

## **One Interpretation of the Global Financial Crisis**

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Listen to the current wisdom (i.e., sound bites) of the media and the politicians and the global financial chaos is due to the twin villains – subprime mortgages and Wall Street. Yet estimates suggest that only about 20% of mortgage securitizations are subprime, and of those about 80% are performing. So how can 20% of 20% subprime exposure cause such global chaos?

That's because they are looking in the wrong place. The real problem ... we are really deep into a global liquidity crisis. So just what is a liquidity crisis? In its simplest form, it is a massive hoarding of cash. I have surplus cash but won't lend it to someone in need – because I'm not sure I'll get it back. So the entity needing cash either defaults or cuts back to conserve their own cash. Basically, no one trusts anyone – so financial transactions grind to a halt.

This just happens to be an area where finance theory and the “real world” converge. The theory explains the current situation and may provide the direction for a solution.

Back in 1970 George Akerlof introduced the concept of information asymmetry and markets. Popularly known as the “lemons problem” it suggests that when “investors” are unable to reliably distinguish between good and bad (i.e., lemons) opportunities, they will do nothing and avoid all opportunities. This leads to a market freeze – or a “market failure”. The market failure can be unfrozen by resolving the asymmetry (distinguishing the good from the lemons) or by reducing the penalty for choosing a lemon (ensuring the investment).

Moving to 2008 we see the identical lemons situation. We have firms in need of cash; some are good firms that will repay while others are lemons who will not. And, of course, the lemons aren't telling. In fact they are doing their best to look like their good counterparts. How many firms were touting their positions only to crash the next day?

Now while we know the overwhelming majority of firms are good, we just can't distinguish them from the lemons. So rather than risk providing funds to a lemon, and losing them, we do nothing. So neither good nor lemons receive anything. Under the circumstances it becomes a very rational and reasonable position.

The consequences? Funding dries up. Penalizing the good with the bad, it begins to depress economic activity as good firms reduce activity to conserve cash. Sound familiar? This is the underlying dynamic of the present crisis. And it is not limited to financial services firms. Reports of tightened Accounts Receivable policies are already escalating.

The way out? Supposing investors received some sort of assurance their funds would be recouped. That certainly reduces any consequences of lending to a lemon... and without that exposure, general lending might be expected to recover. Loans to good firms would be repaid (the majority) while losses from the limited number of lemons would be “covered”. While the fundamental asymmetry remains, the “insurance” reduces the lemons consequences and may then unfreeze liquidity.

The cost? – the lemons loss coverage.

So, in the end, Akerlof's Nobel Prize winning concept may help us understand and provide a groundwork for addressing a liquidity crisis 38 years later.