Global Financial Crisis

Economic and Political Outlook - Adelaide

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1. **How did the world economy get into the mess**
2. **Financial derivatives and the global capital market**
3. **Some graphic dimensions of the current economic downturn (courtesy of QIC)**
4. **Thoughts on the Rudd, IMF style packages**

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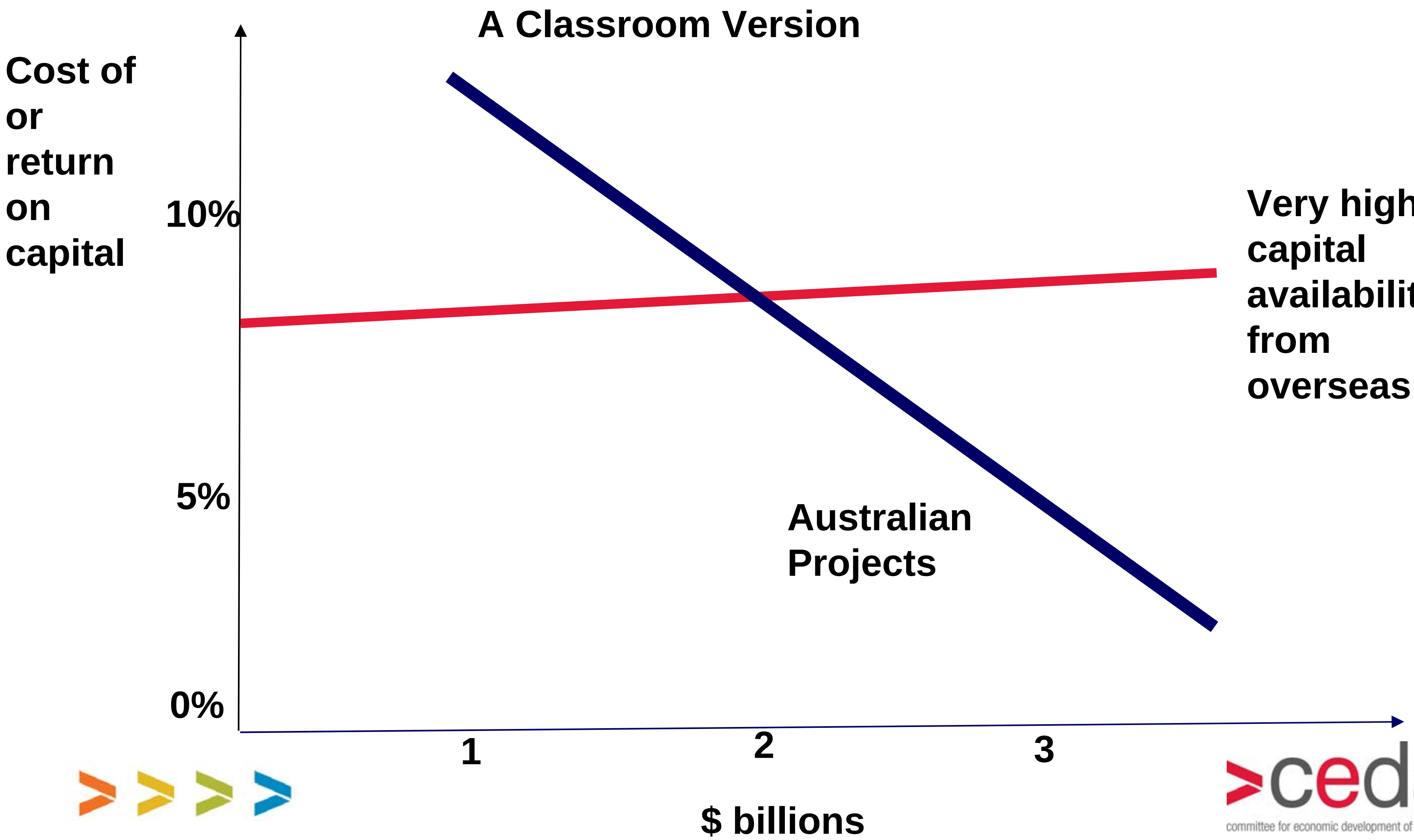
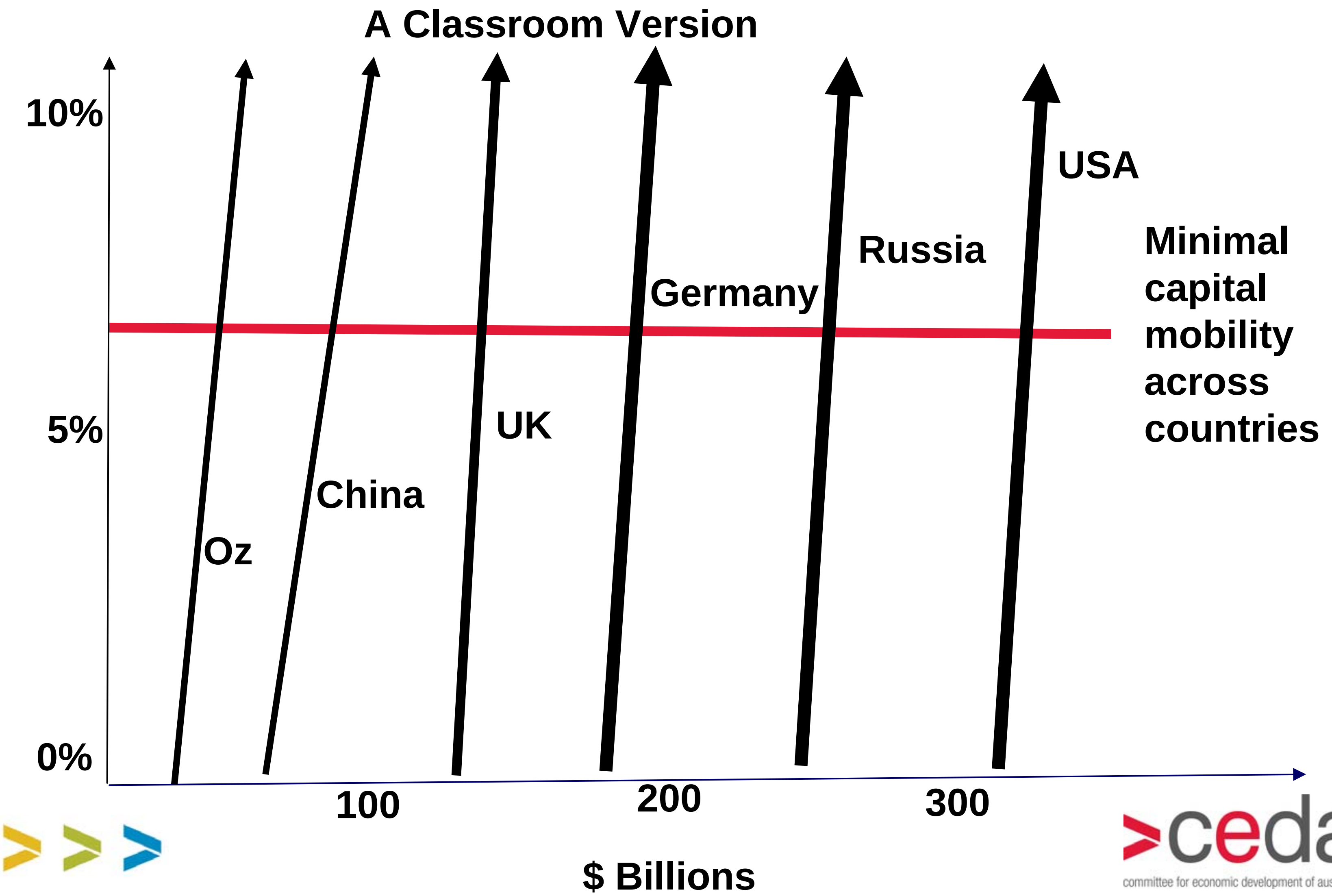
Australian Capital Market (Pre Sept 2008)–

