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The Financial Crisis:

Causes, Impacts, Strategies

Conference on the Financial Crisis

Keynote Lecture

Mendel University Brno, Czech Republic
26. November 2009

Karl Aiginger

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Outline

- The trigger and the roots
- Comparing the Recent Crisis with the Great Depression
- Economic policy reaction
- Prospects and lessons
- Conclusion

References

Karl Aiginger: Finanzkrise: Anlass, Ursachen, Strategien, inklusive Blick nach vorne, WIFO-Vorträge, No. 104/2009
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The trigger

- US housing sector
  - Permissive credits: subprime segment
  - Tricks (back loading, variable interest rate) are exit options
- Accepted due to price experience and expectations
- Bundled, sliced, classified according to risk
- Sold to subsidiaries (conduits, SPV) or foreign banks
- Rated by stock market listed agencies, friends (etc.)

⇒ The bursting of the bubble revealed the final holders

⇒ Mistrust, credit crunch and ever more toxic assets.

The deeper roots

- Macroeconomic imbalances
- Unrealisticexpectations about returns (exuberance)
- Microeconomic incentives
- Regulatory failures (incl. greed and ideology).

The deeper roots 1: Macroeconomic imbalance

- **Abundance of rent seeking capital world-wide**
  - Due to non restrictive monetary policy after 2001
  - Imbalances of current accounts / Asia, Oil countries / Saving surplus in China, Russia, oil producers
- **Triple US deficit: trade, budget, savings**
- **Peak oil, resource and food shortages, inflation**
- **Increasing inequality of incomes.**

The deeper roots 2: Exuberance

- Attempts to beat the market (goal: above average returns)
- Financial innovations CDO, CDS etc.
- Financial “institutions” circumvent reserve rules, sector regulation, national authorities
- Increasing choices by liberalisation and globalisation
- Underestimation of risks of a simultaneous downturn
- Demand for high yields:
  from local government to private pensions.

The deeper roots 3: Microeconomic incentives

- Bonuses for managers
- Short-term incentives and perspective of analysts
- Smart financial community, best brains go for fast money
- Risks could be shifted to non regulated firms
- Securisation without obligation to originator
- Rating agencies: conflicts of interest and highly concentrated.

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The deeper roots 4: Regulatory failure

- Globalisation prevents regulators and analysts to see risks
  - sometimes even insiders, managers
- Ideology of self regulation (Greenspan doctrine)
- Shadow banking, off balance sheet transactions
- Cosy relations between agents, regulators, politicians
- Extension of mark to market rules (IFRS)
- Pro-cyclical regulation (Basel 2)-

The amplifiers

- Globalization of financial markets
- “Bubbles” in raw materials, oil, food, currencies
- “Just in time” production and specialized sourcing
- Increasing size and scope of firms
- Dominance of the short term
- Shortages of resources, oil, food – inflation
- Increasing inequalities in income and wealth.

Transmission: from financial to the real sector

- Distrust because of revealed toxic asset
  - inter bank-credit market breaks down
  - Stock market decline destroys assets
- De- leveraging on all levels: banks, firms, households
  - Sometimes with moving target
- Consumer spending, investment decreased
- Stop of long run projects (construction, mergers etc.)

⇒ **From September 2008 on, downward synchronisation in all regions and industries.**

The positive impact and the tragedy of financial markets

- Financial markets first became powerful, boosted economic growth,
- Then changed from service function into dominant position; and failed
- Financial markets are known to be driven by optimism & pessimism waves – globalisation and financial innovations made it more difficult to see the bubbles.

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Caveats and limits

- Crisis is not over as far as unemployment is concerned
- Regulatory reform is not done yet
- Fiscal consolidation strategies are necessary

⇒ History warns us that crises can continue and may come back

⇒ The calculations assume it ended for production in mid 2009 and will end for unemployment in 2010.

Results on depth in a nutshell: 1932/1929 vs. 2009

	Great Depression	Recent Crisis	
	1932/1929	2009/ peak 2007/2008	Trough 2009/ peak 2007/2008
	Annual data		Quarterly data
	Percentage change		
GDP, real	-10,0	-4,0	-5,4
Manufacturing	-23,2	-20,2	-23,0
Exports	-58,5	-20,9	-24,6
Stock market	-55,4	-53,4	-53,6
Employment	-17,3	-2,5	-1,6
Unemployment rate 1932 and 2010	19,6	9,2	
Unemployment rate; change	13,2	3,1	2,0
Inflation	-12,8	1,0	-0,1

Data for world if existent, for subsets of mainly large industrial countries (GDP weighted) otherwise (in parenthesis quarterly data).

