

America's Financial Crisis: End of an Era?

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Financial Crisis

- Economic crisis initiated by flawed innovations in U.S. mortgage market, excessive risk-taking, and a breakdown of prudential oversight.
- Has now spread to rest of world economy with severe disruption of financial markets and trade flows.

Paper Outline

- Origins of the Crisis
 - Immediate Causes
 - Underlying Causes
 - Excess Liquidity
 - Excess Global Saving
- Financial Panic
- Economic Consequences
- Policy Response
 - Monetary Policy
 - Fiscal Stimulus
 - Financial Reform
- Implications for Global Economy

Immediate Causes of the Crisis

■ Real Estate Market

- Asset bubble in housing market fueled by lax lending standards in primary market
- Conforming Mortgages – meet underwriting standards, no significant problems
- Sub-prime Mortgages – elevated risk
 - Either lower credit score or higher loan-value ratio
 - Large portion were to extract equity for existing homeowners.
 - Mostly originated by non-traditional “private-label” lenders.

Secondary Mortgage Market

- Growth of a parallel 'private-label' alternative to conventional mortgage market dominated by GSEs.
- Most sub-prime mortgages were used as collateral for high-yield, high-risk mortgage-backed securities (MBS)
- MBS's were used in turn as collateral for Collateralized Debt Obligations (CDOs)
 - Sold in tranches with junior tranches absorbing default risk
 - Used to convert senior tranche to AAA
 - Not traded on organized exchanges
- Participating institutions were highly leveraged.

IMF Estimate of Losses

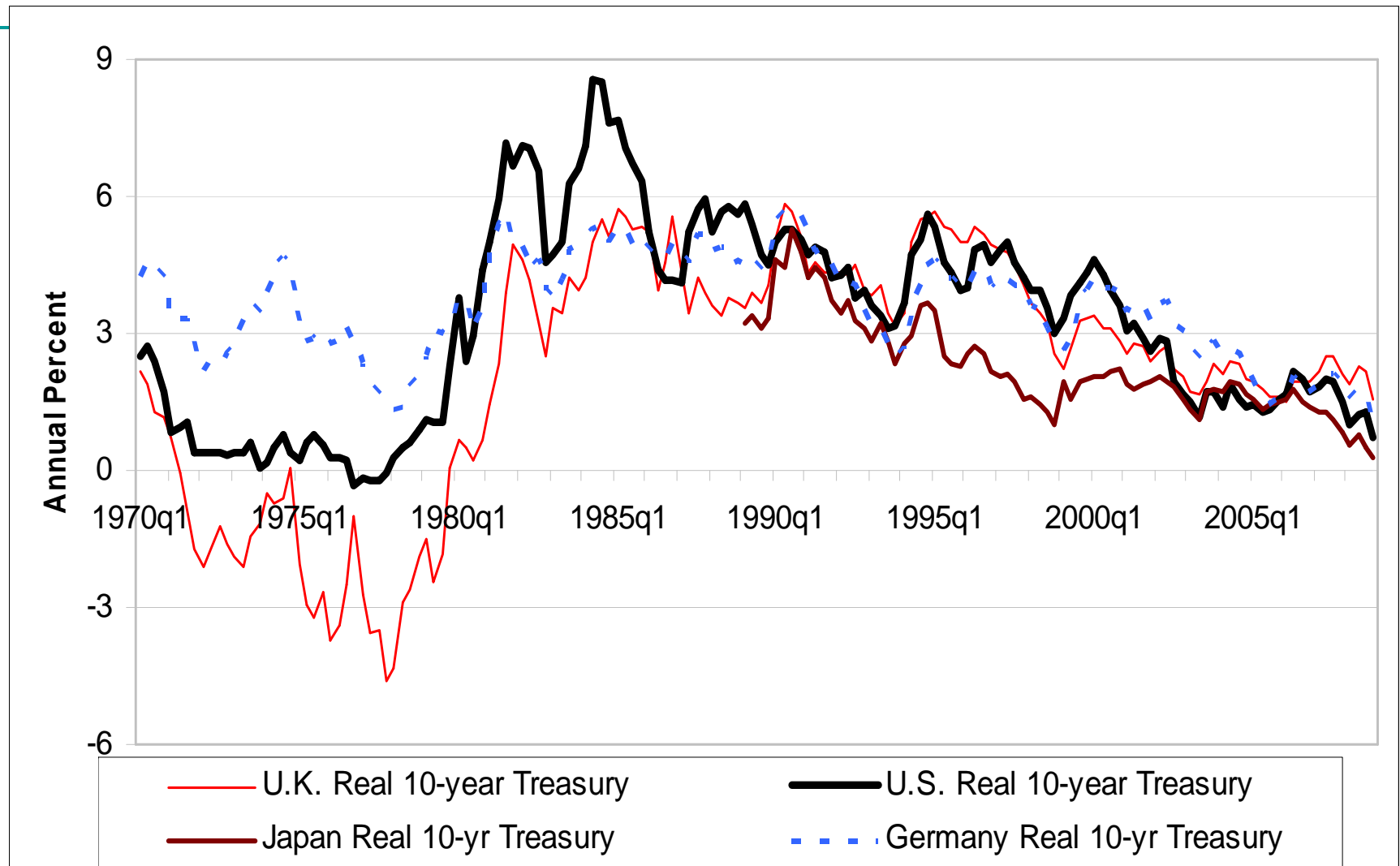
	Outstandings April 2009	October 08 Losses	April 09 Losses
Subprime Alt-A	2,630	585	1,010
Othe Mortgages	11,980	325	820
Total Mortgages	14,610	910	1,830
Other Debt*	11,944	495	880
Total	26,554	1,405	2,710

