

5 The Current Crisis (2007-?)

This chapter delivers a very brief summary of the current financial and business crisis. The emphasis lies on “brief” because the summary only picks the major events of the financial meltdown, the major policy reactions, the major regulatory questions, the major recent cyclical observations on the world economy and the major challenges for globalisation. In this sense, it only provides a first survey of an enormously complex issue that will remain the subject of intense economic research for years to come.

5.1 International Financial Meltdown

The current financial crisis has roots that go a long way back, at least to the beginning of this decade. At that time, the so-called dot-com crisis hit the American economy. The boom in modern information technology came to a temporary halt, and the young industry, which had grown vigorously for a number of years, entered a serious adjustment crisis. Many young firms went insolvent, and even those that survived experienced a sharp downward correction of their stock market valuation. In the American economy, the danger of a severe recession seemed to be real. On top of this came the events of September 11, 2001, which further aggravated the fears of a slump.

As a consequence, monetary policy in the United States turned towards expansion. From 2002 to 2004, short-term interest rates reached an extreme low, with the federal fund rate standing at an annual average of 1.67 % in 2002, 1.13 % in 2003 and 1.35 % in 2004. Note that these expansionary steps were taken in a climate of more or less price stability (i. e. very moderate inflation), which had prevailed for a long period of time after the tough stabilization policies of the 1980s had been successful. This is why they did not appear at all to be preposterous. Most observers – though not all – considered the monetary policy of the Federal Reserve System under its renowned Chairman Alan Greenspan as adequate and responsible.

At the same time, the American government began to pursue a deliberate policy of raising the share of home ownership in the United States. At about 65 %, this rate

stood already high by any international standard, but the political goal was to raise it further to about 70 %. (Note that this was a kind of American-style social policy: traditionally, welfare state provisions to help lower-income individuals and families are rather limited in the United States - compared to Europe - so that home ownership is widely regarded as a substitute for supporting the poorer strata of society.) The policy was put into practice by largely by-passing the state-sponsored real estate banks Freddie Mac and Fannie Mae, which were traditionally responsible for the housing market and tended to have relatively conservative (i. e. risk-averse) standards. By putting pressure on investment banks to foster the real estate business, the political establishment tried to make sure that, even those who normally would find it difficult to obtain real estate loans, had a chance to do so. As a consequence, the loose monetary policy was accompanied by a major political initiative towards expansion in the housing market.

In fact, the policy worked: mortgage rates went down in tandem with short-term interest rates, and the housing market began to boom, with annual rates of increase of the American house price index of 8-10 % from 2000 to 2003, 13,9 % in 2004, 15,6 % in 2005 and eventually 7,5 % in 2006. All this amounted to nearly a doubling of house prices in six years, with an enormous expansionary impact on the book values of wealth and what may be called measured prosperity of the public at large. At the same time, the quality of housing and real estate loans worsened significantly: from 1996 to 2006, the incidence of fraud cases rose by a factor of 15. Cynics in the market were speaking of “teaser” rates that were offered to borrowers for NINJA-loans, with Ninja standing for: no income, no job, no assets.

Internationally, this process of expansion was strongly supported by a glut of liquidity, which stemmed from the large surpluses on current account that a number of notably Asian countries ran during that time – as a consequence of a prudent “mercantilist” policy following their own financial crises in the 1990s. Most notably, China ran huge surpluses, thus massively accumulated currency reserves and exported capital to indirectly finance the American real estate boom. A very large international imbalance emerged, with the United States saving little (if at all) and consuming heavily while eastern Asia doing the opposite. At the time, this situation was not seen as a major element of instability. To the contrary, there was a widespread discussion among

academics about “the great moderation”, meaning a new era of benign macroeconomic circumstances all over the world, with fast growth, fast trade integration, low interest rates and also low price inflation.

To understand the causes of the later crisis, it is important to recognize the major mechanisms through which the expansion in real estate markets came about. In particular, the method of “securitization” deserves attention. “Securitization” (in German: “Verbriefung”) is a procedure of transforming actual loans into securities that can be traded in financial markets. The trend towards securitization goes back to the liberalisation of financial markets in the 1980s when new instruments were developed to distribute credit risks in an optimal form. The basic idea was that loans could be bundled (or “structured”) so as to create new “products” with specific risk characteristics. And in well-functioning financial markets, these products could be sold to agents who were apt to take these risks. E. g., one could imagine that life insurance companies with a particularly long time horizon of investment decisions were well suited to carry some short-term risks at high returns, given the fact that the liabilities in their balance sheet were very long-term and thus allowed them to hold on to whatever asset even in “bad” times of significant asset devaluations. Hence, in theory at least, securitization looked like an economically efficient procedure and was widely hailed as a major innovation to improve the allocation of capital.

