ECONOMIES IN CRISIS

Part 1: The Global Financial Crisis: Origins and Ramifications

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Introduction

- Origins of the Global Financial Crisis (GFC).
- Inflation, growth, unemployment and debt.
- Recessions and depressions.
- Scenarios for the future..

1. Origins of the GFC

- What is the GFC?
- Causes of the GFC.
- People who predicted the GFC.
- The cost of US government bail-outs so far.

What is the GFC?

- The term “Global Financial Crisis” refers to the financial crisis that first started with the collapse of the US housing bubble, then spread throughout the US financial system, and then spread throughout financial markets around the world.
- The GFC has now developed into a full-blown global economic crisis.

What is the GFC?

- The GFC is widely accepted as having started on at least 9 August 2007, with the French Bank BNP's announcement that it was suspending redemptions from three of its funds that were heavily exposed to the US securitisation market.
- Securitisation means to convert an asset, especially a loan, into marketable securities, typically to raise cash by selling them to other investors.
- On 15 September 2008 Lehman Brothers collapsed, triggering the onset of a world-wide financial crisis.

Source: "What Is Really Going On?" Steve Keen, DebtWatch No 28, 2 November 2008

What is the GFC?

BNP Paribas press release:

- “The complete evaporation of liquidity in certain market segments of the US securitisation market has made it impossible to value certain assets fairly regardless of their quality or credit rating… We are therefore unable to calculate a reliable net asset value (NAV) for the funds.”

  Source: BNP, Paris, 9 August 2007

Causes of the GFC

- “Today’s global crisis was triggered by the collapse of the US housing bubble, but it wasn’t caused only by it. America’s credit excesses were in residential mortgages, commercial mortgages, credit cards, auto loans and student loans.
- “There were also massive excesses in the securitised products that converted these into toxic financial derivatives; in borrowing by local governments; in financing leveraged buyouts that should never have occurred; in corporate bonds… in the unregulated credit default swap market.”

  Source: “Worst Still Is Ahead of Us”, Nouriel Roubini

Causes of the GFC

- Securitised products are marketable securities, sold to raise cash. (Securities are broadly categorized into debt securities - banknotes, bonds, debentures - and equity securities - common stock.)
- Derivatives are financial products that have a value that is derived from the value of an underlying asset, often some type of loan.
- Leveraged buyouts means the purchase of a controlling share in a company by its management using outside capital.

Causes of the GFC

- A credit default swap is a credit derivative contract between two counterparties - a buyer and a seller. The buyer makes periodic payments to the seller and in return receives a payoff if an underlying financial instrument defaults.
- It is estimated that the size of this market alone is over $US55 trillion.

Causes of the GFC

Michael West on the main causes of the GFC:

- “Leverage, speculation and lax regulation were broadly to blame - the main culprits being the Wall Street banks and the kowtowing US Federal Reserve.”

  Source: “Bank Risks Remain”, Michael West, 11 December 2008, The Age

Causes of the GFC

- Leverage means the ratio of a company's loan capital (debt) to the value of its common stock (equity). It also means using borrowed capital for an investment, expecting the profits to be made being greater that the interest payable on the loan.
- Speculation means making risky investments in stocks, property or other ventures in the hope of making a profit but with the risk of making a loss.
- Lax regulation means poor control and supervision of financial markets.

Causes of the GFC

- In 2004 the US Securities and Exchange Commission revoked long-standing rules that required financiers to keep their debt-to-net-capital ratio to 15:1 - meaning for every $15 of debt, the banks were required to have $1 of equity.
- Thanks to lobbying from Wall Street, this ceiling was dropped, and the likes of Bear Sterns soon ran up a gross debt ratio of 33:1.

Source: “Bank Risks Remain”, Michael West,

11 December 2008, The Age

Causes of the GFC

Ross Gittins on the main causes:

- Weak regulation;
- Interest rates in America and Europe were held too low for too long;
- Financial institutions borrowed too heavily, lent unwisely and made too much use of financial instruments they didn’t understand.

Causes of the GFC

Ross Gittins on the main causes:

- Banks lost trust in each other and refused to lend because no one knew who was holding how much in bad debts;
- Because many banks had lent too much relative to their share capital, they were unwilling to increase their lending.

Source: “It’s Not All Bad News”, Ross Gittins, 29 October 2008, SMH

Causes of the GFC

Who is to blame for the GFC?

