The World Economy in Crisis: What Should We do?

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Outline

- 1. Origins of the Financial Crisis
- 2. What Caused the Crisis of 2008?
- 3. The International Monetary System
- 4. China's Economy
- 5. Five Goats of the Crisis
- 6. What Should We Do?
- 7. Policies for Rest of the World
- 8. Conclusions

1. Origins of the Financial Crisis

The Financial Crisis

- The financial crisis started in the summer of 2007.
- It was reflected in the great liquidity crisis that developed on August 9-10 when awareness of the troubles associated with sub-prime mortgage assets became general.
- It exploded in the summer and fall of 2008 with the insolvency of Fannie Mae and Freddie Mac and the failure of Lehman Bros.

The Origins

- The early origins go back to the Federal Reserve policies used to cope with the global slowdown of 2001-2.
- With very low interest rates and a low dollar in the recovery, a housing boom developed.
- As long as house prices were rising there was a cushion of safety between mortgages and house values.

Financial Innovations

- Securitization of mortgages greatly increased the supply of capital but increased distance between issuers and holders.
- Derivatives spread risk from averters to takers but created new systemic risks.
- Credit default swaps posing as insurance with the difference that you could insure these assets even if you didn't own them.
- Mark-to-market accounting in investment accounts created instability in balance sheets.
-

End of the Boom

- When the house prices stopped rising and began to fall, the boom ended.
- When house prices fell below mortgage values homeowners walked away from their mortgages leaving banks holding the bag.
- Sub-prime mortgage assets became toxic assets, creating a devastating hole in balance sheets.

Massive Liquidity Crisis

- Suddenly in June 2007 there was a massive balance sheet problem for banks amounting to hundreds of billions of dollars.
- Mark-to-market accounting forced them to cover the holes.
- The resulting scramble for liquidity was completely unprecedented in the annals of finance.
- A financial panic was about to occur.

The Liquidity Crisis: Aug 9-10, 2007

- The panic was averted by prompt and astute action by the ECB. It offered unlimited credit at 4% on August 9.
- 95 billion in euros were lent at that rate
- More came from the Fed and other central banks when their markets opened later.

Injections by ECB and FRB in Billions of Dollars in August 2007

	Thursday August 9	Friday August 10
ECB	130	54
FRB	24	38

Liquidity Problem vs Solvency Problem

- The prompt actions of the ECB and FED and others in August 2007 solved the **liquidity** problem at the time.

- What remained was the **solvency** problem of all those institutions around the world holding these defaulting assets.

2. What Caused the Crisis of 2008?

Slowdown and then Recovery?

- For a year there was relative quiet.
- The great expansion of 2002-2008 came to an end in the U.S. with the great slowdown in 2007 (4) and 2008 (1).
- Then there seemed to be recovery in 2008 (2) with growth of 2.8%.

Financial Blowout and Recession in 2008-II

- But in the last half of 2008 came the great financial blowout and the unambiguous recession with negative growth in both 2008 (3) and 2008(4).
- Bear Stearns, Fannie Mae & Freddy Mac, Lehman Bros, AIG, Goldman Sachs, Bank of Washington were all victims.

Lehman's Collapse

- Lehman's demise was the biggest failure in world history.
- Previously, Enron in 2002 had been the biggest.
- But the Lehman failure was six times bigger than Enron.

Lehman's Collapse

- Lehman was too big to fail.
- But the Treasury let it fail, a colossal mistake.
- It put other institutions at risk and made the take-over of AIG, at a cost of $78 billion, inevitable.

The Big Question

- Why did the financial crisis occur and why did it happen to come about in August and September 2008?
- In the spring it looked as if the U.S. economy was recovering with 2.8% growth in the second quarter of 2008. The Bear Stearns problem was the largest bailout since LTCM in Sept 1998 but it was being handled with absorption into J.P. Morgan at the revised price of $10/share.
- What caused the debacle that September?

The Answer

- The answer was that the Federal Reserve screwed up. Tight Money!
- Yes, interest rates were very low and Fed actions were making the money supply soar.
- But neither low interest rates nor rapid monetary expansion prove that money was easy.
- Monetary ease is not measured by monetary expansion or low interest rates but by the relation between the money supply and the demand for it.

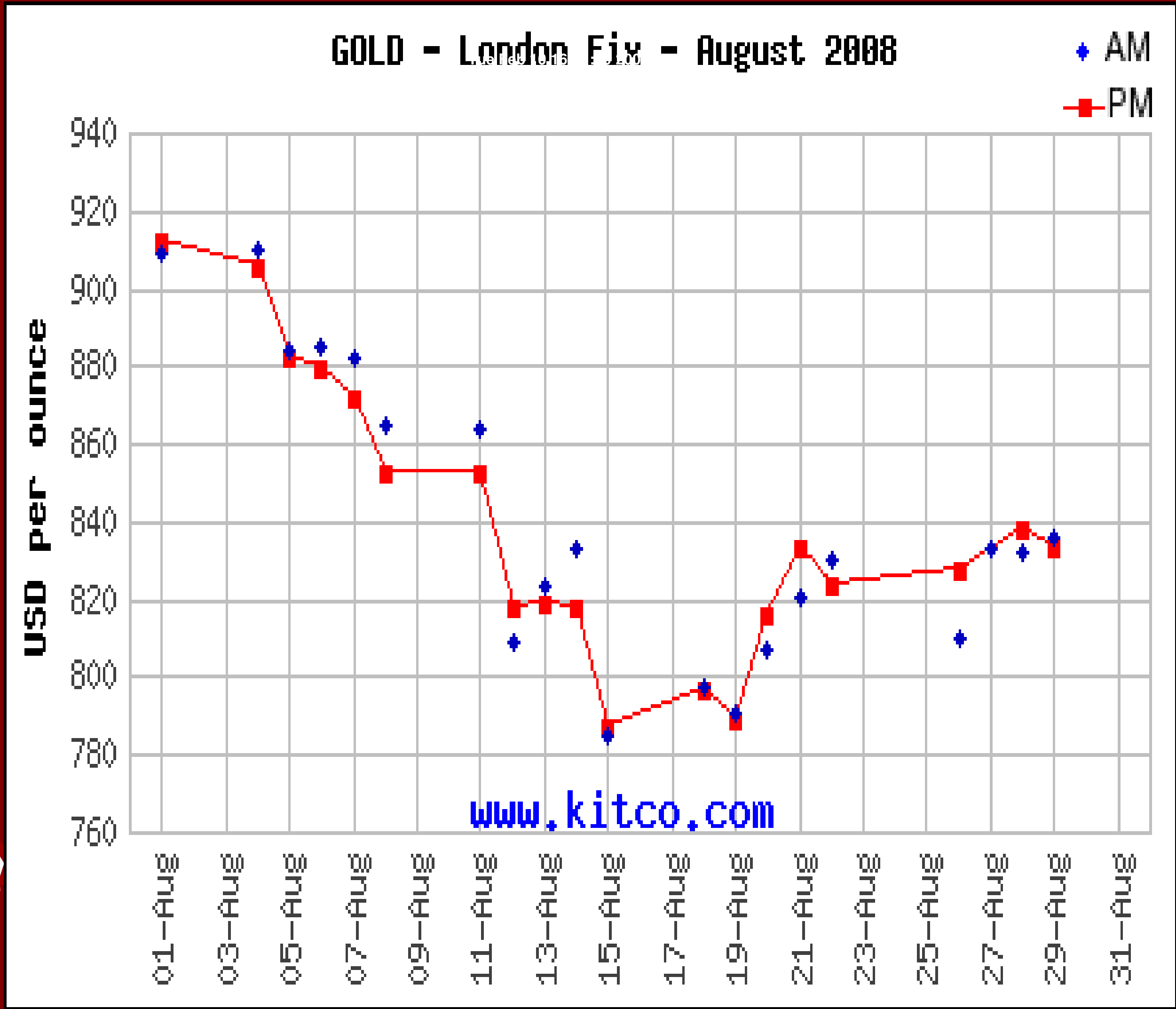
The Soaring Dollar

- The tight money that sunk the financial markets was indicated by the fall in the price of gold and the soaring dollar.
- The euro fell against the dollar from above $1.6038 per euro on July 15 to $1.2330 per euro on Oct. 28, 2008.
- This was a 30% appreciation of the dollar hardly more than 3 months!

