Let small fires burn

The remarkable stability of the past two decades sowed the seeds of the current crisis. In future, monetary authorities will have to be more aggressive about removing the punch bowl when the party gets interesting, argues ***David Rowe***

In a generic sense, financial markets are one example of a dynamic adaptive system. As pointed out in my September column (*Risk* September 2009, page 110[1]), considerable discussion surrounds what we can learn from other such systems to improve financial supervision and risk management. I believe one important lesson comes from the area of forest fire prevention and control.

For many years, the US Forest Service followed a policy of quenching every small fire as quickly as possible. Exceptions to this policy were first introduced in 1972, with the rationale that "reduction of hazard fuels in selected areas reduces risks and costs".[2] The idea was that small fires consume brush and other dry tinder that provides fuel for fires. Periodic small blazes consume this fuel without doing irreparable damage to the trees themselves. Extinguishing every small fire allowed such dry tinder to build up progressively over time until it reached a stage where a fire could spread quickly out of control, becoming so massive that it enveloped the crown of the trees and effectively destroyed the entire forest.

While many analogies from other dynamic adaptive systems have limited relevance for financial markets, I think this one is highly pertinent. For almost 20 years, the world experienced the 'Great Moderation', which saw low inflation and interest rates, and – with occasional exceptions – low volatility in prices, interest rates and exchange rates. Even periodic shocks (for instance, the 1987 stock market crash, the US savings and loan crisis, the dot com bust and the September 11 attacks) were absorbed without a major decline in real economic activity. Gradually, the dangerous attitude developed that we had entered a new era and 'this time is different'.

Risk premiums declined to unrealistically low levels as investors accepted more and more leverage to achieve what they deemed to be minimum returns. Alan Greenspan is widely cited for coining the term 'irrational exuberance', but I remember another less widely noted comment of his: "History is seldom kind to periods of unrealistically low risk premia."

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In many ways, I think the analogy to extinguishing every small fire is quite appropriate. Increasing globalisation kept inflation in check as many third world countries became effective participants in international markets. This, in turn, allowed central banks around the world to keep interest rates low without fear of stoking general price inflation. The combination of low interest rates and generally stable economic conditions encouraged firms and individuals to assume ever greater structural risks in exchange for higher current returns or lower current cost.[3] This led to periodic asset price bubbles, most recently in the housing market. Steady economic expansion and low interest rates encouraged many middle class families to stretch to build second homes or borrow to enter the buy-to-let market, and many low-income households assumed mortgage obligations they had no reasonable expectation of repaying if home prices fell. In effect, the careless growth in leverage throughout the economy was a nearly perfect analogy to progressive accumulations of highly flammable tinder in the forest. Absent the spark to ignite a crisis, such leverage seemed quite benign. In fact, it set the stage for a major conflagration once a crisis started.

Former chairman of the Federal Reserve, William McChesney Martin, was fond of saying the thankless job of a central bank was "to take away the punch bowl just as the party gets going". The rapid advance of global economic integration over the past 20 years mitigated the need for central banks to raise interest rates aggressively to fight inflation. The comparative economic stability that prevailed for two decades, however, spawned dangerous structural vulnerabilities.

One lesson we should heed in future is the wisdom of chairman Martin's prescription. Modest economic corrections can be instrumental in constraining the build-up of structural vulnerabilities such as those that preceded the current crisis. One danger is that politicians will undermine the now widely accepted independence of central banks, thereby making it harder to impose periodic corrections that are needed to prevent less frequent, but far more damaging, economic conflagrations. ■

[1] *www.risk.net/risk-magazine/opinion/1532623/financial-network-risk*
[2] *US Department of Agriculture and US Department of Interior, Fire Management Policy Review, December 15, 1988*
[3] *One example of this is the growth in low interest foreign currency mortgage loans, often in yen, that exposed many people to significant exchange rate risk. See Rowe, D, A yen for financing, Risk April 2007, page 83 (www.risk.net/risk-magazine/opinion/1497322/a-yen-financing*