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Lessons from the financial crisis

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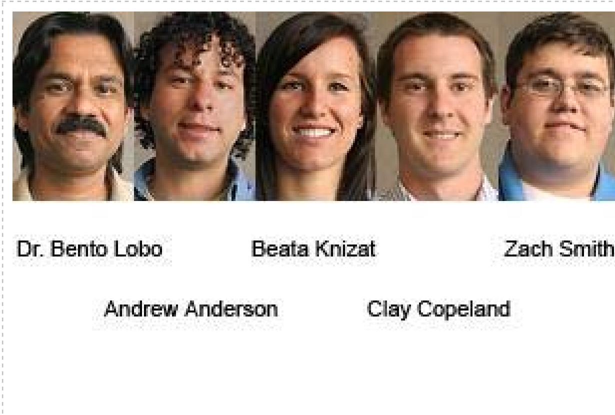
(This analysis is written by Dr. Bento Lobo, UC Foundation Associate Professor of Finance at the University of Tennessee at Chattanooga, with research support from Andrew Anderson, Clay Copeland, Beata Knizat and Zach Smith, all students in his international finance class at UTC, in the past spring semester.)



Dr. Bento Lobo Beata Knizat Zach Smith
Andrew Anderson Clay Copeland

Even as the national unemployment rate climbs toward 10 percent and the budget deficit soars to over one trillion dollars, there are some signs that the worst of the recent financial crisis is behind us.

The U.S. stock market has gained 23 percent from the bottoms hit in March, and treasury yields have started to rise on signs of a recovery. Credit appears to be flowing somewhat more plentifully than it did even six months ago. Some of us might actually summon up the courage to read our 401(k) statements next quarter.

Economic projections from the U.S. Federal Reserve point to a return to typical GDP growth levels of 2-3 percent in 2010, an unemployment plateau in 2009 and inflation at levels around 1-2 percent.

However, investor psyche has been damaged and confidence is slow to return. Much like the Great Depression of the 1930s, the Great Recession of our times has left much to be studied and remedied.

RISK AND RETURN

In hindsight, analysts will look to subprime mortgages as the source of the problem. This view, however, is only partially correct. At the heart of the current crisis lies excessive risk-taking (some may call it “greed”) and financial globalization. As one writer put it, the root of the crisis is a cocktail of debt with a chaser of pathological optimism.

When the global economy emerged from fears of widespread deflation in the aftermath of 9/11 and the 2001 dotcom bust, investors found themselves starved of traditional sources of yield. Stocks, bonds and money markets could not be counted upon to generate satisfying returns. A global savings glut awaited deployment.

The global investment community began to place bets on the American housing market because home values had never fallen nationally and no one expected them ever to do so. Securitization of home mortgages, which had begun decades earlier, began to pick up significant steam in the 1990s. Financial innovation gave rise to mortgage-backed securities and collateralized debt and mortgage obligations.

As central banks everywhere lowered interest rates and credit conditions eased, financial institutions began to place leveraged bets on credit derivatives linked to mortgages.

The demand for mortgage-backed securities climbed steeply raising the need for more mortgages to be sold. This stimulated the Subprime mortgage market and lending standards dropped precipitously as No-Income-No-Jobs-or-Assets (NINJA) and Alt-A loans grew dramatically. Lenders knew they could originate the mortgages and sell them in the secondary market and failed to respond to the traditional red-flags that come from bearing too much risk.

Banks repackaged and sold off most of their loans, taking a “quantity over quality” approach to lending. As their revenue source shifted to loan-generating fees rather than the repayment of loans over multiple years, the incentive for banks to carefully screen loan applicants declined. The traditional bank lending model had broken down.

When interest rates in the U.S. began to climb in 2004, homeowners with adjustable rate mortgages or ARMs began to get severely squeezed. Foreclosures and defaults climbed significantly, while securities backed by mortgages began to go bad. Collateralized Debt Obligations (CDOs) and Credit Default Swaps were especially badly hit.

It became apparent that risk was being priced cheaply on the belief that housing values would hold and even rise. The ratings agencies, in particular, got it all wrong.