$ Appreciation

- On July 15, 2008 the euro was $1.60, but by Nov. 13, it had fallen to $1.25.
- Looked at the other way, the dollar was 0.63 euros on July 15, but 0.8 euros on Nov. 13.
- The dollar appreciated by 27% between the middle of July and the middle of November.
- These dates almost exactly frame the period of the colossal financial debacle

The price of gold plummeted.



Advertise o

The Dollar in Euros and the Price of Gold in Dollars in July and November 2008		
	Euros per Dollar	Gold ounce per Dollar
July 15	0.63	980
Nov 13	0.80	720

The FED Mistake

- The soaring dollar and falling gold price were symptoms of a shortage of dollar liquidity.
- Had the FED recognized this shortage and bought foreign exchange to prevent the appreciation, there would probably have been no financial crisis in the fall.
- Instead, the dollar appreciation overvalued US dollar assets including all fixed income securities and mortgages, tipping Lehman Bros and other banks over the edge.

Low Gold, Strong Dollar

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Conclusion

- The Federal Reserve cut off the economic recovery in 2008(2) and tipped the economy into recession and financial crisis.

Like the early 1980s

- In 1979 oil prices nearly tripled to $34/bbl, gold soared and the dollar tumbled, while inflation in 1980 registered 13%.
- The Reagan administration lowered tax rates and increased defense spending, while the Federal Reserve Board tightened, creating a policy shock that made the dollar soar, gold prices fall, the recession of 1982, the savings and loan debacle and the international debt crisis.
- The tight money of summer 2008 reflected in the strong dollar and low gold price panic all over the world and a flight to the dollar that brought a halt to bank lending.
- Similarities are great because of oil prices, exchange rates, gold prices, and massive fiscal policies.

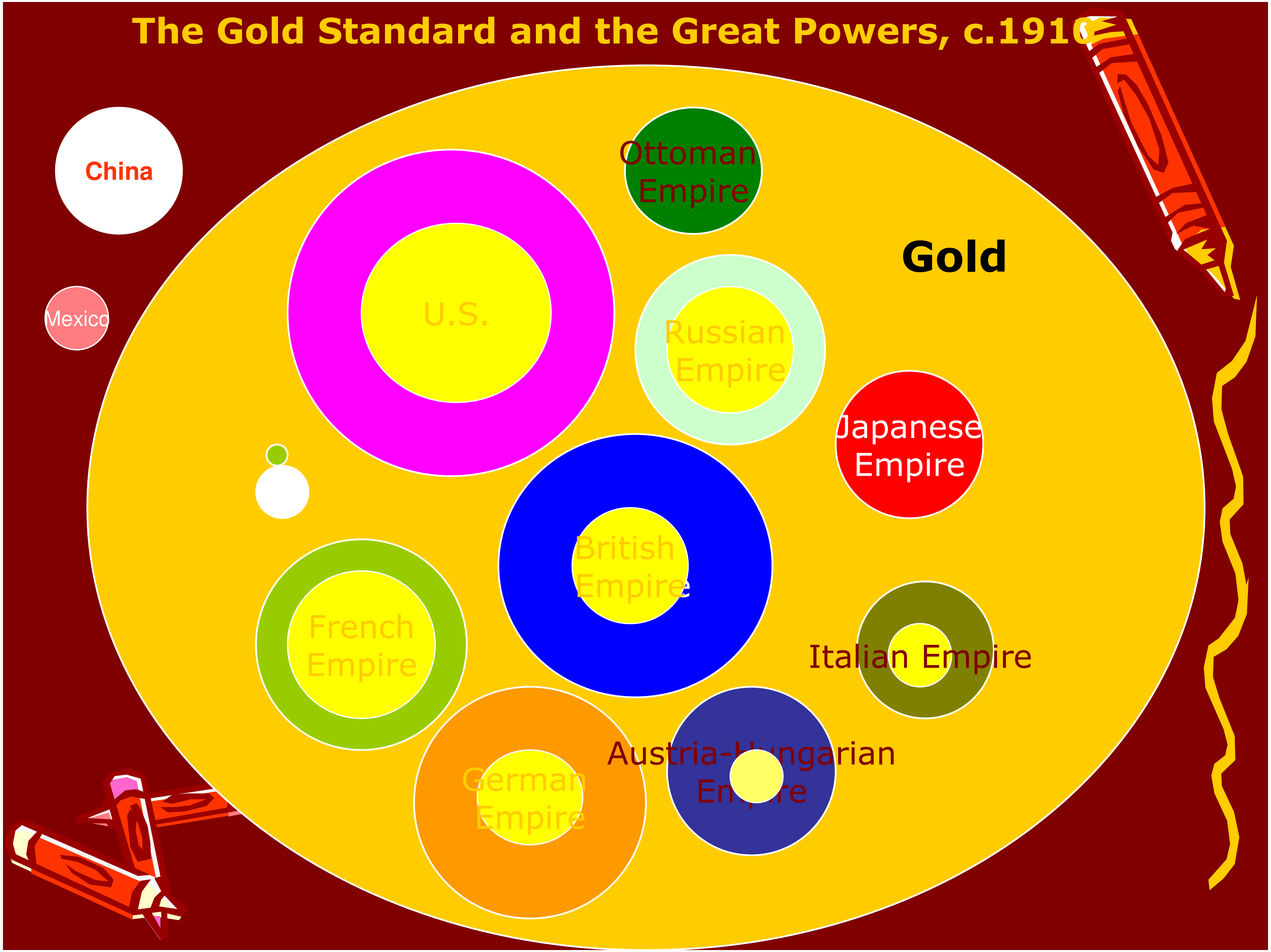
3. The International Monetary System

Phases of the International Monetary Arrangements

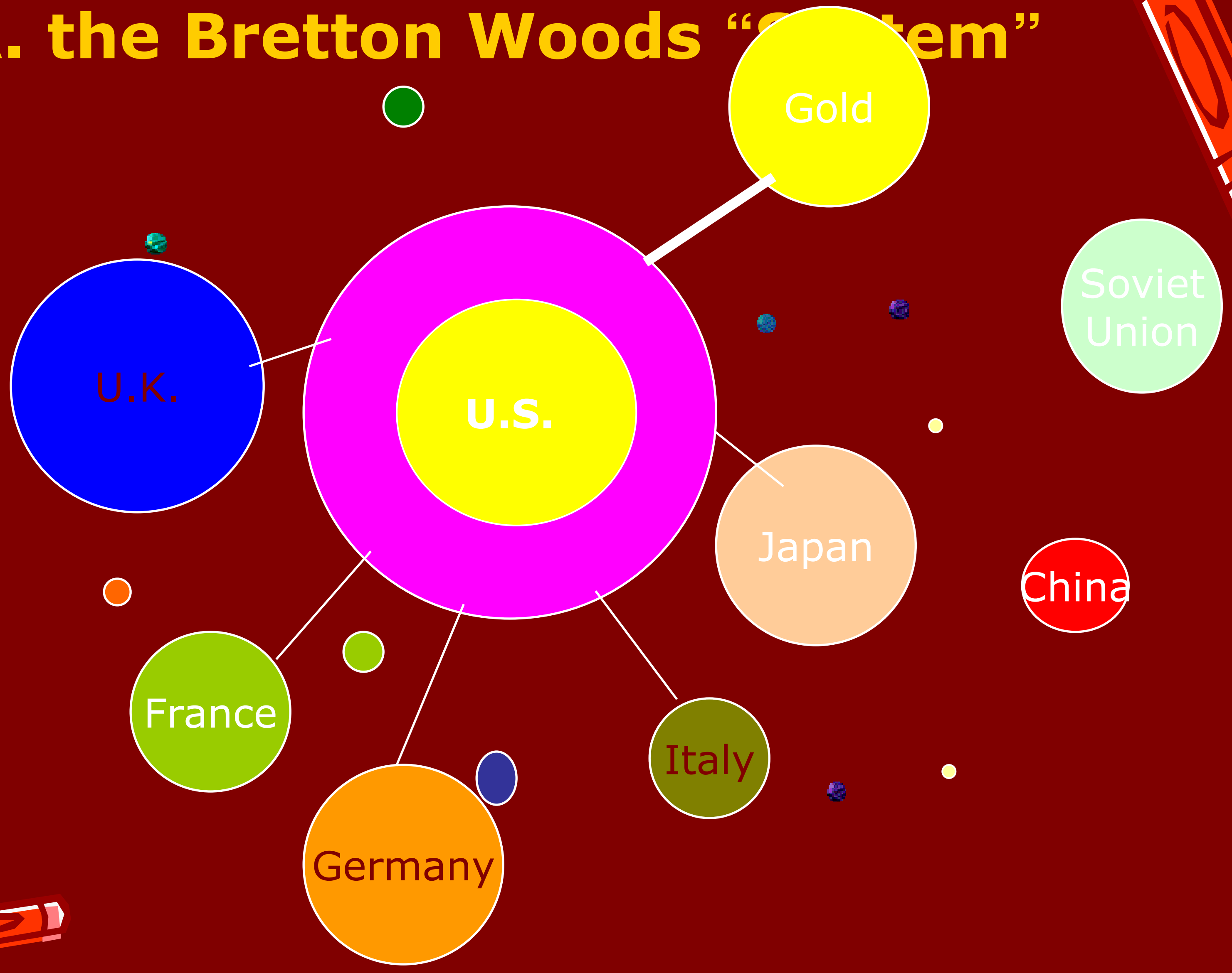
Int'l Gold Standard	1873 - 1914
Bretton Woods System	1945 – 1971
Flexible Exchange Rates	1973 – 1999
Dollar-Euro	1999 –

