THE CRISIS OF 2008

Iñaki Erauskin, 13 January 2009
Preliminary draft.
Comments are very welcome!

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1. Introduction

Introduction

- The economic situation has deteriorated enormously in the second half of 2008.
- The prospects for 2009 (and 2010?) are gloomy.
- These lines offer an account on the current economic crisis and possible “solutions” for the challenges ahead.

2. Key factors

Key factors

Which are the factors behind the current crisis?

1. The deterioration of the housing market.
2. The collapse of the financial system.
3. Global energy and food crisis.

Key factors (1): Housing market deterioration

- "The *subprime crisis* is the name for what is a historic turning point in our economy and our culture. It is, at its core, the result of a speculative bubble in the housing market that began to burst in the United States in 2006 and has caused ruptures across many other countries in the form of financial failures and a global credit crunch"

(Shiller, 2008, p. 3)

Key factors (2): Financial collapse

- "Global financial intermediation is broken. That intricate and interdependent system directing the world´s saving into productive capital investment was severely weakened in August 2007. The disclosure that highly leveraged financial institutions were holding toxic securitised American subprime mortgages shocked market participants. For a year, banks struggled to respond to investor demands for larger capital cushions.

Key factors (2): Financial collapse

- But the effort fell short and in the wake of Lehman Brothers default on September 15th 2008, the system cracked. Banks, fearful of their own solvency, all but stopped lending. Issuance of corporate bonds, commercial paper and a wide variety of other financial products largely ceased. Credit-financed economic activity was brought to a virtual standstill. The world faced a major financial crisis".

Greenspan, The Economist, December 20th 2008, p. 114.

Key factors (3): Global energy and food crisis

- The price of petrol was at its high in July 2008 (around 150$ per barrel) and since then it has been declining, with up and downs (now around 50$ per barrel).
- This is a structural problem, now alleviated due to the recession.

Key factors (3): Global energy and food crisis

- "World food commodities prices increased 130% from January 2002 to July 2008. Individual agricultural commodities show even more pronounced increases: corn (up 190%) (*maíz*/artoa), wheat (162%) (*trigo*/gari), rice (318%) (*arroz*/arroza), and soybeans (246%) (*soja*) rose dramatically. Food prices began to fall in July, bringing some relief, but prices are likely to stay high for the foreseeable future."
  - Source: Nora Lustig, 22 October 2008, "Thought for food: Rising food prices, poverty, and safety nets in developing countries", http://www.voxeu.org/index.php?q=node/2467

3. The crisis

- The account is mostly based on Shiller (2008), Kregel (2007), and Abadía (2008).

Funny videos as starters

- Leopoldo Abadía in Andreu Buenafuente (YouTube):
  - http://www.youtube.com/leopoldoabadia
    - On subprimes: http://es.youtube.com/watch?v=lU-j2mIwOpE (in Spanish, 7 minutes)
    - On Bernard Madoff (and Ponzi games): http://es.youtube.com/watch?v=yUM7UYp65qc (in Spanish, 10 minutes)

Funny videos as starters

- On "The last laugh" (YouTube):
  - http://www.youtube.com/watch?v=mzJmTCYmo9g (in English, 9 minutes)
  - http://www.youtube.com/watch?v=pFmYIFk5i1Q (in English with subtitles in Spanish, 9 minutes)

3.1. A short story

- Based on Shiller (2008, p. 4-).

A short story

- "The view that the ultimate cause of the global financial crisis is the psychology of the real state bubble (with contributions from the stock market bubble before that) has certainly been expressed before. But it would appear that most people have not taken this view to heart, and the least that they do not appreciate all of its ramifications."

A short story

- "Accounts of the crisis often seem instead to place the ultimate blame entirely on such factors as growing dishonesty among mortgage lenders; increasing greed among secutirizers, hedge funds, and rating agencies; or the mistakes of former Federal Reserve chairman Alan Greenspan".
- This is a crisis in a bubble.

A short story

- "By now the whole world has heard the story of the problems in the subprime mortgage market, which began to show up in the US in 2007 and then spread to other countries. Home prices and homeownership had been booming since the late 1990s, and investing in a house had seemed a sure route to financial security and even wealth".
- "But the subprime dilemma in the US points up problems with over-promoting homeownership".

A short story

- Chain of events in the subprime crisis:
  - "Overly aggressive mortgage lenders, compliant appraisers, and complacent borrowers proliferated to feed the housing boom."
  - "Mortgage originators, who planned to sell off the mortgage to securitizers, stopped worrying about repayment risk."
  - "They typically made only perfunctory efforts to assess borrowers´ ability to repay their loans."

