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## “Without real leadership, we face disaster”

**A lethal new threat is emerging at the dark heart of the financial system. We must have a unified global response or an already perilous position will become a calamity.**

**Will Hutton\***

In the week of the crash in 1929, Wall Street fell by 23 per cent. Last week, it fell by 18 per cent, London and Frankfurt by 21 per cent and Japan's Nikkei by 24 per cent. Every major financial centre's interbank market is frozen. Trust and confidence have collapsed; the global system is paralysed on a scale that now surpasses 1929. There is a combination of a worldwide bank run, seizure of credit markets and collapse of asset values that could plunge the globe into a depression. This is history's joke: the crisis of capitalism long predicted by communists and socialists who are no longer able to take advantage of it.

The scale of what is happening is scarcely credible. On Wednesday morning, the UK government committed itself to an unparalleled £500bn of extra support for Britain's paralysed

financial system - up to £50bn of capital, guarantees for £250bn of lending between banks and additional injections of cash. This is the biggest, most comprehensive and best-thought-through operation of its kind mounted by any Western government since 1945. It was rewarded for its pains by a further 10 per cent fall in stock market prices, a further freezing of the already crisis-stricken interbank markets and, most ominously of all, the beginnings of a run on sterling.

One government can do so much; the British plan was simply swept to one side by what is now a financial pandemic which only a global response can address. G7 finance ministers, at last jointly aware of the gravity of the crisis, attempted to produce such a response in their five-point plan announced at the meeting of the IMF and World Bank in Washington on Friday night.

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The proposals are distressingly broad brush and hardly add to the markets' knowledge. It is no longer news that governments do not intend to let a major bank fail, nor that they will protect depositors, inject capital from taxpayers, free up liquidity and do whatever is necessary to keep the system going. At best, I fear it will temporarily hold the line; at worst, it will be ignored as platitudinous.

The problem is that the markets no longer have any faith that the world financial system they helped create has any future. The model is bust. It is encouraging that both the Americans and Germans are now moving towards what they considered ideologically unthinkable a fortnight ago - they are preparing to follow the British lead, take big public stakes in banks and offer guarantees to the interbank market.

But while this is a necessary condition for stabilisation it is not sufficient. What needs to happen on top is an assault on the dark heart of the global financial system - the \$55 trillion market in credit derivatives and, in particular, credit default swaps, the mechanisms routinely used to insure banks against losses on risky investments. This is a market more than twice the size of the combined GDP of the US, Japan and the EU. Until it is cleaned up and the toxic threat it poses is removed, the pandemic will continue. Even nationalised banks, and the countries standing behind them, could be overwhelmed by the scale of the losses now emerging.

This market in credit derivatives has grown explosively over the last decade largely in response to the \$10 trillion market in securitised assets - the packaging up of income from a huge variety of sources (office rents, port

charges, mortgage payments, sport stadiums) and its subsequent sale as a 'security' to be traded between banks.

Plainly, these securities are risky, so the markets invented a system of insurance. A buyer of a securitised bond can purchase what is in effect an insurance contract that will protect him or her against default - a credit default swap (CDS). But unlike the comprehensive insurance contract on your car which you have with one insurance company, these credit default contracts can be freely bought and sold. Complex mathematical models are continually assessing the risk and comparing it to market prices. If the risk falls, the price of the CDSs rises; if the risk rises - because, say, a credit rating agency declares the issuing company is less solid - the price falls. Hedge funds speculate in them wildly.

Their purpose was a market solution to make securitisation less risky; in fact, they make it more risky, as we are now witnessing. The collapse of Lehman Brothers - the refusal to bail it out has had cataclysmic consequences - means that it can no longer honour \$110bn of bonds, nor \$440bn of CDSs it had written. On Friday, the dud contracts were auctioned, with buyers paying a paltry eight cents for every dollar. Put another way, there is now a \$414bn hole which somebody holding these contracts has to honour. And if your head is spinning now, add the three bust Icelandic banks. They can no longer honour more than \$50bn of bonds, nor a mind-boggling \$200bn of CDSs.

