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Deleveraging Must Continue

The credit crisis has reached a culminating point. Financial Armageddon has been averted, but the industry is not yet off the hook. Although the reduction of risky assets has gathered momentum since the fall of Lehman Brothers, hammering stocks hard, the deleveraging process still has a long and rocky road ahead.

The fallout from failed banks, like Lehman Brothers or the Icelandic banks, will continue to show up in banks' upcoming quarterly results. Emerging-market bonds and currencies have plummeted amid foreign capital flight. There is significant counterparty risk on the credit-derivatives markets, causing more writedowns. Corporate and consumer loan defaults are set to rise in the months to come. Last but not least, hedge funds face severe liquidity constraints and substantial investor withdrawals. The resulting "de-risking" of hedge funds is dragging global stock markets down; hundreds of funds are likely to close.

So where is the ray of light? For one, there is public money on the sidelines and governments will not let further big bank failures happen. Central banks are cutting rates and flooding markets with liquidity. Yet while these measures are helpful, they cannot substitute for the necessary consolidation of banks' balance sheets.

There is no alternative. The persistence of an overleveraged financial sector would pose a much bigger threat to the real economy than the deleveraging process itself.

Deleveraging does not necessarily mean reducing loans to the private sector. It is first and foremost a financial affair. The decade prior to the meltdown saw an explosion of activity between financial institutions. Financial assets, such as mortgage loans, were used and reused many times over to create new trading and hedging opportunities. Much as a small amount of sugar can be spun up into a huge cone of candy floss, investment engineers created a new financial cosmos with only thin real underpinnings.

As a result, balance sheets mushroomed, more or less unconstrained by capital requirements. The total assets of U.S. investment banks saw compound growth of roughly 15% per year between 1997 and 2007; U.S. issuers of asset-backed securities grew by 17.5% annually. That is the story of leveraging. It provides striking evidence for the decoupling of at least some parts of the financial sector from the real economy. The financial industry, propelled by ever higher leverage, entered its own orbit of stellar profits and bonuses.

Now that banking and capital markets have come crashing down to earth, the leverage rocket has switched to reverse thrust. As too many of the new financial instruments morphed literally overnight from low-risk securities into toxic assets, bloated balance sheets required considerably more capital. The shrinkage of the balance sheet will concentrate on financial assets within the financial sector, such as repos, hedge-fund loans, leveraged loans, credit derivatives, CDOs and the like.

With the refocusing of the U.S. Troubled Asset Relief Program away from buying toxic assets, the challenge for banks has changed. The easy part will be to call short-term loans, passing the burden to business partners such as hedge funds. Banks will also sharply reduce their own trading activities, eliminating repo demand.

For other more complicated and toxic assets, some banks will probably follow the lead of UBS and others, shifting them onto special-purpose vehicles and thereby ring-fencing their own balance sheets. Others will choose the route of further writedowns. Either way, more capital is needed. No wonder that banks are now queuing up for government funds.

The whole process would of course be simpler if private investors could be tempted to enter the field. However, given the bleak outlook for the world economy and the mounting domestic problems for many sovereign wealth funds, one of the biggest investor groups, the arsenal of public measures is indispensable to restore the health of the financial sector in an orderly process.

In a sense, this process will result in the focus of business shifting away from ever more sophisticated ways of shunting risk around the financial cosmos, and toward the more traditional banking practice of acquiring, holding and monitoring risks. In other words, it will engender a kind of reconnection of financial markets with the real economy. After years of tremendous growth, the ratio of financial assets to GDP will decline; levels of above 400% no longer look compatible with markedly lower financial-sector leverage. If the adjustment proceeds quickly, the flow of credit from the financial sector to the real economy will not be impeded for long. With recapitalization still under way, growth in corporate and household lending is possible—if the demand is there.

However, apart from this deleveraging process within the financial sector, there remains another question: Are not sectors of the real economy sorely in need of some balance-sheet repair? That is the story of unwinding imbalances in the real economy—which have existed for much longer than the financial excesses in quite a number of countries. The process of rebalancing the world economy does indeed look long overdue, with a starring role for the U.S. household sector.

For that reason, it is of overwhelming importance to make a clear distinction between the deleveraging process within the financial sector and debt consolidation in the real economy. In countries that have experienced a credit boom, such as the U.S., the U.K., Spain and many eastern European countries, both adjustments are necessary—and painful. Public assistance is required, but using recapitalization funds or monetary policy to duck inevitable adjustments in the real economy is dangerous. The longer the reduction of debt is postponed the more brutal the final reckoning.

Trying to grow out of the problems—or, put differently, growing into the high debt levels—would mean repeating the "Japanese problem." Japan resumed its growth only after it tackled its bad loan crisis head-on. A swift correction of balance sheets may have painful effects for financial markets, but it is the surest way to restore confidence quickly and avoid a "lost decade" with a lingering credit crunch.

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The process will hurt, but there is no good alternative.