Gold Standard

- No major banking crises under gold standard or Bretton Woods System
- Baring's Crisis of 1890s
- Knickerbocker Crisis of 1908
- Rather anecdotal by comparison


The Gold Standard and the Great Powers, c.1910
China
Mexico
Ottoman Empire
Gold
U.S.
Russian Empire
Japanese Empire
British Empire
French Empire
Italian Empire
German Empire
Austria-Hungarian Empire

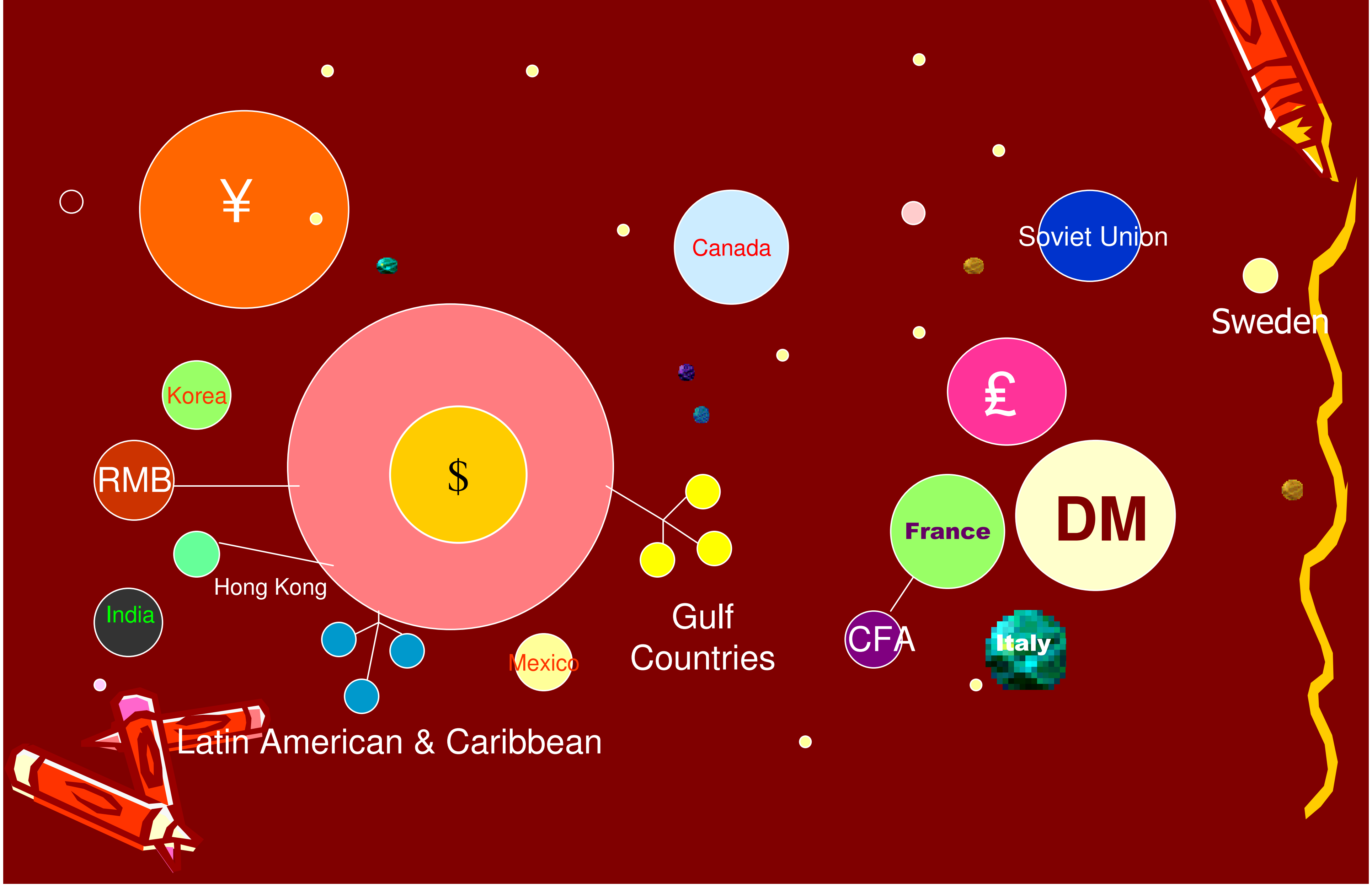
Dollar Standard II. 1934-1971.
A.K.A. the Bretton Woods "System"



No Major Banking Crisis

- No major banking crises under either the gold standard before 1914 or under the Bretton Woods system of fixed exchange rates.
- Four crises under floating.

Flexible Rates 1973-99



Four Crises Under Floating

- Four major banking crises under floating rates:

1982:International Debt Crisis

1982-3: Savings and Loan Ass. Crisis

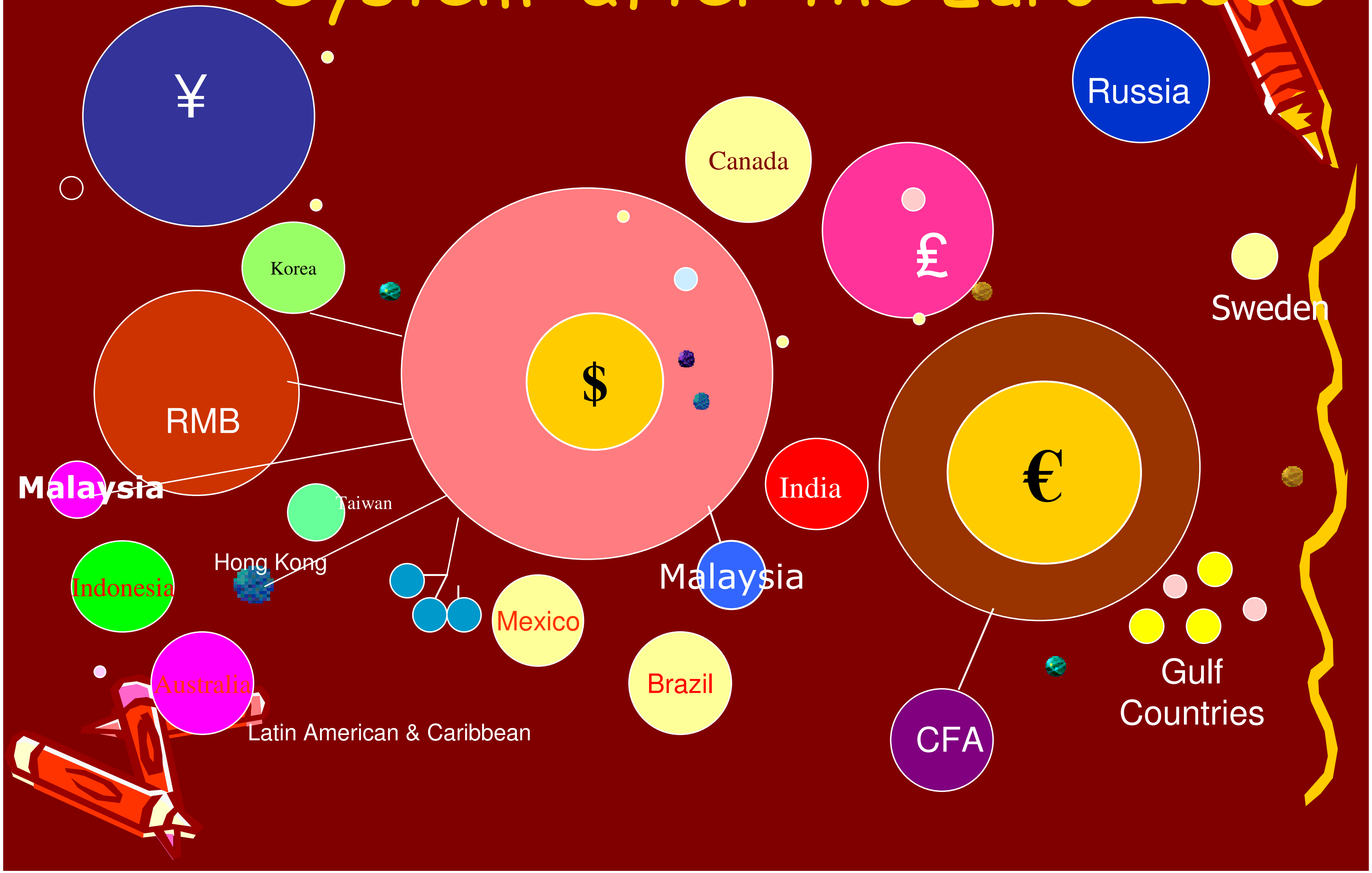
1997-8: Asian Crisis

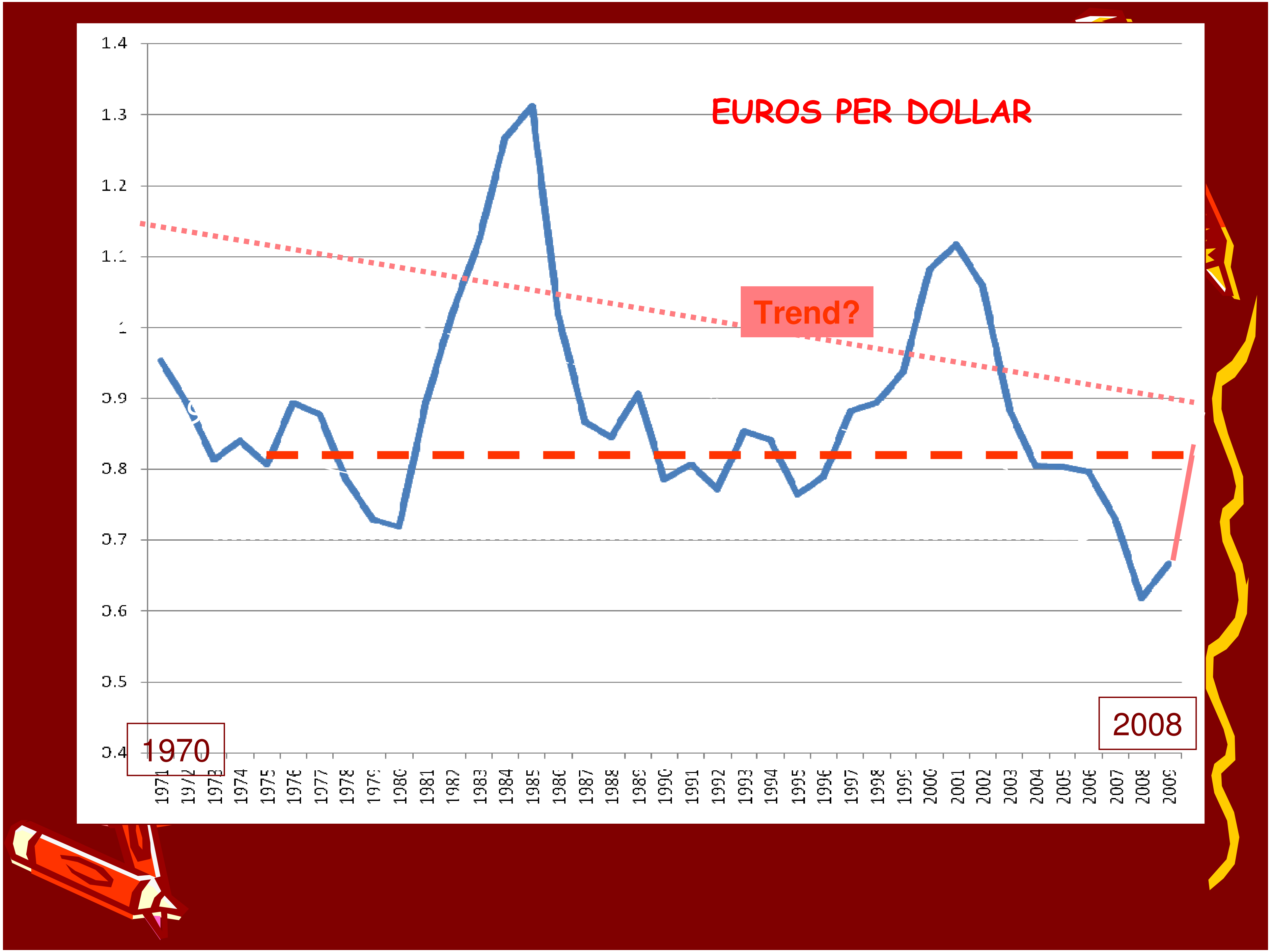
2007-9: Financial Meltdown

Exchange Rate Instability

- All of these crises were associated with swings in exchange rates of big currencies, mainly dollar-euro (or ECU) and dollar-yen.

The International Monetary System: after the Euro: 2008





EUROS PER DOLLAR
Trend?
1970
2008
1.4
1.3
1.2
1.1
1
0.9
0.8
0.7
0.6
0.5
0.4

Harmful Effect of Big Swings in Exchange Rates

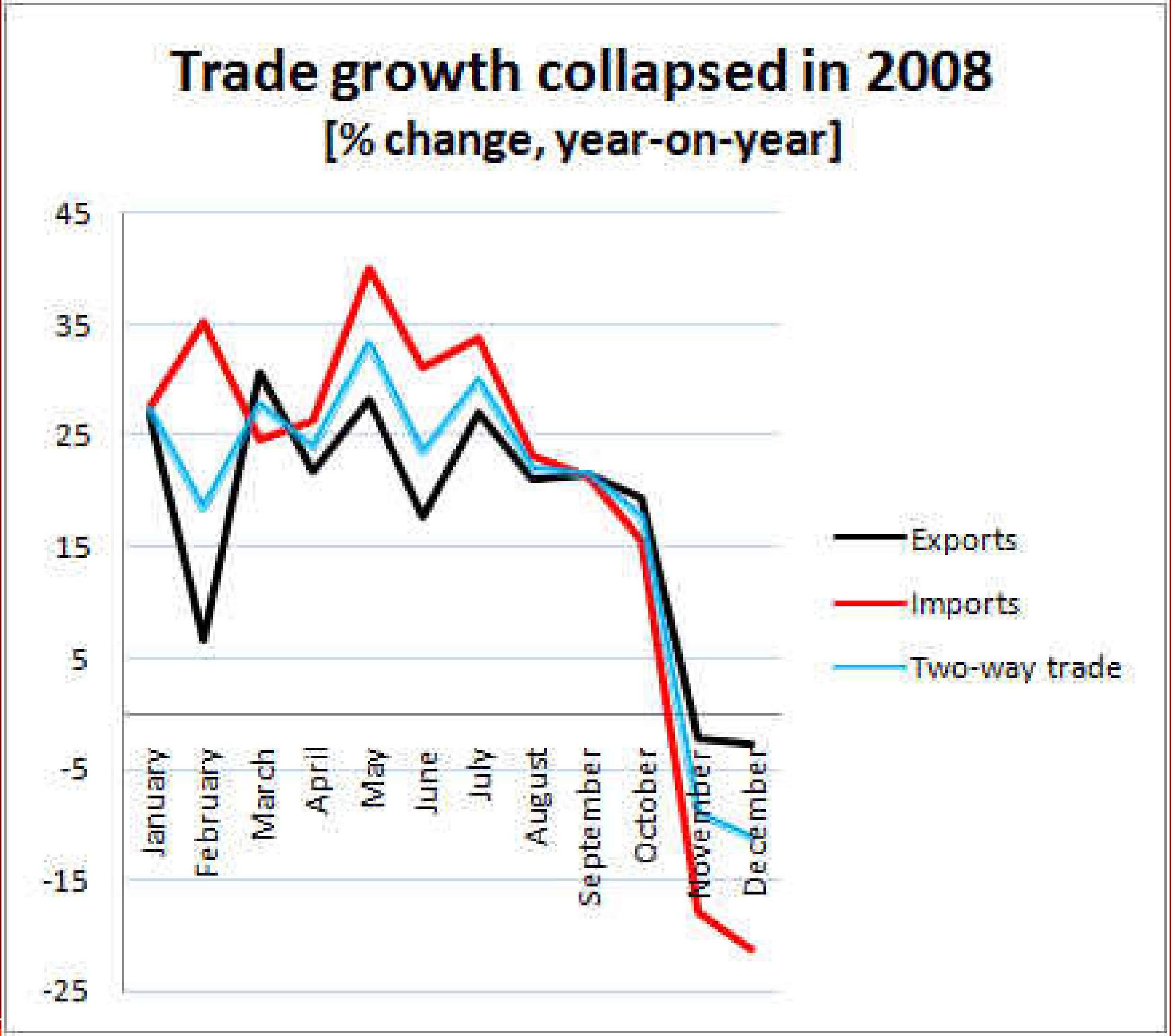
- Huge redistributions of wealth because currencies denominate debts
- Dollar system benefits U.S. in short run, hurts it in long run
- Dollar weakens with easy monetary policy during recessions and strengthens during booms
- Harmful to Europe and Other Countries

