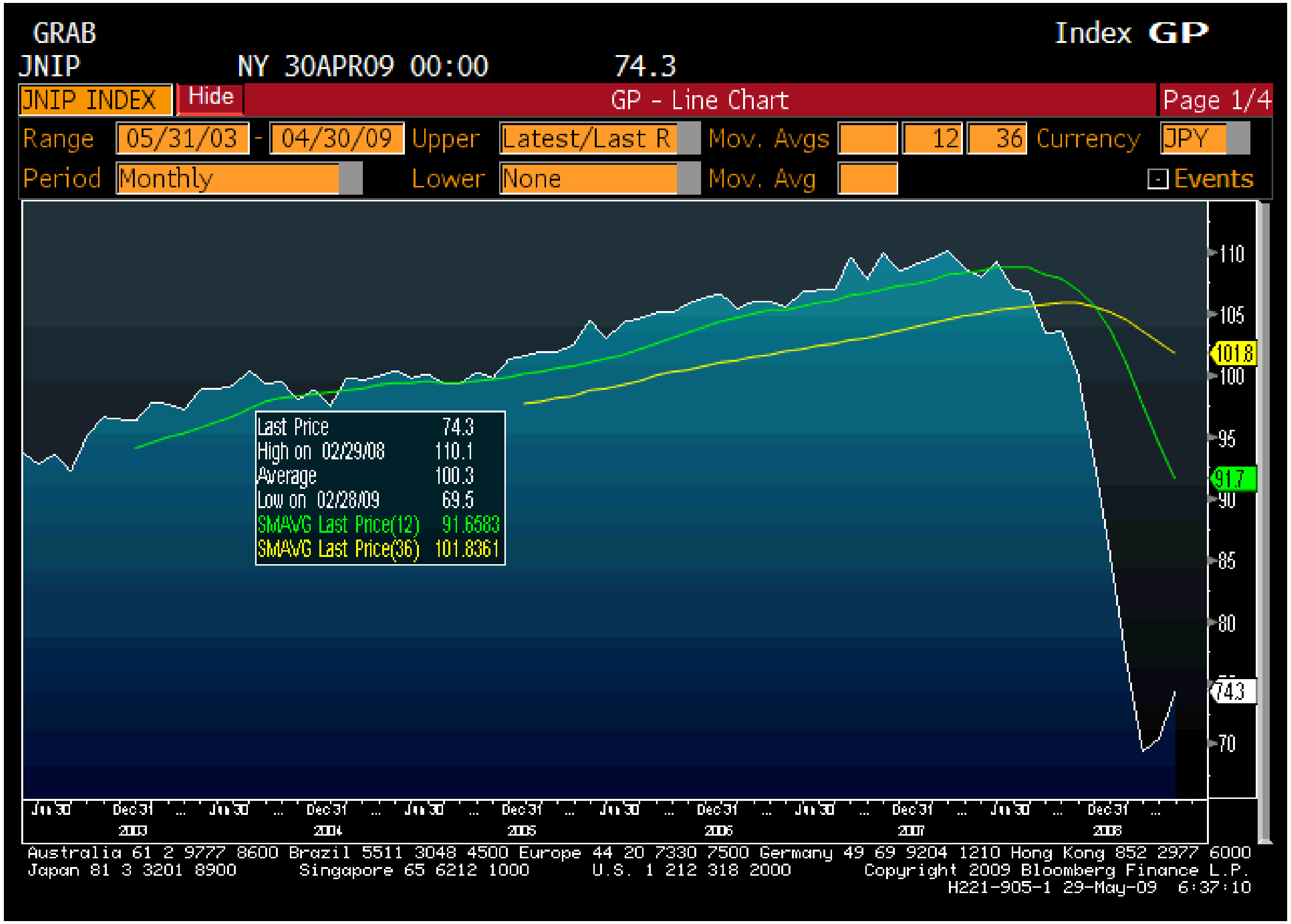
The Global Crisis: Is It Over Yet?

Simon Johnson
MIT Sloan School of Management
Peterson Institute for International Economics
http://BaselineScenario.com

Is it a V?

Japanese Industrial Production (+4.3% in April)



Are We Making Any Progress?