Results on depth for countries: 1932/1929 vs. 2009

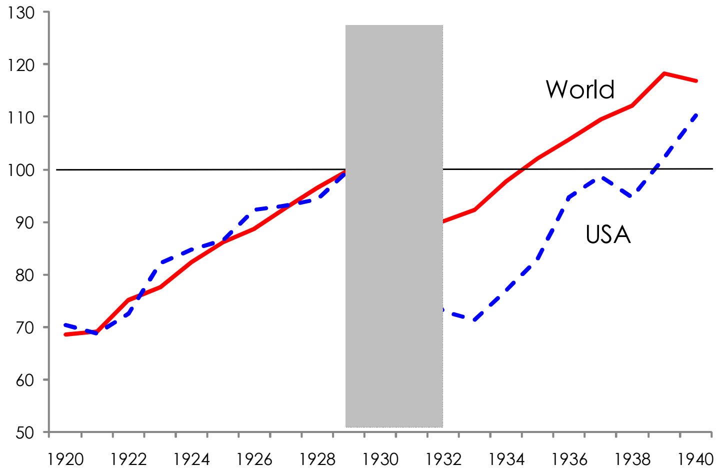
	Great Depression			Recent Crisis				
	1929/1921	1929/1912	1932/1929	2008/2000	2008/1990	2009 forecast/ peak 2008	Trough 2009/ peak 2008	
	Annual data			Annual data			Quarterly data	
	Percentage change							
Austria	43,0	4,6	-19,8	17,3	50,9	-3,4	-4,5	1)
Germany	38,4	15,5	-15,8	9,8	35,2	-5,4	-6,7	2)
Belgium	33,4	27,2	-7,1	15,6	42,9	-3,5	-4,2	1)
Spain	34,2	58,8	-3,8	27,9	68,5	-3,2	-4,2	3)
France	61,0	33,6	-14,7	13,6	38,2	-3,0	-3,5	2)
Finland	55,7	53,4	-4,0	25,1	52,0	-4,7	-6,5	2)
Sweden	49,2	38,3	-4,3	20,9	47,6	-4,0 *)	-6,3	3)
United Kingdom	28,5	16,2	-5,1	19,5	53,2	-3,8	-5,6	3)
USA	45,4	69,4	-27,0	19,0	64,7	-2,9	-3,8	1)
Japan	22,0	81,7	1,3	10,7	25,4	-5,3 *)	-8,4	3)
World	44,7	38,8	-9,8	39,8	89,0	-1,3	-4,6	4)
Unweighted average over countries	41,1	39,9	-10,0	17,9	47,9	-3,9	-5,4	
Standard deviation	12,2	25,3	8,9	5,8	13,1	0,9	1,6	
Coefficient of variation	0,297	0,635	-0,886	0,325	0,274	-0,234	-0,294	

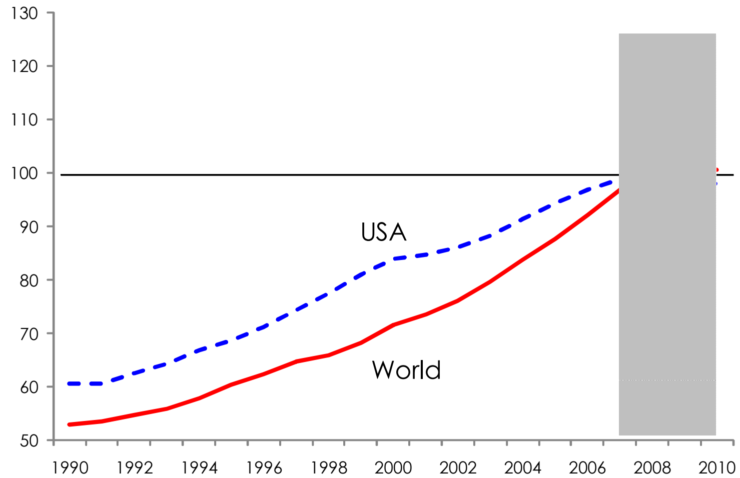
Comparison of two crises: Growth of GDP

Great Depression (1929=100)

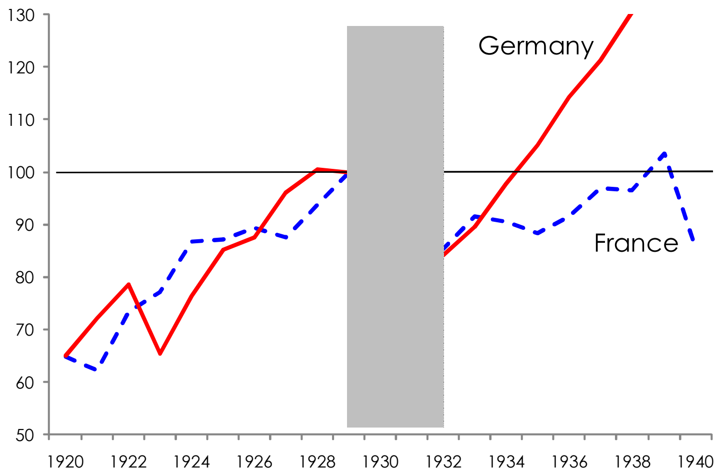
Current crisis (2008=100)