A short story

- Chain of events (cont.):
  - "**<u>These mortgages were packed, sold, and resold in sophisticated but arcane ways to investors around the world, setting the stage for a crisis of truly global proportions</u>**."
  - Many investors did not know the real nature of these assets.
  - "The housing bubble, combined with the incentive system in the securitization process, amplified moral hazard, further emboldening some of the worst actors among mortgage lenders."

A short story

- Chain of events (cont.):
  - "Higher home prices made it profitable to build homes. The huge supply of new homes began to glut the market, and US home prices began to fall in mid-2006. As prices declined at an accelerated rate, the boom in home construction collapsed."

A short story

- Chain of events (cont.):
  - "At the same time, mortgage rates began to reset to higher levels after initial "teaser" periods ended. Borrowers, particularly subprime borrowers, began defaulting, often owing more than their homes were worth or unable to support their higher monthly payment with current incomes". The participant institutions suffer tremendous distress.

A short story

- Chain of events (cont.)
  - Other sectors (credit card and automobile loan default) follow suit.
  - Even credit ratings of municipal bond insurers are being downgraded, creating a risk that the problem will spread to state and local government financing.
  - Other countries follow suit. Booming real estate markets have also ocurred in other countries.
- In addition, please note that we find a global energy crisis, and a global food crisis.

3.2. A longer story

- Based mainly on Kregel (2007).

A longer story

- Let go through the process in some detail (USA).
- Fannie Mae (1938) is a government owned corporation that buys mortgages outright from the banks that originate them (these mortgages are "prime").
- Government support of the housing market is restructured in 1968, so that the impact of housing support on the budget deficit is reduced. Freddie Mac is created in 1970 to "compete" with Fannie Mae. These are now known as government sponsored enterprises (GSEs).

A longer story

- GSEs were "obliged" to find alternative sources of funding through sales to private investors (instead of direct borrowing from the government).
- Searching good financing schemes for GSEs, *mortgage backed securities* (MBSs) were created. They sold (passed through) the income stream from a pool of mortgages to private investors (institutions, insurance companies, ...).

A longer story

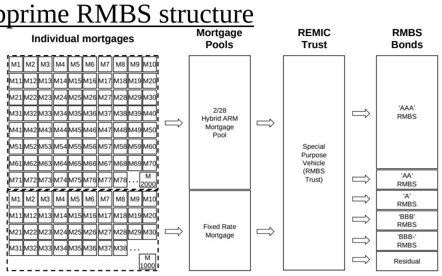
- Securitization (*titulizazioa/titulización*)=the process by which current or future loan rights of an entity, previously modifying and aggregating some of their characteristics, can be totally or partly transformed into securities that can be bought or sold in an organized market.
- The securitization of mortgages involved some problems (different maturities, for example). To solve them "tranches" were created, separating the passed through cash flows from the underlying mortgages into specific income flows of different maturity.

A longer story

- Following that scheme (MBS+tranches), collateralized mortgage obligations (CMOs) are created. Those redistribute prepayment risk among different classes or tranches with risk profiles ranging from extremely low, to significantly high, risk.
- Therefore, CMOs were more "flexible" than MBSs.
- To organize that scheme, creating a "real estate mortgage investment conduit" (REMIC) was required. REMIC holds the mortgages as collateral and distributes cash flows.

Example

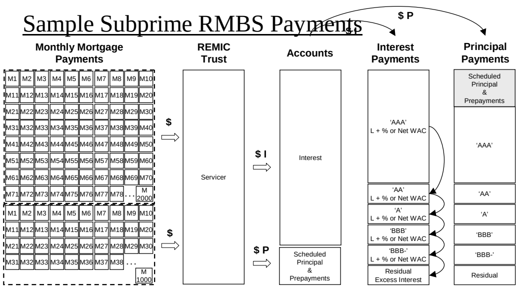
Subprime RMBS structure



Source: www.fitchratings.com

Example

Sample Subprime RMBS Payments



Source: www.fitchratings.com

A longer story

- That transformation implied that the finance of housing passed from traditional banks and the GSEs to private investment bankers.
- Why then the system collapses after some 25 years of experience and stability?
  1. Change in the motivation behind the creation of the MBSs. From “buy and hold” (thrift institutions) to “trade” (private financial institutions).
  2. The Financial Modernization Act of 1999 deregulates financial markets.

A longer story

- Why collapse (cont.)?
  3. The dot-com bubble and equity market collapse in 2001 made investors to shift towards housing market.
  4. CMOs transferred risks from the mortgages originators to the buyers of CMOs. This was very important, since Basel Capital Adequacy requires a proportion between assets (loans) and capital: if banks hold more assets (the volume of loans increases) they are required more capital, which is costly.