- Banks: want to use PPIP (government subsidy) to buy toxic debt from themselves, and then hold off balance sheet (WSJ, Wednesday)
- Thursday morning: BaselineScenario (and others) blasted the banks
  - "Sheila Bair and Tim Geithner must speak out against this"
- Thursday: Sheila Bair said that this bank idea is not good; June 5, WSJ reports FDIC push Citi
  - Still waiting to hear from Mr. Geithner…

Outline

1. Weak institutions around the world
   - What does this mean?
   - Who has weak institutions
     - And why?
2. Weakening of previously strong institutions, 1980-
   - Origins of global financial crisis
     - Rise of US and European financial sectors
   - Impact so far: US, Europe, emerging markets
3. Implications going forward
   - Stress tests, for emerging markets and developing countries
   - Can we recover soon?
     - Importance of institutions vs. balance sheets
   - Role of the IMF? (and other G20 outcomes)

Thinking About Weak Institutions (circa 2007)

- What happens in the face of a big shock, for example coming from the world economy
  - In Canada?
  - In Australia?
  - In Argentina?
- Dimensions that matter, under stress
  - Political stability
  - Powerful people taking property of others
  - Corporate governance break down

Institutions Matter

- Institutions: the laws, rules and norms that govern how we behave, politically and economically. Major impact on:
  - Sustained economic growth rates, over long periods
  - Derailment of growth, through crises
- In boom times
  - Behavior is relatively “good”: longer time horizons, more certainty; but still difficult issues to deal with
- In a bust
  - More opportunism, grab for power and property
  - But then there is always, eventually, a rebuilding of trust phase
- Development dynamic
  - Attempting to improve institutions in order to sustain prosperity

Why Is It So Hard To Change Institutions?

- Three possibilities
  1. We don't know how
     - There are no blueprints, but we have some strong suggestions
  2. Something intrinsic in certain locations or cultures that prevents strong institutions from developing
     - Seems unlikely, as we've seen big changes in surprising (to outsiders) places sometimes
  3. It's not in the interest of powerful people to support stronger institutions
     - They do very well when institutions are weak, and feel threatened by institutional "reform"
     - Attempts by outsiders to impose reform (e.g., transparency) often lead to unintended consequences

Global Crisis and Institutions (1) Who Dunnit?

- The Usual Suspects:
  - Was it housing? (incentives, regulation, globalization)
  - Or overexpansion of credit? (capital flows)
  - Or excessive risk taking by financial institutions?
- Deeper causes: metabubble/new oligarchs
  - Rise of the financial sector, US/Europe since ~1980
    - Share of profits, compensation relative to average
  - *Undermining* institutions around the world

Who Dunnit: Regulation v. Deregulation

- Regulation: Democrats pushed to expand ability to buy housing
  - Community Reinvestment Act
  - Fannie and Freddie, origins of securitization
- Deregulation: Democrats and Republicans agreed not to control finance tightly
  - End Glass-Steagall, commercial/investment bank
  - Agree not to regulate derivatives
- Cognitive capture/cultural capital: policymakers believed in finance ideas

Who Dunnit: the Pushback

- It wasn't a new form of financial oligarchy, as in *The Quiet Coup*, because
  – It was an accident (Summers, Geithner)
  – US is not like Russia (Wolf, Kay)
  – Banks are stupid, not super smart (Brooks)
- Obama administration is not captured by this oligarchy
  – These are the experts and we need them (NEC)
  – There are no serious conflicts of interest (Liddy)
  – What the banks want is what we want (Gross)

Events and Policy Responses

- Caution: while major vulnerability always has deep roots, the depth and duration of crises can result from relatively small missteps: crisis of confidence
  - Lehman allowed to fail; AIG “rescued” but creditors took a big hit and effects evident by 6pm on September 17th
  - Immediate policy response from US was too little, and Europe showed up way too late
- By September 29th, the only chance was: expansionary monetary policy, bank recapitalization, fiscal stimulus and (for some places) direct measures on mortgages; likely not possible forestall big recession

