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A world in crisis?

The US Federal Reserve took the unusual step of cutting rates twice in January by a combined 125 basis points to stave off a recession. First, it reduced rates by an unscheduled 75 basis points on January 22, its biggest single-day move for more than 20 years. Then, at the end of the month, it cut the Federal Funds rate by a further 50 basis points to 3 per cent.

Ilian Mihov, INSEAD Professor of Economics, says the Fed's moves were necessary to bring stability to the markets. "When the financial sector goes down, it starts spiraling in such a way that it's very difficult to restore confidence and bring back the economy on track," Mihov says.

The Fed's emergency rate cut was partly prompted by the largest sell-off in the Asian and European equity markets in a single day since the terror attacks on the US in September 2001 and the threat of panic selling in the US markets. The exodus from the equity markets was fuelled by fears of a US recession and concerns about the structural integrity of its financial system.

According to a recent *New York Times* profile of the 54-year-old Fed chairman, Ben Bernanke has spent much of his career studying the causes of the Great Depression.

Yet Bernanke has been widely criticised by leading economists and investors for providing poor economic guidance and for being 'well behind the curve' in his management of the US subprime crisis.

"There are many episodes like this we can think about (such as) the Great Depression, which was the biggest banking crisis in the history of the US," Mihov says. "And you can see how one panic after another can not only affect the financial sector but can have very significant real effects."

The January 22nd move by the Federal Open Market Committee, however, drew sharply divided views, with some critics calling the rate cut dangerous and reckless as it fueled the perception that the Fed was reacting to the turmoil in the financial markets rather than actively managing economic imbalances.

The Fed's credibility took a further drubbing following news that the sharp sell-offs in the equity markets overseas could have been exacerbated by French bank Société Générale's bid to unwind the positions of a rogue trader, which led to losses of nearly five billion euros.

In any case, 2008 will be a 'very difficult' year for the financial sector, Mihov says. That's because defaults on mortgages in the US are expected to pick up as a significant number of mortgages will be reset from low initial fixed rates of three to five per cent to much higher floating rates of more than 10 per cent, he says.

Mihov adds that starting from this March, US$40-50 billion worth of mortgages will be reset every month for six consecutive months, of which 60 per cent are subprime mortgages.

"To me, the important thing is that if you look at the data, there'll be new write-offs. There'll be all these subprime mortgages that will have to be reset. There'll be defaults for sure."

"The problems will still be there in this market, and one way to alleviate this process of resetting and reducing the defaults is actually to lower interest rates again to a level that refinancing would be relatively easy," he says.

Certainly lowering interest rates would enable US homeowners to refinance their increasingly expensive mortgages, help shore up the housing and banking sectors, as well as bolster the flagging US economy in the short term.

Easing interest rates would, however, also drive up inflation, Mihov says. "One consistent interpretation" of the Fed's aggressive easing is that "they believe that the recession risks are high enough."

"And if the recession risks are high, it means that demand will go down and inflationary pressures will subside," he says.

In his view, the likelihood of a recession in the US is 'slightly below 50 per cent' as there are no clear signals from the economic data. For instance, jobs growth is slowing but remains positive, while industrial production remains flat, Mihov says. However, he notes that many economists believe a recession will occur and that the US may already be in a recession.

Even so, the US economy is 'very resilient', he says, having weathered and recovered from major shocks in the past.

"How fast the economy will be able to absorb these shocks and then just recover is clearly unknown," he adds.

But judging by the economic data and the amount of subprime mortgages that will have their mortgage rates reset, the US financial markets will be 'very volatile', he says.

"With possibly new interventions from sovereign wealth funds financing banks in the US, it's clear that it's only towards the end of 2008 that things will subside and will clear up."

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