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Three letters that speak volumes.

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# The long and the short of it

Aug 30th 2007

From *The Economist* print edition

## A complex system, but a simple problem

ILLIQUIDITY—the difficulty of selling assets at a reasonable price—is at the heart of all financial crises. The market turmoil of the past few weeks is proving that maxim, albeit in novel and interesting ways.

The financial system has been transformed over the past 25 years, with the emergence of new investors (hedge funds and private-equity groups) and new instruments (derivatives and structured products). But what look like incredibly sophisticated strategies on the surface can still be very simple at heart. Investors have been doing what banks have done over the centuries, borrowing short and lending long. Or, to put it another way, they have borrowed in liquid form and invested the proceeds in illiquid assets.

Most of the time this strategy works, because illiquid assets offer a premium return to compensate for the higher risk. It has been given an extra kicker over the last two decades by the “Great Moderation” in the global economy. Falling inflation and steady growth have meant that periods of economic turmoil have been shorter than expected, causing less pain to investors.

But the markets never rest. As more money flowed into risky assets, the excess yields on offer were reduced. Investors were tempted to use more and more borrowed money to enhance the returns. That left them very vulnerable to any abrupt change in sentiment.

The problems of structured investment vehicles (SIVs) are a case in point. These are specialist funds, kept separate from their parent company’s balance sheet, that invest in illiquid assets, such as securities backed by subprime mortgages. They funded those long-term investments by borrowing short-term in the money markets, in the form of commercial paper. Other investors were happy to buy that commercial paper because it was “asset-backed”, in the form of the mortgage debt.

Now investors, worried about the value of the mortgage-backed debt, are boycotting the commercial paper. The amount of paper outstanding has fallen by \$181 billion in two weeks, according to Société Générale, a French bank. This has driven the vehicles on an increasingly desperate hunt for funding. On August 28th Standard & Poor’s, a rating agency, downgraded one SIV, Cheyne Finance, and gave warning that it may be forced to sell all of its assets.

The effect is rippling through the system. First, forced liquidations push down the price of assets, hitting confidence further. Second, some of these SIVs were either set up by, or have back-up lending facilities with, banks. So banks are ending up back on the hook. Third, these unwanted assets are putting additional strain on banks’ balance sheets, which forces them to restrict their lending. It all adds up to a classic liquidity crisis.

Two new academic papers suggest that such crises may be inherent to financial markets. In the first\*, the academics link the liquidity of the markets to the ability of traders to get funding. In some circumstances (like now), this system becomes destabilising as traders are forced to put up more capital to fund their positions. This causes them to sell assets, sending prices down further and prompting lenders to demand pledges of even more capital. This is a description of the liquidity trap that doomed Long-Term Capital Management, an American hedge fund, almost a decade ago.

The second paper† suggests that traders face “Knightian uncertainty”, or risks that

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cannot be measured. When liquidity appears to be limited, those faced with this uncertainty fear the worst and try to hang on to their capital, exacerbating the lack of liquidity in the markets.


This uncertainty may have been increased by the lack of transparency in the modern financial system. No one is sure who owns what, so investors are treating all counterparties with suspicion. And the much-touted advantage of the system—the way that risk has been dispersed—looks less convincing now that banks have been saddled with the cost of funding private-equity buy-outs and SIVs.

In the past, liquidity crises have been solved by the emergence of a confident buyer with deep pockets, such as John Pierpont Morgan in 1907. But who could it be this time? Pension funds and insurance companies no longer have the flexibility, while hedge funds are facing tighter funding and the prospect of redemptions. That leaves the sovereign wealth funds of China and the Middle East. But even if they want to buy in bulk, do Western governments want to let them?


\* "Market Liquidity and Funding Liquidity", by Markus Brunnermeier and Lase Heje Pedersen, June 2007.

† "Collective Risk Management in a Flight to Quality Episode", by Ricardo Caballero and Arvind Krishnamurthy, August 2007.

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