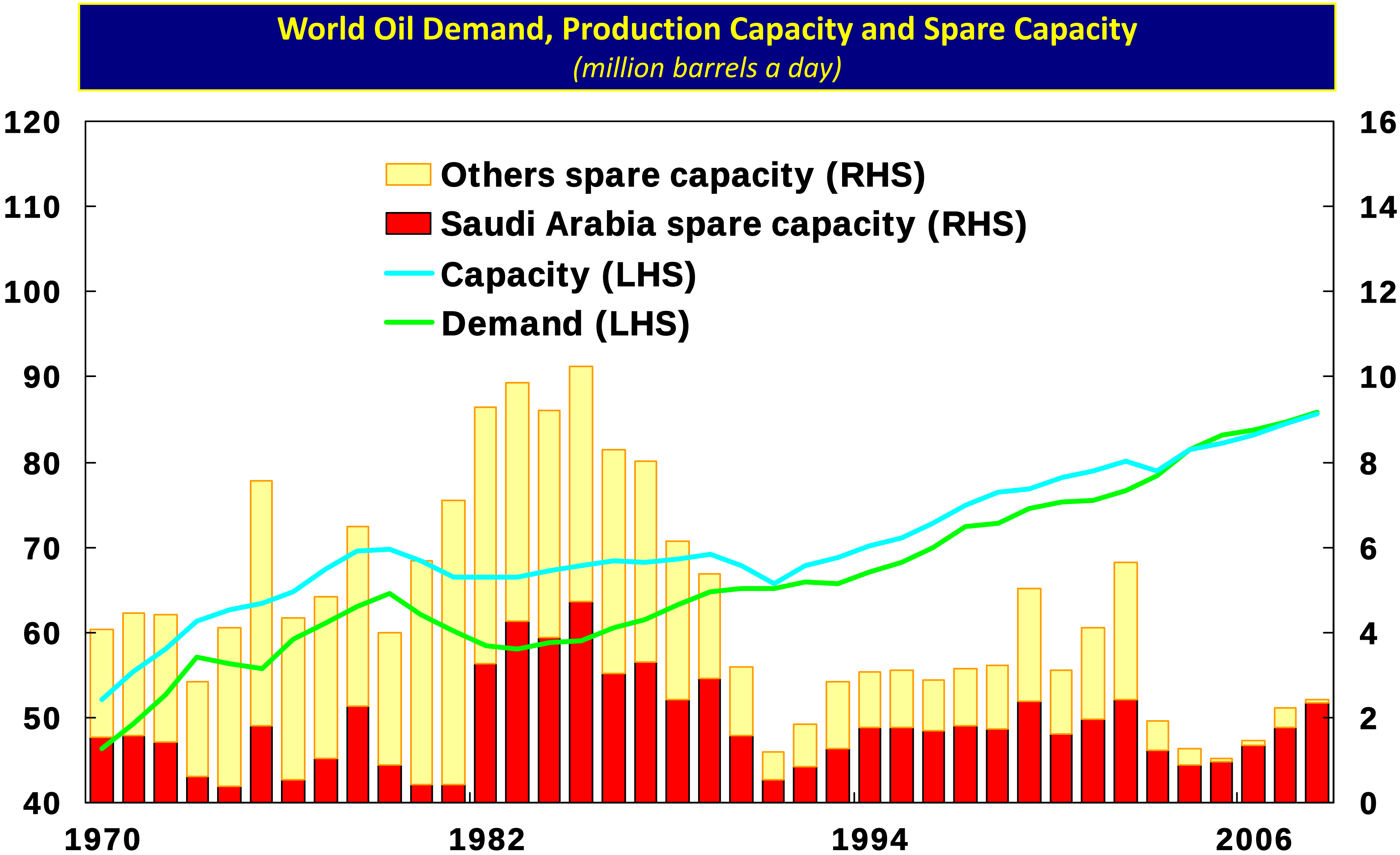
Global Crisis and Institutions (2) The Situation Today

- Jump from (financial) companies to countries, and back
  - The Iceland affair (Tom Clancy?); week of October 5th
  - Danger of global financial war
    - Averted, October 12th?
    - Or just postponed, a bit? "Buy America"
- Bank recapitalizations in G10 did serve as a stop-gap measure
  - Combined with large (partial) guarantees
  - This might destabilize other parts of the global financial system
  - But it stabilizes the European core, right?
    - Only if they have sufficient balance sheet to absorb the coming losses
    - Serious tensions begin to emerge within the eurozone
- Now the crisis is "in the real economy," almost everywhere
  - Falling confidence for consumers and business: lost decade?
  - Lower consumer spending, reduce investment
    - Reductions in employment
  - Fall in demand for credit, feeding into deleveraging worldwide

What(ever) Next for the Global Economy?