The implications are global. The UK government might have frozen Icelandic assets in Britain to get some compensation for the losses, but we

are only part of the story. Austrian, Danish and Finnish banks all hold near valueless Icelandic bonds on which they will have bought CDSs from heaven knows whom - Deutsche Bank? A two-bit hedge fund in Dubai? Lehman Brother? Kaupthing? Shareholders in Barclays and RBS are rightly concerned; the two banks hold a stunning \$2.4 trillion of CDSs each - more than the UK's GDP.

We don't know their exposure to Iceland and Lehman Brothers, but with such enormous credit derivative books it would be amazing if there were none. While every bank tries to pass the toxic parcel on to somebody else, the system has to find the money. So will compensation for the near valueless contracts and thus now uninsured debt ultimately be made - and by whom? And because nobody knows - not the regulators, banks or governments - who owns the swaps and whether they are credit-worthy, nobody can answer the question. Maybe holders of insurance policies will get the cash due to them, but will that weaken somebody else? The result - panic.

This is the ultra-dangerous downward vortex in which the system is locked. It is why share prices are plummeting. As recession deepens, there will be defaults on securitised bonds and the potential collapse of more banks outside the G7 ring-fence. Nobody knows what proportion of the \$55 trillion of credit default contracts that have actually been written will be honoured and who might bear losses running into trillions of dollars. Buying new contracts to insure against default has become prohibitively expensive. Securitisation, and insuring against risk, has effectively ceased. And because the markets don't know where the losses will fall, banks cannot

borrow from each other except overnight or from their central bank. Credit flows are at a standstill. Property prices are plummeting. A famous economist, Hyman Minsky, foretold that unregulated finance capitalism inevitably ends in a meltdown and slump. The world is facing a Minsky moment.

One element of the necessary response is in the making - giving banks access to unlimited taxpayers' capital, guaranteeing interbank lending and pumping cash into the system. I suspect that only majority government control of the West's major banks will now stabilise matters. But that is not enough. The markets no longer believe in the financial market structures they have invented. As a result, the US Fed, the European Central Bank, the Bank of Japan and Bank of England must become not just lenders, but insurers of last resort, providing the insurance contracts that the markets have stopped. Governments must write CDSs themselves.

In future, the global credit derivative markets will need to be organised into regulated, licensed exchanges rather than conducted in a way that made the Wild West look tame. We will need a global authority to supervise the credit derivative markets, write insurance contracts and stand ready to guarantee that contracts are settled. And we will need a global, independent credit rating agency to assess risk objectively. More immediately, there needs to be deep coordinated cuts in interest rates; last week's half per cent cut was useful but inadequate.

I don't know whether politicians and their advisers can move as quickly as they need in so many areas and collaborate across so many countries to restore stability. Most of those who

should be leading the world's recovery are, politically speaking, numbered among the politically walking wounded or dead; either near the end of office like George Bush, in a fractious coalition like Angela Merkel, or leading a dysfunctional party like the weak Taro Aso of Japan.

Without collaboration and leadership, we face disaster. On Friday, there were terrifying signs that the contagion was spreading to the foreign exchange markets: for example, the Australian dollar dived 20 per cent against the yen over the week; sterling fell 3 per cent against the dollar. If investors start to think that politicians cannot control the situation and the necessary international action falls short of what is required, then Britain has got neither the GDP nor financial firepower to support the scale of capital flight and financial losses that will hit the City of London.

The pound could fall at least the 30 to 40 per cent that currencies fell during the Asian financial crisis. London could become the centre of the rout. If so, it will not just be complete nationalisation of the banks we will be considering but the reimposition of capital and exchange controls.

For 30 years, greedy, callow, ignorant financiers, supported by no less callow politicians from all the political parties, have proclaimed the wonders of financial innovation and how proud we all should be of the City of London. The price tag for their behaviour is an economic calamity. We should never have bought such snake oil. The consolation in these dark times is that we never will again.

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