- Good times
- Alan Greenspan
- Twisted regulation
- Wall Street
- The homeownership obsession
- Too much money
- The myth of the rational market
- You and me

Source: “Blame Them”, Justin Fox, 27 December 2008, Time

Causes of the GFC

- To avert a complete collapse, governments in developed countries stepped in to slash interest rates, prop up faltering banks, buy up bad debts, provide banks with additional capital by taking up issues of their shares, guarantee the safety of bank deposits, and undertake massive fiscal stimulus programs.

Key people

People who predicted the GFC include:

- Robert Shiller, Professor of Economics, Yale
- Nouriel Roubini, Professor of Economics, New York University
- Steve Keen, Associate Professor of Economics, University of Western Sydney
- Hans Redeker, Head of Foreign Exchange, BNP Paribas, Europe’s largest investment bank

Key people

Robert Shiller:

- In 2003, Shiller published a paper called “Is There a Bubble in the Housing Market?”
- “From 1890 through 1990, the return on residential real estate was just about zero after inflation… Since 1987 it’s been 6% [or 3% a year after inflation]… I’m inclined to think there’s a good chance that the return on real estate will be negative, substantially negative, over the next 10 years because all booms reverse in the end.”

  Source: “Mr Worst Case Scenario”, Jason Zweig,

  6 July 2007, Money Magazine

Key people

Nouriel Roubini:

- On 7 September 2006, Roubini addressed an audience of economists at the International Monetary Fund, and warned the US was likely soon to face the bursting of the housing bubble, an oil shock, declining consumer confidence and a deep recession;
- He also warned of homeowners defaulting on mortgages, trillions of dollars of mortgage-backed securities unraveling and the global financial system coming to a halt.

“Dr. Doom”, Stephen Mihm, 15 August 2008,

NY Times Sunday Magazine

Key people

Steve Keen:

- In July 1996, Keen made a submission to the Wallis Committee, warning that the securitisation of loans could lead to a crisis exactly like the subprime crisis;
- Subprime mortgages are mortgages sold by lenders, some of whom were unscrupulous, to uncreditworthy borrowers who were also often poor and vulnerable;
- In June 1998, Keen wrote to the RBA regarding his "Financial Instability Hypothesis", which suggests we are likely to face a Great Depression.

Source: "Steve Keen vs. Gerard Henderson",

Trevor Cook, 21 October 2008

Key people

Hans Redeker:

- In December 2006, Redeker predicted a sharp recession in the US, claiming the condition of the housing market was worse than the experts were stating and the flow-on effects will be far worse than expected;
- In October 2008, he repeats his warning that abundant foreign money has been available to Australia and much of it has been spent on real estate, creating a speculative bubble.

Key people

Hans Redeker:

- "The easy money went straight into real estate. Australia will now have to generate 4% of GDP to meet payments to foreign holders of its assets. This is twice as high as the burden faced by the US."
- GDP - Gross Domestic Product is the total value of the goods produced and the services provided in a country in one year.

Source: “Greed a Deadly Sin for the Economy”,
20 October 2008, SMH

US government bail-outs

The cost of US government bail-outs so far, according to Forbes:

- Bear Sterns: $US29 billion
- AIG: $US144 billion and rising
- Fannie Mae: $US100 billion
- Freddie Mac: $US100 billion
- Wall Street: $US700 billion
- Car industry: $US200 billion so far
- IndyMac: $US8 billion

US government bail-outs

The cost of US government bail-outs so far, according to Forbes:

- Stimulus package: $US700 billion to $US1 trillion
- Money market funds: $US50 billion
- Lehman Brothers (via JPMorgan, post Lehman insolvency): $US138 billion
- Currency swaps from the Federal Reserve: $US620 billion
- New loan programs (Nov ’08): $US800 billion

US government bail-outs

The cost of US government bail-outs so far, according to Forbes:

- Include the $US1 trillion deficit projected for 2009, and that's a grand total of over $US4.5 trillion;
- Most of the bail-out money has come from the Federal Reserve.

Source: "Despite All the Economic Woes, US Bonds Are Showing a Gold-Plated Rally", Michael West, 9 December 2008, The Age

2. Inflation, Growth, Unemployment and Debt

Recent broad trends (end of 2008):

- Inflation rates for goods and services are now declining but until recently financial assets were highly inflated;
- Growth rates are declining;
- Unemployment levels are set to increase;
- Levels of debt are still extremely high.