- Oil and other commodity prices: which way are they heading
  - Major issue for developing countries and key emerging markets
- Small shocks in some places continue to become major disruptions elsewhere (often far away)
  - e.g., links from East-Central Europe to W. Europe to USA
  - What about Asia?
- Policy begins to go bad in emerging markets
  - New role for the IMF?
  - Is the G20 the next new thing?
- And policymakers continue to have “communication moments” (or worse) inside G7, Euroland
  - US banking policy: Achilles’ heel
  - Denial, even now, in key parts of Europe (e.g., Germany, Austria, Hungary chain)
- Looking for trouble in Credit Default Swap spreads
  - E.g., start with Financial Crisis for Beginners on http://BaselineScenario.com

What Is Wrong With This Picture?
(If You Run The United States)



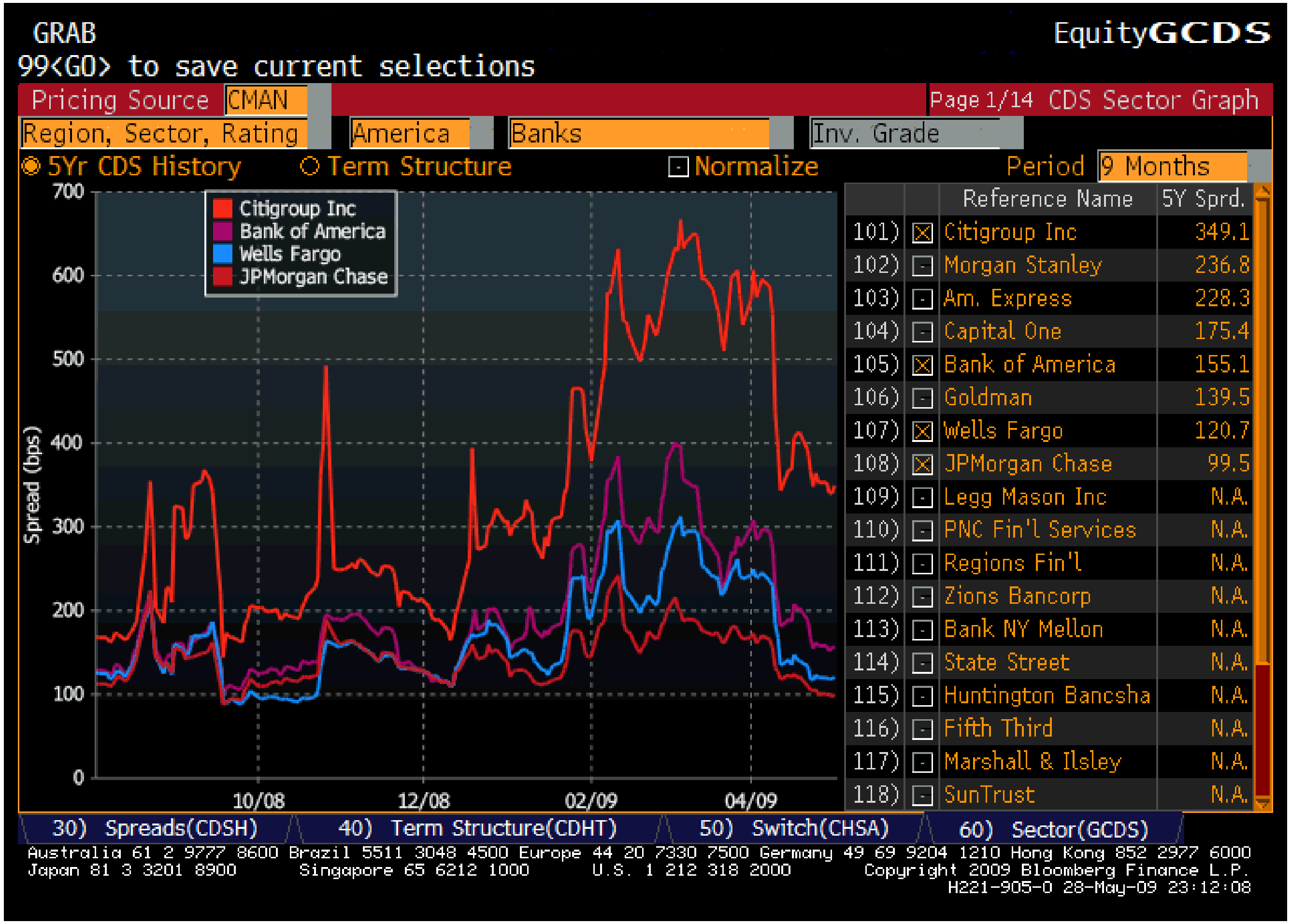
Policy Moves, Emerging Market Contributions