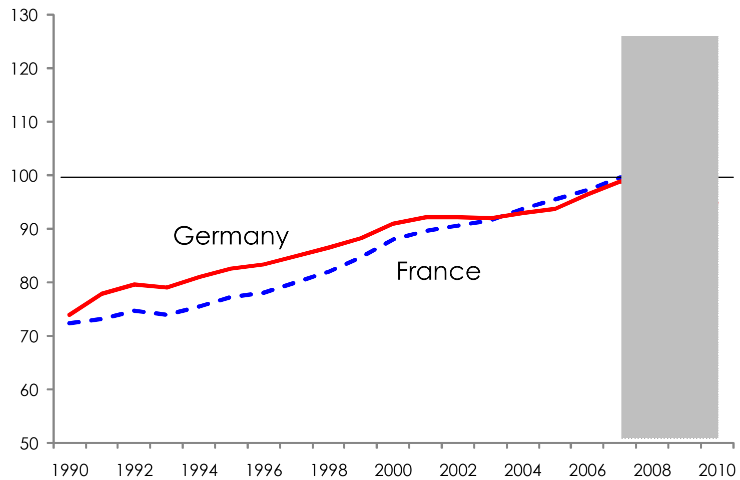
World vs. USA





Germany vs. France





Results III: The decline was very steeper in several months in the Recent Crisis

- Exports declined by 25% in the first three quarters
- Manufacturing by 19%

⇒ For some indicators the decline between mid 2008 and spring 2009 was as deep or deeper than in the Great Depression

⇒ The Recent Crisis had the potential to become a very deep and long depression.

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The depth of the crises differed

- The Great Depression was much deeper
  - specifically for GDP, employment, inflation
  - least difference for manufacturing
- The speed at the start had been faster in the Recent Crisis (and the synchronization)
- The length differed – hopefully
- Economic policy made the difference
- GDP Czechoslovakia 1929/1932 -10%.

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Economic policy made the difference

- Recapitalization of banks, guarantees, support incl. nationalization
- Monetary policy
- Fiscal policy
- International coordination
- (Surprising) consensus of economists
- Better institutions
- Less protectionism – up to now.

Results in a nutshell: policy variables

	Great Depression	Recent Crisis
M1 (2008/2007)	-11 % (1932/1929)	+ 8 %
Discount Rates	4% (1930)	0.5 % (2009)
Budget deficit/GDP	-2.5% (1932)	- 9 % (2009)

⇒ **There are many indicators on monetary/fiscal policy – all show quicker, stronger reactions in the Recent Crisis.**

Monetary policy in the Great Depression vs. Recent Crisis

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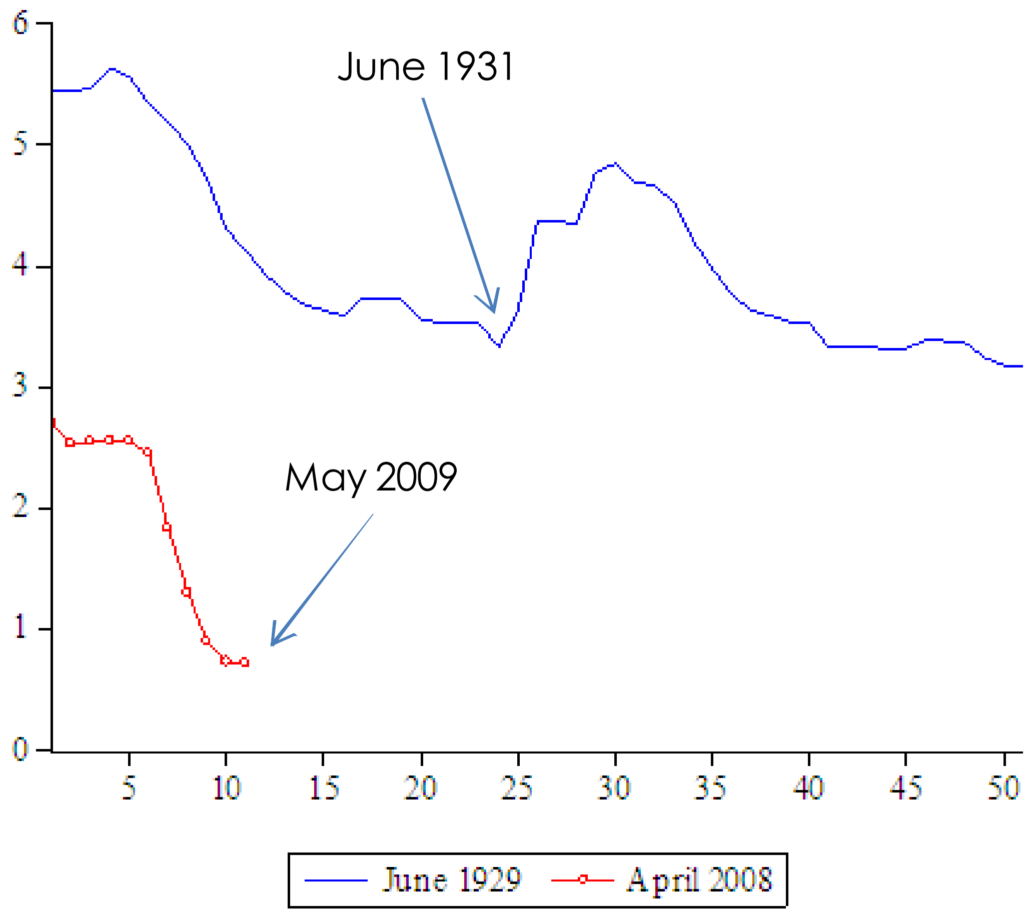
- Fed increased Rate in 1928 to curb stock market speculation
  - M1 flat in 1929/30 (18 countries), then -15% 1929/32
- Gold standard, currency goal, asymmetric reaction
  - Decreasing multiplier, higher reserve requirements, bank runs and failures
- Nominal discount rates reduced somewhat from 5.5 to less than 4
  - Deflation resulted in enormous (double digit) real rates!

