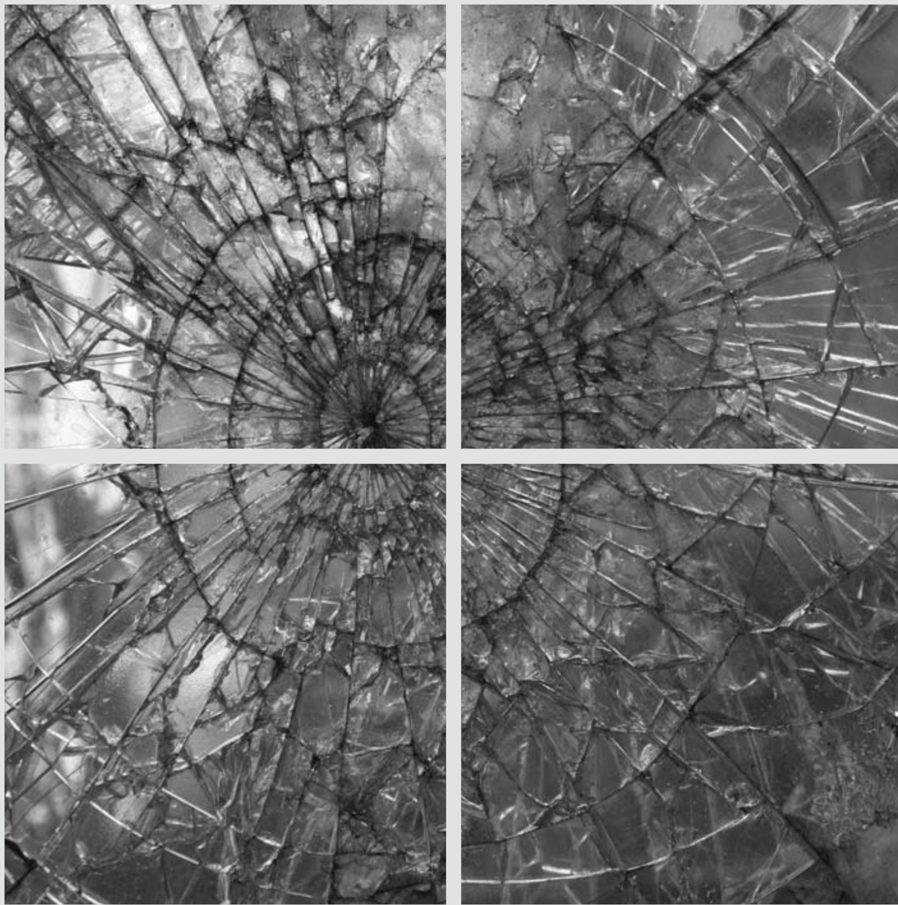

The crash of 2008 and the challenges ahead

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Introduction

The world dodged a bullet after the *Crash of 2008*. Asset booms and bubbles, such as those experienced in the years from 2003 to 2007, have always led to asset crashes and often also to severe economic depression. Examples abound: the Dutch tulip boom, the South Sea bubble, frequent real estate and share price booms and busts, and repeated banking crises.

Three of my favourite books are:

- *Extraordinary Popular Delusions and the Madness of Crowds*, by Charles MacKay;
- *Manias, Panics, and Crashes*, by Charles Kindelberger and the 2005 edition by Robert Aliber; and
- *The Great Seesaw. A new view of the Western World, 1750–2000*, by Geoffrey Blainey.

These writers all document the massive role played by swings in confidence that are a natural part of the capitalist system.

No-one with any sense of history could be surprised by the near-misses experienced in 2007 and 2008.

Now we see a tepid recovery in most western nations and a strong rebound in the developing nations. No-one should be too surprised if a fresh shock reverses these improving trends.

The view expressed here is one of guarded optimism. While all governments fail to prevent booms turning to busts, and most analysts fail to provide unambiguous warnings, governments and central banks acted quickly and decisively in 2008 in ways that John Maynard Keynes – economic policy's great innovator – would have been quick to recommend.

