Emmanuel Tumusiime-Mutebile: The sub-prime banking crisis in the USA and its impact on the East African financial system

Speech by Mr Emmanuel Tumusiime-Mutebile, Governor of the Bank of Uganda, at a Commonwealth Business Forum Luncheon, Kampala, 21 November 2007.

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Over the last few months, capital markets around the world have been going through uncertain times as a result of the sub-prime mortgage crisis affecting the American banking industry.

This started out as a problem of excess liquidity and quickly degenerated into a credit crisis, originating from financial institutions having exposure to the sub-prime market and thereby incurring huge losses as delinquencies and foreclosures increased following US Federal Reserve's tighter monetary policy.

Over the last few years, the US financial system had experienced substantial excess liquidity, which created huge surges in the valuations for home prices in the US.

As interest rates fell due to excess liquidity, house prices rose rapidly. This was attributable to declining interest rates that saw their lowest levels in the last 20 years. Banks lowered lending standards, allowing "sub-prime" borrowers to obtain home mortgages on increasingly favorable and imprudent terms.

This, coupled with the emergent practice of selling these mortgages to other financial institutions, in packaged products known as Collateralized Debt Obligations (CDOs), enabled the lending banks immediately to take such mortgage loans off their balance sheets. This increased the banks' propensity to make such loans on increasingly liberal and imprudent terms. Borrowers with very poor or insufficient creditworthiness were able to obtain mortgages far in excess of what they should have been able to, for houses that were far beyond their means.

In addition, these sub-prime mortgages were frequently granted to borrowers with limited or no credit history at variable interest rates, characterized by very low initial "teaser" rates, which would be sharply adjusted upwards after the initial period – typically after two years.

As house prices rose, borrowers' equity in the properties grew and they were able to sell their homes and take out profits or as was more frequently the case, they borrowed against their "increased equity" in the properties and used such "secondary mortgages" to engage in increased consumer spending, and in other cases, to make payments on the original mortgage.

This further created a cycle, resulting in very high consumer spending and fuelling global growth. However, as interest rates started to rise in the US due to inflation concerns, this cycle came to an end and the demand for houses started to decline. This resulted in sharp falls in home prices and as a result, many owners/borrowers have become unable to service their mortgage loans.

The excess liquidity has been slowly drying up and the levels of equity extraction available from home purchases is coming down – leaving less money for consumer spending. This has started causing problems for the US economy in the form of foreclosures, job losses, loss of consumer confidence and reduced consumer spending and the fears of a slowdown, if not outright recession.

This is what has become known as the sub-prime crisis.

The sub prime crisis has also had a "contagion effect" and we have already started to see huge write-offs by banks business in the US as well as the UK, where housing prices during

last five years have also risen very rapidly, creating a potential effect such as in the US. This is expected to have global effects since the US consumer demand amounts to more than 40 percent of the total OECD demand, and to 18 percent of world demand.

Unlike the Asian financial crisis approximately 10 years ago, the current events triggered off by the US sub-prime market has not sent global markets and currencies into a tailspin. Indications are that, fundamentally, the global economy has firm foundations, although there is still the possibility that the turmoil may have some long-term impact due to the domino effect of reduced economic activity in the world's largest economy, the US.

Initially, as was the case with the Asian crisis, as the problem exacerbated over the last couple of months, large institutional investors appeared to shed both developed and emerging-market equities and foreign exchange markets witnessed a significant increase in volatility, and emerging-market spreads rose significantly between late July and mid-August, as losses related to sub prime mortgages prompted investors to shed riskier assets, and the spread, or extra yield, investors demand to own emerging-market dollar bonds instead of U.S. Treasury securities widened according to JPMorgan Chase & Co.'s EMBI index.

Interestingly, however, unlike the previous global financial crisis, the rise in emerging-market debt spreads was not as pronounced or as sustained as that of credit markets in developed economies.

What does all this mean for East Africa?

There appear to be two broad schools of thought.

Substantial impact

Some think it will reduce the flow of capital coming to the emerging as well as "pre-emerging" markets as ours is characterized. In this regard in East Africa, we have experienced significant interest and flows into our markets of late. There has been a large increase in the number of foreigners participating in our market, as international investors across the globe have searched for higher yielding assets, including ours. Therefore, some consider that as a region, we are vulnerable to any increase in global risk aversion stemming from the sub prime crisis. Proponents of this view suggest that when investors get scared, they sell their riskiest assets (among them investments in emerging and pre-emerging markets) in search of safe havens, as they reassess their appetite for risky assets. It is therefore felt that now, with the sub-prime crisis, this interest will dry up.