Recent Crisis

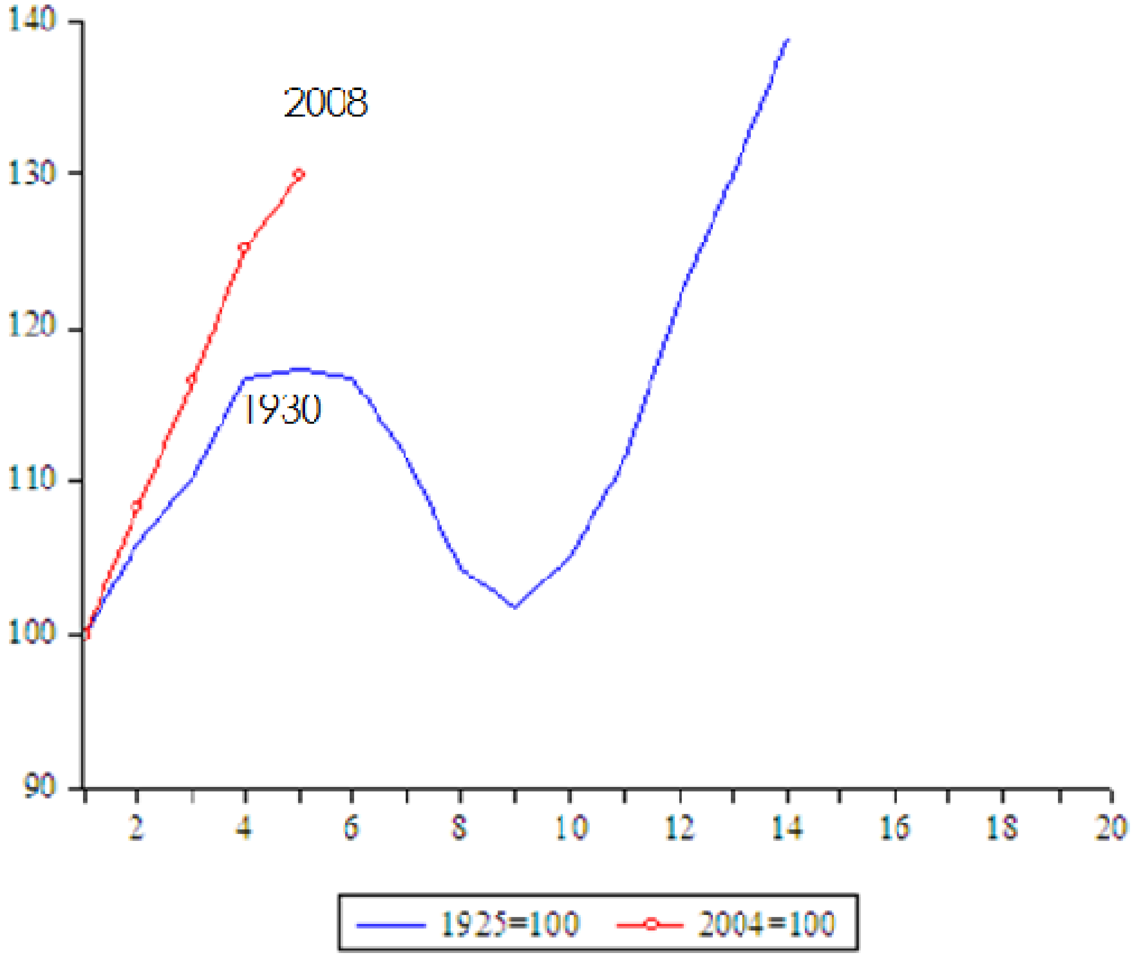
- Discount rate $\Rightarrow$ 0,
- Quantitative easing,
- Unconventional operations.