* broader definition used in 2009

Underlying Causes

- Monetary policy – excess liquidity (Taylor)
- Excess global saving (Bernanke et al)
- Basic thesis
 - Asset market bubbles and excess risk taking are induced by low interest rates and surfeit of liquidity.
- Global interest rates were very low
 - Decline stretches over past quarter century
 - Caused by excess liquidity or surplus of saving?

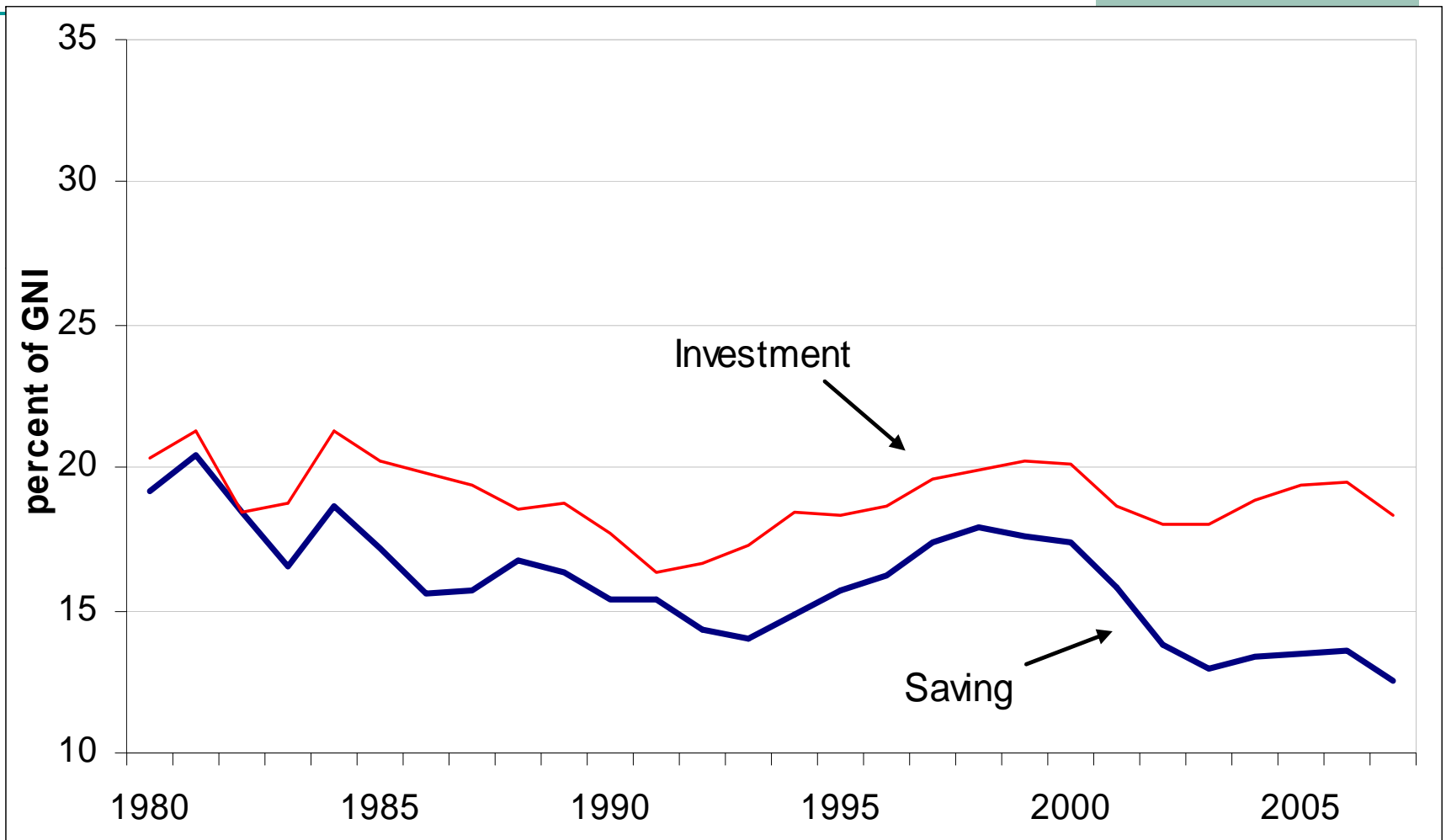
Real Long-Term Interest Rates: United States, United Kingdom, Germany, and Japan 1970-2008