If there is a fresh shock, governments and central banks will again apply the Keynesian remedies. Whether repeated doses of the Keynesian medicine would be as effective as they currently appear to be, is one of the great questions. At present the US budget deficit has trillions of dollars of red ink (that is, budget deficits) 'as far as the eye can see'. Thus there are serious impediments to further stimulus.

Already in the US, Main Street is angry that Wall Street was bailed out with taxpayers' money and the issuance of government debt; future taxpayers' money.

A taxpayers' revolt could limit government's freedom to act, or demand faster 'red ink' reduction. Taxpayer concern at the massive debts could lead to frugal behaviour by households and businesses, keeping private economic activity subdued for years. Japan's decade and a half of permanent recession following its great stock market crash that began at the very end of 1989 is a warning example.

Another shock, with another Keynesian response, would strengthen all these understandably adverse reactions.

Governments, central banks and financial system regulators have several great challenges and these are discussed later in this paper. The main reason for guarded optimism is this. Wall Street, Main Street businesses and households in the US and elsewhere have been given the mother of all scares and should behave more responsibly for at least the next decade or two.

This should provide time for economic recovery to erode current debt commitments, for central banks to restore normal operations (including sensible levels of interest rates), and for financial regulators to devise better methods of regulating finance.

Whether it is *possible* to remove booms, bubbles and busts is another great question for economists. Whether it is *desirable* to do so is an even bigger question. Some far-sighted economists – notably Austria's Joseph Schumpeter – see economic busts like bankruptcies – as cleaning out the crooks and incompetents, and reducing the dead hand of pre-bust oligarchies.

Some environmentalists see bushfires as performing such a role in managing Australia's unique environment. The question is, of course, whether controlled burning when the land is relatively damp is a suitable and safer method of managing the bush.

What is clear, at least to this author, is that 'burn, baby, burn' is unlikely to be the best approach in either environmental or economic policy.