4.China's Economy

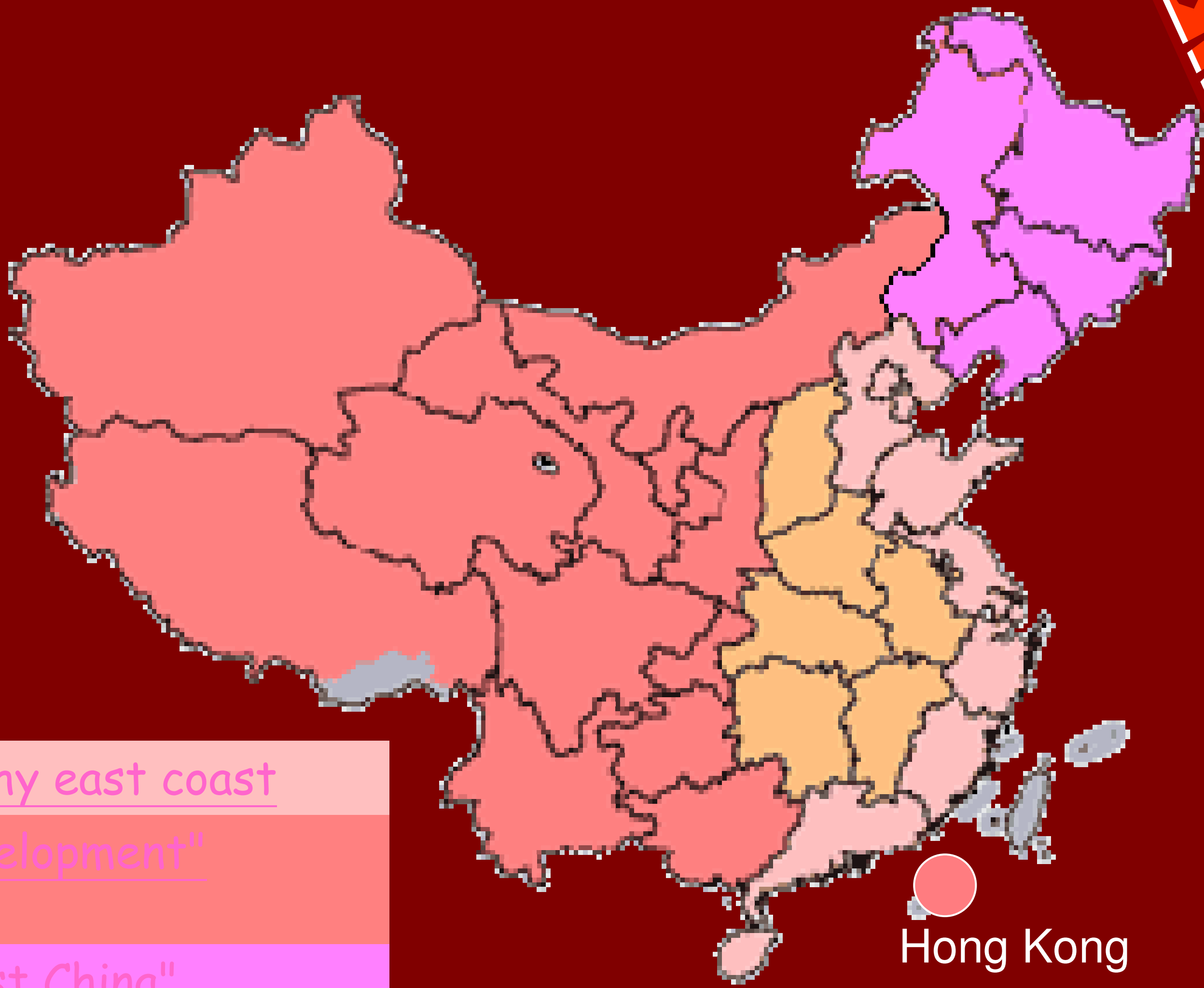
China's Growth

- All the major countries are in recession except China.
- But China will not escape a recession with Chinese characteristics.
- China's GDP is decelerating, i.e., it s growth is slowing.

China’s Growth Rate	
2002	9.1
2003	10.0
2004	10.1
2005	9.9
2006	11.1
2007	11.4
2008	9.0
2009?	6.0


Trade growth collapsed in 2008
[% change, year-on-year]
45
35
25
15
5
-5
-15
-25
January
February
March
April
May
June
July
August
September
October
November
December
Exports
Imports
Two-way trade

The Crisis Affects Each Region Differently



The relatively wealthy east coast

"China Western Development" Strategy

"Revitalize Northeast China" Initiative

"Rise of Central China" Strategy

Outlook

- Very likely huge slowdown of industrial production.
- Collapse of both export and import growth
- Trade balance could go either way, probably improve.
- Urgent to increase consumption spending in China

Biggest Problem

- Problem for China was two decades ago a problem for Japan.
- What to do with economic growth.
- Limits on extent to which surplus can be dumped abroad.
- To maintain growth of output will require demand for output and growth in supply of services.

5. Five Goats of the Crisis

Five Goats Who Contributed to the Financial Crisis

- Ranieri
- Clinton
- Greenspan
- Bernanke
- Paulsen

Lewis Ranieri

Julia Finch Guardian.co.uk (26/01/09)

- The bond trader who turned home loans into tradable securities
- The father of securitized mortgages
- Pioneered mortgage-backed bonds in 1980s
- “Mortgages are math”
- Created collateralized pools of mortgages
- Lost connection between original borrowers and lenders
- But ranked by Business Week with Bill Gates and Steve Jobs as one of the greatest innovators of the past 75 years.

Bill Clinton

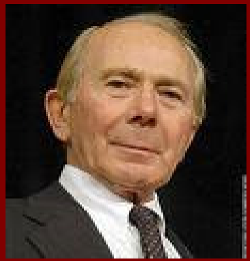
Julia Finch Guardian.co.uk (26/01/09)

- Strengthened the 1977 Community Reinvestment Act to force mortgage lenders to relax their rules to allow more socially disadvantaged borrowers to qualify for home loans
- In 1999 repealed Glass-Steagal Act, which ensured complete separation between commercial banks, which accept deposits, and investment banks, which invest and take risks, prompting the era of the superbank and primed the sub-prime pump.
- In 1998, sub-prime loans were just 5% or all mortgage lending; by 2008 it was approaching 30%

Alan Greenspan

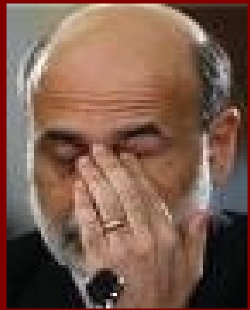
Julia Finch Guardian.co.uk (26/01/09)

- Kept interest rates too low, dollar too weak, for too long, led the housing bubble to develop
- Supported sub-prime lending
- Advocated variable rate mortgages
- Defended derivatives: “Derivatives have been an extraordinarily useful vehicle to transfer risk from those who shouldn’t be taking it to those who are willing to and are capable of doing so.” Senate Banking Committee, 2003



Maurice "Hank" Greenberg

- The founder of AIG, the biggest insurance company in the world.
- Conducted a vast business in credit default swaps (CDS).
- Insured mortgage assets for a regular premium for people/institutions that didn't own them.
- Similar to insurance, but different because the buyer of a CDS does not need to own the mortgage asset or even suffer a loss from a default event.
- Allowed mass multiples of derivatives.