Central Bank Discount Rates in Great Depression vs. Recent Crisis



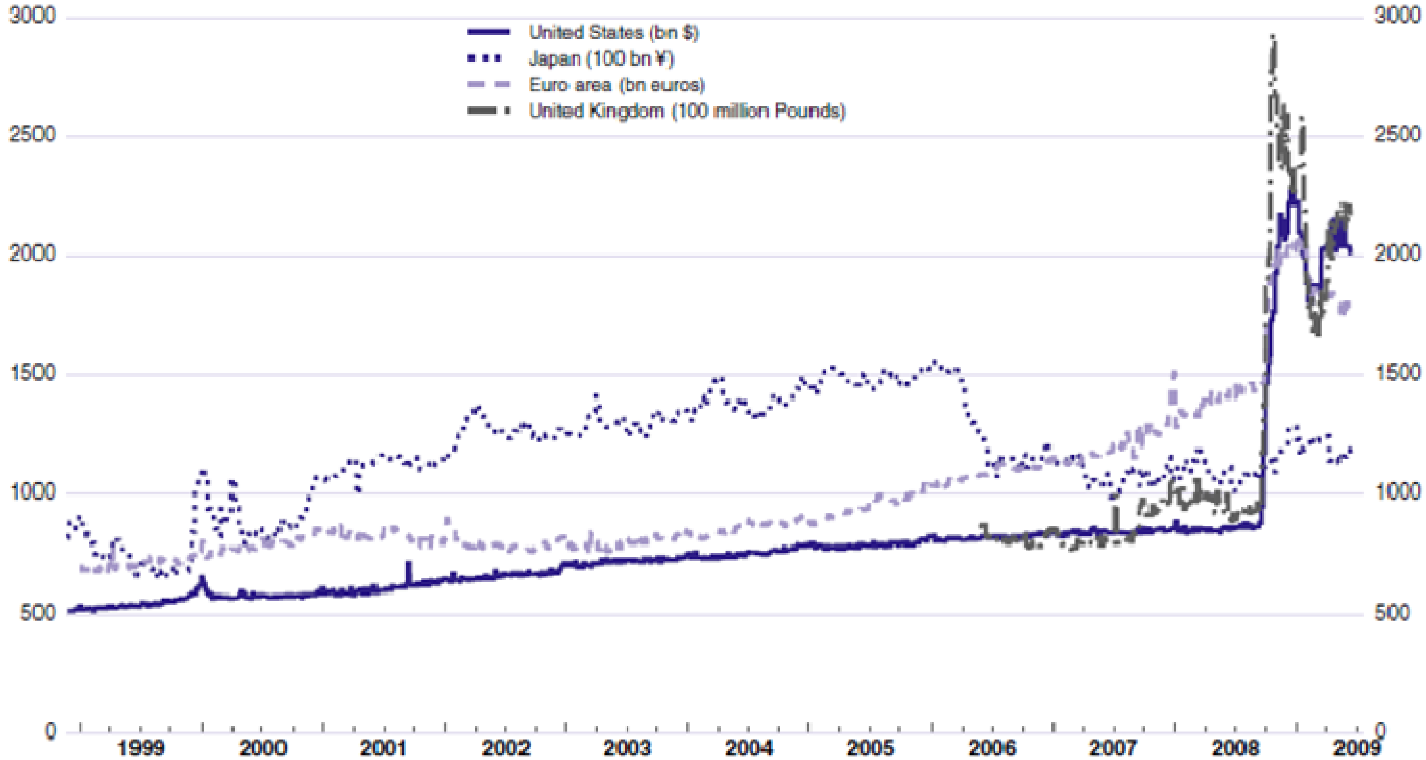
Source: Eichengreen–O'Rourke (2009).

Money Supplies in Great Depression vs. Recent Crisis



Source: Eichengreen–O'Rourke (2009).

Expansion of Central Banks' balance sheets 2000/2009



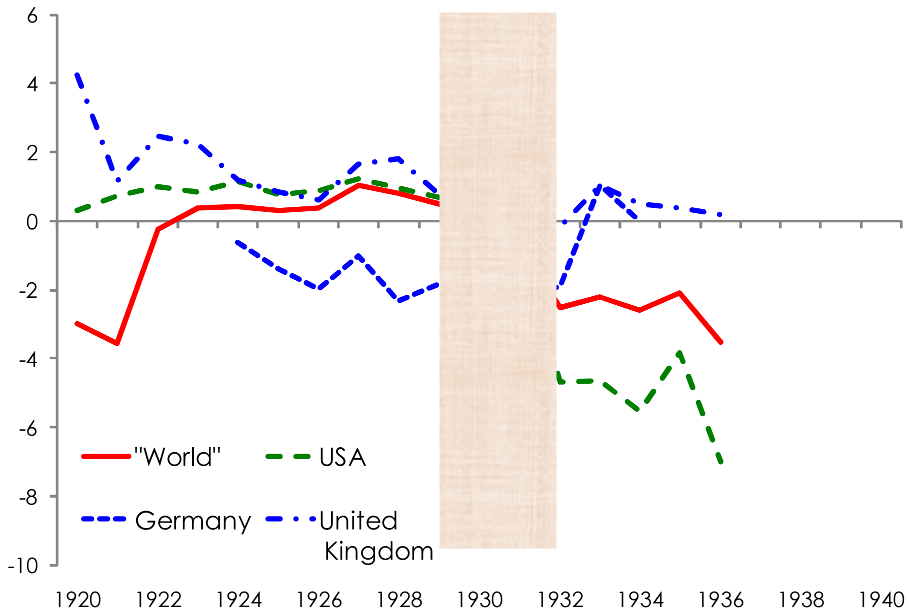
Source: IMF (2009) using Bloomberg, Bank of Japan, Datastream, ECB.