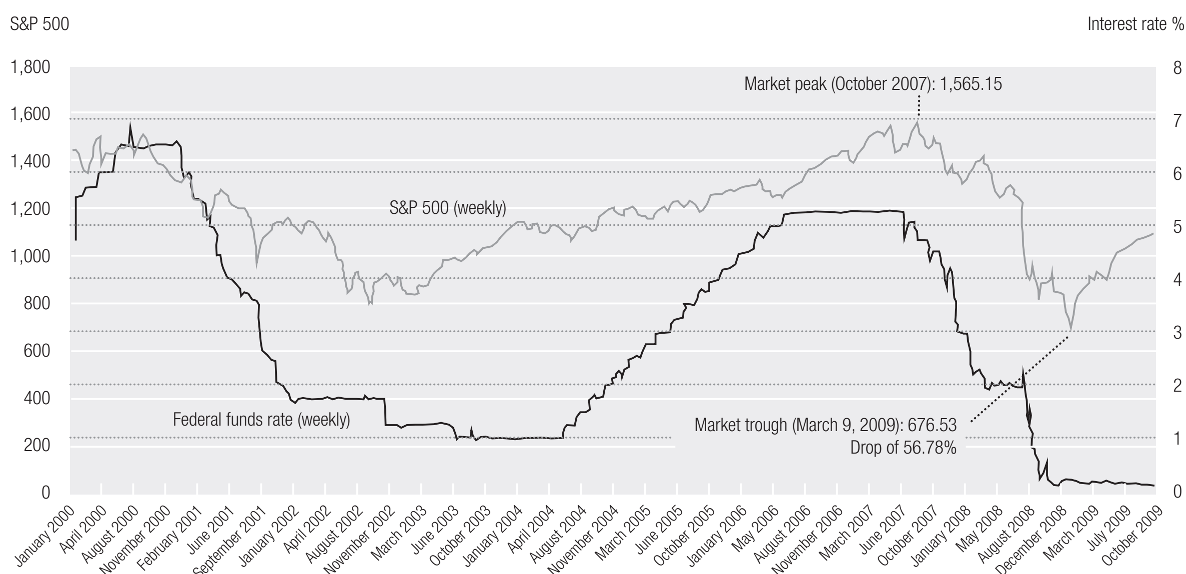
The boom of 2003 to 2007

At its deepest level, the boom of 2003 to 2007 arose from many people forgetting the lessons of history. One can assert without fear of contradiction that every boom in history has been followed by a bust and (with less confidence) that the size of busts is related to the size of the preceding booms. Indeed, the bust of 2008 may turn out to be smaller than normal precisely because of the application of Keynesian theory.

One traditional cause of booms is easy money. In the case of the boom of 2003–07, the role of US Federal Reserve Chairman , Alan Greenspan – who deserves to be known as 'Bubbles' Greenspan – was crucial. It was Greenspan's Fed that reduced cash rates to 1 per cent following the 'tech wreck' of 2002. This was a bubble bursting, and the easy money that followed was the proximate cause of the quick reversal of the equity price falls of the 'tech wreck' and the quick build-up of a new and more general equity boom.

Figure 1

US equity prices and US cash rates from 2000 to end 2009



Source: Dow Jones

Greenspan did not believe that anything sensible could be done to reduce asset inflation, and so the Fed raised interest rates only slowly as equity price inflation gathered momentum.

Figure 1 shows US equity prices and US cash rates from 2000 to end 2009.

But a more technical cause was changed attitudes to risk by households, businesses and financial institutions. Like easy money, relaxed attitudes to risk are a feature of virtually all historical asset booms. The post World War II economy saw the world's greatest surge of wealth creation. Businesses were urged to use borrowed money to 'leverage' equity and at a time of strong growth, this produced strong profits.

Households, too, got the borrowing bug, and threw away the lessons of grandparents who had learned frugality in the Great Depression of the 1930s. The new orthodoxy was 'Why wait, buy now, pay later'; perfectly attuned to the mindset of the post-war baby boomer generation.

Financial regulations everywhere were reduced and, in particular, the US repealed the Glass-Steagal legislation. This act, passed by Congress in 1933, prohibited commercial banks from collaborating with full-service brokerage firms or participating in investment banking activities and '… protected bank depositors from the additional risks associated with security transactions. The act was dismantled in 1999. Consequently, the distinction between commercial banks and brokerage firms has blurred; many banks owned and still own brokerage firms and provide investment services'.[1]

Similar relaxation occurred in other western nations, often with the result that many people could get loans which, in the past, their parents obtained only after long periods of keeping their money in banks and being nice to the local bank manager. Credit rationing was abolished, allowing baby boomers to borrow as much as they could afford to pay. As these loans were used to buy assets whose value escalated, gearing up became the practice of smart individuals as well as businesses.

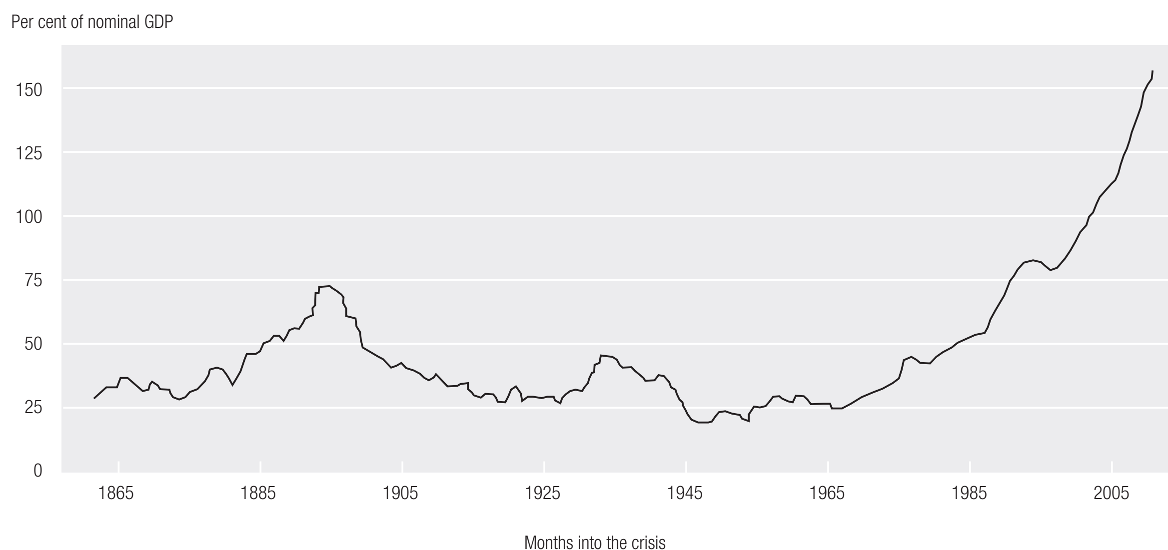
The net result of all these forces was a massive and ultimately unsustainable expansion of credit.