Inflation

- For much of the last 20 years, central bankers have used monetary policy (setting interest rates) to control inflation.
- But the inflation they should have been worried about was in the prices of assets such as houses and shares, not goods and services.
- Deregulation (the removal of restrictions on businesses) discouraged governments from imposing controls on lending.

Inflation

Ross Gittins:

- “You can’t have bubbles in asset markets without the ready availability of credit. And it’s been the long build-up in debt on the balance sheets of households, businesses (via private equity) and financial institutions (hedge funds, investments banks and even commercial banks) that’s at the heart of the GFC and the global recession it’s feeding.”

Source: “It’s Not Inflation, but Borrowing”,

8 December 2008

Growth

- “The International Monetary Fund’s latest forecast predicts that the world’s advanced economies will contract 0.3% in 2009 - the first such shrinkage since the end of World War Two.”
- “The week of 3-10 October 2008 was the worst stock market week in the US since the Great Depression.”

Source: “Reviving the Animal Spirits”,
Robert Shiller, November 2008

Growth

Dominique Strauss-Kahn, chief of the International Monetary Fund:

- “Our forecasts [for 2009] are already very dark, but they will be even darker if not enough fiscal stimulus is implemented. I can see that some measures have been announced, but I’m afraid it won’t go far enough.”
- The IMF wants a global fiscal stimulus of about 2% of GDP, or roughly $US1.2 trillion.

Source: “Financial Leaders Remain Pessimistic”, 22 December 2008, Yahoo

Growth

- In December 2008, in its “Global Economic Prospects” report, the World Bank sharply cut its growth forecasts, predicting world trade volume would fall 2.1% as the GFC hits rich and poor countries alike.
- “The outlook for the world economy has deteriorated significantly and the global recession will be broader and deeper than previously anticipated.”

Source: “Bleak Outlook for World Economy - World Bank”, 10 December 2008, SBS

Growth

Australia’s quarterly growth was in decline well before the collapse of Lehman Brothers, and the onset of the GFC, on 15 September 2008:

- Q3 2007: 1.1% growth
- Q4 2007: 0.9% growth
- Q1 2008: 0.6% growth
- Q2 2008: 0.4% growth
- Q3 2008: 0.1% growth

Source: “Warning Signs in Place Before Global Meltdown”, Ross Gittins, 6 December 2008, SMH

Unemployment

- US job losses have risen to about 1.9 million people in the last two years.
- November 2008 job losses alone were 533,000. The median forecast from economists was for 335,000 job losses.

Source: “Despite All the Economic Woes, US Bonds Are Showing a Gold-Plated Rally”, Michael West, 9 December 2008, The Age

Unemployment

- In 1932, in the Great Depression in Australia, unemployment rose to 30%.
- In the current recession, some commentators believe that the unemployment rate will rise from about 4.5% to 10% or 12%.

Source: “It’s Not All Bad News”, Ross Gittins, 29 October 2008, SMH

Debt

Nouriel Roubini on US debt:

- “We have problems with credit-card debt, student-loan debt, auto debt, commercial real estate loans, home-equity loans, corporate debt and the loans that financed leveraged buyouts… We have a subprime financial system, not a subprime mortgage market.”

Sources:

“Anatomy of a Financial Meltdown”, Nouriel Roubini, February 2008;

“Dr. Doom”, Stephen Mihm, 15 August 2008,

NY Times Sunday Magazine

Debt

- In June 2007, the Reserve Bank said that Australian household debt had reached $1 trillion for the first time.
- Denis Orrock, of InfoChoice: “Australians [in 2007] have $40 billion racked up in outstanding credit card debt alone.”

Source: “Debt’s $1 Trillion Headache”,

John Collett, 15 August 2007, The Age

Debt

Commentators generally argue that Australia is well placed to face the GFC, but that it has two weak spots:

- Australian banks are heavily dependent on US short-term commercial funding, where lenders are reluctant to lend and rates have increased sharply;
- Many Australian households are heavily indebted.
- Source: “It’s Not All Bad News”, Ross Gittins, 29 October 2008, SMH

Debt

- Steve Keen argues that the level of debt in the Australian economy as measured by the debt to GDP ratio has been on an upward trend for 44 years, and is unsustainable.
- It currently stands at 165% of GDP.

