

WHEN FREE MARKETS FAIL: THE “CREDIT CRUNCH” DEBACLE

Prince Asante, HSA (HASS, GHS) discusses the global financial crisis

In today's world there are two opposing economic models on how society organizes and allocates resources. On the one hand is the free market model by Adam Smith. On the other hand is the pure communist model by Karl Marx and Vladimir Lenin. Current global forces are in favour of the former while the latter appears to be out of fashion.

Ghana has been pursuing a free market policy with its attendant over-liberalisation of the economy since the days of structural adjustment and economic recovery programmes. Some major fall-outs of the economic reforms have been the absence of government intervention in agriculture and the removal of subsidies to our farmers, the introduction of cost recovery concept in health and education at the tertiary level. Today, most Ghanaians accept the saying that “government has no business being in business”. Thus, an era of “golden age of business” for the private sector with government providing the enabling socio-political-economic environment has been occasioned. The argument that one hears quite often is that the market is more efficient in allocating scarce resources than state institutions. That, privately managed businesses perform better than their state counterparts. Recent developments in the financial markets in the UK and US seem to challenge this theory. The credit crunch in the UK and US financial markets has informed this write-up.

The term credit crunch has been used to describe the situation where no financial institution is ready and willing to lend money to any one. This has been due to anticipated decline in the value of the collateral used for loans. It all started with the way and manner mortgage companies operated in the “free” financial markets in the UK and the US.

Mortgage companies are banks who lend money to people to buy houses. The houses are in turn used as collateral for the loans given out. Defaulters have their houses seized by the companies and sold to repay the loan. Chief executives of mortgage companies in their quest to rake in more profit, and possibly reward themselves with huge bonuses, began to repackage the mortgage loans and sold them to other companies at a discount. In effect, they passed on the risk of default to discount companies through financial engineering known as securitization. These repackaged mortgage loans (mortgage-backed securities and collateralized debt obligations) became known as sub-prime mortgages. Many banks were actively engaged in the sub-prime mortgages business in the UK and the US.

The troubles all began when the banks went soft on the initial requirements which qualified someone for a mortgage loan coupled with rising housing prices. This encouraged borrowers to go in for difficult mortgages believing that they will be able to quickly refinance the loans at more favourable terms. When the housing market began to experience low prices in 2006 and 2007 and borrowers were unable to repay their loans, most of the companies who retained credit risk were the first to be affected. Banks who owned sub-prime mortgages wanted to sell them in a bid to minimize their losses. Eventually, more of such loans came up on the market

and consequently their price fell leading to serious cash flow problems even for the “big boys” in the market.

As the crisis deepened, the Bank of England reluctantly agreed to take over and guarantee the loans of one of UK’s financial giants, Northern Rock. Then it was realized that many more banks were in distress positions requiring some help to stay in business.

In the United States, the financial market was not spared the credit crunch. In fact, the effect of the crisis in the US has been more devastating and causing ripples in Europe and elsewhere. The US government after studying the situation for sometime came to the realization that direct intervention in the operations of the market was not an option but imperative. Subsequently, the government decided to inject up to \$100 billion in each of the two most troubled mortgage groups, Frannie Mae and Freddie Mac. These two groups were described by government officials as so large and so interwoven in the US financial system that a failure in either of them would cause great turmoil in financial markets in the US and abroad.

So pervasive is the crisis that US government’s mitigation measures are not adequate enough to see all banks suffering from the crisis stay in business. In September, 2008 the fourth largest U.S. investment bank, Lehman Brothers Holdings Inc., filed a petition with the U.S. Bankruptcy Court in Manhattan. The 158-year-old bank which had survived the Great Depression in the 1930s and the recent turmoil in the long-term capital market has finally succumbed to the sub-prime mortgage crisis. It is reported that the company lost more than 90 per cent of its value after takeover bids by Barclays Plc and Bank of America Corp. were abandoned.

Other banks that could not survive the credit crunch include Bear Stearns Cos and Merrill Lynch & Co. Inc. Like Frannie Mae and Freddie Mac, Merrill Lynch has also been given a rescue package by the government. The world’s largest insurance group, American International Group (AIG) has also been forced to restructure due to the credit crunch.

Meanwhile, the US Federal Reserve Bank, in consultation with the Treasury Department and the Securities Exchange Commission, has announced a number of measures to strengthen the US financial market. These measures are not only aimed at throwing more largesse through emergency spending to the distressed banks but also introducing regulatory reforms into the market.

From the accounts above, there is no doubt that markets do fail. Market failure could threaten even the most developed economies such as the UK and US, who are well endowed to withstand external economic shocks. One could only imagine how governments of developing countries would react should they experience such market failures.

The Government of Ghana (GoG) sold 70 per cent of its stake in Ghana Telecom to Vodafone in August this year. We are told that the company is saddled with so much debt that a “strategic investor” is needed to turn the fortunes of GT around. The GoG has indicated that it will launch a \$300 million seven-year bond on the international market to settle the debts of GT as agreed

upon with Vodafone in the purchase agreement. Clearly, Ghana does not have the financial muscle to bail out “big” businesses in the event of a serious market failure.

Critical looks at the measures introduced by the US Government to mitigate the ripples from the crisis suggests that perhaps the governments should not have stood aloof and leave the players in the market to do their own thing. The Bank of Ghana and the Securities Exchange Commission must strengthen their supervisory role and ensure that profiteering on the part of managers of financial institutions are kept in check to prevent “smart” CEOs from plunging the local financial market into such unfortunate crisis.

The credit crunch in the UK and US provides us with the opportunity to re-examine our economic policies carefully and tread on the side of caution on the liberalization of the economy. Can you imagine the repercussions of the government withdrawing completely from intervening in the cocoa sub-sector of our economy?