

Emerging Lessons from the Crisis

by *Eswar Prasad*

ITHACA, NY – The US financial system is careening on the edge of a meltdown. All that has kept the much-vaunted font of global capitalism from sliding into cataclysm is the US government, which has effectively become the guarantor and lender of last resort.

How could things have come to such a pass in a financial system once touted as being the deepest and most sophisticated in the world? Where will it end? What effects will this have on the world financial system? It is difficult to answer these questions with much conviction while we are still in the midst of the crisis. Indeed, every passing day now seems to bring worse news—even weekends no longer provide respite from the steady stream of gloom!

Whatever the final outcome, one thing is certain—the rest of the world will no longer be enthusiastic about adopting the free-market principles that guided US financial development. While desperate times may call for desperate measures, massive US government intervention will also make it difficult in the future to make the case that the state should stay out of the workings of the financial system.

No doubt the satisfying emotion of *schadenfraude* – pleasure at the pain of others – is coursing through the minds of central bankers and policymakers in emerging markets, who for long bore the brunt of US hectoring about free-market principles. They are probably also saying their hosannas for having resisted financial innovations to some degree or another, thanking that for the fact that their economies have not yet been pummeled by the unfolding crisis to as great an extent as the US.

Unfortunately, these lessons – if taken literally – may end up being the wrong ones for emerging market economies to be drawing. Unfortunate because the real lesson to be taken from this crisis is that the abnegation of certain free-market principles may in fact have led to the mess the US now finds itself in. Financial development, moreover, is ultimately going to be important for these economies to sustain high growth rates and allow a broader swath of their populations to participate in and benefit from the development process.

What went wrong in the US? A key problem with Fannie Mae and Freddie Mac, for instance, was that their regulator failed to do its job of uncovering the massive accounting fraud embedded in their books. That and the implicit guarantee of government backing (which finally turned explicit) allowed these two institutions to expand enormously, including into exotic financial transactions that they had no business being involved in.

The roots of the US crisis, of course, go back to the years when Alan Greenspan was chairman of the US Federal Reserve. Then, money was easy and regulation light. The famous ninja (no income, no job and no assets) mortgage loans were as clear a sign of regulatory negligence as any. But these obvious signs of malfeasance were all too easily ignored when times were good and in the face of the current US administration's hostility towards regulation.

Clearly, financial innovation without effective regulation does not work well. In the new world of more sophisticated financial markets, dangers lurk in hidden places.

Today's crisis indicates that a set of rigid rules allows resourceful financial institutions to mask riskiness in their portfolios or shift things around to make standard risk metrics appear better than they really are. It is impractical to devise a regulatory framework that accounts for every specific financial instrument and institution. Rather, it makes more sense to develop a "principles-based" framework that can adapt to financial- market evolution and adopt a broader approach to managing systemic risks. Clearly, that was lacking.

The crisis also confirms that some types of government involvement in financial markets – especially through implicit backing of ostensibly "private" institutions – generate bad outcomes that end up with taxpayers inevitably footing the bill. The real lessons from the Fannie and Freddie debacle should be about the dangers of implicit government guarantees coupled with moral hazard and weak regulation, and the risks that lurk even in advanced financial systems. These risks are greater in less-developed financial systems, and the costs of cleaning up the messes could also be proportionately larger for poorer economies.

One thing the crisis does show is that fraud, corruption, and government interference can eat away at the foundations of even the deepest financial systems, especially when these problems are compounded by a regulatory system that is too narrow and rule-bound in its outlook and that, at times, turns a blind eye to obvious rot in the system. Now that, at least, is a lesson the emerging markets definitely *should* take away from the financial crisis.

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