In September 2007, the Reserve Bank of Australia (RBA) Deputy-Governor, Ric Battellino, drew the world's attention to the size of Australia's credit expansion. The strength of his implied warning was all the greater because he compared recent experience with that of the booms in the 1880s and 1920s, famously followed by the busts of the 1890s and 1930s (Thornton 2007). See Figure 2.

Over-borrowing and over-lending in pursuit of new wealth was not a global phenomenon, though it was a practice of people in western nations. At the more technical level, an important part of the problem was due to 'imbalances' between the developed and developing economies.

The predominant cultural value in the developed West was that of consumerism. In the developing East, the predominant culture emphasised the virtues

Figure 2
Australia's total bank and non-bank credit – to mid 2007*



* Bank credit only prior to 1953
Sources: ABS, RBA

of hard work and dedication to building family self-sufficiency in the absence of the generous social welfare schemes that are deeply entrenched in the developed nations.

China rapidly became a creditor nation with the US its largest creditor; a highly visible symbol of the change in the balance of economic power between the hemispheres. This change is gathering pace as China continues with double-digit growth as the US, along with most other developed nations, is recovering only gradually from the crash of 2008.

In the Australian context, I lay claim to an early warning (via my Henry Thornton blog (2005) with the statement: 'But in recognising the need for caution, we urge members of the "no hike" school to ask what happens if you are wrong. If demand keeps bubbling too strongly in the absence of rate hikes, and wages and inflation break out, there will be a painful slowdown imposed by far higher market rates at some stage. Far better to try to get ahead of the game and therefore (possibly) to head off this damaging scenario.'

This was followed by a Thornton (2006) critique of the RBA's approach to the boom, saying it was acting 'too little, too late' to curb excessive demand, unsustainable current account deficits and inflationary pressure. Other bloggers to issue early warnings included among the earliest, Professor Nouriel Roubini via the Dr Doom site.

As Mihm (2007) reported, 'On Sept. 7, 2006, Nouriel Roubini, an economics professor at New York University, stood before an audience of economists at the International Monetary Fund and announced that a crisis was brewing. In the coming months and years, he warned, the United States was likely to face a once-in-a-lifetime housing bust, an oil shock, sharply declining consumer confidence and, ultimately, a deep recession. He laid out a bleak sequence of events: homeowners defaulting on mortgages, trillions of dollars of mortgage-backed securities unraveling worldwide and the global financial system shuddering to a halt. These developments, he went on, could cripple or destroy hedge funds, investment banks and other major financial institutions like Fannie Mae and Freddie Mac.'

Gradually it became clear to more and more people that the global economic dynamic was overwhelming policy makers.

Thornton (2008a) warned against further interest rate hikes in Australia in April 2008 and in the process questioned the wisdom of rate hikes in pursuit of a target for goods and services inflation at a time when particular prices – for food, petrol and housing – were rising sharply. Furthermore, China's deflation, which had kept goods and services inflation low throughout the world economy, had turned to sharply rising inflation.