Example of selling mortgages to *conduits (REMICs)*

Bank of Kansas: typical bank balance sheet	
Assets	Liabilities
10 Cash 100 Credit Total: 110	Deposits and loans from other banks: 80 Capital (+Res.): 30 Total: 110

Example of selling mortgages to *conduits (REMICs)*

Bank of Kansas: once mortgages are “sold” to REMIC Trusts (Kansas Trust)	
Assets	Liabilities
110 Cash Total: 110	Deposits and loans from other banks: 80 Capital (+Res.): 30 Total: 110

Kansas Trust: Bank of Kansas´s Subsidiary. Balance sheet does not need to be consolidated. Kansas Trust does need to satisfy Basel Capital Adequacy.	
Assets	Liabilities
100 Mortgages Total: 100	Capital (+Res.): 100 Total: 100

A longer story

- Additionally since international interest rates were low (after the dot-com bubble in 2001), financial institutions:
  1. Made riskier loans to *NINJA* (*No Income, No Job, no Assets*) customers *(NINJA loans*), in addition to usual customers, and
  2. Increased the volume of operations to compensate for the lower interest rates.

A longer story

- Riskier loans were made at higher interest rates. These loans were "subprime":
  - Prime: FICO score (risk of default) is between 660 or higher (up to 850), that is, the best mortages.
  - Subprime: FICO score is below 660 (up to 300), that is, the worst mortgages.
  - Please note that both prime and subprime loans coexist.
- Given that subprimes were so risky, who was going to buy them? Credit assessment becomes crucial.

A longer story

- Lack of experience (and data) of CMOs and choosing the agency that produces the less conservative assessments made possible the proliferation of CMOs.
- As the market expanded and the number of qualified borrowers declined, originators of CMOs started to experience a decline in demand of good mortgages.

A longer story

- To solve that problem, two type of measures were taken:
  - Creation of another set of special entities (known as Structured Investment Vehicles, SIVs), so that they can buy those CMOs.
  - Guarantee was available from a monoline insurer or a CDS (*credit default swap*) written by an insurance company or the bank itself.

A longer story

- The subprime market was stable as long as an increasing number of new mortgages could be originated, and the prices of houses was increasing steadily, in a favorable environment (falling interest rates).
- Interest rates started to increase by mid-2006 in the USA and one year later in the eurozone.
- House prices started to decline in 2006 in the USA, due to the increase in delinquency rates in 2005.

A longer story

- Mortgages used to collateralize the CMOs started to be returned to banks (thus reporting exposures and capital losses not communicated before). This implied a drastic change in bank capitalization ratios. As the market for CMOs collapsed, credit rating agencies downgraded securities, and insurers were unable to meet their obligations the whole system fall.

A longer story

- Please note that this story created a problem for the whole financial system (prime mortgages, with reckless credit, opaqueness creating MBSs, then CMOs, then ...), not only for the subprime industry.

A longer story

- Please note that there is an intrinsic maturity mismatch in the banking system (long run lending, but short run borrowing). Therefore, bank runs can occur. Can they be avoided? Yes.
  - Deposit insurance has been instituted (limit was increased in the EU to 100.000 euros per account and holder).
  - Central banks act as a lender of last resort.
  - These two tools are key differences with respect to the situation faced in the Great Depression.

Some key data

- 2007/8 (first days): there has been a continued fall in the value of certain MBSs. Exposure of big banks and hedge funds (BNP Paribas, Bank of China) is “discovered”.
- 2007/9/14: *Northern Rock* bank runs (United Kingdom).
- 2008/3/16: *JPMorgan Chase* buys *Bear Stearns*.
- 2008/9/7: Federal Government in the USA buys *Fannie Mae* and *Freddie Mac*.
- 2008/9/14: *Bank of America* buys *Merrill Lynch*.

Some key data

- **2008/9/15: *Lehman Brothers* bankcrupts.** This leads to a tremendous impact on other financial entities.
- 2008/9/17: *American International Group* (AIG), an important insurer, is severely damaged. It receives support from the Fed.
- 2008/10/3: US President Bush approves “toxic” assets´ purchase (Troubled Asset Relief Program, TARP).
- 2008/10/6-10: worst week for the stock market in 75 years (USA).

Some key data

- 2008/11/12: Paulson abandons TARP (and money is directed towards banks´ capitalization).
- 2008/11/15: G-20 (plus Spain and others) meeting.
  - 5 principles: strengthening transparency and accountability, improving regulation, promoting market integrity, reinforcing cooperation and reforming international institutions.

Digression on Freddie Mac and Fannie Mae (USA)

“Fannie Mae is a government-sponsored enterprise (GSE) chartered by Congress with a mission to provide liquidity and stability to the U.S. housing and mortgage markets.