The extent of the problem only gradually became apparent as financial institutions such as Bear Stearns, Fannie Mae and Freddie Mac, Lehman Brothers, AIG, and WaMu began to feel the liquidity pinch and quickly became under-capitalized.

By the week of 6 October 2008, in dealing rooms and corporate treasuries, the bond of trust that linked banks to one another and to their clients and counterparties was shattered. British Prime Minister Gordon Brown declared, “The global financial market has ceased to function.”

THE GREAT RECESSION: HOW DOES THIS ONE COMPARE?

Many compare the recent credit crisis to other crises of our times, notably the Great Depression. While the common threads of an asset price bubble, excessive leverage and a crisis of confidence permeate the comparison, the two are different in important ways.

Perhaps most importantly, in the way the Federal Reserve, and indeed other central banks, has acted to curb the worst of the credit crunch. The aggression of the Bernanke Fed is unparalleled in economic history in terms of the size and swiftness with which liquidity was pumped into the system and in terms of how policy has been coordinated with other foreign central banks.

This crisis is also different in that the extent of financial globalization today is unprecedented. This means that a problem in one part of the world transmits to every corner of the globe much more quickly and with more severe implications.

In some ways, the Great Depression was more severe. The stock market lost more than 60 percent of its value, one-third of all banks failed, investment spending declined by 90 percent from 1929-33 and the unemployment rate climbed to 25 percent.

In comparison, in the last couple of years, the stock market has dropped 40 percent, the unemployment rate is around 10 percent and a relatively small number of banks have failed.

Yet, in other ways, the Great Recession has been deeper and broader. The World Bank estimates that three in four developing countries experienced equity price declines of more than 40 percent, while the composite equity index for emerging markets has fallen by almost 80 percent from the peak reached in October 2007.

An IMF database, which covers the universe of systemic banking crises from 1970 to 2007, shows that the average fiscal cost of a crisis is about 15 percent of GDP. About half of these fiscal outlays relate to costs associated with government-assisted recapitalization of banks. The remainder relate mainly to costs associated with government asset purchase and debtor relief programs.

At a global cost of over three trillion dollars and counting, this crisis dwarfs several others. For instance, the Marshall Plan cost about $115.3 billion, the S&L crisis cost $256 billion, the New Deal is estimated to have cost $500 billion, while the Vietnam War is said to have had a $698 billion price tag.

GLOBAL EFFECTS

According to the Brookings Institution U.S. consumption accounted for more than a third of the growth in global consumption between 2000 and 2007. With a recession in the U.S., declines in growth elsewhere have been dramatic.

For the first quarter of 2009, the annualized rate of decline in GDP was 14.4 percent in Germany, 15.2 percent in Japan, 7.4 percent in the UK, 9.8 percent in the Euro area and 21.5 percent in Mexico. China's exports have had their steepest decline in thirteen years even as information technology service providers based in India are feeling the impacts from abroad. This is clearly a global crisis.

Why did subprime mortgages which comprise a small proportion of all U.S. mortgages bring the global financial system to the brink of collapse?

As investors everywhere search for yield, a natural consequence is that domestic assets come to be globally held. A 2008 report from the McKinsey Global Institute estimates that foreign investors own one in three government bonds around the world, one in four equities and one in five corporate bonds.

The hunger for yield has deepened the connection between economies previously thought to be unrelated. Moreover, as markets get more volatile, they tend to move together.

The International Labor Organization projected job losses would take global unemployment to 210 million in late 2009 from 190 million last year, the first time in a decade it has topped 200 million.

Worryingly, a recent survey of over 1,000 CFOs in the United States, Europe and Asia indicates that in the scramble for

short-term cash flow, firms are cutting back or canceling projects that they know add to long-term value. This implies lower future growth opportunities and lower future employment growth.

THE HUMAN COST

But as is often the case, hard data do not necessarily tell the whole story. In fact, one reason why so many Wall Street strategists and economists missed the boat on the unfolding economic storm is because they gave short shrift to anecdotal reports and other evidence of widespread economic distress that could not be easily distilled into simple data points.

While the World Bank estimates that globally 90-million more people could be living in extreme poverty by the end of next year, bankruptcies, foreclosures, evictions and layoffs have taken a heavy toll on Americans.