from a virtual Infinite Supply at the covered Australian “world” rate of interest



World Capital Market – from a virtual Infinite Supply at the localised world rate of interest – to Vertical national rationing



The Nature of the Global Financial Bust (1)

- The Sub-Prime bust in the US 2007 - followed a forced feeding of housing loans. This was sufficient to cause a significant recession in the US, but does not explain what has happened since.
- The 15 yr boom China, India, E Europe … with 3 billion people converging on capitalism and western standards of living. Meant there was little cleansing re-regulation that goes with downturns. Derived and contrived incomes dominated, as financial institutions became poorly governed .
- What emerged was a psychological or herd issue as much as an economic problem. Yes there was over-leveraging – but it was the structure and "independence" of that credit and swaps industry that blew our socks off. Who had heard of Credit Default Swaps – all $60 trillion of them (world GDP is about $50 trillion). Back to that later.
- The diversification/packaging of assets was meant to reduce risk per average unit of return – due to offsetting risks. But the asset packages were so opaque that the resulting securities were unfathomable.
- Since this happened across the board, all financial institutions became vulnerable. Directors shrugged – rather than ask questions re packaged securities. As did central banks, regulators, economic advisers...

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The Nature of the Global Financial Bust (2)

- The Chinese and resulting Australian boom was not a bubble. But we did not know that a financial pass-the-parcel game was about to implode the external economy.
- Yes, there were critics of leverage – but they did not flag the key innovations and the lack of regulatory protection. Pass-the-parcel was not a recognised game. Opaque parcels were just assumed to deliver better risk/return mixes.
- The new "swaps and derivatives" industry was understood by virtually none of our directors, bankers, CFOs and even central bankers. The swaps financiers also did not understand classical economics or central banking.
- Issues here for process-driven business schools – no classical training.