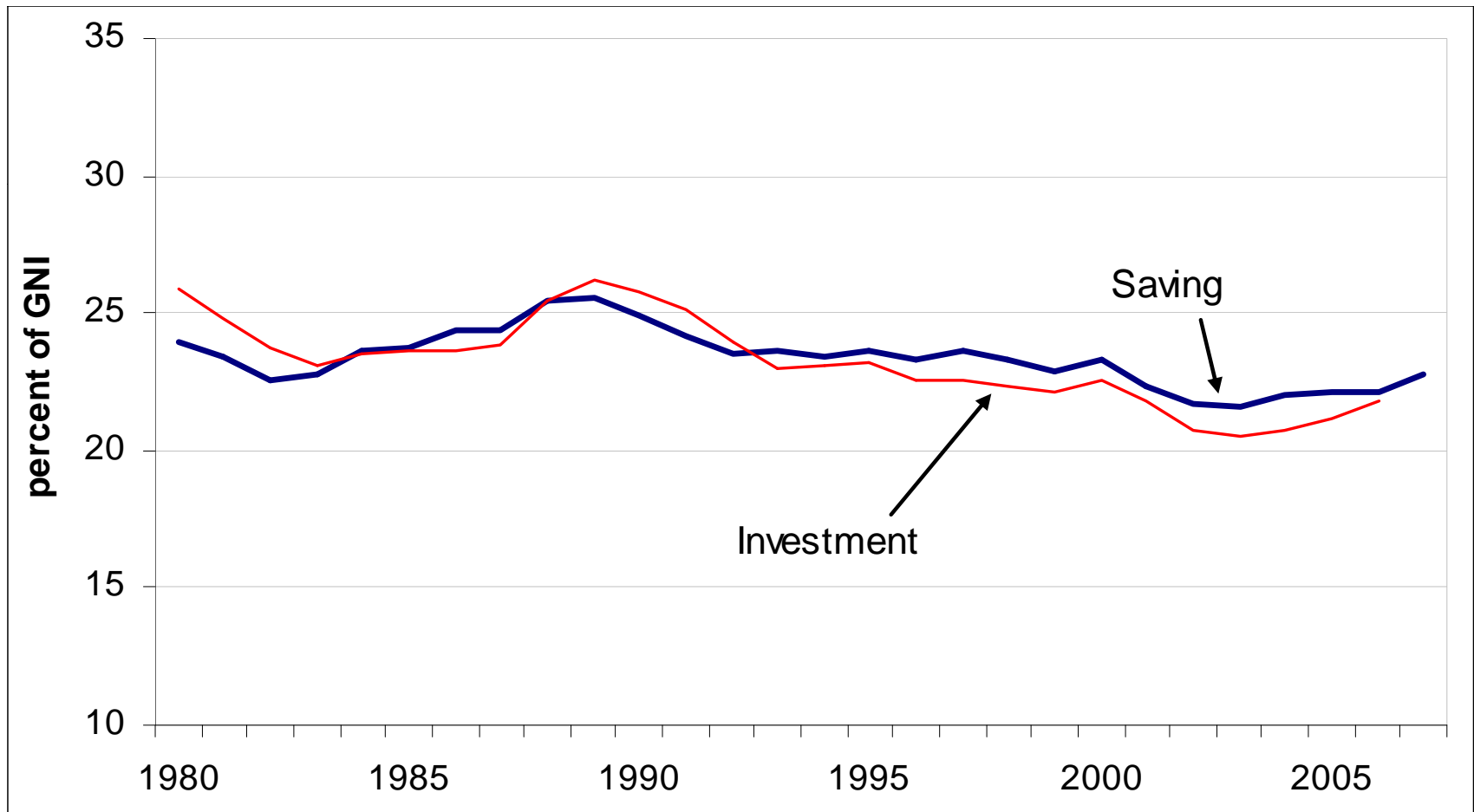
Global Saving

- Two views
 - United States saves too little
 - Rest of world saves too much
 - (Benanke's global saving glut)
- Offset to U. S. saving deficit was largely in East Asia and the Middle East (oil producers)
- The U.S. had declining saving, but relatively strong investment.
- Saving and investment have both been slowly trending down in other industrial countries.