Fannie Mae operates in the U.S. secondary mortgage market. Rather than making home loans directly with consumers, we work with mortgage bankers, brokers, and other primary mortgage market partners to help ensure they have funds to lend to home buyers at affordable rates. We fund our mortgage investments primarily by issuing debt securities in the domestic and international capital markets.”

Source: www.fanniemae.com

Digression on Freddie Mac and Fannie Mae (USA)

- Freddie Mac is Fannie Mae´s “brother/sister”. Both have the same charters, but different strategies.
- The behavior of Freddie Mac and Fannie Mae did not cause the subprime crisis:
  - Source: http://www.mcclatchydc.com/251/story/53802.html

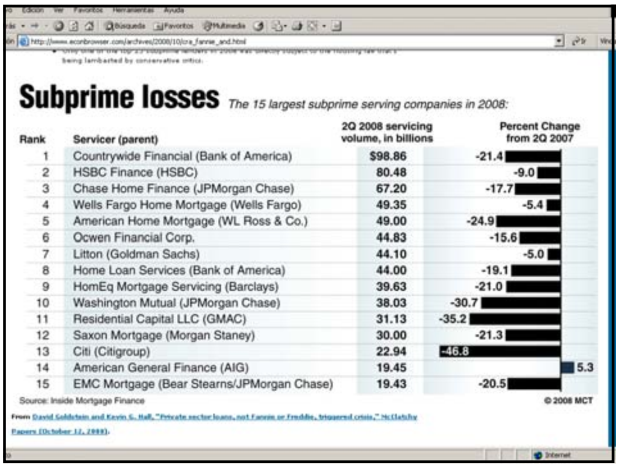
  “Only one of the top 25 subprime lenders in 2006 was directly subject to the housing law that's being lambasted by conservative critics.”

Digression on Freddie Mac and Fannie Mae (USA)

- “Between 2004 and 2006, when subprime lending was exploding, Fannie and Freddie went from holding a high of 48 percent of the subprime loans that were sold into the secondary market to holding about 24 percent, according to data from Inside Mortgage Finance, a specialty publication. One reason is that Fannie and Freddie were subject to tougher standards than many of the unregulated players in the private sector who weakened lending standards, most of whom have gone bankrupt or are now in deep trouble.

Digression on Freddie Mac and Fannie Mae (USA)

- During those same explosive three years, private investment banks — not Fannie and Freddie — dominated the mortgage loans that were packaged and sold into the secondary mortgage market. In 2005 and 2006, the private sector securitized almost two thirds of all U.S. mortgages, supplanting Fannie and Freddie, according to a number of specialty publications that track this data.”



Subprime losses *The 15 largest subprime serving companies in 2008:*

Rank	Servicer (parent)	2Q 2008 servicing volume, in billions	Percent Change from 2Q 2007
1	Countrywide Financial (Bank of America)	$98.86	-21.4
2	HSBC Finance (HSBC)	80.48	-9.0
3	Chase Home Finance (JPMorgan Chase)	67.20	-17.7
4	Wells Fargo Home Mortgage (Wells Fargo)	49.35	-5.4
5	American Home Mortgage (WL Ross & Co.)	49.00	-24.9
6	Ocwen Financial Corp.	44.83	-15.6
7	Litton (Goldman Sachs)	44.10	-5.0
8	Home Loan Services (Bank of America)	44.00	-19.1
9	HomEq Mortgage Servicing (Barclays)	39.63	-21.0
10	Washington Mutual (JPMorgan Chase)	38.03	-30.7
11	Residential Capital LLC (GMAC)	31.13	-35.2
12	Saxon Mortgage (Morgan Staney)	30.00	-21.3
13	Citi (Citigroup)	22.94	-46.8
14	American General Finance (AIG)	19.45	5.3
15	EMC Mortgage (Bear Stearns/JPMorgan Chase)	19.43	-20.5

Source: Inside Mortgage Finance © 2008 MCT

Digression on Freddie Mac and Fannie Mae (USA)

– Sources on this digression:
  - Econbrowser blog: http://www.econbrowser.com/archives/2008/10/cra_fannie_and.html
  - The New York Times: http://www.nytimes.com/2007/12/18/business/18subprime.html?_r=1&oref=slogin
  - Mark Thoma´s blog: http://economistsview.typepad.com/economistsview/2008/09/it-wasnt-fannie.html

The global energy and food crisis

- The price of petrol reached almost 150$ per barrel in July 2008.
- Now, facing a severe recession, pressures of high prices have somewhat gone for a while. However, the structural problem persists.
- What price can petrol achieve in the foreseeable future? It seems it will be a high one. Alternatives are crucially needed.