Alas, reality did not quite follow the theoretical models. The so-called mortgage-backed securities, which were created by bundling loans to finance real estate and housing, did not typically land in the portfolios of investors with a long-term time horizon. To the contrary, it was American investment banks (bullied by the US-government!) that heavily invested in mortgage-backed securities and refinanced their investments in the capital markets by issuing commercial paper with short maturities, thus profiting from the high degree of market liquidity and low short-term interest rates that prevailed in world markets. At least with the benefit of hindsight, it is quite obvious that this constellation created serious risks: once the market would not be ready any more to provide an easy re-financing – say, by a rise of short-term interest rates, a decline of real estate prices or a downgrading of debtors –, the process of leveraging may be rolled back and give rise to a major credit squeeze. This is exactly what finally happened.

Note that the selling of mortgage backed securities had a worldwide dimension. E. g., German state-owned banks (“Landesbanken”) were also heavily engaged in the business of acquiring these seemingly profitable assets. In a state of very low short-term interest rates, all options to improve the rate of return of banking operations were welcome. After all, a kind of “yield panic” (Martin Hellwig) began to prevail in many financial institutions, which led them to create “special investment vehicles”, i. e. subsidiary firms that could carry out appropriate operations in financial markets without being subject to the strict regulations of the parent company. Thus, from the accounting standpoint of the bank, a whole branch of risky economic business could be done “off-balance” although appropriate liquidity guarantees had to be extended in case of illiquidity or insolvency. An extreme case of this sort eventually happened in Germany, with the Sächsische Landesbank coming very close to insolvency in 2007 because its liquidity guarantees to its Irish special investment vehicle by far outstripped the bank’s equity capital.

In 2006, the first strains in the market for mortgage backed securities became visible as real estate prices in the United States stopped rising and, from 2007 on, began to fall sharply. At that time, it became increasingly clear to many market participants that there had indeed been a “bubble” in real estate markets. Still then, however, the real extent of the risks was vastly underestimated: as late as 2007, so-called stress tests of the International Monetary Fund basically led to the conclusion that the associated dangers for the world economy as a whole were limited. Generally, credit rating agencies continued to give very good ratings to mortgage backed securities as financial products.

This changed only after the number of defaults on mortgages began to rise sharply in the course of 2007. Within a very short period of time in August 2007, the whole market including the rating agencies radically changed their views and downgraded the products substantially. That led, within a few weeks time, to an almost complete breakdown of the inter-banking market for short-term loans. The reason was simple enough: as basically all banks presumed that those in need of short-term credit were all those who had engaged in all too risky operations connected to the downgraded

mortgage business (as possibly oneself had), nobody stood ready to provide credit to others. An economic standstill of mistrust was the consequence.

All in all, the situation in late summer 2007 began to take features of a very severe and unusual financial crisis. With the breakdown of the inter-bank short-term credit market, the major liquidity flows in the economy were stalled. The consequences might have been disastrous: even with a healthy economy, a short-run stop of liquidity flows might lead to major banking crises, a situation very much reminiscent of the early stages of the Great Depression 1930-32 when bank failures and bank runs massively deepened the crisis. In terms of the standard macroeconomic quantity equation $MV=PY$, which has been invoked a couple of times in this lecture, a massive decline of the velocity of circulation (V) could have been in the making, and thus, at a given quantity of money (M) and a naturally rigid price level (P) in the short run, an equally massive decline of output Y might become the consequence. For the first time after more than 75 years, central banks and governments faced a situation that resembled the dramatic choices of policy makers in the Great Depression.

In view of the crisis, the major central banks reacted fast. Massive liquidity support was granted to banks from August 2007 on, thus attempting to support the interbank market and to avoid anything like a massive decline of the circulating money supply. In Britain, the Bank of England met the first run on a bank since 1866 (!) when it bailed out Northern Rock, a bank that had heavily engaged in the mortgage business and was on the brink of becoming insolvent. To avoid a panic of depositors, governments in Britain and also Germany proclaimed an unlimited guarantee for private banking deposits. All these short-term emergency measures helped to avoid a complete implosion of the credit system, but they did not restore anything like the prior confidence in the market.