Saving and Investment: United States 1980-2008



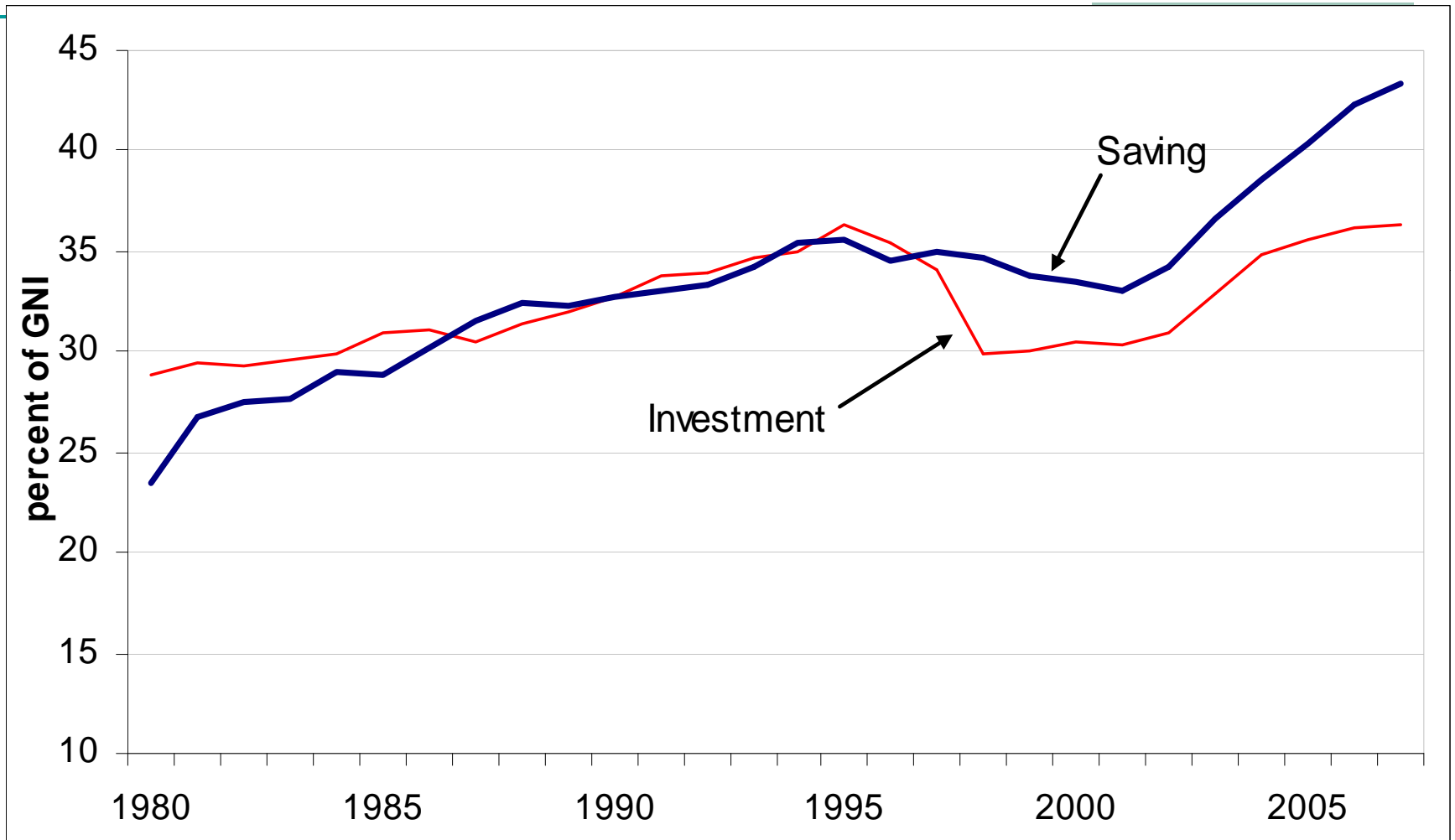
Saving and Investment: Industrial Countries (excl US) 1980-2008



Global Saving (2)

- Sharp drop of investment in Asia after 1997-98 crisis.
 - Particularly notable in crisis countries.
- Very large surge of saving in China after 2004
 - Reflected in large S-I imbalance
- Sharp rise of saving in Middle East due to higher oil prices.

