A framework to end the market volatility

By David McCormick and Robert Steel

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Recent capital market challenges have prompted calls for immediate regulatory action. Before recommending lasting policy changes, US economic decision-makers are committed to working multilaterally to put these events in perspective, examine the root causes and respond in a thoughtful and timely fashion.

Despite understandable anxiety over current market turmoil, recent events are unfolding against the backdrop of very robust economic fundamentals. The global economy continues to grow at about 5 per cent annually; overall worldwide growth in recent years has been the strongest in three decades, with emerging markets as a key driver. US economic fundamentals remain strong: unemployment is low, wages are rising, core inflation is contained and our financial system remains well-capitalised.

Positive worldwide economic conditions over the past few years have helped fuel a demand for credit and investment. The marketplace responded with an abundant supply of both, through a broad array of innovative, complex financial instruments and structures. Borderless capital flows made it possible for financial institutions and economies around the world to benefit from these new investment products. These new opportunities also brought some challenges and we are dealing with some of those today.

Benign market conditions bred complacency and credit discipline deteriorated, particularly in leveraged loans, US subprime mortgages and other, related asset classes. Recent volatility in the credit and mortgage markets reflects a reassessment and a re-pricing of risk, as well as retrenchment from lower-quality and less-liquid assets. This readjustment is a painful reminder of the importance of robust risk management and of the need for investors to properly understand, evaluate and examine risk.

We have also been reminded that when capital markets are globally integrated, disturbances and uncertainty, like capital, also flow across borders. We have seen some improvement in recent weeks, but it will take more time for the impact of these financial market dislocations to play out and for their impact on the global economy to be completely clear.

US economic policy-makers have a three-part framework for response. First, President George W. Bush and Treasury secretary Hank Paulson remain steadfast in their commitment to the core policies - low taxes, free trade, open investment and fiscal restraint - that have contributed to the strong US economy.

Second, the US is addressing short-term challenges. This includes ongoing actions and monitoring by the independent Federal Reserve to restore orderly conditions in financial markets and improve market liquidity. Additionally, President Bush recently announced a series of proposals to help troubled homeowners remain in their homes while also ensuring that predatory lenders bear full responsibility for their actions.

The third part of our framework includes working closely with our international economic counterparts to evaluate the contributing factors of this uncertainty and determine appropriate actions. Consistent with this objective, Mr Paulson and his counterparts in the Group of Seven leading industrial nations will ask the Financial Stability Forum (FSF) - a body of finance ministries, central banks and regulatory bodies from leading financial centres created after the Asian financial crisis - for a timely examination of four issues.

First is financial institutions' liquidity, market and credit risk practices, including treatment of complex credit products and conduits. The second is accounting and valuation procedures for financial derivative instruments, particularly for complex, narrowly traded products that become difficult to price in times of stress. Third is basic supervisory oversight principles for regulated financial entities, especially given exposures to off-balance sheet, contingent claims. And fourth is the role of credit rating agencies in evaluating structured finance products.

The FSF's initial report will be provided to the G7 finance ministers at their October meeting. This report's recommendations will be an important input towards targeted, balanced, multilateral action.

The international economy is well-positioned to weather the current storm. The globalisation of capital markets has brought enormous benefits to the world - broader choices in financial products, greater prosperity and expanded opportunity. The US is committed to policy prescriptions that address the root causes of recent volatility while maintaining the benefit of competitive global markets.

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