The Nature of the Global Financial Bust (3)

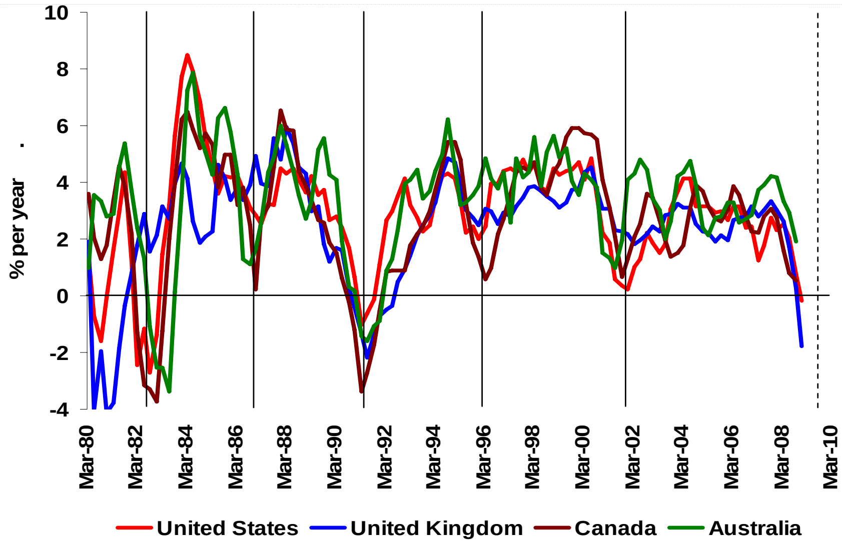
- **We had become <u>disjoint in a policy and market sense</u>. Financial modellers got a degree of independence on Wall Street that that was not deserved.**
- **Greenspan and the Fed, IMF... were pre-occupied with aggregates rather than prudential security. They accepted opacity dressed up as diversification**
- **A series of financial instrument time bombs had escaped notice – partly because the <u>word "swap" was used instead of the words insurance or guarantee</u>. These words would have brought regulation!**
- **A year ago about <u>$60 trillion of Credit Default Swaps existed</u> – held by parties accepting counterparty risk that was/is unfathomable. Allegedly risk was being separated and sold off, enabling a given equity to drive more debt. Risk was being shifted "behind the tree". But many trees have lacked roots.**

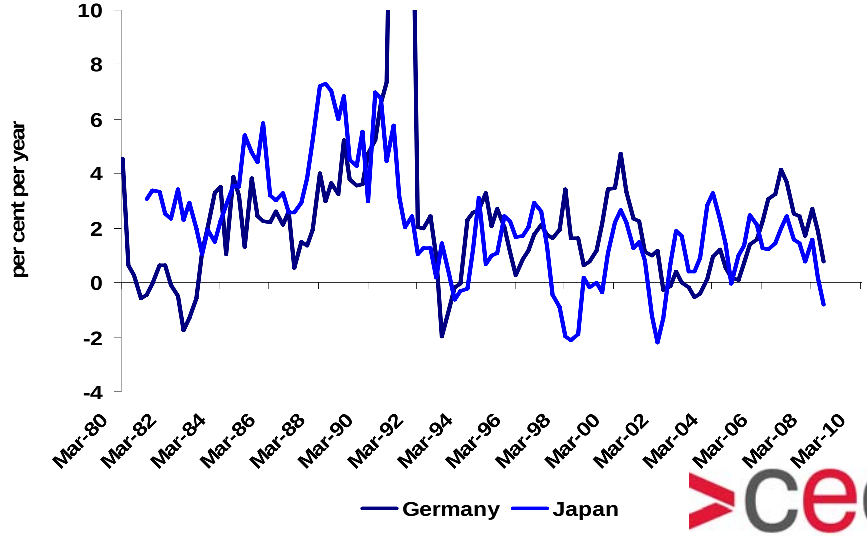
The Nature of the Global Financial Bust (4)

- To most of the finance and mathematical jockeys this meant avoidance of regulation, which was then sanctioned by the Fed's Greenspan (and indirectly endorsed in Australia by Wallis Committee).
- The post-Lehman bust of 15th Sept 2008, the flow-on and crisis of confidence, triggered what was sufficient to generate synchronised slumps of most world economies.
- The unusual dimension to the shock is that it is largely a "wealth effect" of the order of over 30% – corporate, personal and institutional – a size probably not seen before in such a short space of time.
- Many persons with savings have lost roughly the value of a house – and this story is bad world-wide.
- I set out some graphics on the international situation – kindly made available by Dr Doug McTaggart head of Queensland Investment Corporation and a former Under Treasurer of Queensland and Economics Professor. Doug is also a Board Director of CEDA.
- The governance issues and the origins of the bust are discussed in my attached note to the CEDA Board of Governors.