Saving and Investment: Emerging Asia 1980-2008



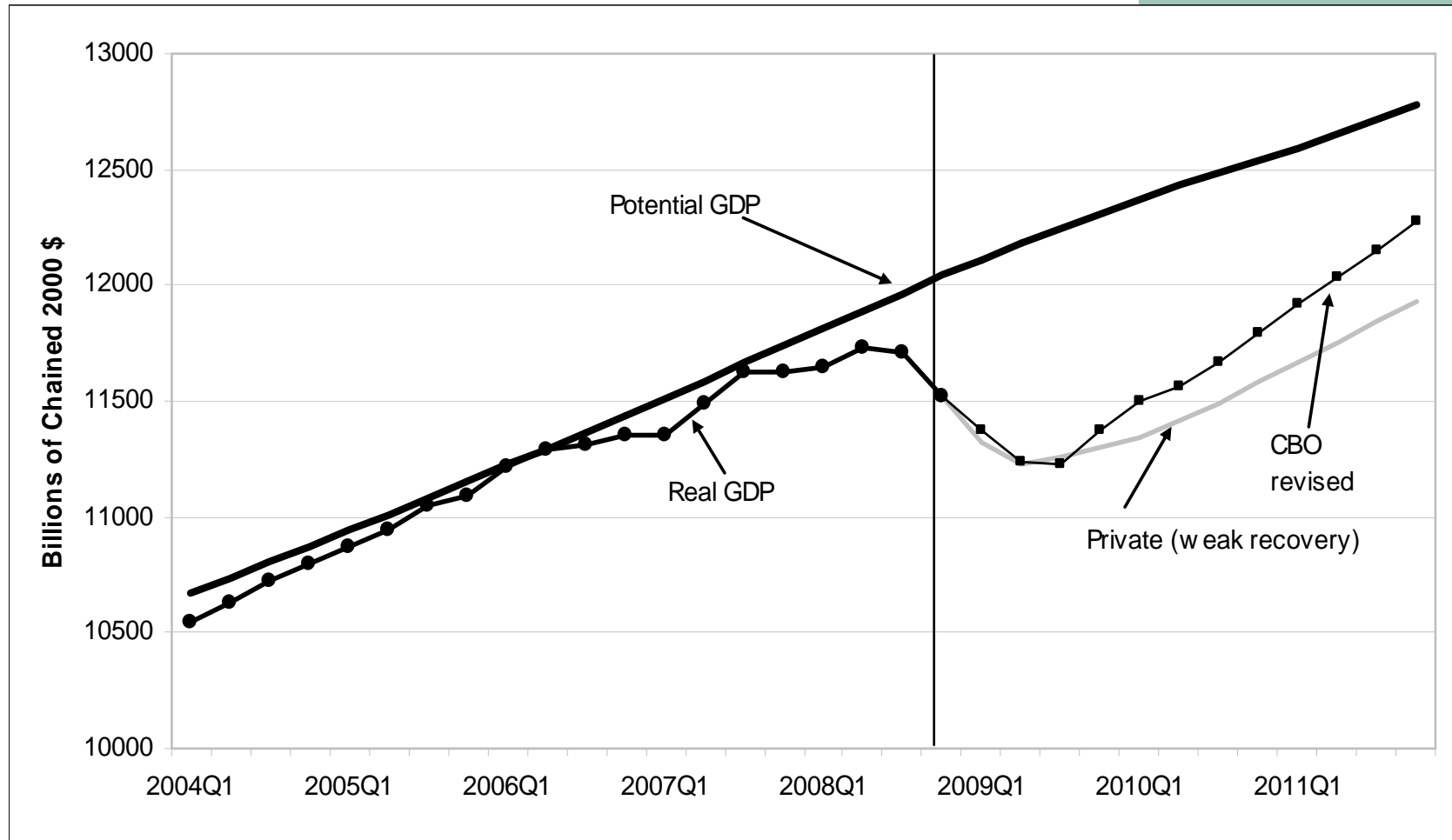
Overview of Causes

- Excess liquidity and high global saving were contributors, but the far more important factors were the flawed innovations in U.S. financial markets and the poor risk assessment.
 - Low interest rates were a global phenomenon, but financial excess was concentrated in the United States, the UK, and - to a lesser degree - Europe.
 - The emphasis on a 'saving glut' is a convenient American argument that shifts portions of the blame to others.