Ben Bernanke

- Allowed dollar to soar as the euro fell from above $1.60 in June to below $1.30 in October 08.
- Failed to realize this appreciation surge freezing of credit markets and extreme shortage of dollar liquidity.
- Dollar surge brought on the recession in last half of 2008 and the financial crisis with Fanny Mae, Freddy Mac and Lehman and AIG etc.

Hank Paulsen

- Bailed out Bear-Stearns but allowed Lehman Bros. to fail.
- Failure of Lehman Bros. made it necessary to save AIG.
- Failed to notice significance of dollar appreciation in third quarter of 2008

6. What Should We Do?

Summary of Proposals

- 1. Issue Dates Spending Vouchers to increase effective demand.
- 2. Cut corporation tax rates from 35% to 15% to allow recapitalization of corporations and increase competitiveness.
- 3. Government Takeover and Restructuring of Insolvent Banks for subsequent privatization to rehabilitate the banking system.
- 4. Stabilize dollar-euro rate with the euro fixed at limits between $1.20 and $1.40 to avoid beggar-thy-neighbor exchange rate opportunism.
- 5. Establish an International Macroeconomic Advisory Council as a global version of the Volcker-Chaired Obama Advisory Council to deal with the coordination of international macroeconomic policies.

1. Dated Spending Vouchers

- Dated Spending Vouchers (DSVs) of $500 billion (divided up among individuals) that expire after three months. Retailers would use the executed vouchers as tax credits.
- This would amount to stimulus in one quarter that would represent a potential 12.5% increase in spending in the quarter's income.
- It is superior to a tax change because it is temporary and flexible: it doesn't change the tax structure and it can be repeated as needed.
- Given the fact that there is great uncertainty about the needed amount that is necessary, a tool that targets spending per quarter is flexible is superior to a one-shot guess.
- It would involve a once-for-all redistribution that benefits lower income groups and maximizes the proportion of it that will be spent.

2. Slash Corporate Profits Taxes

- Cut the corporate tax rate from 35% to 15% to recapitalize banks and corporations and spur investment.
- This measure takes account of the fact that the government is already a non-voting shareholder in corporations with 35% of the stock – without adding any capital to the corporation or share in any losses.
- Instead of the government buying stock in corporations to recapitalize them, the tax cut would let the corporations recapitalize themselves.
- (Note that Germany recently cut its corporation tax from 25% to 15%, and its overall taxes on corporations from 38.7% to about 30%.)

Corporation Tax Cut, cont'd

- Economists have been behind the curve on the impact of the corporate profits tax on investment and growth and employment. It is usually looked upon as an instrument for redistribution from the rich to the poor, ignoring the negative effects on the allocation of resources.

- Elimination of the corporation tax has long been a project of tax experts like the late William Vickrey, Nobel-prize-winning tax expert who, although a left-leaning liberal, regarded the corporation income tax as an "abomination" because of its harmful effects on output, growth and efficiency.

- A large cut in the corporate tax rate would make the stock market soar and restore the health of ailing corporations and banks and together with the DSVs jump-start investment and recovery.

3. Restructure and Privatize Insolvent Banks

- Government should take over and restructure large insolvent banks for subsequent privatization.
- Several key banks are at present technically insolvent if their assets were written down to their market value, and the purpose of this measure is to avoid the unproductive trauma of new bank failures.

Banking System

- Government takeover of prominent insolvent banks.
- Selection and removal of toxic assets.
- Reconstitution followed by privatization.

4. Dollar-Euro Anchor

- 3. Stabilize the dollar-euro rate and let the dollar-euro be the new anchor for the international monetary system around which an international currency can be based.
- The stabilization can be done gradually by creating a band of fluctuation at the margins of which the banks intervene and then narrow the band as the FRB and ECB get more comfortable at coordinating monetary policies.
- The Treasury/FRB can start by putting a floor to the euro (and a ceiling for the dollar) at $1.20 and the ECB put a floor to the dollar (and a ceiling for the euro) at $1.40.

$-€ Anchor, cont'd

- The Federal Reserve should modify its policy of sterilizing automatically all foreign exchange intervention.
- Japan and China could also be invited to take part in the stabilization program as could the United Kingdom

5. International Macroeconomic Advisory Council

- Work to establish for the world as a whole an International Macroeconomic Advisory Council as a counterpart to the Volcker-chaired Obama Advisory Council.
- Form a committee of 10-15 wise people from around the world to advise and evaluate economic strategy and make recommendations.
- These could raw materials for an International Economic Advisory Council for policy at the Global Level.

Policies for U.S.

- Dated Spending Vouchers (DSVs)
- Corporate tax cut from 35% to 15%
- Stabilization of Dollar-Euro Exchange Rate and Plan a World Currency
- Reform of Banking System with Reconstitution of assets and Privatization.

