The Financial Crisis Inquiry Commission (FCIC) hearings this week represent a critical opportunity to understand how stress in the subprime mortgage market mushroomed into the most severe financial crisis since the Depression. Unfortunately, the opportunity will likely be squandered. The FCIC is myopically focused on the role of institutions rather than markets and the need to score political points versus engaging in a real investigation.

The problem originates with its Congressional mandate.

The FCIC is charged with examining a whopping "22 specific and substantive areas of inquiry related to the financial crisis." Unfortunately, only two areas directly address financial markets. This represents a serious omission. Markets provide rich informational content with prices frequently signaling risks and the motives of its participants. Unfortunately, none of the 22 items dares to address the most pressing issues of evaluating complex inter-linkages among markets.

The areas of inquiry largely fall into two categories. First, topics such as accounting practices, tax treatment, legal and regulatory issues, as well as others represent items the government can control. Second, financial institutions, rating agencies, the Fed, fraud, and enforcement provide institutions or forces the government can blame.

Admittedly, these issues contributed to the crisis. Nonetheless, the FCIC should exercise leadership and more thoroughly explore financial inter-linkages that deepened the crisis and extended its duration. A failure in one market triggered a crisis in another seemingly unrelated asset class. With each successive failure, the crisis gained vigor and momentum.

In fact, more active integration of market analysis into policy in the fall of 2007 might have meaningfully limited the severity and length of the crisis as well as thwarted the failure of Lehman and AIG.

The spike in the Libor-OIS spread in August 2007 is often cited as exacerbating fragilities in money markets. However, the discussion falls short of revealing how a delayed response to the early widening of the Libor-OIS spread meaningfully deepened the crisis. Namely, the failure to effectively incorporate price signals and an understanding of inter-market linkages into policy led to a remarkably sluggish response by the Federal Reserve. This shortcoming set the stage for a spread of the crisis to
Lehman and AIG as well as Emerging economies that were previously thought to have "decoupled".

Although small relative to the nearly 300 basis point spike in the spread during 2008, the jump in the 3-month Libor-OIS spread from August 2007 into early September from 0 to over 90 basis points should have served as an early warning for officials. At that time, market practitioners were painfully aware that a shortage of US dollars abroad was adversely influencing the spread and exacerbating money market conditions in advanced economies.

With each passing day, the shortfall became increasingly acute and market participants began to question the quality of their counterparties’ credit.

The solution was simply for the Fed to engineer reciprocal lines of credit with other central banks. The policy would not prove original, challenging, or "out of the box," as major central banks in Asia implemented Chiang Mai swaps in the aftermath of the crisis in 1997-98 to avoid currency shortages across borders.

After over three months of escalating problems, the Fed finally eased access to US dollars in foreign markets through the implementation of dollar liquidity swap lines with the ECB and SNB. However, the damage to confidence was done and mistrust of counterparty credit meaningfully elevated.

The disturbance in advanced economy money markets set the stage for the crisis to spread to the Emerging Markets. For instance, the implied yield or cost of dollars in the Non-Deliverable Forward (NDF) market for Emerging Market currencies spiked from 0 to nearly 200 basis points for a basket of 13 exchange rates between August and September 2007. The NDF market was and remains a critical vehicle for local and foreign corporations to hedge their currency exposure in rapidly growing Emerging economies.

The on-going freeze in US dollar liquidity ultimately served as a clear transmission mechanism for difficulties in Emerging Markets. The shortage of US dollars abroad prompted corporations in Emerging economies to scramble for credit and funds in already illiquid markets. This contributed to the eventually even more powerful slide of asset values in Emerging Markets than their advanced economy counterparts.

Going forward, failure to focus on markets will lead to a myopic view of the causes of the financial crisis and risk creation of new regulation that lags future advances in finance. Technology will facilitate a rapid transfer of funds and claims across borders and among varying market players. Likewise, market players will continue to develop
new methods and mechanisms to structure and sell risk. These irreversible trends will without doubt deepen the inter-connectedness of nations and markets in the future.

The FCIC needs to supplement its focus on institutions with a serious look at financial market inter-linkages and mechanics involved rather than simply scoring political points before the mid-term elections.

Lawrence Goodman is President of the Center for Financial Stability, Inc. Previously, he led international crisis prevention analysis at the US Treasury as well as chaired an Inter-Agency group to advise senior officials throughout the US government on potential crises.