Fiscal policy

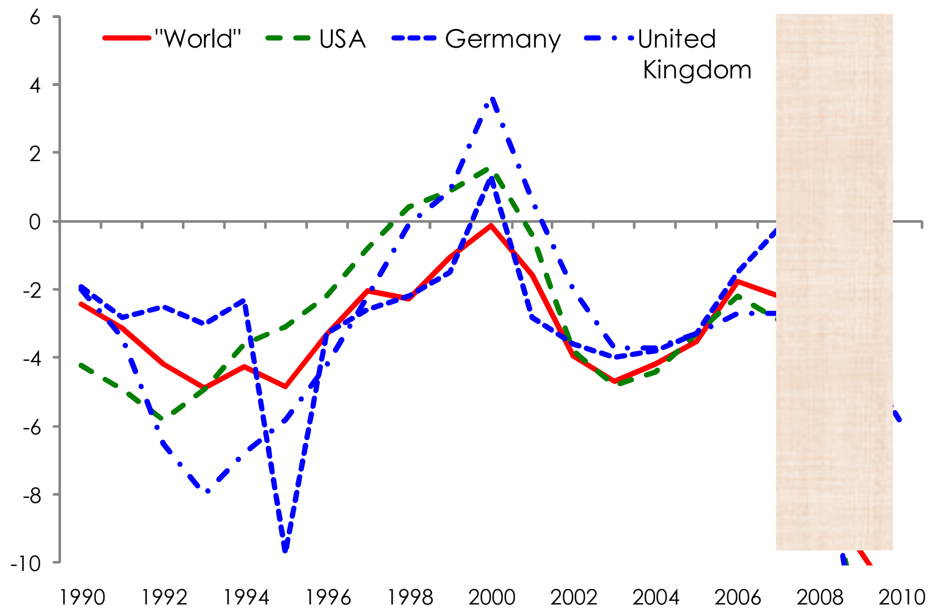
- Balancing budgets / hesitating vs. coordinated, aggressive boost
- Great Depression:
  - Mitigate or sterilize (smaller) automatic stabilizer
  - Balanced budgets at least up to 1932
    afterwards expansion with country differences
- Recent Crisis:
  - Larger automatic stabilizers
  - Adding stimulus packages (within 6 month, nearly all countries)
  - International help for countries who could not (deficits, currency problems)
  - China did an extra effort
  - We have to do and we can do mentality.

Budget surplus/deficit: boom and decline

Great Depression



Recent Crisis



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Is the Recent Crisis over? Burdens left

- For production it could be over (decline stopped)
- Not for unemployment
- Lower growth expected in the medium term

- **Mega burdens to be tackled:**
  - Consolidation of budgets without increasing taxes (too much)
  - Fighting unemployment while preparing for ageing society
  - Increasing economic growth while switching towards sustainability
  - Regulatory reforms without impairing financing of firms, consumers

⇒ **Prudent governments and excellent policy advice needed.**

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The world will be different

- Lower mid-term growth
- De-leveraging and higher risk aversion
- High public debt
- Less money for research, education, ecology
- Reforming public sector necessary

If expenditures cannot be cut enough:

- New taxes?
- Tax on financial transactions of 0.1%

  ⟶ 90 bn € in Europe done.

The hierarchy of problems will look (partly) similar

- Globalisation
- Catching-up Eastern Europe plus neighbours
- Ageing, health, socialisation
- Climate change, clean energy -50% (-30%, -20%)
- Shortages of energy, resources

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The recovery - most likely course

- The recovery will be flat and bumpy (More L, than V)
  Large output gap will prevent inflation
- Unemployment rate will surpass 10% in the USA and Europe (in 2010?)
- Long-term finance for risky projects will be more expensive
- Budget stimuli still needed in 2010
- Large efficiency reforms with upfront costs should be started.

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OECD Forecast November 2009

	Real GDP					Unemployment rate	
	2008	2009	2010	2011	2011-2017	2009	2010
	Percentage change						
Austria	1.9	-3.8	0.9	2.2	2.5	5.8	7.1
Czech Republic	2.6	-4.4	2.0	2.8	4.1	6.9	8.4
Germany	1.0	-4.9	1.4	1.9	1.6	7.6	9.2
Euro Area	0.5	-4.0	0.9	1.7	2.1	9.4	10.6
USA	0.4	-2.5	2.5	2.8	2.6	9.2	9.9
OECD	0.6	-3.5	1.9	2.5	2.6	8.2	9.0

Some long-run lessons

- Think about resilience increasing strategies
- Face long-run shortages
- Accumulating deficits is dangerous
- Budget surplus in good years is very important
- More intelligent, systemic, comprehensive,
  international regulation
  Not necessarily more, no larger public sector
- Firms and banks too big to fail are a risk
- Liberalization and globalization needs proactive policy.

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Summary on causes and policy

- The roots of the financial crises are beyond US housing
- Economic policy has reacted correctly, but slowly and not strategically
- The crisis will not end at a given date, unemployment and higher government debt will remain for years
- Growth will be lower after it, regulation more prudent.

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Summary on depth and length

- The drop in activity was much smaller and shorter
- The rebound of the stock market is larger and longer than during GD
- The Recent Crisis had the potential of a much greater crisis
- Higher globalization and synchronization were outweighed by better institutions and new multi polarity
- Policy acted decisively, strong, early, partially coordinated
- All policy lines were applied at the same time
- Consensus of economists was surprisingly strong.

Did we learn from the crisis?

- Policy not strategic enough and no focusing on long-run goals
- Smart regulation will come, old players want to prevent it
- Policy conflicts and protectionism have to be avoided

⇒ Learning from the European Model: more emphasis on longer term and broader goals

⇒ Learning from the US: tacking with a problem decisively and quick

⇒ Learning from the Chinese:
build up reserves and complement globalisation by prudent industrial policy.