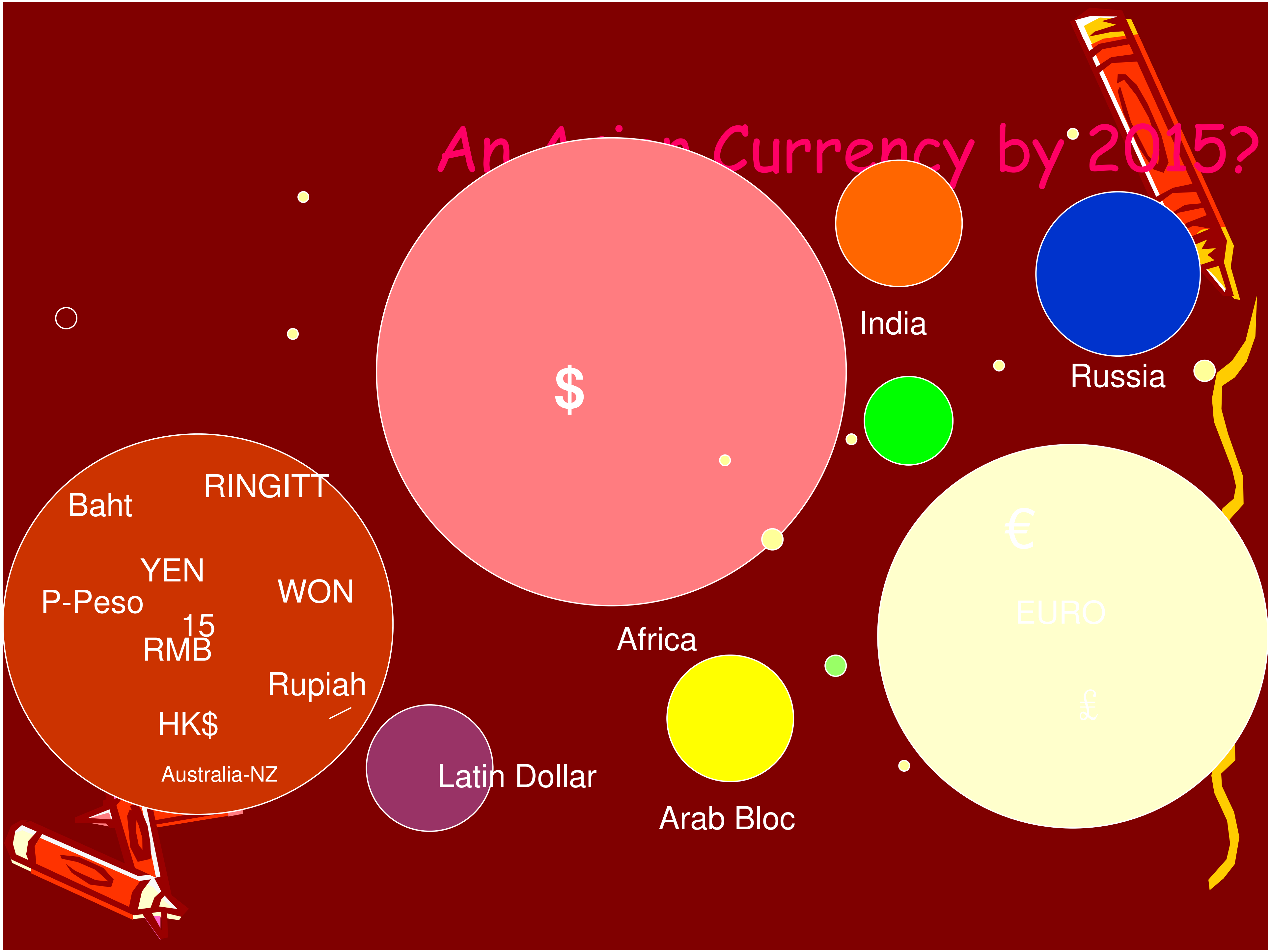
7. Policies for Rest of World

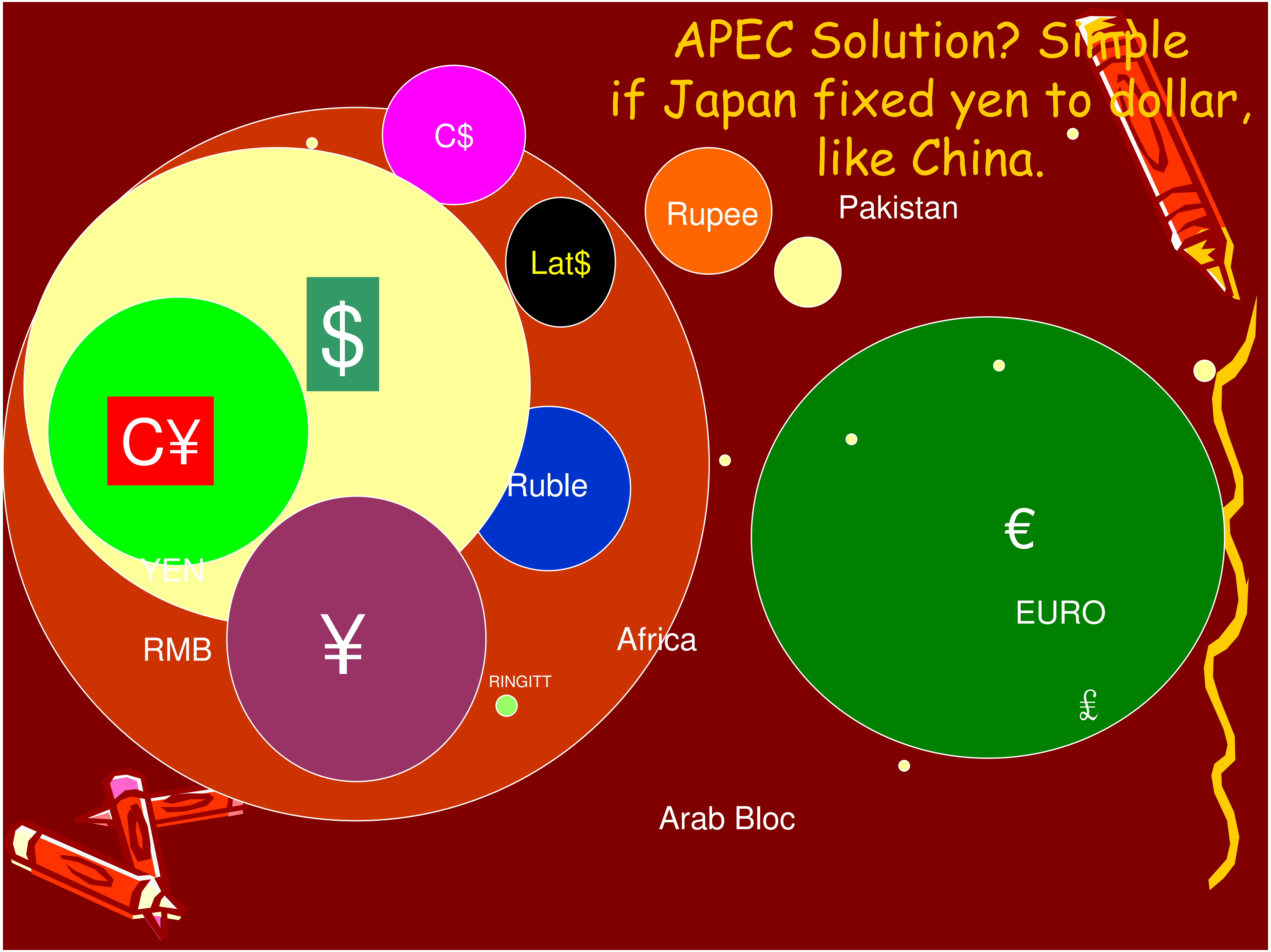
Policies for Rest of World

- Establish an international counterpart to the Volcker-Chaired Advisory Committee
- Stabilize exchange rates were feasible
- Support and Contribute to Formation of Global Currency
- Bretton Woods Type Conference in Shanghai in 2010.

Regionalism

- If the major countries do not support a multilateral approach toward a restoration of the international monetary system, Asia should act for itself by creating an Asian currency.


An
Currency by 2015?
$
India
Russia
Baht
RINGITT
YEN
P-Peso
WON
15
RMB
Rupiah
HK$
Australia-NZ
Latin Dollar
Africa
Arab Bloc
€
EURO
£