Real GDP growth is falling in all countries

- Real GDP growth is falling in all major economies
- September 2007 shaped as the trough in a "normal" business cycle, until the GFC hit
- Growth appears to be falling harder and faster in Europe and Japan





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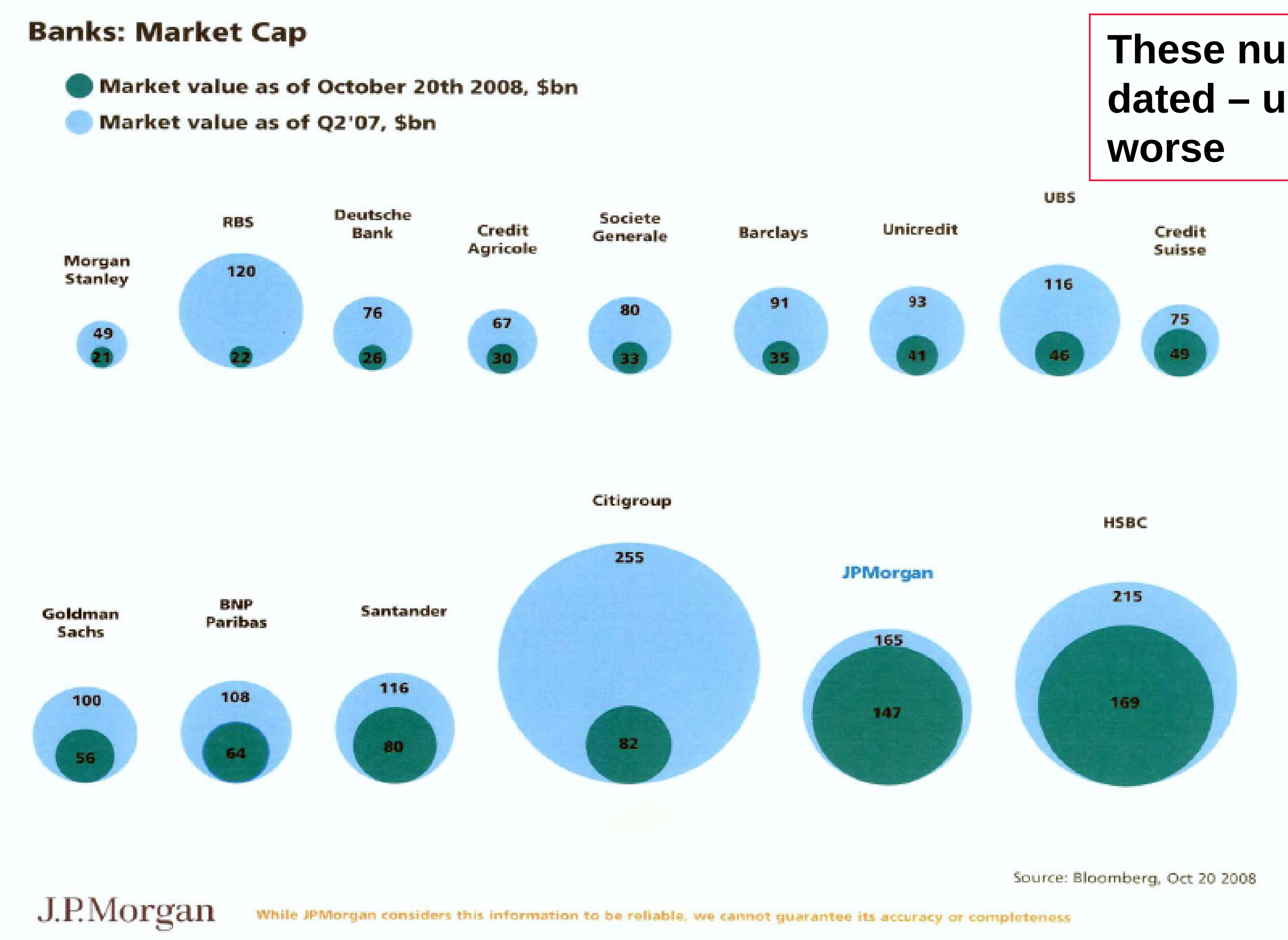
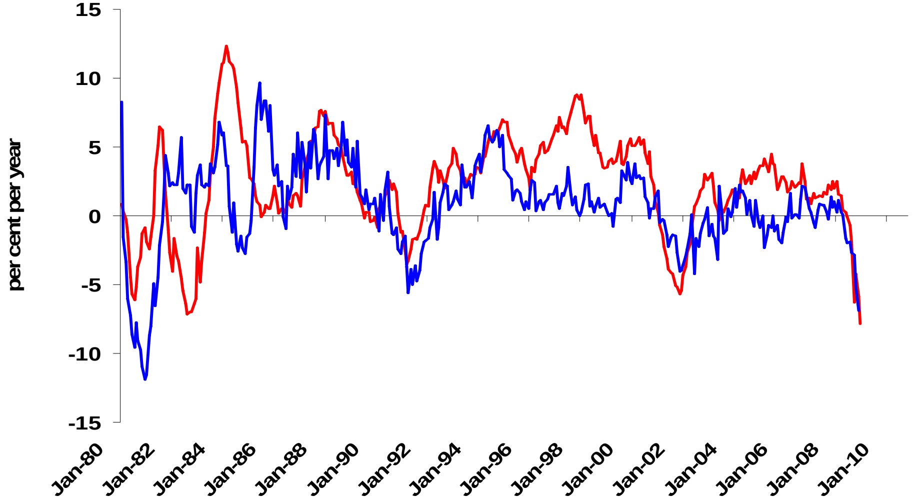
Contraction of bank balance sheets