Little or no impact

The other thought school is of the opinion that our economies appear resilient, and will weather the ongoing market correction in the industrialized world. It has also been speculated that lower demand for products in the developed world would be balanced by increased demand in developing countries.

In fact, some analysts have started to talk about a new "flight to quality" idea – that buying securities in an emerging market could be an appealing opportunity when there is turmoil in the developed markets. In other words, emerging markets have started to resemble a safe haven!

Given these observed phenomena, a school of thought is becoming convinced that economies in the rest of the world have become "de-coupled" from the US. In this view, it is claimed that, even if the US economy slows, the rest of the world, particularly the fast-growing emerging markets of China and India, will not.

This view appears to be supported by the International Monetary Fund (IMF), which in its most recent World Economic Outlook publication, released in September, stated that "…

world growth is expected to slow but remain solid, supported by the strong momentum of the main emerging markets, China, India and Russia, which together accounted for one-half of global growth over the past year".

Others suspect this latest burst of enthusiasm is nothing more than a whim that will disappear when confidence in US and European markets returns. Still others see it as the beginning of a new speculative bubble. Nonetheless, investors' new-found confidence in emerging markets does reflect one reality, namely that many emerging economies are in far better shape than ever before to weather broader financial turmoil.

Impact on East Africa

In East Africa, our money markets have so far been relatively unaffected. Our banking systems within the region had very little exposure to the sub-prime market and as such, there has not been a need for the Bank of Uganda or any of the regional central banks to provide extra liquidity to markets, for this purpose.

Based upon these trends and observations, there is reason to believe that, at least to some extent, East Africa, which now enjoys a more stable regional financial economy than in the past, may equally be able to "decouple" from this slowdown that has been triggered off by events in the mortgage industry in the US and has impacted other countries such as the UK.

Our banks are now well capitalized in accordance with Basel II requirements and very liquid. In contrast to recent surges in US fed funds rates, our regional and domestic rates have not been affected by the sub-prime situation.

Furthermore, BOU and sister central banks in the region have made a deliberate move towards the use of market-based instruments for monetary and fiscal purposes. This is a key aspect of the East Africa Community's monetary and financial convergence criteria, and this has also enhanced our capability to respond to external shocks. For example, we now rely substantially on treasury securities sales and the use of repurchase agreement (repo) operations for the transmission of monetary policy.

We also have developed our domestic debt markets and have seen a more diverse group of investors – including our pension funds, regional asset managers and non resident nationals and local retail investors – whom are increasingly investing for the long term. Thus, overall, it would appear that our markets are far less susceptible to events in the markets of the developed world, than they may have been in the past.

In particular, it may be noted that many of us are commodity exporters and many commodities are at record highs. We have also substantially shed the baggage of external debt and have built relatively strong foreign exchange reserves thereby making us less vulnerable to currency depreciation and other contagion effects.

However, to say that we will be completely immune is very dangerous, since a significant volume of our regional commodity exports is to the US and UK and an increasing volume of investment inflows are from the US and the UK.

Also, the rapid movement of capital as result of globalization as well as the liberalization of capital accounts such as we have done in Uganda, has increased significantly in recent years, posing further challenges to the conduct of monetary policy. To a large extent, most of us would agree that globalization has been positive insofar as it has imposed market discipline on us. There are many who also think that globalization actually reduces volatility.

Going forward – what we need to do

As the IMF has noted, most of the world will likely emerge relatively unscathed from this crisis. The recent shifts away from the US as being the key driver of global growth, together with the better balance achieved during the last two years represents significant support for

the global economy. However, the ramifications of any sharp slowdown in the US always remain and should not be underestimated.

Whilst the global economy is deemed to be robust enough to shake off US weakness, contagion effects means that the sub-prime problems can contaminate other countries. As noted, our markets are better prepared for, but certainly not immune to global financial market risks. A reduction in global risk appetite would eventually reduce net capital inflows into our markets and may dry up much needed FDI.

If the US, which has a 25 per cent share of global GDP, slows down, it will definitely have an impact on the entire global economy, including East Africa. The next few months will therefore, be crucial for the US and international markets.

However, our lower external debt, better external reserves levels, more prudent fiscal management, debt markets with a investor base that is not dependent on foreign investors, will all undoubtedly help to cushion our financial system compared to say, those of China which exports a fifth of all Chinese exports. China's Central Bank estimates that ever 1 per cent drop in US economic growth translates into a 6 per cent drop.

The fact however, is that we should be concerned about the problems in the US. A slowdown in the biggest economy in the globe will have repercussions for all of us.

Under these circumstances, extreme vigilance on the part of policy makers is warranted. During periods of financial market stress, the focus of central banks shifts to ensuring the banking system remains functional.