APEC Solution? Simple
if Japan fixed yen to dollar,
like China.
C$
Rupee
Pakistan
Lat$
$
C¥
Ruble
YEN
¥
RMB
RINGITT
Africa
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EURO
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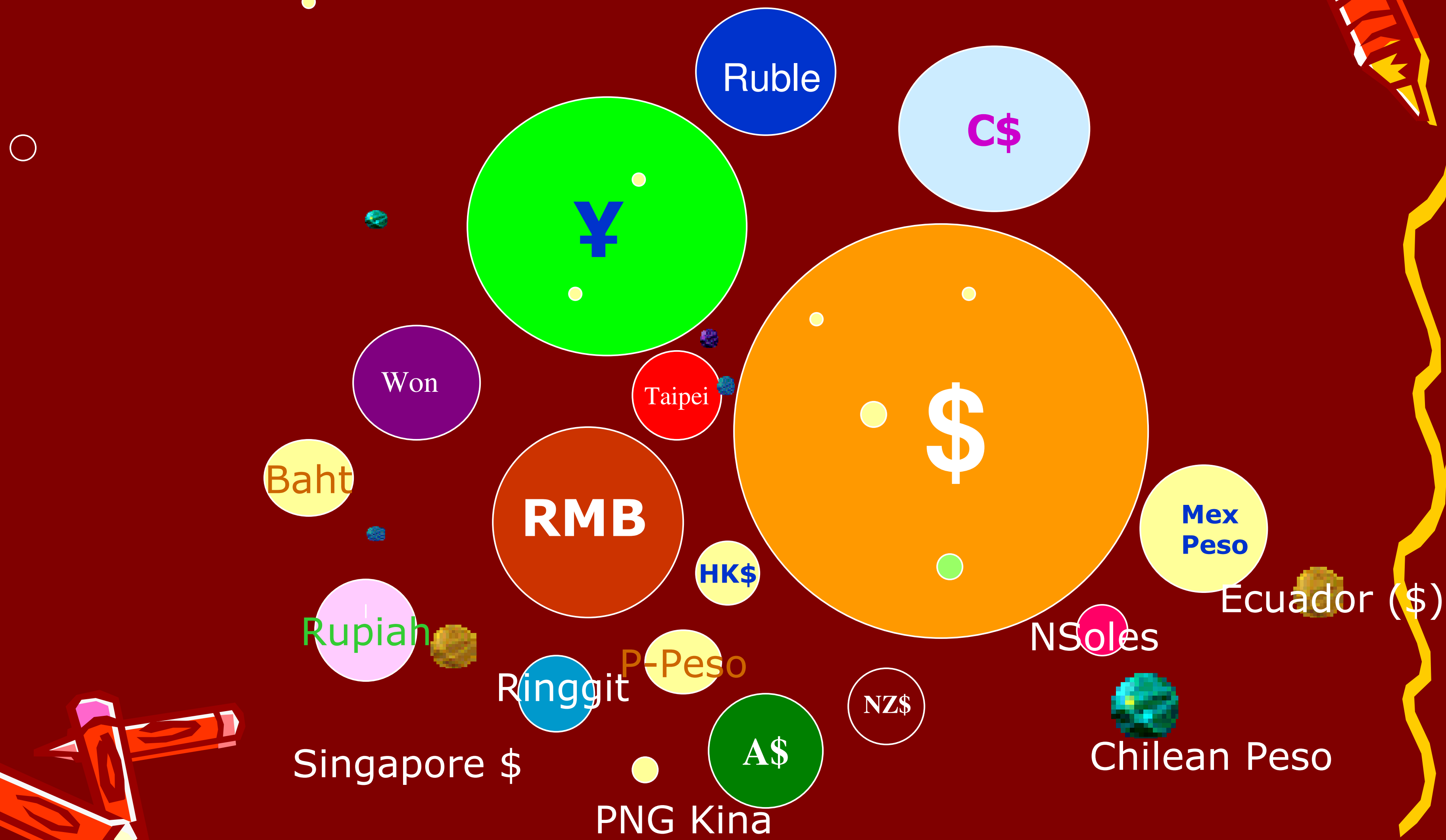
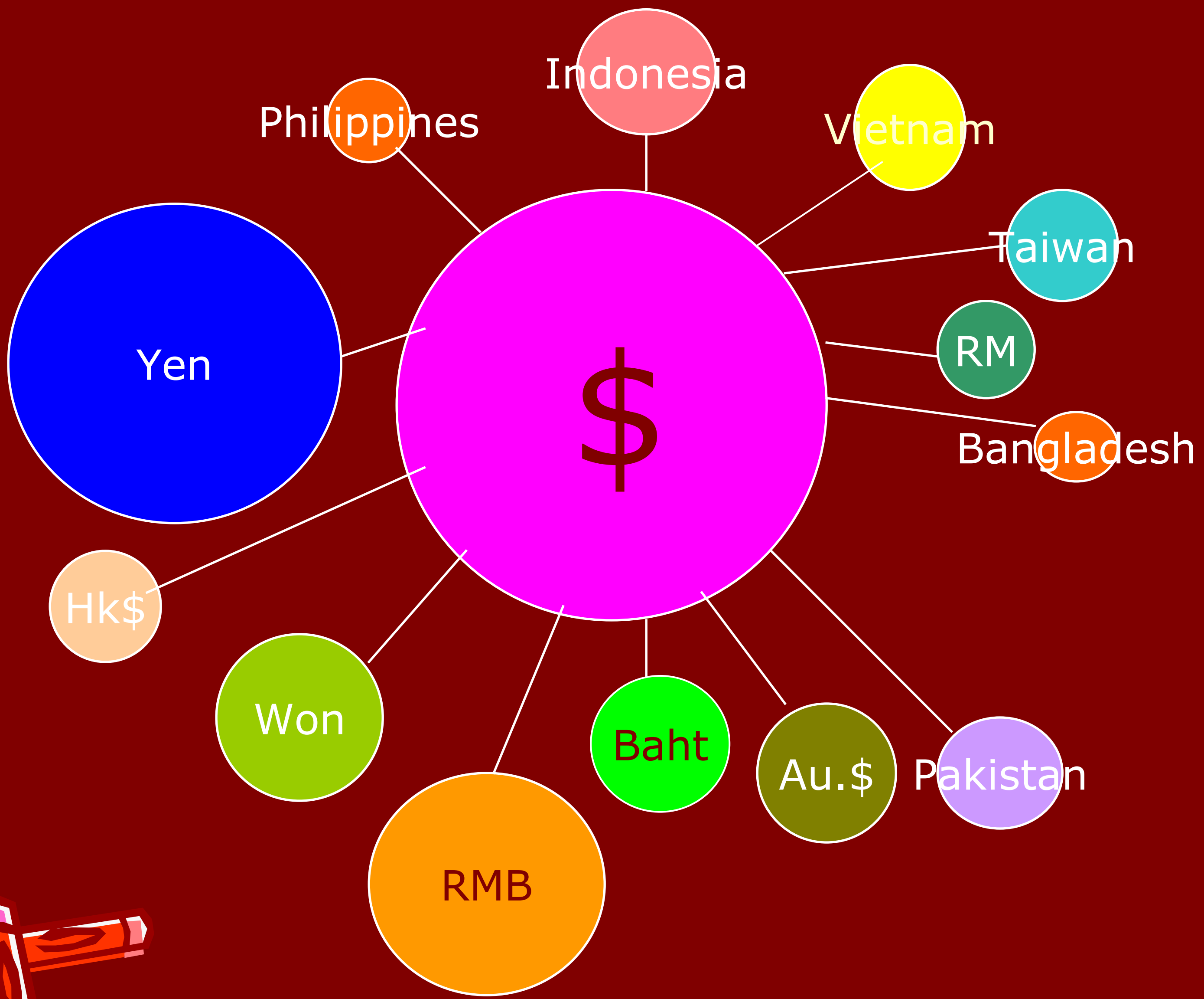
Arab Bloc

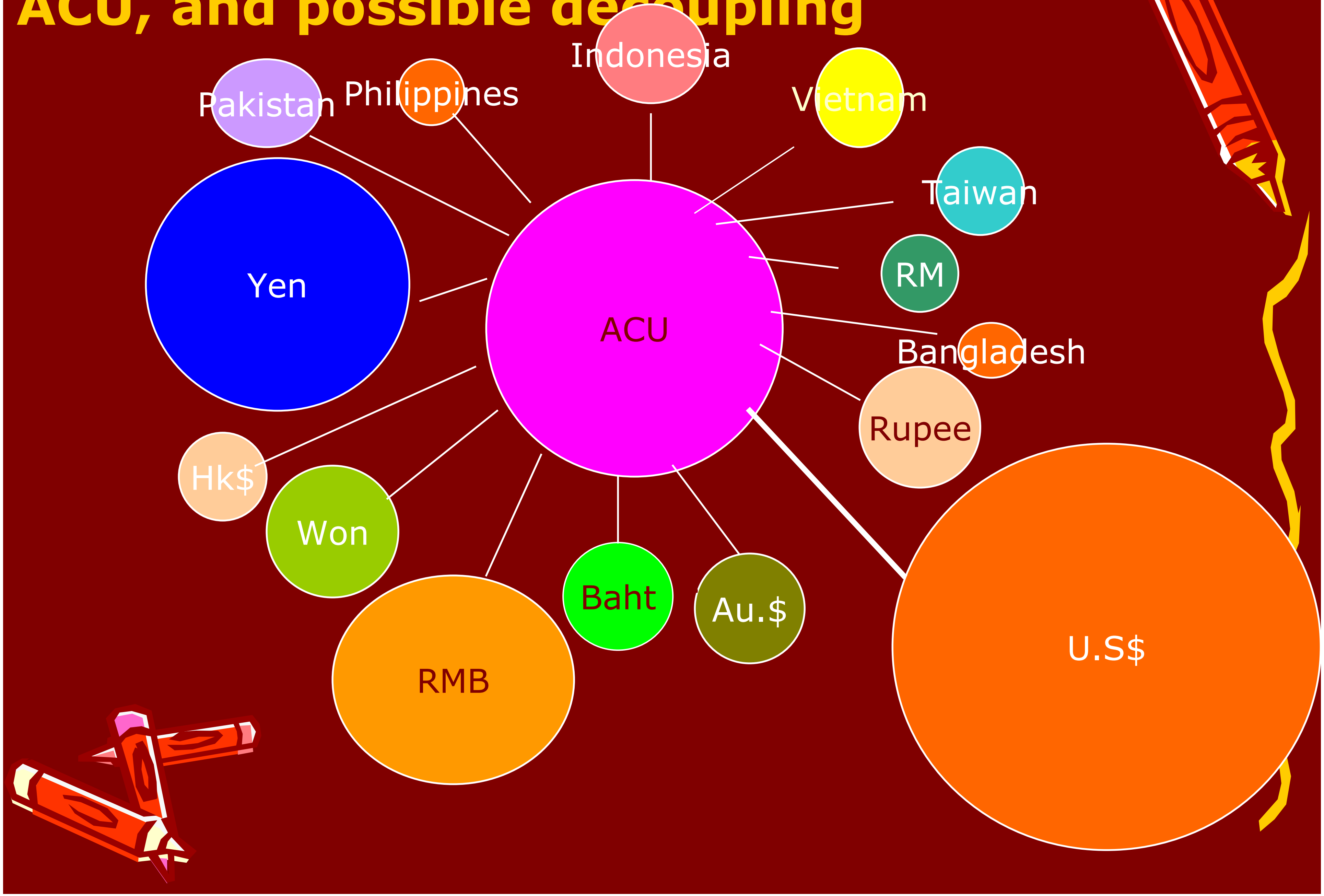
The APEC Currency Community



Stage I. Locking Exchange Rates to the Dolla



Stages II & III: Fixing Exchange Rate to ACU, and possible decoupling



Alternative Scenario: APEC + Europe?

8. Conclusions

Outlook I

- The outlook depends on policies.
- If my policies were adopted, I believe the US economy would be on track for expansion by the middle of the year with strong growth in the last half.
- China will restore growth to 8%.

Outlook II

- Failing that I would be more pessimistic in that the future will be worse than the present.
- Negative growth for most of 2009 with rising unemployment. More banking collapses and insolvent corporations. Decline of US leadership in the world.
- No recovery in Europe until 2010.

감사합니다

谢谢

thank you

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