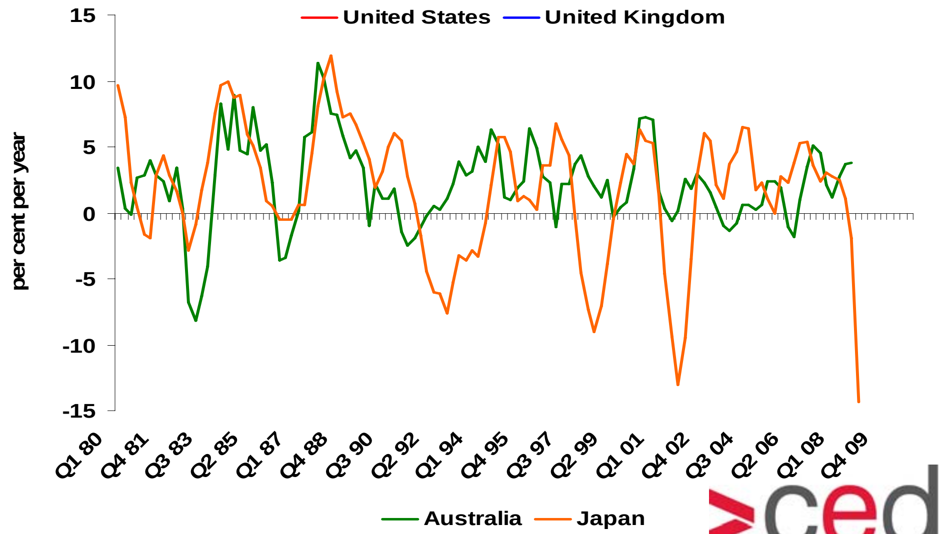
These numbers are dated – updates much worse



Production is falling in all countries

- Industrial production (IP) is falling rapidly in all major economies
- In the US IP has fallen faster than any time since WWII. IP in UK falling at rates similar to early 1980s
- IP in Japan falling fastest on record
- Employment highly correlated with manufacturing IP





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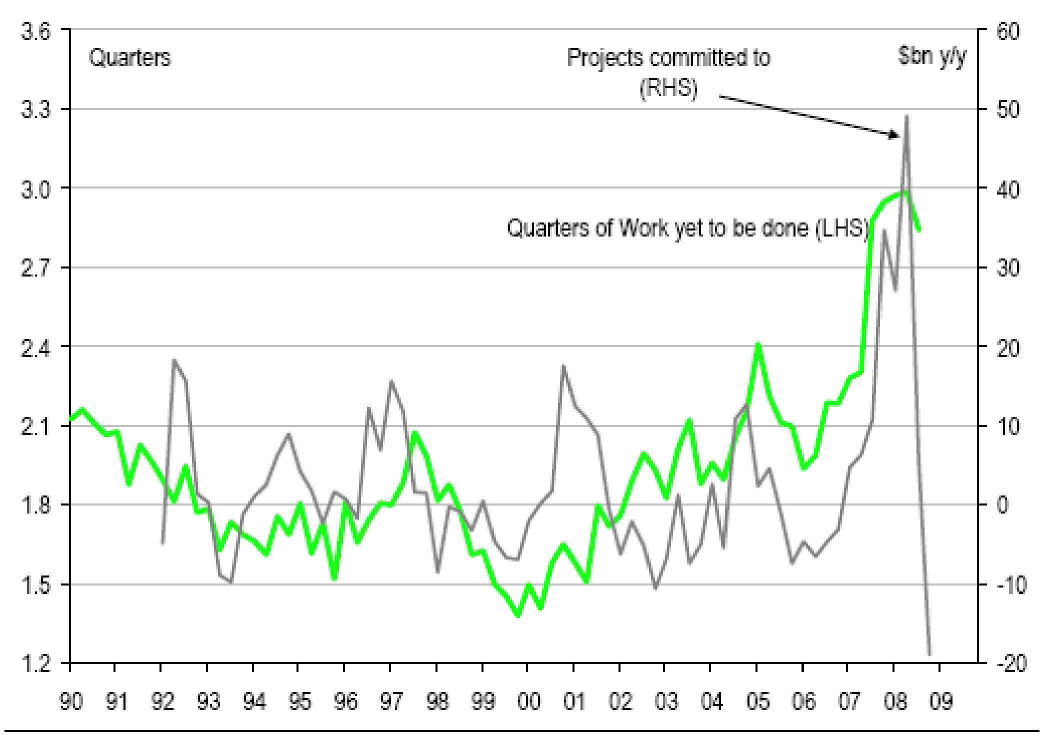
Australia will fall with a lag

