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Three Paradoxes of the Financial Crisis

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Is the global financial system headed for a meltdown? From Nobel Prize-winning economists to captains of industry, the world's top experts are united by a common answer: We don't know. Understanding three key paradoxes about the economic crisis can reveal the path to clarity.

Are the current economic problems a crisis of epic proportions that will change the world forever or just a painful but typical downturn in the business cycle? Every week, governments and rating agencies issue dire warnings and dour estimates about this year's economic performance. The world's financial markets have behaved erratically in recent months, dropping sharply in response to the latest negative report on jobs, new housing starts, consumer sentiment—or anything else that looks like bad news. But then they bounce back as central banks cut interest rates and throw more money into the economy. The confusion over markets is so great that investors in Asia are even turning to *feng shui* experts for advice on the economic outlook for the Year of the Rat.

Astrology will probably not add clarity to this picture. But financial experts don't seem to have a much better hold on the future than the soothsayers. When I was at the World Economic Forum in Davos last month, the general mood was one of great anxiety. A group of ultrapessimists, led by financier George Soros and NYU economist Nouriel Roubini, argued that we had entered the most important economic crisis in the last 60 years. They are convinced that the world will likely change in ways that are both profound and permanent. Others, such as *Financial Times* columnist Martin Wolf, said this is merely another crisis, one that's undoubtedly important, but not catastrophic. According to this group, the world economy will grow at a slower pace, but will not fall into a deep recession. But the mood among experts at Davos and in the weeks since has been divided. Executives at manufacturing companies, for example, tend to be more optimistic than people in finance, many of whom are bracing for a terrible couple of years. However, the overwhelming majority of those in attendance at Davos—distinguished captains of industry, political leaders, well-respected media commentators, and even Nobel Prize winners in economics—all confessed to not having a clue as to what will end up happening.

It certainly gives one pause when such uncertainty is holding sway within a group that includes many of the best-informed people on the planet. But amid the confusion, I detected three revealing paradoxes regarding the current economic crisis.

The first paradox is that this surprise should not be that surprising. We have been hearing for years that the global economy was suffering from significant imbalances. In the United States, commercial and fiscal deficits were becoming unsustainable and the real-estate market bubble would soon burst. For these reasons, those who foresaw this crisis said it was an inevitable adjustment. And what was the initial reaction when everyone else caught on? Surprise, followed by frantic attempts to stop the adjustment. But the purported cure may be worse than the disease. Addressing global economic imbalances is not only necessary in the short term—it is also the key to ensuring a more solid foundation for the future.

The second paradox is the fear of an impending credit crunch and a prolonged period of illiquidity at a time when the world is awash in cash. Countries that are major exporters of oil and other raw materials, as well as most Asian countries, currently hold enormous currency surpluses. Yet it's not clear how or at what price these surplus funds can be accessed by those who need the cash. The global commercial banking system therefore remains the means for matching lenders and borrowers. The problem, though, is that credit markets have become opaque to an unprecedented degree. Risk has become so hard to price that lenders are either overcharging for loans or postponing lending altogether until the creditworthiness of the borrowers, usually large banks with exposure to mortgage-backed securities, becomes clearer.

And so, dry financial patches coexist with massive reservoirs of cash. Nothing illustrates this paradox better than sovereign wealth funds—companies owned by countries that use them to invest in foreign companies—which are one way in which these cash surpluses are being put to use. For instance, the United Arab Emirates, Singapore, and Kuwait recently contributed to the rescue of Citigroup and Merrill Lynch—thus cushioning the blow from the nearly $20 billion in losses these banks have so far suffered as a result of the home mortgage and subprime crisis—by investing in them via their sovereign wealth funds. While they can become very important, their highly personalized governance and murky decision criteria make Western bankers and politicians very apprehensive, as one of the most contentious sessions at Davos illustrated. Former U.S. Treasury Secretary (and **FP** editorial board member) Lawrence Summers suggested that the sovereign funds of Norway, Russia, Saudi Arabia, and the United Arab Emirates were conducting their business in non-transparent ways and were sometimes letting politics shape their investment decisions. One panelist from the Persian Gulf responded, with an ironic tone, that it was not clear to him why they were being held to a higher standard of transparency than private equity funds, hedge funds, or private investment banks.

It is precisely this lack of transparency that is the third paradox in this crisis. In every financial crash, information is incomplete and hard to interpret, but rarely to the extent we are witnessing today. Information is now being cloaked by the excessive and generalized use of sophisticated financial instruments, such as derivatives. Derivatives are so complex that, on occasion, even those who buy and sell them have difficulty measuring their exact worth as well as the level of risk attached to them. These kinds of contracts—which disperse risk and are transacted electronically at great speed all over the world—make it harder to understand who owns what, who transferred to whom, and who transferred what percentage of the assets and liabilities associated with them. If ascertaining the value and risk of these financial products proves difficult for the very experts who trade in them, it certainly is even more difficult for the government agencies in charge of overseeing these markets. The paradox is that this lack of clarity occurs precisely in the kind of financial markets that, in theory, should be the most transparent, since buyers, sellers, and the analysts that track them are usually very well-informed about what everyone else is doing.

And yet we now know that financial markets are far less transparent than we have been led to expect. The global economy now faces a financial monster whose size, behavior, and global travel itinerary remain a mystery. We do not yet know how much destruction it will cause, which countries and industries it will hit next, and how will it respond to governmental initiatives like the U.S. stimulus package. But there is one thing we do know. With every such crisis come calls for a radical restructuring of the world's financial system. We are already seeing proposals for a completely refurbished financial architecture. If the past is any guide, we will get new plumbing instead. And so we must learn to live in a world of confusion and paradox—the perfect market conditions for soothsayers.

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