Despite the turmoil a financial meltdown is not on the cards

By Alan Ahearn
15 September 2008

DEVELOPMENTS in the United States this week might give the impression that the entire US financial system is on the brink of collapse. Measures of financial stress have soared to levels last seen in March at the time of the crisis in the US investment bank Bear Stearns.

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Amid the turmoil, you could be forgiven for thinking that the crisis has become unmanageable and that the authorities are helpless to restore stability to financial markets. But you would be wrong.

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What's clear is that America's banking industry must shrink. The bursting of the speculative housing bubble and the resulting eye-popping losses have exposed deep flaws in the way banks were doing business.

Many of the activities and financial products of the boom years are now a thing of the past. The industry must consolidate. This consolidation is not happening in an orderly, seamless manner -- but, then again, it never does.

The stronger banks will survive, with a focus on new lines of business and in some cases under new ownership. Weaker institutions -- those banks which took the largest gambles and made the biggest mistakes -- will perish.

That is the way it must be if the market economy system is to function properly. As Allan Meltzer, my old economics professor at Carnegie Mellon University in Pittsburgh used to say: "Capitalism without failure is like religion without sin -- it doesn't work."

The authorities' priority is to make sure that there is enough cash in the system to stave off a collapse of a solvent financial institution that might result from short-term liquidity problems.

The other task for the authorities is to decide which financial institutions they bail out, and which ones they allow to fail. Here, the only consideration should be whether the troubled institution poses systemic risk to the broader financial system.

Put another way, would the collapse of an institution bring down the entire system?

The authorities this week clearly judged that the giant insurance company AIG was too big to fail. The US government on Tuesday effectively nationalised AIG, the world's biggest insurer, and the Fed injected $85bn in emergency funds into the ailing company to keep it afloat.

These moves followed the rescue nine days earlier of Fannie Mae and Freddie Mac, the country's largest mortgage buyers.

No such luck for the investment bank Lehman Brothers, which was allowed to fail over the weekend. The reshaping of US banking is also taking place through private mergers and acquisitions, like Bank of America's purchase of Merrill Lynch.

Naturally, events in the US raise the question, "Could it happen here?" If US banks are falling like ninepins, how concerned should we be about Irish banks? Irish banks have their difficulties, but there are good reasons to be cautious in drawing parallels between US and Irish banks. For starters, Bear Stearns, Lehman Brothers and Merrill Lynch were investment banks whose main business was securities trading.

In contrast, Irish banks are largely involved in old-fashioned lending to households and businesses. Second, US banks are directly exposed to the mess in America's subprime mortgage market. Irish banks have no such exposure.

Of course, Irish financial institutions have their own problems, stemming from their significant exposure to the slumping Irish and UK property markets. Property lending accounts for a substantial proportion of Irish banks' assets. Some commentators have drawn parallels with the property market busts in Finland and Sweden in the early 1990s which were associated with severe crises in those countries' banking sectors, including major bank insolvencies.

But the nail in the coffin for the Nordic banks during those episodes was the collapse in their exchange rate regimes. The share of bank lending to the corporate sector denominated in foreign currency increased from about 25pc in 1986 to 45pc in 1990 in both Finland and Sweden.

Corporate borrowers' debt burdens increased sharply when the Nordic currencies dropped after their governments were forced to abandon the fixed exchange rate pegs in the early 1990s.

Our membership of the euro area removes those exchange rate risks. Our debts are essentially all denominated in euro, and there is no prospect of Ireland leaving the euro area. Moreover, although property lending accounted for a substantial proportion of banks' assets in the UK in the early 1990s, the major banks and building societies there withstood the property bust fairly well.

Bank failures, like airplane crashes, are rare events and usually occur only if a series of things go badly wrong. And they occur only if the banks are not too big to fail.

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