- Australian IP data only to Q3 2008, and appear to be holding
- Look for a lagged effect, in part due to strong investment in the resources sector
- However, bottom has fallen out of resources and future commitments for business investment in Australia look grim

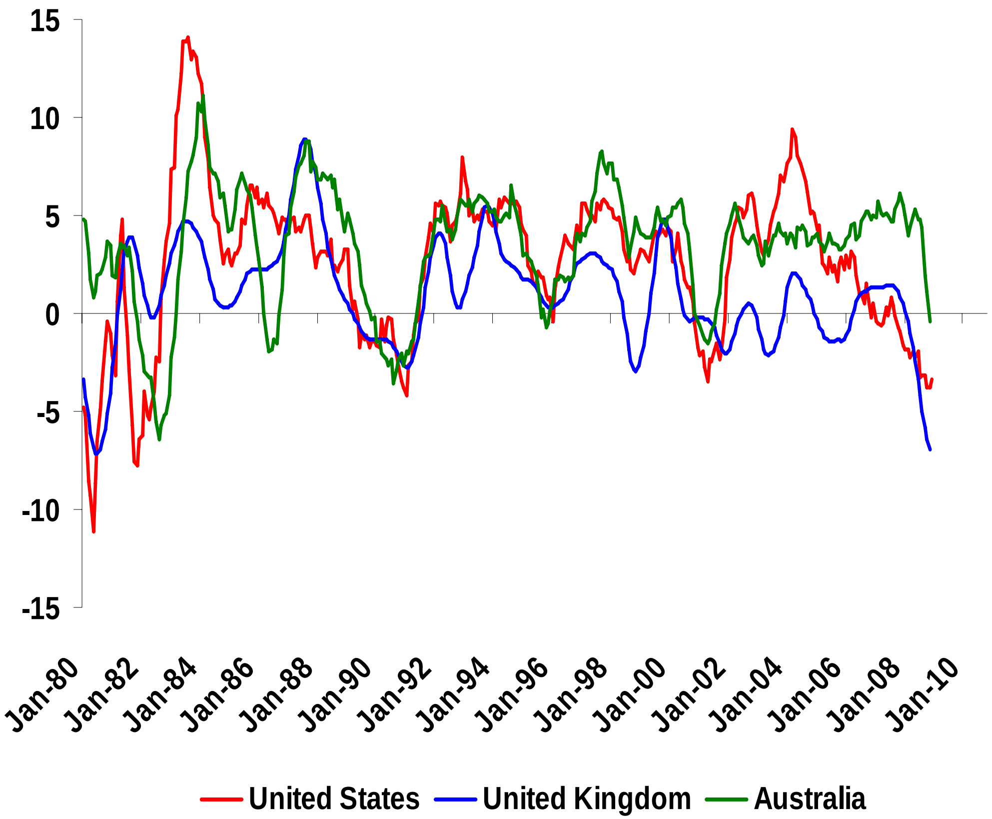
Chart 6: High work on hand, but new commitments collapse