- Leading analysts' measures of vulnerability, macroeconomic and financial
  - East Central Europe tops any list; Hungary at medium-high level
  - Relatively safe countries: Russia, Korea, Argentina and of course China
- But vulnerability, again, does not predict sequencing or severity
  - Russia: ban the words "crisis" and "collapse"; information is on the web, of course
  - So China: not allow access to websites, such as http://BaselineScenario.com
  - Argentina: take the money and run (to de facto default on government debt)
    - Pension assets
  - Korea: where is the money exactly?

Policy Messages, From the G7, becoming the G20

- Europe (Bini Smaghi, October 20th): the people (and society) who let Lehman fail are to blame
  - ECB internal debate on inflation "window" is obvious
- US: flip-flop on spending $450bn in auctions to buy MBS, CDOs, etc. What is the strategy now?
  - Forbearance vs. PPIP
    - June 4, 2009: legacy loan PPIP suspended??
- G20 meeting, November 15th, agreed to international cooperative approach to
  - Do nothing effective in terms of short-term macro
    - Despite China's leadership on fiscal stimulus
  - Not properly recapitalize the IMF; Japan as exception
  - Engage in potentially dangerous pro-cyclical tightening of regulations
- Global messages only changed with G20 summit in April
  - Largely due to US leadership: fiscal stimulus rebuffed, but able to get extra funds for the IMF
  - Signal that large international creditor bailouts available

US Bank CDS, May 28, 2009



European Bank CDS, May 28, 2009

East European Sovereigns, CDS, May 28 2009

West European Sovereigns, CDS, May 29, 2009

Latest IMF Assessment (end of April 2009)

- Sharp fall in global growth, with reasonably rapid rebound expected
  - Assuming that demand stimulus will work; no further financial disruption
- What else could go wrong?
  - Speed and extent of recovery; Japan's surge
  - Credit losses; JP Morgan on credit cards
  - Emerging market debt; rollover risk, Kazakh scenario
  - West European wild cards; the run

Think the Unthinkable: Two Examples

- Things we know "for sure"

1. China will continue to grow at 8-9%
    - Even the pessimists think that real growth will be at least 5%
    - One view: Chinese exports will be flat next year
        - Who will buy more Chinese goods than in 2008?
    - And, of course, the renminbi will continue to appreciate
2. There will be global recession and risk of deflation
    - No imminent prospect of inflation
        - Because global "output gap" drives inflation…

Is that in New Dollars or Old Dollars?

- No deflation (falling prices) in United States, some others
  - Bernanke: we will not repeat the mistakes of the 1930s
  - Competitive devaluation episodes: UK, Canada, Australia
- What's your model of inflation?
  - Output gap view: no inflation
    - But Fed is credit provider of first resort; how can they cut this off when the economy recovers?
  - And how do you now control liquidity? Expect volatility, at least
  - And there is the budget deficit (Bernanke, November 21, 2002)
    - Global inflation, move into commodities as store of value
    - Interest rates rise
    - Monetize the deficit (remember Sargent and Wallace?)
- It couldn't happen here…
  - Recession and inflation: more emerging market characteristics in the heart of the global economy
    - Spring 2008 as foreshadowing: rising commodity prices with declining growth prospects?

Inflation Expectations in the US (from 5 year swaps, May 28)

One Page Summary

- Institutions are the rules that govern behavior
  - Shapes the environment for all kinds of business activity
  - These definitely change over time, but improvements are usually slow
    - Serious undermining is also gradual, but has happened
- When institutions are weak
  - It does not prevent growth, necessarily
    - But it shapes who benefits and how
  - And makes a country more prone to crisis, particularly when under pressure
  - Does the US (even more so Western Europe?) now have some emerging market features?
    - Rise of economic power and political influence from financial sector
- Recovery could around the corner, depending on balance sheets, confidence
  - But then so is the next crisis?
    - Which will cost another 40% of GDP, or more?
- Crony capitalism is still on the rise, globally
  - Are oligarchs generally helped or hurt by crises?
  - Will the 21st century turn out to be a great deal like the end of the 19th century? The Long Debate is only just starting…