Source: Steve Keen: DebtWatch No 23

June 2008

Debt

- Gabriel Stein, of Lombard Street Research, noted in October 2008 that Australian household debt has reached 177% of GDP, almost a world record.
- "It is amazing that in the midst of the biggest commodity boom ever seen they have still been unable to get a current account surplus. They have been living beyond their means for 10 years. What worries me is that productivity growth has been very low: they have been coasting after their reforms in the 1990s."

Source: “Greed a Deadly Sin for the Economy”,

20 October 2008, SMH

Debt

- The “current account” is the difference between a country’s exports of goods and services and its imports of goods and services, if all financial transfers and investments are ignored.
- A country is said to have a current account surplus if it exports more than it imports, and a current account deficit if it imports more than it exports.

Debt

Ross Gittins:

- “This is the point that’s yet to sink in: recessions come not from excessive braking to control inflation, but from excessive borrowing and the bursting of asset bubbles. These days we have balance-sheet driven recessions.”

Source: “It’s Not Inflation, but Borrowing”,
8 December 2008, SMH

3. Recessions and Depressions

- Definitions of recessions and depressions.
- Types of recessions and depressions.
- Are we facing a global recession or a global depression?

Recessions defined

- A recession is generally defined as two consecutive quarters of negative economic growth as measured by GDP.
- Ian Macfarlane, a former Reserve Bank governor, once suggested that if GDP is negative at the end of any given year, Australia is in a recession.
- Some also suggest that an unemployment rate of 6% or more indicates a recession.

Depressions defined

- A depression is generally defined as four consecutive quarters of negative economic growth as measured by GDP.
- Some also suggest that an unemployment rate of 10% or more indicates a depression.

Types of recessions

Four types of recessions:

- V-shape: short and shallow, lasting about 8-9 months;
- U-shape: longer and deeper, lasting 12-18 months;
- W-shape: ‘double dip’ type, in which government stimulus works in the short term but quickly fades, and a contraction resumes;
- L-shape: protracted economic stagnation.

Types of recessions

- The US entered a recession in the first quarter of 2008.
- The economy rebounded - a W-shaped 'double-dip' recession - in the second quarter, boosted by the $100 billion in tax rebates.
- But the effects of this stimulus had faded by the middle of the third quarter.

Source: "The Perfect Storm of a Global Recession", Nouriel Roubini, August 2008

Types of recessions

Nouriel Roubini:

- “I expect a U-shaped recession, lasting at least 12 months and possibly as long as 18 months - one of the most severe US recessions in decades - because today’s macroeconomic and financial conditions are far worse.”

  Source: “The Shape of America’s Recession”, April 2008

Types of recessions

Nouriel Roubini:

- The global recession "will be a long and protracted U-shaped recession, possibly lasting at least two years… And, given the rising risk of a global systemic financial meltdown, the prospect of a decade long L-shaped recession… cannot be ruled out."

  Source: "From Financial Meltdown to Global Depression", October 2008

Types of recessions

Factors feeding the global recession:

- The collapse of the housing bubbles in the US, UK, Spain, Ireland, etc;
- The punctured credit bubbles;
- The credit and liquidity crunch;
- The negative wealth effects of falling stock markets.

Types of recessions

Factors feeding the global recession:

- The negative global impact of the US recession (the US accounts for about 30% of global GDP);
- The US dollar’s weakness, reducing the competitiveness of US trading partners;
- The stagflationary effects of high oil and commodity prices.

Types of depressions

Two types of depressions:

- Inflationary depression, or stagflation: the combination of rising inflation and negative growth;
- Deflationary depression, or stagdeflation: the combination of deflation and negative growth.

Types of depressions

- In mid-2008 Roubini argued that stagflation is unlikely, unless there is a negative supply-side shock, such as war with Iran.
- However he also suggested that central bankers could face a nightmare scenario in which they need to tighten monetary policy (raise interest rates) to fight inflation and ease it (lower interest rates) to reduce the downside risks to growth.

Source: “The Specter of Global Stagflation”, June 2008

Types of depressions

- By the end of 2008, as inflationary pressures eased, Roubini raised the prospect of stagdeflation.
- Governments could become the spenders of only resort: if deficits are monetized, inflation will follow short-term deflationary pressures; if they are financed by debt, the solvency of some countries may be at stake.