Source: ABS, Access Economics, UBS

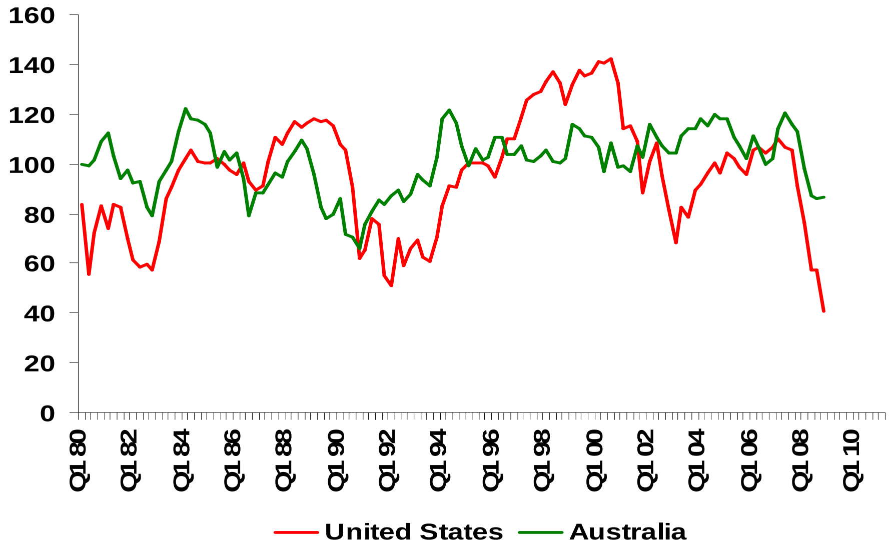
Leading indicators are still falling

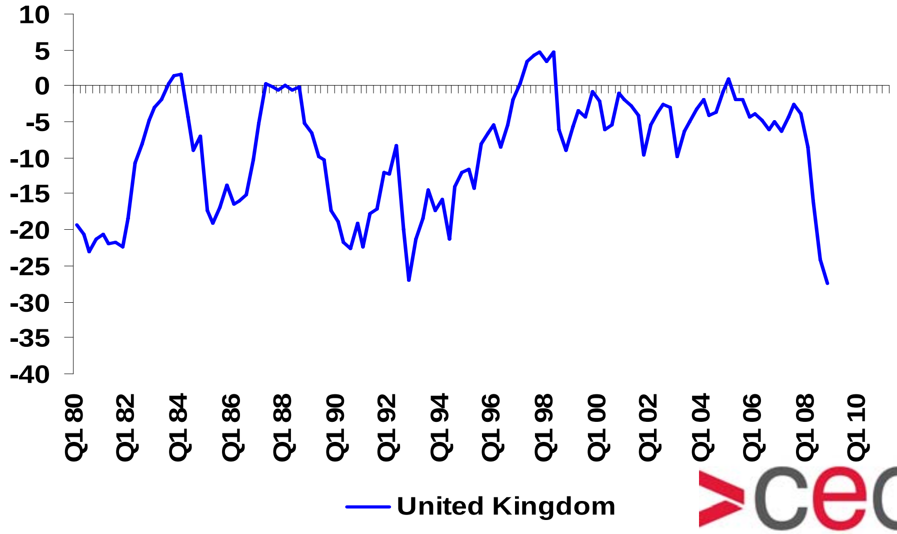
- At present, there is no end in sight to falls
- Leading indicators in all major economies falling
- Of interest is the observation that LIs only recently collapsed in UK and Australia
- In US, steady fall since peak of cycle in 2004, but accelerated collapse in 2008



Consumer confidence plummeting …

- Consumer confidence has also collapsed in dramatic fashion
- Consumer confidence began to fall with the onset of the credit crisis in late 2007 early 2008, but the declines accelerated in 2H08
- In US and UK levels are testing historical lows





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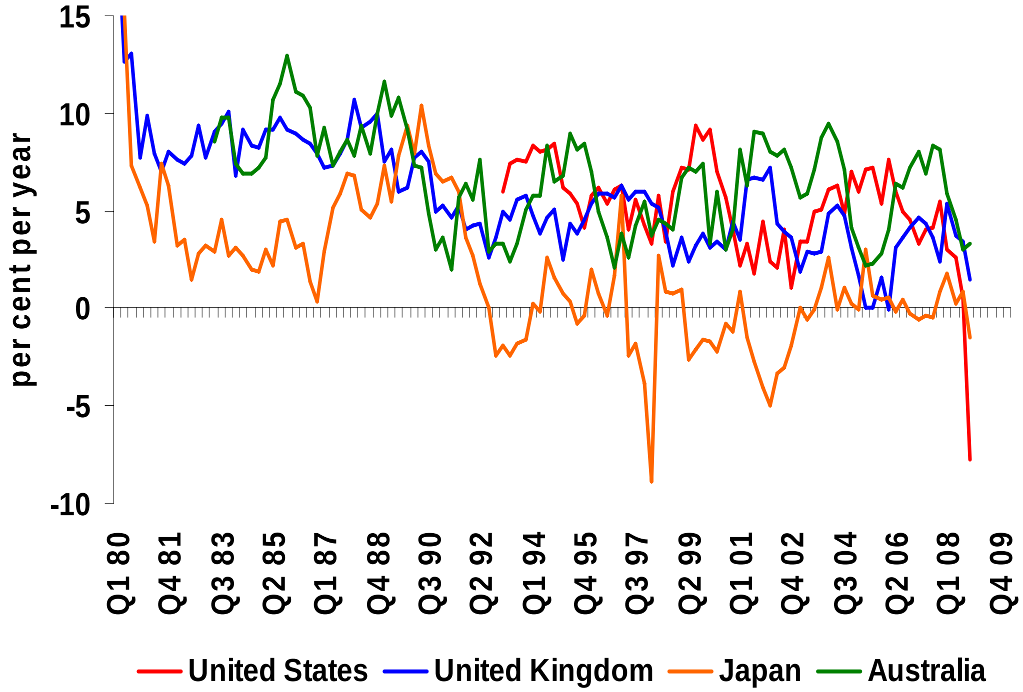
…leading to falling retail sales

- Most interesting is the behaviour of retail sales
- In US, UK and Australia, sales only began to decline in 2H08, even as confidence was declining earlier
- Contribution from consumers in Japan does not surprise. Japanese downturn, like China's, is the product of collapsing export markets