Economic Consequences

- Sharp recession is now underway
- Extremely high rate of employment losses
 - -600 thousand monthly rate of job loss,
 - Unemployment has increased to 8.5%
- GDP at a negative 6.2% annual rate in 4th quarter
- CBO forecast of -2.2 percent decline in 2009
- Annual GDP loss of about \$1trillion by 2010
- Unemployment rate projected to reach
 - 9 percent by summer
 - 10 percent in 2010
- Recession is spreading to global economy
 - Financial channel in Europe
 - Trade channel in Asia

GDP Projections



Source: BEA (2009),FRB of Philadelphia (2009), CBO (2009)

Recovery

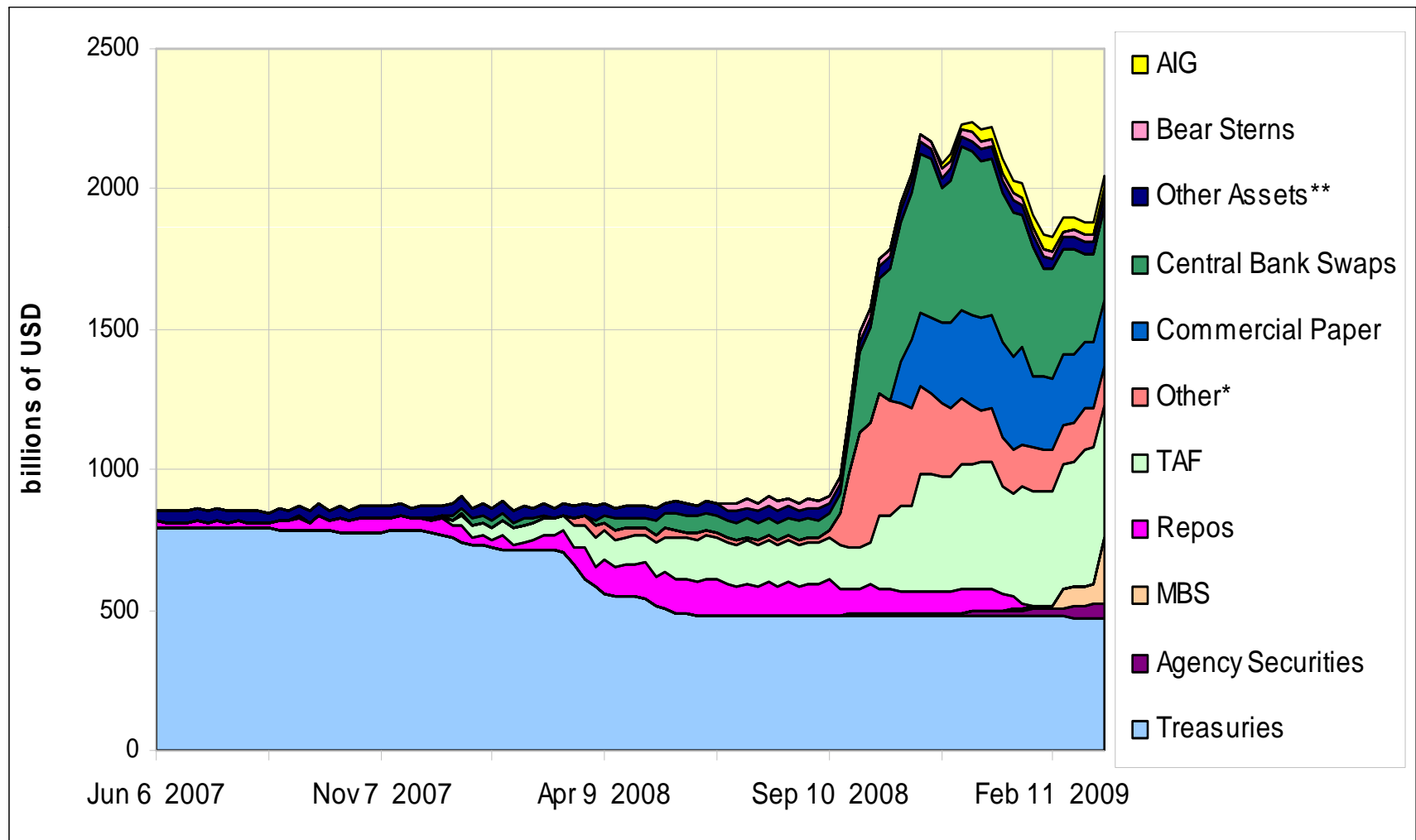
- Financial crises are more severe and last longer
 - Japan, Asia financial crisis, and Scandinavia.
 - Recovery has required 3 – 10 years
 - Output declines for about two years
 - Growth resumes, but losses in level appear to be permanent.
 - Result in very large increases in public debt
- Wealth effect on consumption may lengthen recession.
 - Capital loss of \$11 trillion
 - Generates a permanent consumption decline of 3 percent of GDP
 - Long-run offset would be increased exports.
 - Reflective of long-run need to restructure demand side of the economy.