In response, a range of extreme acts including suicide, self-inflicted injury, murder, and arson have hit the news. The National Suicide Prevention Lifeline logged a record 568,437 calls in 2008, compared to 412,768 the previous year.

Not surprisingly, the economic meltdown has also strained marriages and, according to experts, is contributing to a rise in domestic violence. A spokeswoman for the National Domestic Violence Hotline notes that calls increased 18 percent between October 2007 and October 2008 and attributed the spike to the poor economy.

As social and civil unrest picks up, it is no surprise that the Department of Homeland Security considers the main threat to the country as economic, even as the CIA rushes to employ financial analysts who can make sense of the economic storm.

MARKETS V GOVERNMENTS

Nobel laureate Joseph Stiglitz wrote recently that among the “legacies of this crisis will be a worldwide battle over ideas-over what kind of economic system is likely to deliver the greatest benefit to the most people. While there may be no winners in the current economic crisis, there are losers, and among the big losers is support for American-style capitalism. This has consequences we'll be living with for a long time to come.”

Stiglitz continues, “America's financial system failed in its two crucial responsibilities: managing risk and allocating capital… Regrettably, many of the worst elements of the US financial system … were exported to the rest of the world.”

The Economist magazine points out that while global integration, in large part, has been about the triumph of markets over governments, that process will likely be reversed in important ways.

It will first start with Western finance being re-regulated since we are now considered “financial lunatics.” Because of this financial lunacy, America will continue to lose economic clout and intellectual authority. New financial powerhouses will emerge. China's vice-premier reportedly told his American counterparts at a recent Sino-American summit that “the teachers now have some problems.”

Indeed the ideological stance that had shifted in recent times from regulation to deregulation and self-regulation is likely to be hotly debated.

Former Federal Reserve chairman, Alan Greenspan, framed the issue when he famously remarked, “Those of us who have looked to the self-interest of lending institutions to protect shareholders' equity (myself especially) are in a state of shocked disbelief.”

RELIANCE ON FLAWED MODELS

In blaming the economics profession for its over-reliance on unrealistic models, the Dahlem Report put together by eight American and European economists condemns a growing reliance over the past three decades on mathematical models that improperly assume markets and economies are inherently stable, and which disregard influences like differences in the way various economic players make decisions, revise their forecasting methods and are influenced by social factors.

Yet, as French novelist, Anatole France, once said, “Of all the ways of defining man the worst is the one which makes him out to be a rational animal.” Research in the area of behavioral finance recognizes the bounds to rationality and the limited ability of individuals to process and assimilate complex information.

As opposed to the high level view of the crisis that most analysts tend to take, it is perhaps more important to study the micro-level decisions of individuals and households.

Indeed, as one of the authors of Nudge, Cass Sunstein, prepares to take over as Reform Czar in the Obama Administration, the focus of mainstream finance is likely to shift toward a better understanding of the psychological elements of individual decision making. The marriage of finance and psychology has been slow to bear fruit but is likely to be a growth industry from here on out.

NO APP FOR THIS

A recent study of 800 years of financial crises points out that not much is new about the broad features of this crisis. Excessive risk taking and leverage, skewed incentives and poor oversight are common themes.

This time we lost household names such as Bear Stearns, Lehman Brothers, Merrill Lynch and Wachovia. Who will be next?

As in the past, we will be left to ponder the nature of regulatory reform. The Great Depression spawned Glass-Steagall, the SEC, the FDIC and Social Security. The Great Recession will likely give rise to a new, perhaps global, systemic risk regulator, a call for greater transparency in financial transactions, and restructuring of ratings agencies.

We will be left pondering the too-big-to-fail argument and the role of government in the marketplace.

We will be left pondering the size of the public debt, estimated to rise to $50,000 per U.S. citizen in 20 years.

We will be left pondering the fate of the U.S. dollar in global finance, and the rise of other economic powers.

As always, we risk throwing baby out with the bath water as the public outcry sways political decision-makers to seek and destroy what Warren Buffet called “financial weapons of mass destruction.”

Many business school curricula will be reshaped to address the changing nature of the financial marketplace.

But we will never be able to protect against future crises if we rail against greed and wrongdoers without looking in the mirror and understanding what incentives individuals respond to and how they make choices.

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