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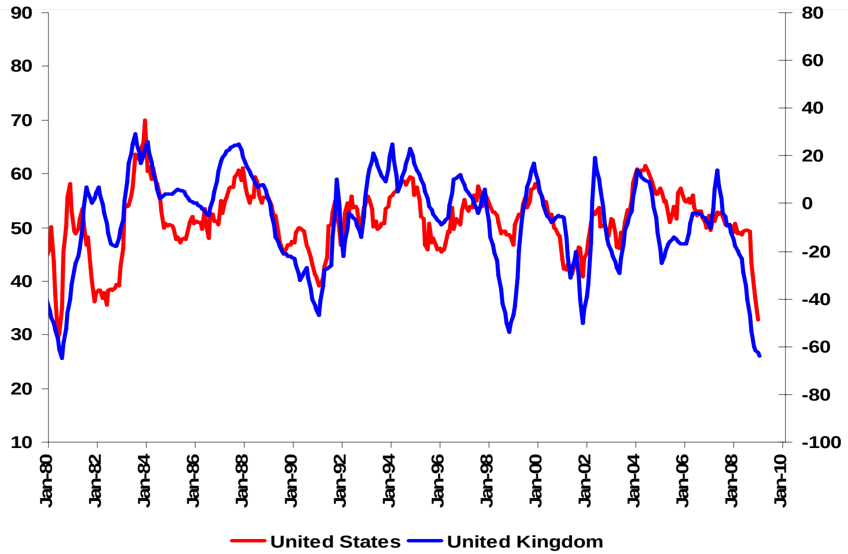
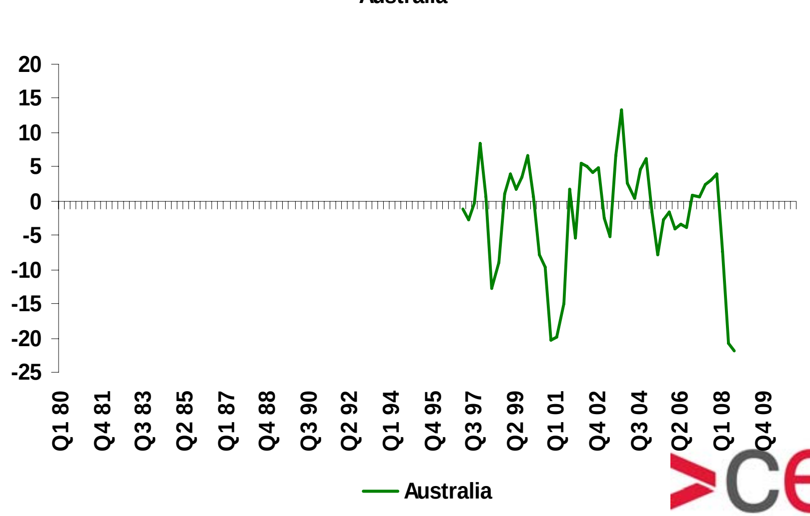
Consequently business confidence collapsing

- The last domino to fall has been business confidence, which has been resilient up to 2H08

- With retail sales, exports (in US), orders and capacity utilisation all falling, confidence finally gave way

- With falling business confidence we get falling business investment and employment growth





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The Rudd & RBA Packages - last week

Decisions

- Inadequate reflection on the root causes of the bust – simplistic analysis by PM
- The RBA cut its official interest rate by 1% to a 44 year low of 3.25 per cent. Real issue is low volume of lending, not price.
- The Rudd government announced new fiscal spending worth $42 billion on top of earlier $26 billion packages (~5.8% of GDP). No evidence of positive multipliers

Background

1. Government projected revenue falls over next four years of $75 billion, mainly due to a weaker corporate tax take.
2. Government is now expected to run a cumulative budget deficit of $118 billion from 2008-09 to 2011-12, averaging almost 2.5 per cent of DP.
3. The Government's growth forecasts, incorporating packages, revised down sharply, to 1 per cent in 2008-09 and 0.75 per cent in 2009-10.

Issues

- Slump has not yet really hit – are we firing shots too soon, Debt implications?
- Would infrastructure, skills $ if well targeted be better than welfare payments and tax cuts (training, localised water, transport, fibre optic... Projects?)
- Too much too soon? If a 5 year recession – why a 5 day review?
- Adam Smith and the other Moral Philosophers who advanced classical economics, would be appalled at the drift of the financial dimensions to capitalism

How Central Banking is *Supposed* to Work

- The central bank has a discount window of securities and money – available only to licensed bank at policy set rate
- Banks guaranteed they can borrow at that rate, but …
- Deposits NOT guaranteed
- All other financial institutions deposit with banks – and can thus only indirectly access discount window
- When a building society or investment bank is in trouble they can get funds indirectly through the banks
- The government does NOT guarantee any institutions
- The regulator – now APRA –monitors assets, liabilities and practices of banks and other deposit taking institutions