The suppression of one type of inflation – goods and services inflation – allowed easy money to spill over into other types of inflation; of assets such as shares and real estate.

In Australia, the Secretary of the Treasury, Dr Ken Henry, saw fit to describe people arguing for the suspension of (goods and services) inflation targeting line as 'seriously misguided'.

By early July 2008, the Bank for International Settlements (BIS) – the central banker's central bank – in its 2008 Annual Report issued a stern warning of a more general kind: 'The fundamental cause of today's problems in the global economy is excessive and imprudent credit growth over a long period ...'

The BIS added the prediction that the world economy was near a 'tipping point', likely to eventually slow inflation and even create a severe slowdown, even a global depression that converts inflation to deflation.

Policy response to the crisis

The first, absolutely clear evidence of real trouble came with the onset of the 'subprime' crisis in US housing markets.

Bank failures surfaced first in the UK, where in September 2007, the Bank of England announced that it had nationalised Northern Rock. This, the third largest home lender in the UK, had 'been offering home loans of up to 125 % of the value of the property and 60 % of whose total lending was itself financed by short-term lending' (Skidelsky 2009, P 8). Ironically, it was in the same month in 2007 that Lehman Brothers closed its subprime lender. Thirteen months later, Lehman Brothers filed for bankruptcy, the Bank of England having reportedly vetoed a takeover by Barclay's Bank.

Share prices fell sharply, led by bank shares. Central banks pumped billions of dollars into markets but interbank lending almost totally dried up. Bankers lost faith in each other. Rather than lending as usual to clear money transfers quickly, many bankers were asking, 'Who's next?' in the liquidation or forced merger game.

Global share prices were to keep falling until March 2009, when the main Wall Street index was 56 per cent below its recent, all-time peak.

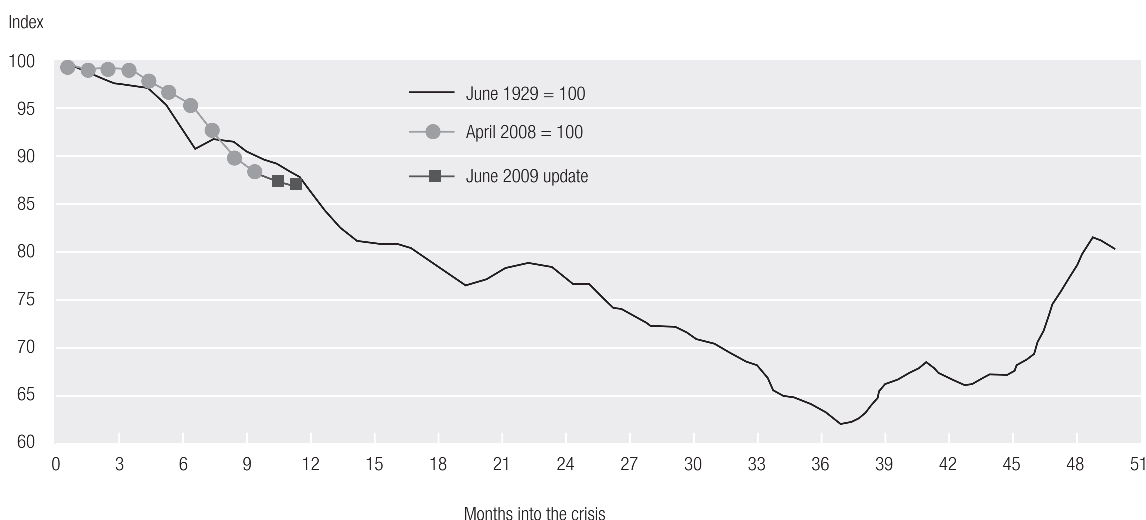
Garnaut (2008) comments: 'Platinum Age growth had continued through 2006 and 2007 as subprime and banking problems began to ooze into international consciousness.'