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Jeffrey Sachs (Columbia University)
in Financial Times August 19, 2008

In contrary to the view:

... "Europe in decline ... increasing irrelevance ... relative economic decline"

"What about Europe's internal peace, strong democracies, social market systems that avoid a US-style underclass, strong scientific and technological capacity, high educational attainments, generosity in aid given to the low-income world compared with aid given by other high-income countries, a productivity to negotiate rather than to bomb, the highest life expectancy and lowest child mortality of any world region, impressive commitments to alternative energy and energy efficiency, high environmental awareness, ample leisure time for the broad population, and the stabilisation of the overall population, not to mention very high levels of self-reported life satisfaction in world surveys?"

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Problems and imbalances: before the crisis started

- The three US deficits (budget, current account, savings)
- Surpluses in China, Russia, oil countries (sovereign funds)
- Shortage of raw material, peak oil, climate change, food prices
- Budget deficits, export deficits, reform deficits in several Eastern European, Asian countries (Latvia, Bulgaria, Ukraine etc.)
- Migration without integration (Eastern Europe, North Africa)
- Unequal incomes, unemployment of less qualified, ageing
- Ignorance of US car industry

→ Some of the problems are the consequence of fast increasing world economy (+25% in 5 years), and reduction of poverty

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New prudent regulation

- All products should be included in reserve obligation
- For securitized assets predetermined part of highest risk class has to be kept
- Special surveillance for multinational players (European?)
- Nationalized banks should return to private ownership
- Transparent rules for rescue money and repayment

→ Regulation is important, but

- no return to government as owner and manager of fimrs
- recruiting best management is extremely difficult for government

World economy: "Old Players"/"New Players"
Growth over five years, cumulated

	1998 - 2003	2003 - 2008
USA	13.7%	13.1%
Japan	4.6%	8.7%
EU 15	11.7%	10.8%
EU 9 1) (new Members)	22.2%	29.5%
BRIC's 1)	32.7%	46.3%
World	14.1%	25.0%

1) Average over countries

⇒ **A Period of exceptional high growth – outside of the "old triad"**

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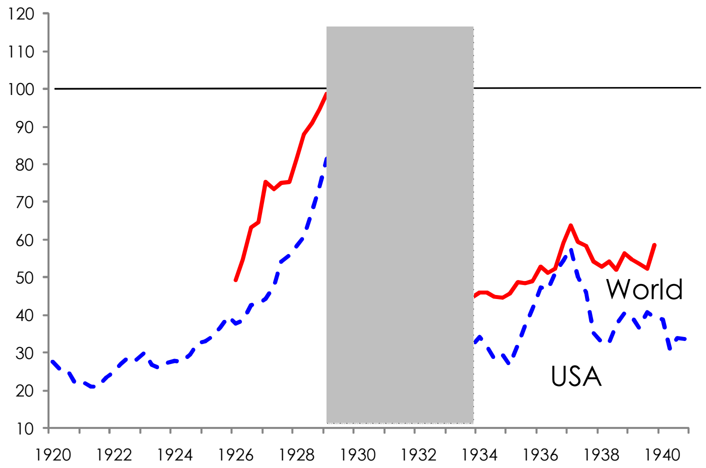
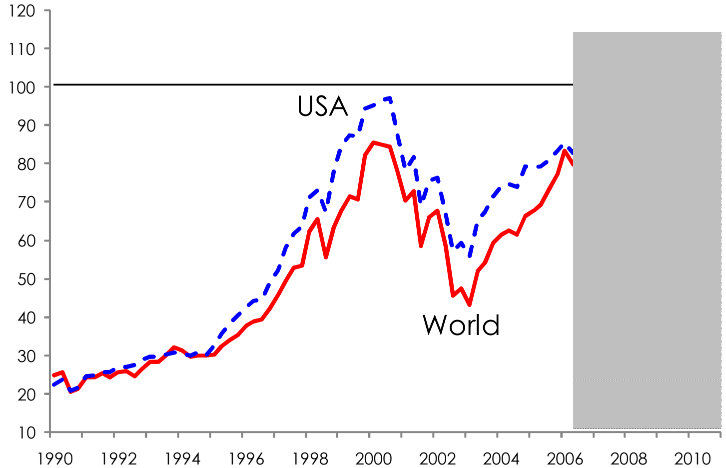
Comparison of two crises: Stock markets

Great Depression (3Q1929=100)

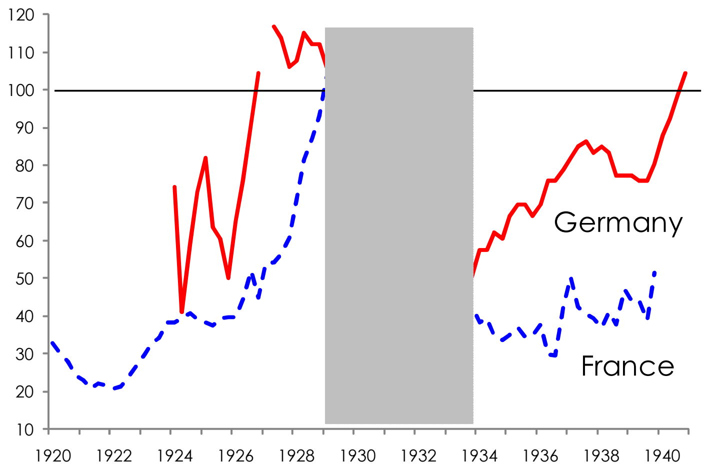
Current crisis (2Q2007=100)