The global energy and food crisis

- Biofuels seem to be a key factor behind the food price increase, even though growth in China and India, and speculation have also helped. “In the future, food prices will be high but not this high” (as July 2008).
  - See Tangermann, 2008, “What’s causing global food price inflation?” http://www.voxeu.org/index.php?q=node/1437

3.3. Some interesting views

Nouriel Roubini (Dr. Doom) http://www.rgemonitor.com/blog/roubini/

- His view is nicely summed up in http://www.rgemonitor.com/roubini-monitor/254919/latest_project_syndicate_column__will_banks_and_financial_markets_recover_in_2009

- Financial collapse: major financial institutions going bust, falling global stocks, turbulence in interest rates, severe liquidity and credit crunch, some emerging economies asking IMF for help, ...
- Two-year recession for the USA through the end of 2009 (L-shaped crisis, as opposed to U- or V-shaped). Similar prospects for other advanced and emerging economies.

Nouriel Roubini

- Stagflation is present already (remember what stagflation meant in Chapter 12 of textbook please). Even stag-deflation? Please note that deflation is very dangerous.
- As traditional monetary policy becomes ineffective, other unorthodox policy measures are being taken: bail out policies, massive provision of liquidity, radical actions to reduce long term interest rates, and so on.

Nouriel Roubini

- “Today's global crisis was triggered by the collapse of the US housing bubble, but it was not caused by it. America's credit excesses were in residential mortgages, commercial mortgages, credit cards, auto loans, and student loans. There was also excess in the securitized products that converted these debts into toxic financial derivatives; in borrowing by local governments; in financing for leveraged buyouts that should never have occurred; in corporate bonds that will now suffer massive losses in a surge of defaults; in the dangerous and unregulated credit default swap market. [...]”

Nouriel Roubini

- “[...] But the worst is still ahead of us. In the next few months, the macroeconomic news and earnings/profits reports from around the world will be much worse than expected, putting further downward pressure on prices of risky assets, because equity analysts are still deluding themselves that the economic contraction will be mild and short [...]”.

Nouriel Roubini

- " [...] While the risk of a total systemic financial meltdown has been reduced by the actions of the G-7 and other economies to backstop their financial systems, severe vulnerabilities remain. The credit crunch will get worse; deleveraging will continue, as hedge funds and other leveraged players are forced to sell assets into illiquid and distressed markets, thus causing more price falls and driving more insolvent financial institutions out of business. A few emerging-market economies will certainly enter a full-blown financial crisis. [...]"

Nouriel Roubini

- "[...] So 2009 will be a painful year of global recession and further financial stresses, losses, and bankruptcies. Only aggressive, coordinated, and effective policy actions by advanced and emerging-market countries can ensure that the global economy recovers in 2010, rather than entering a more protracted period of economic stagnation.[...]"
  - More on his views at http://www.rgemonitor.com/roubini-monitor/253933/revisiting_my_february_paper_the_risk_of_a_systemic_financial_meltdown_the_12_steps_to_financial_disasterand_some_new_policy_recommendations_to_avoid_the_meltdown

3.4. Spain, the Basque Country, and Navarre

Spain

- Housing construction has been enormous in recent years in Spain. Now it is suffering an abrupt decline. It seems that there are around 0.8-1.4 million of new houses that cannot be sold. Nominal prices are expected to vary -0.5% in 2008, -5% in 2009 and –10% in 2010 (BBVA: http://servicioestudios.bbva.com).

Spain

- The banking system in Spain is expected to suffer less than in the USA. Why? The key lies in the differences between both financial systems:
  - Spanish banks did much traditional banking (receive deposits and make loans), as opposed to the business in the USA (make loans, pack and sell them). Good.
  - Assets:
    - There were no subprimes and not much mortgage repackaging. Additionally, banks were more cautious (sometimes, following the "advice" of Banco de España). Good.
    - However, things were different with developers. They asked for loans to purchase land, and its price has fallen dramatically. Bad.
  - Liabilities. Not much short term financing in financial markets. Good.

Spain

- The building sector is losing many jobs now. Where can the unemployed be allocated? Not easy.
- All that implies a multiplier effect in related industries.
- Additionally, negative wealth effects (due to the loss of houses´ value) and liquidity constraints (more difficult to get loans).
- Summing up, all that means a negative effect on aggregate demand.

Spain

- GDP has increased 0,8% in 2008 (annual terms, 3rd quarter), but –0,2% in quarterly terms. It seems that Banco de España is about to confirm recession.
- Unemployment. Now at 11,33% (2008, 3rd. q.), but it has increased 3.29% in a year.
- Stock exchange. Closed at 9.195,9 in 2008 (-39,4% increase in a year.)