In September 2008, the crisis reached a new apogee with the insolvency of Lehman Brothers, an important American investment bank. Apparently, the American government wanted to make clear to the market that a massive bailing-out of ailing investment banks was out of the question. The Lehman breakdown had immediate and massive consequences: interbank lending rates shot up again, and the largest insurance company in the world, the American International Group (AIG) also faced

insolvency. There was widespread agreement that a breakdown of AIG would have disastrous worldwide consequences as AIG had been massively involved in providing insurance to exactly the type of business that was at the core of the crisis. Tearing away that insurance cushion from the balance sheets of a vast number of firms worldwide would be extremely dangerous and would massively speed up the de-leveraging of banks and other financial institutions. As a consequence, the Federal Reserve system stepped in to provide massive liquidity support; and the government stepped in as a shareholder to provide equity to endangered financial and insurance firms.

It is fair to say that, from this time on, the American government and virtually all other governments of industrial countries fully engaged in massive short-term emergency aid to minimize the macroeconomic effects of the crisis. The contrast to the Great Depression could not have been bigger: in 1930-32, governments and central banks basically watched their economies getting caught in a vicious circle of deflation; in 2008-9, they massively stepped in using all pragmatic instruments from extremely low discount rates to liquidity aid up to outright nationalization of firms.

To this date, these measures have apparently helped to prevent a completion of the financial meltdown and a further worsening of short-term credit conditions. However, they have not prevented a sharp worldwide downturn of business activity as we shall see in section 5.3.

5.2 Regulation of Financial Markets

A financial crisis of the current dimension raises questions: What went wrong in terms of banking regulation and supervision? How could a crisis of this type evolve even in the presence of international bank regulations as exist in the form of the Basle Agreements (Basle I and II)? What has to be done to avoid future crises of this type? Clearly, it is much too early to draw any firm conclusions, but five major issues to be discussed in the years to come appear to stand out in importance:

- The supervision of financial markets should be improved. In general, all institutions that incur major risks should be supervised. So far, the tight

supervision in advanced industrial countries like Germany is focused solely on banks. This must change. Whether this should be done on a national or an international level is still open to discussion. Some argue that an international supervision is required because the risks are global. Others argue (including myself) that it is completely unrealistic to aim at the international level because no supranational institution can be given the authority to discipline financial institutions in one country (e. g., by closing a bank). Therefore, the “homework” should be done on the national level, but there should be a close cooperation of national supervisory authorities.

- Accounting rules should become more transparent. They should fully reflect the extent and risks of banking operations. “Off-balance sheet” activities that possibly involve massive risks for a bank’s liquidity must be prohibited. To put it differently: accounting rules should be such that the full extent of financial engagements comes out clearly, and not just the “core” banking activities. Also, the extent of supervision that is assigned to the supervisory authorities (e. g., in Germany, the Bundesanstalt für Finanzdienstleistungsaufsicht (Bafin)) may have to be enlarged so as to include all activities that involve risks.
- The application of fair-value accounting should be re-examined. The experience during the crisis showed that the valuation of assets according to the current market price (“fair value”) may have had a strong procyclical effect: drastic asset devaluations forced many banks and financial firms to sell assets, thus further worsening the market conditions and provoking “fire sales” of other firms. In some cases, the market even “dried up” so that a proper market value could not be fixed anymore. Apparently, the limits of fair value accounting in extreme crisis times must be reflected in the legal framework. A better balance must be struck between transparency on one side, which calls for market valuation, and the risks of procyclicality, which may speak against it.
- The predominant role of a few rating agencies (Standard & Poor’s, Moody’s, Fidge) should be scrutinized. The crisis showed that the rating agencies did not remotely recognize the risks involved in the mortgage business. Until 2007,

they generously assigned excellent ratings to the structured mortgage products, and then all of a sudden downgraded them massively. They were also subject to a strong conflict of interest: they designed the products and then evaluated them. All in all, their performance was dismal. However, it is not yet clear what the consequences of this should be. Most economists argue in favour of a strict legal separation between the two types of activities of the agencies: consulting on financial products (including their design) and proper rating of the products, which should then be done by other agencies. Also, more competition in the rating business is called for, maybe with a stronger “European” component because all agencies so far are American. Few economists argue in favour of government intervention in the sense of a public quality test of products (as in the case of technical standards). Most economists (including myself) reject this idea as it would involve an enormous ex-ante responsibility of the government for inherently subjective judgements.