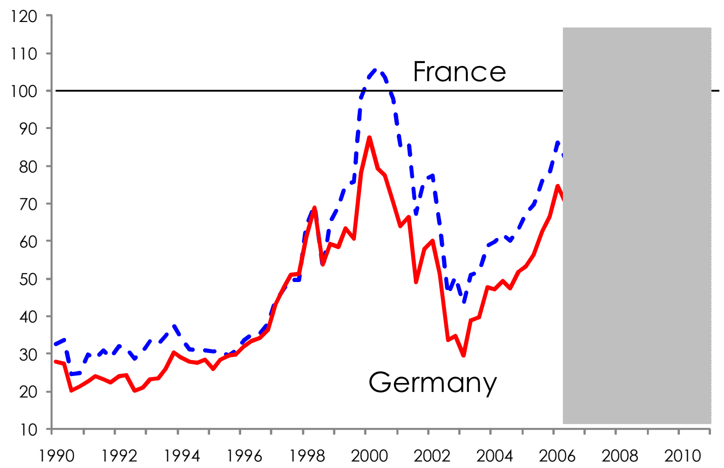
World vs. USA





Germany vs. France





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Fiscal balances 2006 to 2010: Per cent of GDP/Potential GDP

	2006	2007	2008	2009	2010
United States					
Actual balance	-2.2	-2.9	-5.9	-10.2	-11.2
Underlying balance[2]	-3.0	-3.5	-5.8	-7.7	-8.5
Underlying primary balance[2]	-1.0	-1.4	-3.8	-6.2	-6.8
Gross financial liabilities	61.7	62.9	71.1	87.4	97.5
Japan					
Actual balance	-1.6	-2.5	-2.7	-7.8	-8.7
Underlying balance[2]	-4.0	-3.8	-4.3	-5.9	-6.0
Underlying primary balance[2]	-3.3	-3.1	-3.5	-5.0	-4.7
Gross financial liabilities	172.1	167.1	172.1	189.6	199.8
Euro area					
Actual balance	-1.3	-0.7	-1.9	-5.6	-7.0
Underlying balance[2]	-1.6	-1.4	-1.9	-2.6	-3.8
Underlying primary balance[2]	1.0	1.2	0.7	0.0	-1.2
Gross financial liabilities	74.6	71.2	73.4	82.5	89.2
OECD[1]					
Actual balance	-1.3	-1.4	-3.2	-7.7	-8.8
Underlying balance[2]	-2.4	-2.5	-3.8	-5.5	-6.2
Underlying primary balance[2]	-0.5	-0.6	-2.0	-3.8	-4.4
Gross financial liabilities	75.0	73.5	78.7	91.6	100.2

Source: IMF (2009) using OECD Economic Outlook 85 database.

Why there should be no further steps of decline (we hope)?

- Everything happened in the beginning
  - Burst of bubbles, stock market decline, break down of exports, bank failures
  - These problems occurred step by step during GD, as hopes of end had come up
- The policy reacted this time with force, determinedness, coordinated
- In GD first un-decisive, partly restrictive
  - as fiscal policy started to stabilize - money supply collapsed
  - Bank failures were unexpected, at least policy reaction and repercussions
- No deflation this time
- No center periphery pattern - in the contrary: China, India restart the engine
  - Surplus money (sovereign state funds) available for recapitalization and reinvestment: Arab countries, Norway, Indonesia.

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Policy requirements to prevent further steps similar to GD

- Policy recommendation (learning from GD)
  - Refrain from early exit: fiscal policy, monetary policy, bank support
  - Keep reserve funds and task forces for critical situations
  - Minimize protectionism
- Policy recommendations (learning from causes of CC)
  - Shift support from old structures (cash for clunkers) to future needs
  - Improve regulation and international coordination
  - Reduce imbalances in a consistent medium-run strategy
- Will the consensus of economists last: if unemployment and fiscal deficits approach 10%? (in some countries, 7% in others).

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Forecast 2010
Growth of GDP

	2010
USA	+1.0%
Japan	+0.5%
EU 27	+0.6%
Euro area 16	+0.8%
New Member States	+0.8%
Czech Republic	+0.8%
World	+2.0%
China	+7.5%
India	+6.9%
Indonesia	+4.0%

WIFO, September 2009.

Unemployment rate in the EU

	2008	2009	2010
Netherlands	2,8	3,4	5,4
Denmark	3,3	4,5	5,8
Austria	3,8	5,5	6,0
Czech Republic	4,4	6,9	7,9
germany	7,3	7,7	9,2
Italy	6,8	7,8	8,7
France	7,8	9,5	10,2
Lithuania	5,8	14,5	17,6
Latvia	7,5	16,9	19,9
Spain	11,3	17,9	20,0
EU 27	7,0	9,1	10,3
Euro area	7,5	9,5	10,7