Spain

- What about the future?
  - GDP growth will be negative in 2009. And in 2010?
    - 1.4% in 2008 and -0,2% in 2009 (IMF, Oct. 2008).
    - 1.3% in 2008, and –1% in 2009 (BBVA).
    - 1.0% in 2008, –1.5% in 2009, 0.5% in 2010 (Funcas, Dec. 08).
    - 1.3% in 2008, -2.5% in 2009, and –1% in 2010 (Deutsche Bank, Dec. 2008).
    - 1.3% in 2008, -1.3% in 2009, and 1.0% in 2010 (La Caixa, Jan. 09)

Spain

- What about the future?
  - Unemployment rate can raise up to 15.9% in 2009 and 18% in 2010. Job losses: 680.000 in 2009 and 250.000 in 2010 (Funcas). 15.2% on average in 2009, but ending in 16% (La Caixa).
  - Summing up, the recession will be deep and the recovery very slow. According to La Caixa, the recession will not be as strong as that in 1993, but it will last longer.

The Basque Country and Navarre

- The dependence from the building sector (as regards to employment) is somewhat lower in the Basque Country (9%) than in Spain (12%) or Navarre (11%). In the EU the dependence is half of that of Spain. Thus ...
- Economic performance is better in the Basque Country than in Spain:
  - Unemployment rates: 6.27% (3,5% Eustat) in the Basque Country, 7.09% in Navarre, much lower than in Spain (2008, 3rd q.).
  - GDP growth rates: 1.9% in the Basque Country, 1.8% in Navarre, much higher than in Spain (2008, 3rd q.).

3.5. What about other areas?

What about other areas?

- Mostly based on Roubini Global Economonitor, www.rgemonitor.com

  “The global financial system in 2008 experienced its worst crisis since the Great Depression of the 1930s. Major financial institutions went bust. Others were bought up on the cheap or survived only after major bailouts. Global stock markets fell by more than 50 percent from their 2007 peaks. Interest-rate spreads spiked. A severe liquidity and credit crunch appeared. Many emerging-market economies on the verge of a crisis had to ask for help from the International Monetary Fund.”

What about other areas?

- Eurozone:
  - Most countries are in recession or under way. It may be worse than the recession in 1992/93.
  - ECB growth projections are between -1.0% and 0.0% in 2009; HICP between 1.1% and 1.7% in 2009. Other projections are even worse yet. Risk of deflation (For Bernanke on deflation, look at http://www.federalreserve.gov/BOARDDOCS/SPEECHES/2002/20021121/default.htm).
- United Kingdom:
  - Deflationary pressures. Strong pound depreciation. Gordon Brown´s "100.000 jobs plan" on infrastructures.

What about other areas?

- Eastern European economies.
  - Similar situation to the rest of Europe, but aggravated by their own weaknesses (widespread foreign currency lending, high current-account deficits, impact of slump in Eurozone on exports, banks' heavy dependence on foreign borrowing). Hungary and Latvia have even asked for help to IMF.
  - Most vulnerable: Baltic States, Bulgaria, Romania, Hungary, and Serbia.
  - Least vulnerable: Czech Republic, Poland, Slovakia.

What about other areas?

- USA: see Roubini.
  - The US economy fell in recession in December of 2007. The 1.2 million jobs lost in 2008 was the biggest factor in determining the start of the contraction.
  - The prospects are gloomy. The recession may last 2 years (end of 2009).
  - Dow Jones closed at (-33,8% increase). Has it reached to the bottom? Experts say that it may have not ... It may even fall an additional 20%.

What about other areas?

- Japan.
  - It is oficially in recession.
  - Deflation may happen again. Why? Strength of yen, falling global prices, domestic recession, loss of export growth, ...
  - Stock market fall from 15.307,78 to 8.859,56 in 2008 (-42%).

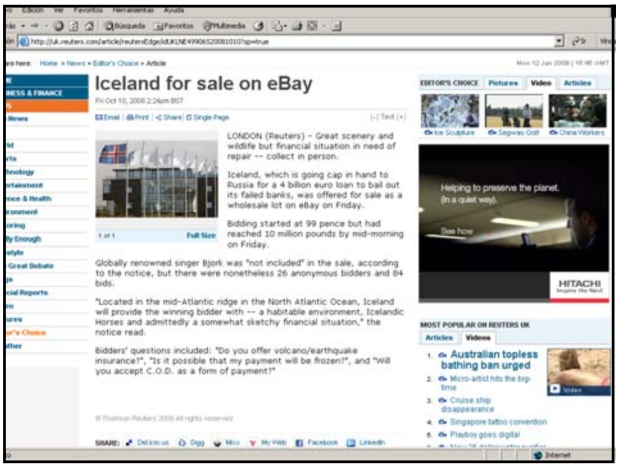
What about other areas?

- China.
  - It is growing at a lower pace, but it will grow more than the rest, thus remaining the most resilient economy in Asia. It seems that it will not save Asia from global recession.
  - Forecasts for GDP growth are now in the range 6-8% (expected: 9%).
  - Experts say China has to grow at least 8% to absorb 10-15 million people going from rural areas to work in factories.