2008 was a year of quickening ooze and deepening concern. Commodity prices plunged as economic forecasts were slashed. Oil, at its all-time high in real terms (US$150 per barrel) in June 2008, was two-thirds that level by December and other commodities fell to less than half their peak values.

Global industrial production fell at the same speed as that during the Great Depression, as Figure 3 illustrates.

Australia's economic resilience surprised even its leaders, yet the prevailing attitude was also close to panic. It is unsurprising, then, that policy makers here also responded with alacrity.

Figure 3
World industrial output



Source: B Eichengreen and K O'Rourke A tale of two depressions, provided by John Mauldin, 'Outside the box', 22 June 2009.

"Australia's economic resilience surprised even its leaders, yet the prevailing attitude was also close to panic."

The Australian Treasury recommended substantial fiscal stimulus aimed at consumers: 'Go early, go hard, go consumers'. Its first post-crash forecast had the rate of unemployment peaking at 8.5 per cent. Since that figure was reached after allowing for substantial fiscal stimulus and with 'emergency' low interest rates, 'policy unchanged' peak unemployment was presumably close to 10 per cent. A second round of predictions reduced peak unemployment to 6.75 per cent. At the time of writing (early January 2010) it seems peak unemployment may be around 6 per cent!

('Forecast early and forecast often' is one message. The state of key policy advisors' minds is another. Having failed to manage the boom, they were determined not to be blamed for the resulting bust.)

Ben Bernanke, the new Fed Chairman, was quick to reduce US cash rates close to zero when the crisis of 2008 hit the US economy, and other central banks followed closely behind. Australia's RBA boldly cut rates in several 100 point drops, reversing the direction of monetary policy from tightening to easing more quickly than in any recent downturn,

Central banks invented what became known as 'quantitative easing', that is, buying private sector assets to inject liquidity into markets in addition to those enormous sums, approaching US$1 trillion, injected by bailing out struggling financial institutions. At one stage it was suggested that the total in bad debts of financial institutions world wide might add up to US$4 trillion; four times Australia's GDP.

Debate has been joined on the issue of what controls taxpayers are entitled to exercise over the Boards of failed financial institutions, and in particular their remuneration practices, which are seen by ordinary citizens everywhere as grossly excessive and indicative of a culture of greed gone mad.

Debate has also been joined on future financial regulation. The return of the Glass-Stegall Act is favoured by some and opposed by greedy failed financiers, seemingly immune to embarrassment or the need to take heed of obvious conflicts of interest. Higher prudential ratios, and ratios that flex upwards when booms are developing and which can be relaxed when economies are subdued, are one sensible potential reform.

Australia's banks are widely regarded as having been relative bystanders, avoiding the leading edge of financial innovation that so obviously became the bleeding edge in the US, the UK and adventurous nations like Iceland, all three of whose banks failed. (After which, the Icelandic Prime Minister told his people they would have to go back to catching fish for a living.[2])

However, Australia's banks were bailed out by the government guaranteeing all bank deposits and crucially, the banks' substantial overseas borrowings. The large overseas borrowings of the Australian banks are due importantly to Australia's massive current account deficits, and so cannot of course be blamed entirely on the bankers. These deficits show our membership of the consumptionist West with crystal clarity, although our role as provider of resources to China protects us (while China keeps growing strongly) from facing all the consequences of our chronic overconsumption.

Expansion of fiscal policy was unhesitatingly embraced by policy-makers everywhere.

The Economist (2009) estimates budget deficits as a percentage of GDP for 2009 as follows: 'US 11.9, UK 14.5, Japan 7.7, Euro area 6.5, China 3.4 and Australia 3.6.' As already noted, the red ink in most cases stretches as far as the eye can see; more than a decade in US estimation.

These are unprecedented deficits in peacetime and they provide the first real test of Keynesian economics. 'So far, so good' must be the verdict, although as outlined above, there are reasons why the stimulus effects might fade or be far less effective if further stimulus is judged to be necessary.

