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| Coping with financial meltdown and contagion: ‘Stress-testing’ banks |

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| **Introduction**For most persons as time passes their memories fade, albeit to varying degrees. Therefore, to protect society and ensure that it learns from experiences, mechanisms must be put in place to preserve its institutional memory. As a case in point: how many readers recall the panicky fear that gripped the world as the worst economic recession since the 1930s unfolded in 2008 and along with it a global financial meltdown of truly humungous proportions? As it turned out in retrospect, at the core of the financial crisis was the bursting of the United States private housing bubble. This produced an enormous pile of toxic sub-prime mortgaged-based securities in bank portfolios and other financial institutions worldwide. As soon as this was discerned in global financial markets, investors panicked and ran for cover; inter-bank lending virtually froze as banks no longer trusted each other’s risk management practices and/or capital adequacy provisions. Most disconcerting of all, however, was the collapse of bank credit to businesses operating in the real economy, where goods and services are produced, and the bulk of incomes is generated, thereby leading to spending and job creation. This collapse fuelled the global recession. Inevitably, a global crisis of this magnitude deeply affected Guyana and the Caricom region, although the authorities in the former seemed anxious at the time to downplay this, implying the de-linking of Guyana from the regional and global economy. Preposterous as it now seems, there was the widely publicized boast that Guyana had an “effective firewall” to guard against the negative consequences of the global financial meltdown.In the United States during 2009, as part of the policy response to the economic and financial situation, and more recently in the case of the European Union (EU), official ‘stress-testing’ of banks has been conducted as a necessary response to financial mayhem.What is official stress-testing? As the phrase suggests, this refers to techniques employed to determine whether a bank’s portfolio can withstand 1) unusual credit events; 2) significant changes to the macroeconomic situation; or 3) both occurring simultaneously. For these tests, potential losses are estimated to gauge the vulnerabilities of the banking system and its resilience to shocks. Put another way, official stress-testing is designed to assess how banks would cope with any further worsening of the economic and financial environment.I shall discuss this subject in the coming weeks. I shall broaden this discussion to consider Guyana and Caricom. One of my aims is to indicate we have not been immune to the contagion effects of the global economic recession and financial crisis. It was not only naive at the time to expect this, but dangerous foolhardiness for future plans to be based on such self-deception at this crucial juncture of the development of Guyana, Caricom and the global economy. Another aim is to evaluate stress-testing as it pertains to rich and poor economies.**The US stress test**The stress test conducted by the US authorities was a novel policy tool. It was designed to combat an unprecedented financial crisis of enormous magnitude. And, apart from the well-known policy of stimulus spending; it is perhaps the most recognised policy intervention of the Treasury and Federal Reserve. As stated, the objective was to evaluate 19 of the largest US banks to ascertain whether they could survive catastrophic events, given their then capital availability.However, we should note that the effort was also designed to estimate the potential size of the bailout which could be expected of the US government, if the banks’ capital was found to be inadequate. Additionally, it was introduced to help formulate backstop measures in support of bailout funding. As such it would help devise general measures to secure and stabilize troubled US banks. The result of the test was that 10 of the 19 banks needed funds. These were expected to have no difficulty in raising the required US$75 billion.This test result seemed to have satisfied the major concerns of global investors, traders, and other financial market operatives. This was indeed a remarkable turnaround, as at the time rumours were being circulated that despite financial bailouts, and the toxic assets relief programme (TARP), several of the biggest US banks were on the brink of bankruptcy and collapse. Analysts, therefore, feared at any moment there could be a run on these US banks, from which none would survive worldwide.**Caveats**In evaluating the test result two caveats should be kept in mind. First, while the test was being conducted, the US government sought to make it abundantly clear that if the banks were found to be inadequately capitalized, the government would provide the needed capital if private investors did not do so. As we now know private capital was forthcoming. This has encouraged the common belief that the stress-test has ‘worked’ because banks’ stocks were subsequently propped-up by private capital and the private bank sale of assets.The second caveat is the stress-test was part of a wider set of important policy measures which had preceded it. These formed, therefore, the backdrop against which it should be evaluated. One of these other policy measures was the massive size of the anti-cyclical government expenditure (stimulus packages). In total, close to US$1 trillion has poured into one form or another of stimulus spending by the Obama administration. Another similarly important policy measure was the government’s infusion of hundreds of billions of US dollars to the crisis-ridden credit markets.This was mainly focused on the purchase of toxic mortgaged-based securities under the TARP programme and the repurchase of Treasury securities with newly created cash. Measures were also put in place to directly combat the impact on private housing after the housing bubble burst. Thus, tax credits were offered to first-time home buyers in order to boost housing demand.**Conclusion**Faced with a set of dramatically worsening economic features, the European Union has also recently turned to stress-testing as a policy response. I shall consider this next week after wrapping up my comments on the US stress-test. Following this in future columns I shall proceed to discuss the situation in Guyana and Caricom. As this unfolds I shall remind readers that official stress-testing has been for the developing world part of the IMF and World Bank-obligatory policy responses to financial instability for nearly two decades now! |