3.6. Some interesting case studies

Iceland, "from heaven to hell"

- Iceland is the first country in the Human Development Index in 2008. Now it is suffering a tremendous financial distress.
  - If you are interested, have a look at VoxEU:
    - Buiter and Sibert, 30 October 2008, "The collapse of Iceland's banks: the predictable end of a non-viable business model": http://www.voxeu.org/index.php?q=node/2498
    - Danielsson, 12 November 2008, "The first casualty of the crisis: Iceland" http://www.voxeu.org/index.php?q=node/2549
    - A view before the bust, Gylfason, 7 April 2008, "Events in Iceland: Skating on thin ice?" http://www.voxeu.org/index.php?q=node/1033
  - "For Sale" on eBay (10 October 2008).


Iceland for sale on eBay

Fri Oct 10, 2008 2:24pm BST

LONDON (Reuters) - Great scenery and wildlife but financial situation in need of repair -- collect in person.

Iceland, which is going cap in hand to Russia for a 4 billion euro loan to bail out its failed banks, was offered for sale as a wholesale lot on eBay on Friday.

Bidding started at 99 pence but had reached 10 million pounds by mid-morning on Friday.

Globally renowned singer Bjork was "not included" in the sale, according to the notice, but there were nonetheless 26 anonymous bidders and 84 bids.

"Located in the mid-Atlantic ridge in the North Atlantic Ocean, Iceland will provide the winning bidder with -- a habitable environment, Icelandic Horses and admittedly a somewhat sketchy financial situation," the notice read.

Bidders' questions included: "Do you offer volcano/earthquake insurance?", "Is it possible that my payment will be frozen?", and "Will you accept C.O.D. as a form of payment?"

4. What should be done now?

What should be done now?

- This is mostly based on IMF (2008). Baldwin (2009) provides a concise summary.
  - The IMF Note offers lessons from five of the most relevant crises: the Great Depression, the Japanese 1990s banking crisis, the 1997 Asian crisis, the 1980s Savings & Loans crisis in the USA, and the 1990s Nordic crisis.

What should be done now?

- The current crisis calls for two main sets of policy measures:
  - Measures to repair the financial system: recapitalization, assets purchases, quantitative easing (direct intervention of central banks), ...
  - Measures to increase demand and restore confidence: public spending, tax reductions, ...
- While some of these measures overlap, the focus of the note is on the second set of policies, and more specifically, given the limited room for monetary policy, on fiscal policy.

What should be done now?

- This recession could be deeper than any since the Great Depression.
- Aggregate demand has declined due to:
  - Fall in real and financial wealth.
  - Increase of precautionary saving.
  - Consumers´ and firms´ "wait and see" attitude.
  - Credit is much difficult to get.

What should be done now?

- Two standard anti-crisis macro tools are ineffective:
  - Export-led recovery strategy (e.g. through devaluation), since recession is global.
  - Monetary policy. The monetary transmission mechanism is weakened due to the collapse of the financial system, and the room to reduce interest rate even more is severely limited.
- Therefore, **fiscal policy is the best policy option.**

What should be done now?

- **Fiscal stimulus** should be:
  - Timely (as there is an urgent need for action),
  - Large (because the drop in demand is large),
  - Lasting (as the recession will likely last for some time),
  - Diversified (as there is uncertainty regarding which measures will be most effective),
  - Contingent (to indicate that further action will be taken, if needed),
  - Collective (all countries that have the fiscal space should use it given the severity and global nature of the downturn), and
  - Sustainable (to avoid debt explosion in the long run and adverse effects in the short run).

What should be done now?

- The **key lessons to manage fiscal policy** in a crisis are:
  - Successful resolution of the financial crisis is a precondition for achieving sustained growth. The archetypal example is Japan where fiscal policy failed because financial sector problems were allowed to fester. By contrast, prompt and sizeable support to the financial sector by the Korean authorities limited the duration of the macroeconomic consequences thus limiting the need for other fiscal action.
  - The solution to the financial crisis always precedes the solution to the macroeconomic crisis.
  - A fiscal stimulus is highly useful (almost necessary) when the financial crisis spills over to the corporate and household sectors with a resulting worsening of the balance sheets.
  - The fiscal response can have a larger effect on aggregate demand if its composition takes into account the specific features of the crisis. In this regard, some of the tax and transfer policies implemented early in the Nordic crises did little to stimulate output.

What should be done now?

