U.S. mortgage-backed securities. Cross-border investors are separated from the originating market by physical distance, which also makes for economic – and informational -- distance. The collapse of U.S. housing prices may be a fundamental reason why there should also be a sharp sell-off of debt securities collateralized by U.S. mortgage obligations. But there has also been an element of panic, reflecting lack of information and herding. And there are intrinsic reasons why financial globalization is associated with herd behavior.

Second, the rating agencies are imperfect solutions to this problem. You will recall that the rating agencies were a particular bugbear during the Asian financial crisis of 1997-8, when they were accused of failing to anticipate developing problems and then overreacting. Rating agencies are supposed to have a special expertise in smelling out credit problems. They are supposed to be in the business of assembling information and providing it to their clients. But, in practice, the rating agencies have limited human resources. Their best people are constantly being poached by hedge funds and investment banks, which offer much higher salaries. Even the best rating agencies lean on the analysis of others, like that in IMF country reports. How much information they add is – how shall I put it politely? – unclear.

Particularly disturbing is that the rating agencies have conflicts of interest. They first earn fees from advising issuers on how to structure bonds and derivatives so that these receive the desired rating. They then have a not-so-subtle incentive to rate those issues in the promised manner. All this was apparent in earlier emerging market crises. Now that the problem has hit home – now that it has hit the United States, in other words – perhaps it will be taken more seriously.

Third, while hedge funds play a role in episodes of volatility in highly-leveraged financial markets, they are not alone. Hedge funds have had large positions in mortgage-backed securities, and a number of prominent hedge funds have failed as the market in CDOs has collapsed. But major losses have also been incurred by the in-house funds of investment banks like Bear Stearns and Goldman Sachs and by the investment conduits of commercial banks.

I take particular satisfaction in this observation, having argued, when I authored the IMF's report on the role of hedge funds in the Asian crisis, that there was nothing special about these particular entities. I argued that a variety of other players – proprietary traders at investment banks, commercial banks, even mutual funds and pension funds – took many of the same positions. They also engaged in the same behavior: using borrowed funds, succumbing to herd behavior, and being less than transparent about their holdings. This is of course just what we have seen in the recent crisis.

My question about the Asian crisis was: how different would the course of events have been in a hypothetical world where there were no hedge funds but everything else remained the same? My answer was: not very different. I think the recent crisis in U.S. financial markets supports this conclusion.

Fourth and finally, recent events in the United States speak to the "spare tire" theory of financial development. Alan Greenspan famously argued that countries with well-diversified financial systems, with both banks and bond markets, tend to be more stable. When the banking system stops lending, the bond market still works. And when the bond market seizes up, it is still possible for investors with good projects to borrow from the banks. This is supposedly one of key lessons of the Asian crisis.

There is something to the point. Bond markets and the securitization they facilitate help in spreading risks, which is stabilizing, other things equal. They put distance between lenders and borrowers, which takes politics out of the intermediation process. They give companies a way of borrowing at longer maturities, since banks are reluctant to lock up their money for long periods of time. This too is stabilizing, other things equal.

The problem is that other things are not equal. The incentive to gather costly information is less in securities markets. Restructuring defaulted debts is also more difficult, since the defaulted claim is held not by a handful of banks but by thousands of individual and institutional investors, a majority of whom must give their consent before payments can be rescheduled. This is something that emerging markets learned, at considerable cost, in the 1990s. U.S. households with teaser mortgages wrapped into CDOs are about to learn the same lesson.

Most importantly, bond markets are not a spare tire. There is no guarantee that they will keep operating when the banking system stops, or that the banking system will keep going when the bond market stops. To the contrary, when problems in the market for collateralized debt obligations caused liquidity in bond markets to dry up, bank lending seized up at the same time. Since banks held the securities in question, they suffered balance-sheet damage, which caused them to stop lending. Previously the banks had accepted CDOs as collateral, which they now stopped doing; again this caused them to lend less and to fewer customers. The banks inferred that the problems in the market for mortgage-backed securities might also be hiding in other markets in which they operated, like sub-investment-grade commercial paper. So they stopped providing liquidity to those markets as well. As a result, when the regular tire was punctured, the spare tire went flat as well.

What should be done? First, continue to press for financial transparency, but don't expect miracles. Issuers of debt securities can provide more information, but the structure of the underlying securities is getting more complicated by the day. It will still be costly for investors to figure out what is lurking below the surface. Herd behavior and volatility are inevitable in this context.

Second, where there are conflicts of interest, there is the need for regulation. The rating agencies' conflicts of interest demand regulation in the form of a Glass-Steagall-style act that prevents them from both acting as advisors and issuing ratings. Inefficiencies can also be addressed through more competition in this industry, since the better rating agencies will tend to out-compete the bad ones over time. Asian governments have sought to promote more entry and competition in this industry. This could also usefully occur in North America and Europe.

Third, cracking down on hedge funds is not going to solve problems of instability, since hedge funds are not alone – since other investors engage in all the same practices. The fashionable solution to this problem is to call for tighter regulation: higher capital requirements for banks and the equivalent of capital requirements for other financial entities, including hedge funds. The question is whether achieving this is within the grasp of regulators, or whether clamping down on leverage in one part of the system will only cause it to migrate. In other words, might not excessive leverage and risk simply pop up elsewhere, in unregulated form?

Fourth and finally, developing securities markets as part of a strategy of cultivating more diverse financial market structures and systems is a good thing, but don't expect too much from it. The different components of the financial system are linked together. When one seizes up, they all experience liquidity problems

Is the current problem in U.S. financial markets the mother of all emerging market crises? Only time – and maybe a DNA test – can confirm motherhood. But we can say with confidence is that these episodes bear more than a passing family resemblance.

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