Source: “Has Global Stagdeflation Arrived?”, December 2008

Recession or depression?

- In early 2008 Roubini said that the US would suffer a severe 18 month recession - “the worst since the Great Depression” - but not suffer a Great Depression.
- By late 2008 he had not discounted a decade long L-shaped recession: “We cannot rule out a systemic failure and a global depression.”
- He currently rates the probability of an L-shaped stagdeflation at a third and that of a U-shaped recession at two-thirds.

Sources:

“From Financial Meltdown to Global Depression”,

October 2008;

“Worst Still Is Ahead of Us”, 1 January 2009

Recession or depression?

Nouriel Roubini:

- “It will take a big change in economic policy and very radical, coordinated action among all advanced and emerging-market economies to avoid disaster.”

Source: “From Financial Meltdown to Global Depression”, October 2008

Recession or depression?

Actions needed to avoid a depression:

- Coordinated global interest rate cuts;
- A temporary blanket guarantee on all bank deposits, close insolvent financial institutions, and inject public capital into distressed but solvent financial institutions partially nationalizing them;
- Massive and unlimited provision of liquidity to solvent financial institutions.

Recession or depression?

Actions needed to avoid a depression:

- A temporary freeze on all foreclosures and a rapid reduction of the debt of insolvent households;
- Public provision of credit to the solvent parts of the corporate sector to avoid a debt refinancing crisis for illiquid corporations and small businesses;
- Massive government stimulus: public works, infrastructure spending, unemployment benefits, rebates to low-income families, grants to cash-strapped local governments.

Recession or depression?

Actions needed to avoid a depression:

- An agreement between creditor countries running current-account surpluses and debtor countries running current-account deficits to maintain an orderly financing of deficits and a recycling of creditors' surpluses to avoid disorderly adjustments.

  Source: "From Financial Meltdown to Global Depression", Nouriel Roubini, October 2008

4. Scenarios for the Future

Four possible scenarios:

- The business cycle;
- Geo-political change;
- The green economy;
- Transformational economics.

The business cycle

- The GFC signifies the beginning of a major economic downturn, but things improve in a few years;
- When things do improve, it’s business as usual, but with some basic reforms;
- No need for systemic change.

The business cycle

- "The Australian stock market will offer investors the best buying opportunity in a generation in 2009, after the bourse suffered its biggest annual decline ever in 2008… The returns on shares are now significantly higher than the alternatives."

  Source: "Bargains Await Investors in 2009", 24 December 2008, The Age

Geo-political change

- The US economy is severely weakened.
- Economic and political power move to Asia (Chindia) and Europe.
- Regional economic blocks arise in Europe, the Middle East, Asia and the Americas.
- While economic and political power shift, minimal systemic change occurs.

Geo-political change

Nouriel Roubini:

- “America’s biggest financiers are China, Russia and the Gulf states. These are rivals, not allies… Once you run current account deficits, you depend on the kindness of strangers. This might be the beginning of the end of the American empire.”

Source: “Dr. Doom”, Stephen Mihm,

15 August 2008, NY Times Sunday Magazine

The green economy

- Sustainable development, energy efficiency, low-carbon industries, carbon trading, triple bottom line accounting, renewable energy, etc., are gradually adopted.
- Climate change and global warming increasingly shape economic policy.
- Environmental concerns lead to some systemic change.

The green economy

- “Investment in a ‘green economy’ is now being discussed at high levels as the pathway out of financial crisis to a new round of job growth, prosperity and a low-carbon society.”

  Source: “Time to Unleash the Power of a Green Economy”, 17 December 2008, ECOS Magazine

The green economy

Sir Nicholas Stern:

- “The credit crunch provides an opportunity to invest in measures such as energy efficiency to tackle global warming as a way of stimulating economic growth… Spending on renewable and other low-carbon industries could help stimulate the economy. We’re going to have to grow out of this.”

  Source: “Time to Unleash the Power of a Green Economy”, 17 December 2008, ECOS Magazine

Transformational economics

- Multi-dimensional transformation.
- The emergence of a new collective psychology.
- Systemic change.
- Examples: ‘Third Way’ models, including Prout.

References

Robert Shiller and Nouriel Roubini:

- www.rgemonitor.com

Steve Keen:

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- http://pia.org.au