Crisis, Response and Innovation in America and Asia

Robert Fauver, Fauver Associates

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It is a pleasure for me to be here this morning. I think that studying the current crisis is critical to understanding its implications for future policy makers. While the organizing theme of this conference is the Global Financial Crisis, the world faces much more than a financial crisis. And we need to consider the broader implications or side effects of the financial crisis in order to understand fully the consequences of the policy decisions that led to the global financial crisis.

This global financial crisis has changed significantly the world's economic and financial landscape. It has created two basic types of costs for investors and consumers: economic and financial. And these two are interrelated and tend to feed off each other. Difficulties in one area create additional problems for the other.

The world economy is experiencing its deepest downturn in decades — and the first synchronized recession in the industrial world since the first oil crisis of 1973/74. As the macroeconomic implications of the financial crisis became better understood — and the depth of the financial crisis itself —, the International Monetary Fund significantly reduced its forecasts for global 2009 real growth from 2.2% to 0.5%.[1] This reduction occurred only three months after the Funds earlier forecast! The industrial countries have been the hardest hit with their forecast real growth deteriorating to a decline of 2 percent — down from the October estimate of a modest -0.5 percent. Hardest hit was the US where growth is now expected to decline by 1.6 percent — down from the earlier estimate of zero. The forecast reduction in global growth since October amounts to a loss of global GNP on the order of $1.2 trillion — simply from the downward revision!

This deteriorating economic outlook has hit financial firms hard. The worsening credit conditions affecting a broader range of markets over the winter months caused the IMF to raise its October estimate of the potential deterioration in U.S. — originated credit assets held by banks and others from $1.4 trillion to $2.2 trillion. Much of this deterioration has occurred in the mark-to-market portion of their estimates (mostly securities), especially in corporate and commercial real estate securities, but degradation

[1] IMF World Economic Outlook, April 2009. Table 1.1 p10.

is also occurring in the loan books of banks, reflecting the weakening outlook for the economy.[2]

The IMF offers rough estimates that expected write downs for European and U.S. banks during 2009 and 2010 (partly offset by the anticipated revenues over the same period) would result in a net capital shortfall of roughly at least half a trillion dollars. This implies that for U.S. and European banks taken together an amount in new capital on the order of $500 billion is necessary just to prevent their capital position from deteriorating further.[3]

Global equity markets have lost more than 50% in one year — roughly $31,000 billion of market capitalization has been lost. According to the Fed's Survey of Consumer Finances, released on February 12, 2009, average net worth is estimated to have fallen 22.7% from 2007 until October 2008. The recent wealth drop likely hit wealthy pre-retirement Baby Boomers and the newly retired the worst, since it is those demographic groups that tend to have the highest net worth.[4]

The current economic situation is the product of many years of economic policy decisions undertaken in the major industrial countries. But it is also important to recognize the role of decisions taken in the leading emerging market economies. In my opinion there is plenty of blame to spread around among economic policy makers in both industrial countries and emerging markets.

The financial crisis was long in making. It was the result of numerous policies choices primarily in the United States, but the crisis was magnified and — I believe — lengthened and deepened by the policy choices outside the US — both those taken before the crisis and those taken in response to the crisis.

The crisis

Most analysts believe that the financial crisis started with problems in the US sub-prime mortgage market. For nearly 20 years, the Congress and various administrations pushed the concept of wide-spread home ownership. And special attention centered on the ability of minorities and lower income families to join the ranks of home owners. From the 1970s onward, policy efforts focused on reducing down payment requirements for home buyers.

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[2] IMF: Global Financial Stability Report GFSR Market Update January 28, 2009 p2.

[3] IMF, ibid. p3

[4] WSJ: 2/12/09

I remember that when my wife and I bought our first home, we were required to come up with 20% of the purchase price as a down payment. And for a young couple that was a lot of money! During the 1970s Congress pushed the Federal Housing Administration (better known as FHA) to devise programs aimed at lowering down payment requirements — first to 10% down and then FHA developed the 'magic money plan requiring only 5% down. By the 1990's, FHA and commercial lenders were financing 'no money down' new home purchases for qualified borrowers.

The Clinton Administration supported by the Congress moved to make 'redlining' of neighborhoods illegal. Banks and other lenders had been selecting some low income neighborhoods as being ineligible for mortgage loans. Congress decided that this practice amounted to discrimination against minorities. Regulations were changed to make this form of credit allocation illegal. And political pressure was put on lenders to increase significantly their mortgage lending to low income borrowers.