- The predominant role of risk management models of banks should be re-examined. In the framework of the Basle rules on equity requirements in the banking sector, the models were the major pillar to assess the risks involved and, as a consequence, the equity required to back up the risk. Apparently, these models were completely unable to develop reasonable estimates of what may be called “systemic” risk, i. e. the risks that emerged once a highly auto-correlated devaluation of asset values occurred all over the world as a consequence of the bursting real estate bubble. There are two consequences of this: first, models should be improved, and notably impartial international observers like, e. g., the International Monetary Fund should be mandated to improve its systemic risk estimation; second, the Basle rules should be re-written to prevent banks from continuing the practice of watering down the equity requirements by recourse to the estimates of their own (over-optimistic) models. In general, the possibility of systemic risk must be taken more seriously – in the models themselves and even more so in general decision-making of boards and supervisors.

So much for the regulatory aspects. In all this, one must keep in mind that any reform of the rules of financial markets – whatever it may be – will hardly prevent the re-

emergence of big bubbles and their bursting in all future times. Much more is required for more stability, notably a sound macroeconomic policy. What this means in practice, however, is still open to debate. Some economists (including myself) argue that monetary policy should aim at avoiding all too big asset price bubbles. With the benefit of hindsight, it is clear that monetary expansion in the United States in the early 2000s massively contributed to the emergence of the bubble (supported by a deliberate “housing policy”). To avoid such pitfalls in the future, a deliberate policy of “leaning against the wind” may be appropriate, with monetary authorities not only fighting current price inflation, but also keeping an eye on asset price booms. One may even argue that a comprehensive fight against “inflation” does not only entail the stabilization of inflation in current prices of goods and services, but also in assets.

Clearly, these are lots of highly controversial questions of policy, supervision and regulation that have moved onto the academic and political agenda as a consequence of the recent crisis. Only that much is sure: they will concern the economics profession for a long time to come.

5.3 Cyclical Downturn

In the wake of the financial crisis, the world economy was pushed into a very severe recession, which may or may not become a genuine depression. In 2009, the aggregate output (Gross Domestic Product) in major industrial countries is expected to fall sharply: by almost 3 % in the United States, by roughly 4 % in Euroland and Britain, in strongly export-oriented economies like Germany and Japan even by 5 to 7 %. The free fall of industrial production will be even more dramatic: in the range of 20 % in Germany and Euroland as whole, about 30 % in Japan and more than 10 Percent in Britain and the United States, which have more service-oriented economies. For the year 2010, output stagnation or very slow growth is predicted, but all forecasts are taken to be highly unreliable.

The speed and strength of any recovery will very much depend on how the worldwide consolidation of banking will work. In particular, the crucial question is whether there will be a sustained credit crunch that may hinder industrial growth. Nobody really

knows whether this will be the case or not. At the time of writing (July 2009), there appears to be some stabilization at a low level of economic activity, which may point towards a deep depression being avoided. But this is all speculation. In any case, the general configuration of the world economy speaks for a long, slow and gradual adjustment of some fundamental world-wide disequilibria. In the American economy, consumption will decline and saving will increase so that the United States will not figure anymore as the “demand locomotive” in the world economy. Conversely, China, Japan and also Germany may face the opposite challenge. At the end, the current account disequilibria that prevailed in the world economy for a long time will be much diminished, but only at the price of a prolonged phase of slow growth, comparable to the re-adjustment of macroeconomic disequilibria in the late 1980s, when the “twin deficit” of the United States began to melt down.

5.4 The Future of Globalisation

With the sustained world-wide cyclical crisis, the risks rise that there may be a backlash of the trend towards globalisation. In fact, world trade has recently collapsed: between the third quarter of 2008 and the first quarter of 2009, there was a decline of the volume of world trade by roughly one third, clearly the sharpest fall since the Great Depression. Whether this is a purely cyclical phenomenon or a definitive downward shift that ushers in a new (and more moderate) growth trend remains to be seen.

In any case, it does raise the danger of protectionism. In times of rising unemployment, it may be tempting for countries to give way to political pressures to pursue a “beggar-thy-neighbour-policy” by raising trade barriers and thus redirecting demand towards domestic goods as happened disastrously in the Great Depression. So far, there have been no such attempts; and the cooperative political spirit, in which short-run emergency policies have been conducted, is very encouraging that history will not repeat itself. But again, all this is speculation. The future is open as it has always been.