In Australia's case, conservative economists, politicians and would be politicians such as the author argued from the outset of the crisis that there should have been substantially less fiscal stimulus and also that within a far smaller total there should have been many fewer handouts to households, and more spending on infrastructure and in other areas to boost productivity and international competitiveness.

It was also argued that the RBA should act more decisively in curbing booms and that a more general measure of inflation, encompassing asset inflation, should be used in setting monetary policy (Thornton 2009b).

The road ahead

For both monetary and fiscal policy, discussion has begun on the 'exit problem' of emergency expansionism. Australia's central bank has bravely raised interest rates in three, 25 basis-point moves to 3.75 per cent, and further increases are expected in early 2010. Norway and Israel have also started to move rates higher.

The BIS is already warning that low interest rates may again create asset bubbles, as indeed most conservative economists have done (Smith 2009).

The Fed's Ben Bernanke has said he will keep US interest rates low for some time yet. If he gets the timing wrong, he may inherit the name 'Bubbles' from his predecessor!

Current predictions are for a 'tepid' recovery of most developed nations.

In many cases, rates of unemployment are still rising and there are greatly increased numbers of people who are underemployed and who would like to work longer hours. The US has lost about eight million jobs since the crisis broke and hours worked are at record lows (for the modern era). In the latest data release, for November 2009, there was the first positive surprise for two years, with jobs almost stabilising and the rate of unemployment edging back from 10.2 to 10 per cent.

The US is an inherently dynamic economy and the stimulus applied has been very substantial. It is likely in my view that the productivity of those employed has already risen sharply and so the economy might surprise on the upside.

Europe, especially the UK, Iceland and other chronically weak economies, are in a good deal of trouble yet, despite substantial stimulus. Spain's rate of unemployment is reported as being 19 per cent and for Europe as an entity, 10 per cent. And it would not be surprising if there were equivalent numbers of people underemployed.

Credit downgrades for some European banks and countries, and renewed bouts of share market wobbles, have followed Dubai's request for a 6-month repayment holiday on the large debts owed by a government-owned corporation.

Japan has been mired in recession for two decades (since its great share price which commenced at the very end of 1989, but has seen growth in its latest GDP statistics. Deflation in the prices of goods and services, and a declining population are chronic problems in Japan, but cyclical performance may be stronger in the immediate future.

It is China, India and the Asian tiger economies that are performing best. In the September quarter, China grew at an annual rate of 9 per cent and is forecast soon to return to double-digit rates.

China has, of course, extremely strong central leadership. When 50 million industrial workers returned to their villages at Christmas, they were instructed not to return until called for. This makes John Howard's 'WorkChoices' seem positively benign.

India reports GDP growth at an 8 per cent annual rate, while in the latest quarter, Indonesia, South Korea, Singapore and Thailand all showed strong growth.

Inflation is not yet a clear and present threat but neither is it totally corralled. In the US, Japan and China, *The Economist* (in the same statistical tables used previously) says consumer prices fell in October and estimates a similar picture for 2009 as a whole. Australia's goods and services' inflation was positive in the September quarter and estimated to rise by 1.9 per cent over the year as a whole.

By end 2009 commodity prices recovered substantially but unevenly from the recent drops and are now forecast to continue growing, though from a lower base and at a slower rate than experienced in the heady days of the great asset bubble of 2003–07.

Australia is well placed, provided China, India and other Asian nations continue to grow strongly and developed nations recover slowly without renewed crisis. One criticism is of the lost opportunities offered by the 2008 crisis to provide stimulus in a form that would add to productivity and international competitiveness .

Australia has a crying need for strong investment in infrastructure and could boost its sustainable growth by spending more on research and development,

"A sustained resumption of the China boom, as now seems likely, will give Australia new chances and challenges."

and by improving incentives to work, to save and to innovate.

It must be hoped that Dr Ken Henry's tax review will offer bold advice on this matter.