After a time, lenders complained that their balance sheets could not take any more risky loans and they threatened to stop lending to low income borrowers. The Congressional reaction was to push Fannie Mae and Freddie Mac to increase substantially their purchases of low income mortgages. The resulting purchases freed up lending by banks and other mortgage lenders. They could make essentially endless new loans and quickly sell them off the Freddie and Fannie. Huge profits came from the service fees associated with the new loans and lenders faced virtually zero risk as they immediately sold off the risky loans.

By 2005 or so, lenders were making loans without verifying the income situation of borrowers or their ability to make the required loan payments. And the use of adjustable interest rate loans became increasingly widespread. Artificially low initial interest rates were essentially 'bait and switch' rates for uninformed borrowers. Unqualified borrowers increasingly became first time home owners. And the flood of new buyers pushed housing prices sky high.

As is always the case, the housing bubble eventually collapsed.

The initial stages of the housing crisis appeared to be a normal kind of market adjustment. But regulators and financial institutions were unaware of the wide extent to which sub-prime mortgages had been securitized. And that these securitized instruments had in turn been used to back other financial products ranging from insurance products to derivatives. The fall in value of securitized sub-prime loans quickly spread to other financial assets and the financial crisis became full blown.

Near the end of the Bush Administration, Secretary Paulson worked with the Congress to pass the Troubled Asset Relief Program — some $700 billion. The original purpose of the TARP was to fund the purchase of troubled or toxic assets of banks in order to strengthen their capital positions. Stronger balance sheets were supposed to enable banks to resume providing credit to the economy. [5]

But Paulson changed his mind. Instead of buying troubled assets, he decided that banks needed straight injections of capital — so he provided loans. A significant problem with the TARP was — and continues to be — the establishment of prices for the assets. Given that the market for securitized mortgage paper had essentially dried up with little trading taking place, it became impossible to determine the 'market value' of the assets. When Treasury decided to purchase a troubled asset it faced a difficult decision on making its purchase proposal — if the price was significantly below book value, then banks would face serious losses. On the other hand if the assets were bought at book value, the government would inevitably lose money on the transactions since a substantial number of the mortgages underlying the securitized assets were likely to be foreclosed on.

While all of this was taking place in the United States, it is important to review what was happening in the rest of the world.

In Europe, banks were also engaged in the sub-prime market both thru direct investments into securitized sub-prime mortgages and indirectly thru the various derivative products based on the sub-prime securities. Significant balance sheet losses were taking place in Europe, but the lack of mark-to-market accounting rules hid the seriousness of their exposure to both market participants and to local regulators. British banks were hard hit. British authorities similarly have rejected a policy of fully nationalizing banks, except in rare individual cases such as Northern Rock. It has also taken a controlling share in other instances, such as with Lloyds HBOS. Germany also has moved forward with new legislative authority to nationalize financial firms.[6]

For Europe, the financial crisis quickly turned into a real growth problem. Dramatic slowdowns occurred across Europe and the recession widened into a global problem. For years, Europe had relied on exports to the US to underpin domestic growth. With the falloff in the US economy, production declined and the underlying weakness of domestic demand became apparent.

In Asia, the two key countries — Japan and China — largely escaped the financial aspects of the subprime crisis. In Japan, the experience of regulators and financial firms with their own financial bubble that started in 1989 led to relatively cautious

[5] Bloomberg News Service. November 13, 2009. Article by Abigail Moses.

[6] University of Toronto, G20 Information Centre, March 30, 2009. Article by Jenilee Guebert.

engagement of Japanese banks in the wide range of sub-prime based instruments. Some would argue that Japan's timid participation in the sub-prime market was not based on foresight, but rather based on fear of repeating their earlier problems.

China's lack of a mature, integrated financial market helped them to escape the global problems. But both China and Japan for a decade or so had formulated their growth strategies based on growing exports to the US market. Exports were to provide the stimulus to their domestic growth and employment creation. Obviously the sharp growth slowdown in the US produced a dramatic decline in exports to the US. While Japan's economy shifted sharply into recession, China's growth rate significantly slowed — roughly by half from the 10-12 percent growth rate of earlier in the decade. Since the second driver of Japan's growth for sometime had been rising exports to China, the Chinese slowdown added significantly to the reduction in Japan's exports. Most of the exports to China could be called indirect exports to the US. These exports largely went to China's export sector. They were not consumer goods for the domestic Chinese market. Hence the derivative effect of the US slowdown was to slow Japan's exports to China.

The response.