Policy Response

■ Monetary Policy

- Short term interest rate cut to zero.
- Large rise in risk premiums on private and State/Local governments
- FRB intervenes to purchase higher-risk private securities.
- MP needed to provide liquidity, but it has weak stimulative effect.
- Financial problems reflect solvency, not liquidity concerns.

Balance Sheet of Federal Reserve



Fiscal Stimulus

- Program enacted in mid February, 2009
- Roughly Two-Thirds Expenditure and One-Third Tax Cuts
 - Expenditures (particularly infrastructure) have somewhat larger multipliers, but long lags
 - 40% of total infrastructure spending to occur in 2012 and later, whereas tax cuts and transfers occur in first two years.
 - Transfers and some tax proposals can quickly get income to people with high spending propensities.
 - Assistance to State and Local governments
 - S&Ls revenues are severely effected by real estate collapse.
 - Grants provide effective fiscal assistance but weak economic stimulus
 - Rebuild financial conditions versus increase spending

Schedule & Composition of U.S. Fiscal Stimulus

In billions USD

	2009	2010	2011	2012 & beyond	Total
Total	283	259	121	56	719
As % of GDP	2.0	1.8	0.8	0.4	5.0
Revenue Measures	99	116	37	-33	219
Individual Income	37	80	32		
Corporate Income	57	32	-2		
Other	5	4	7		
Expenditure Measures	184	143	84	89	500
Infrastructure & other	32	47	47	78	204
Safety nets	77	14	5	7	103
State aid & education	75	82	32	3	192

Source: IMF staff estimates, Congressional Budget Office

Financial Restructuring

- Currently, major problem issue
- Bank restructuring is a well-understood process
 - Identify losses
 - Charge against equity capital
 - Close or recapitalize deficient banks
- Administration has not acted, perhaps because they cannot obtain the funds -- trying to involve private sector.
- Raises fears of a repeat of Japan's lost decade.
- Most substantive actions are by Federal Reserve

Post-Crisis Challenges

- Monetary policy and financial reform
 - Rampant moral hazard problems
 - Effective regulation
 - Future of rules-based monetary policy?
- U.S. economic restructuring and the external balance
 - Initial recovery is likely to be marked by large fiscal deficit, increased private saving, and large trade deficit.
 - How to transition to balanced external position?

Financial Restructuring

- How to return to an arms-lengths orientation of monetary policy
 - Moral hazard from prior bailout of institutions
 - Ineffectiveness of prior regulation – regulated usually capture the regulators
 - Focus on yesterday's problems
- Problem of too-big-to-fail
 - Restrict size of institutions?
- How anticipate systemic risks?
- Did inflation targeting lead to too narrow a focus for monetary policy.
 - Asset price bubbles
 - Excess leveraging

Economic Recovery

- United States needs to shift resources out of consumption into net exports
- Wealth loss should mark end of consumption boom
 - Growth of trade sector will require exchange rate depreciation
 - Exchange rate did fall by about 30 percent in 2002-08, but recent appreciation has eliminated about half of prior decline
 - Will future years be marked by increased conflict over trade as all countries try to use export promotion as a stimulus?
 - Where will ROW find new engine for growth?

Trade-Weighted Exchange Rates: 1990-2008