- **Composition of a fiscal stimulus**. Two important features:
  - First, this crisis is here for some time, so slow-acting fiscal spending can be part of the picture. (In the usual recession, spending often kicks in after the recession is past and thus becomes part of the problem rather than part of the solution). Moreover, expenditure measures have the advantage of directly stimulating demand rather than giving money to consumers and companies who might not spend it (more uncertainty).
  - Second, the unusual macroeconomic conditions mean that existing estimates of fiscal multipliers are less reliable guides to the relative effectiveness of various fiscal policies. Therefore, fiscal policy should be diversified.

What should be done now?

- **Direct government spending:**
  - In theory, public spending has large multiplier effects, and its effects are much more certain than those of transfers or tax cuts.
  - Governments should make sure that existing programs are not cut for lack of resources.
  - Look for spending programs which can be started or restarted quickly. For example, the state could take its share in private-public partnerships for projects that would otherwise be suspended for lack of private capital.
  - Public sector wage increases should be avoided as they are not well targeted, difficult to reverse, and similar to transfers in their effectiveness. Nevertheless, a temporary increase in public sector employment associated with some of new programs and policies may be needed.

What should be done now?

- **Stimulus aimed at consumers.** Consumers face three crisis-specific factors:
  - Wealth reductions are a key cause of reduced consumption;
  - Credit constraints are forcing consumption reductions; and
  - Uncertainty has spawned a wait-and-see attitude that results in the delay of planned purchases.
- These factors suggest two broad recommendations:
  - Tax cuts should target consumers who are most likely to be credit constrained (greater provision of unemployment benefits, expansion of safety nets, support for homeowners, ...), and
  - Clarity of policy and a strong commitment to "take whatever action may be needed to avoid the tail risk of a depression".
- The goal is to reduce uncertainty and to overcome the wait-and-see attitudes.
  - No tax cuts.

What should be done now?

- **Fiscal stimulus aimed at firms.** The high degree of uncertainty surrounding this crisis fosters a wait-and-see attitude when it comes to firms' investments.
  - Giving subsidies or lowering tax adjusted cost of capital are unlikely to have much effect.
  - The key challenge for policy-makers is to avoid that firms have to cut down their current operations for lack of financing, including reasonably-priced credit. This is, of course, primarily the job of monetary, not fiscal, policy. However, there is some scope for governments in supporting firms that are facing particularly difficult problems, and could survive through restructuring, but find it difficult or impossible to receive the necessary financing from dysfunctional credit markets. Sector-wide policies like the US auto bailout are bad idea, for example.

What should be done now?

- **Sustainability concerns.** The call for deficit spending by IMF staff is unusual. However, they add that fiscal stimulus should not undermine fiscal sustainability, due to the adverse effects on financial markets, interest rates, and consumer spending. A fiscally unsustainable path can eventually lead to sharp adjustments in real interest rates, and these in turn can destabilize financial markets and undercut recovery prospects.

What should be done now?

- The IMF suggests a number of things that could help **sustainability**:
  - Measures should be reversible or have clear sunset clauses contingent on the economic situation;
  - Measures that increase the scope of automatic stabilizers are useful;
  - Pre-commitments to future policies that help shore up fiscal accounts are useful.
  - Pre-commitment to unwinding stimulus measures either at a specific date (like lowering VAT for just two years as the U.K. recently did) or on a contingent basis (reversing the VAT cut once GDP growth has risen above a certain level) are a good idea;
  - Strengthening fiscal governance by, for example, setting up an independent fiscal council;

What should be done now?

- **Coordination**: There is a need for a collective approach to providing fiscal stimulus. Nonetheless, there are several important spillovers that could limit the effectiveness of actions taken by individual countries, or even create adverse externalities across borders:
  - More open countries may be discouraged from fiscal stimulus, since the impact is lower. However, if all countries stimulate, the collective effort needed is lower.

What should be done now?

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What should be done now?

- In Spain it took too much time to the government to recognize that Spain was entering into a deep recession.
- Financial crisis is in the way of a solution. But it will not solve the crisis in the real economy:
  - Demand is quite rigid to variations in interest rates.
  - The root of the crisis is in the lack of sufficient aggregate demand, even though additional financing programmes may help SMEs.

What should be done now?

- Channels to increase demand?
  - Export growth. Difficult.
  - More expansive monetary policy. Difficult.
  - Fiscal policy is the only remaining choice. There is some margin to manouvre:
    - Reducing taxes. Something can be done, but it will not do much for the recovery.
    - Increasing spending in infrastructures:
      - Beware of deficits. Not for consumption financing.

What should be done now?

- Recent measures taken by the government seem to be insufficient.

5. Concluding remarks

Concluding remarks

- This will be a long lasting recession, probably the worst since the Great Depression.
- The specific and unusual nature of the crisis asks mainly for a worldwide fiscal stimulus in an appropiate direction, in addition to measures to repair the international financial system.

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