The stage was now set for the incoming Administration. Bank lending had plummeted, the stock market had dropped billions of dollars in asset value, the largest insurance firm — AIG — had been essentially nationalized, several securities firms had been merged with commercial banks, the stock market crash and the freezing up of credit markets had driven the economy into recession, and the Treasury had already spent roughly $350 billion of the $700 billion TARP money.[7]

In addition to the financial market turmoil, the new administration faced a widening recession in the domestic economy, with rising unemployment levels, a declining real estate market, a near bankrupt American automobile industry, and an investor public that had watched billions of dollars of financial assets disappear. Older Americans saw their retirement savings decline dramatically.

During the transition period, the Obama team decided that they needed a fiscal stimulus package passed by the Congress early in the new term. So they let the democratic leadership know that Obama wanted something on the order of a $500 to 700 billion stimulus package.

Speaker of the House Nancy Pelosi moved quickly to draft the stimulus package. She ignored the views of republicans and some democrats by drafting the legislation in her

[7] Reuters News Service. January 16, 2009. 'Paulson: TARP still needed for bank capital.

office instead of in a committee. The final house bill received no republican votes. The Senate also moved relatively quickly with Majority leader Reed controlling the process. The Senate however needed a couple of republican votes in order to secure passage of the legislation. Hence a few small compromises were made. The final bill reconciled by the House and Senate was passed on February 13th. The next week President Obama signed the American Recovery and Reinvestment Act on February 17, 2009. Proposed new spending totaled $787 billion. An historic stimulus package either in dollar terms or as a share of GDP.[8]

While it is too early to determine the success or failure of this stimulus package, many commentators have suggested that a significant portion of the spending will not take place in either 2009 or 2010. The Congressional budget office estimates that only $185 billion of the total spending will take place in 2009 — that is roughly 23 %. And by the end of 2010 roughly one half of the total package will have been spent. This is not a straightforward stimulus bill and unfortunately as a result the direct impact on the current recession will be considerably smaller that the overall package suggests. In early June, President Obama called for faster release of the stimulus money noting that only 5% had been spent so far.

The second major effort by the new administration aimed at the domestic economy was the submission of the first Obama budget on February 26th 2009. The proposed budget looks out over a ten year period. It foresees government spending jumping from 21% of GDP in 2008 to 27.7% in 2009 and 24% in 2010. Clearly a sharp rise in spending levels by the Federal Government. Moreover, the level of federal debt rises from $5.8 trillion to $15.4 trillion over the next 10 years. This is a tripling of the level of national debt! And most analysts argue that the assumptions underlying the budget are very optimistic. The debt level could easily exceed these projections. [9]

Summing up the macroeconomic efforts, the Obama administration has signed into law a very large fiscal stimulus package and submitted an expansionary budget now being reviewed by the Congress.

The administration has simultaneously aimed at strengthening financial markets. But to date, little success has yet been recorded. The administration has not purchased any troubled assets from banking system. More recently, the Treasury seems to have decided that there is no chance for the Congress to authorize additional TARP money so they are

[8] BBC News. February 17, 2009. 'Q and A: Obama Stimulus Plan.

[9] Congressional Budget Office. February 11, 2009. Director Elmendorf letter to the Honorable Judd Gregg Ranking Member, Committee on the Budget.

considering the swap of loans to financial institutions for common stock. This would strengthen balance sheets without requiring new congressional authority. It would of course represent a major Federal ownership in financial institutions. But apparently the Obama Administration is not adverse to partial nationalization of financial institutions.

The Federal Reserve System has been continuously providing liquidity to markets. Staggering amounts of reserves have been added to the system, yet most commercial banks have not used the injections to promote new lending. Rather the reserves have been deposited by banks. Of some concern will be the ability of the FED to remove the liquidity injections when the economy begins to turn around. Some worry that there will be inflation concerns when the recovery gets underway.[10]

Aside from direct financial support of the troubled firms, the new administration is reviewing the regulatory environment for financial firms. It is clear that there were gaps in the pre-crisis regulatory structure. Little oversight existed for hedge funds and off balance sheet transactions. The administration is working on a complete over hall of financial market regulations with an aim of consolidating the oversight functions into a single agency — most likely the Treasury Department. While a role will be continued for agencies like the SEC and FDIC, the Treasury would assume on overall regulatory responsibility hoping to assure that all products are covered and that any risky activities in one sector or product are shared with other product regulators. Given the role of various Congressional committees in this oversight process, I expect that regulatory reforms will be slow coming.

At first glance, responses to the macroeconomic problems in Asia looked strong. Japan quickly passed a supplemental, then a second, and now is focused on a third. China announced a large stimulus package but as the details have become more clear, the package largely consists of subsidized credit, not new spending from the central government. Local and regional governments have been slow to utilize the credits.

It is now clear that the global recession is well entranced and deep seated. Europe continues to postpone hard domestic spending decisions. Essentially European leaders believe that there is little they can do by themselves in way of correcting their domestic recessions. Instead they seem to be waiting for the US recovery to once again provide growing export markets for their products. They seem to believe that their recovery will take place after the US expansion begins. The discussions in the G7/8 leading up to the

[10] Federal Reserve Bank of New York. April 18, 2009. Speech by William C. Dudley, President and Chief Executive Officer.

April G20 meeting proved to be futile regarding joint stimulus efforts.[11] I suspect that the early July Italian G8 meeting will similarly postpone joint commitments to expansionary fiscal policies.

In Asia, Japan continues to work towards a new supplemental budget which has some unique aspects never tried before. This supplemental package announced in April is roughly Yen 15.4 trillion ($154 billion) equal to about 2% of GDP.[12] This new package is double their earlier stimulus effort. The stimulus package is focused on healthcare and medical services, subsidies to local governments, and a new social safety net for non-regular workers, more use of government financial institutions to ease the credit crunch, and solar energy.

The energy credits idea is interesting and will be worth watching if it passes the Diet. But basically, the real growth in Japan over the past 4-5 years has been export dependent and the outlook for recovery continues to depend on the external sector.

In China, the current budget, published shows that it plans to run a deficit of only 3% of GDP. The stimulus program announce in the fall was 4 trillion Yuan ($586 billion). And estimates suggest that over two years the infrastructure package would be worth 14% of GDP. The governments' commitment to domestic structural spending — roads, bridges, etc. — may produce domestic demand growth above what would have been the case.[13] However, the effects of domestic growth on the world economy are very small. The domestic import propensity is quite small. While Chinese imports are very sensitive to Chinese exports — largely commodities, parts and components — consumer demand is not very focused on imported products. So without a renewal of Chinese exports, the rest of Asia will not benefit from modest stimulus to domestic demand in China.

So once again, the global economy seems to be waiting for Godot — and the US recovery is Godot! Most analysts now seem to agree that the US recovery will be coming in late 2009 or early 2010. But none of the analysts suggest that the recovery will be strong. A classic 'V' shaped cycle is not in the offing it appears. Rather there is likely to be a slow pickup.

Innovations in the policy responses.

In the big three countries outside of Europe, the macroeconomic responses to the current crisis has been a combination of classic policy moves and a few new, innovative ideas.

[11] Number 10 Downing Street. April 2, 2009. Statement Issued by the G20 leaders.

[12] Financial Times, April10, 2009. 'Aso Launches $154 billion Japan Stimulus'.

[13] Reuters News Service. November 9, 2008. 'China OKs $586 billion Economic Stimulus'.

All three countries have relied heavily on monetary policy easing. In Japan and the United States, interest rates are very low and liquidity provisions have been significant. In China, monetary policy has eased, but the lack of a sophisticated domestic capital market continues to hamper the effectiveness of classic monetary policy responses to weakening domestic demand. Credit rationing continues to be the primary tool for monetary policy.

On the fiscal front some new ideas are being tried.

In the United States the very large stimulus package is not front loaded. Rather the new spending during the first year will amount to only some 20% of the total package and even during the second year only roughly 50% of the spending will have occurred. And most of the spending is not of the classic pump priming variety. Much of the stimulus package is more on the order of policy changes by the Democratic Party. It remains to be seen if this approach will result in similar multiplier effects experienced historically in conjunction with fiscal stimulus packages.

In Japan a significant portion of the stimulus package relies of energy credits rather than direct spending. We simply do not know what the consumer responses will be to this new concept.

And finally in China, we have no historical experience on efforts to stimulate domestic demand. We do not know for example what the marginal propensity to import from consumption increases is likely to be. We have fairly good data on the relationship between export manufacturing sector growth and import propensities, but none on the relationship between domestic consumption and imports.

Hence from a global perspective, the effect of China's attempt to shift to a consumption led economic growth on the world economy is unknown. Evidence suggests that the global effect will be quite small.

Clearly the macroeconomic situation requires global stimulus that is transferred from domestic to the international economy. Time will tell whether this responses from the US, China and Japan have been successful.