A sustained resumption of the China boom, as now seems likely, will give Australia new chances and challenges. The general challenge for Australia is to avoid boom and bust. Bold tax reform, to encourage saving, wise investing (including in high tech new age industrial production) and entrepreneurial flair is surely part of the answer. Maintaining our world leading performances in agriculture, mining, medical science and treatment, many sports and some aspects of education is another big part of the answer.

A proper understanding of the challenges before us is a necessary start.

Risks to sustained recovery

The most obvious risk has already been canvassed. It is that recovery fades as stimulus is withdrawn.

At best, fiscal and monetary authorities face a difficult and tricky balancing act. Withdraw stimulus too quickly and business and household confidence weakens. But, a renewed shock might weaken confidence and yet another stimulus may be beyond the power of further fiscal expansion or renewed monetary ease to remediate.

Should stimulus be withdrawn too slowly, inflation will take hold and that would destroy confidence almost as surely as a premature withdrawal of stimulus.

Continued strong growth in employment, with the marginal reduction in Australia's rate of unemployment, is a particular risk to Australia's so far stunning recovery.

Indeed, with a resumption of the mining boom, skill shortages will soon re-emerge in the 'miracle economy'. This is a risk to recovery almost unique to Australia (Uren 2009).

We must all hope that stimulus will be withdrawn at just the right speed; the 'Goldilocks' solution. But if not, the global economy may lapse into erratic behaviour, bouncing between an inflationary ceiling and a recessed floor, with authorities pulling policy levers that are not reliably connected to the outcomes that matter: jobs, growth and steady confidence.

There is also some risk of another shock. The proposed debt repayment freeze for the Dubai development corporation briefly rattled the markets but recovery was fast. Not much has been heard yet about the debt problems of European banks, but large loans were made to Eastern European companies and countries where economic performance has been especially poor. The European banks could yet be hiding large, and potentially bad debts and a single large failure could unleash a cascade of bad debts. This would end the tepid recovery of the western nations and send policy back into the melting pot.

In addition, what if the other 'imbalances' between the developed West and the developing East fail to be resolved? The United Nations Climate Change Conference in Copenhagen has exposed damaging geopolitical fault lines and created a challenge to political correctness. How fair is it for the West, so far responsible for most of the excess emissions of greenhouse gasses, to insist the developing East curtail development to make a serious contribution to overall elimination of emissions?

Even if nations at Copenhagen had achieved agreement to adopt the deep emission cuts that scientists believe are needed to prevent serious global warming, who would have policed this agreement and at what cost to economic growth?

Even if a harmonious and not too costly agreement between East and West is eventually achieved, what of China's steady acquisition of US Treasury bills and bonds? China's strong current account surplus offsets the growing current account deficit of the US.

China must learn to spend more and the US to spend less. Furthermore, a rising Chinese exchange rate is necessary if this is to happen with the least amount of friction. But China wants its industries to remain competitive and apparently is happy to build up its holdings of US government paper and other western nation's assets (including Australian resource companies).

The biggest threat is perhaps that the world economy is facing the serious possibility of instability caused by policy swings: expansion/recovery/asset inflation/goods inflation/policy tightens/economy falls back etc. Such outcomes would destabilise the beliefs of the econocrats in major countries, as well and their political masters.

The confidence engendered by the apparent success of the 'Keynesian' policies followed so far might evaporate with the results impossible to predict with any certainty.

Some implications for individuals, businesses and governments

It is an old saw that 'time in the market beats market timing'. If the global economy is doomed to bounce between an inflationary ceiling and a recessed floor, investment strategies will need to be revised.

Many more people will at least be tempted to try to get market timing right; to ride the updrafts and avoid the downdrafts. Some will succeed; many will fail. People with the mind of a mollusc, of course, will avoid temptation.

Boards of directors need to ask if the age of corporate 'leverage' is over. There are many stories of sound businesses having a devil of a time renewing loan agreements, with very tough but entirely understandable need for reassurance by the banks concerned.

An obvious question for executives and boards is whether corporations should reduce debt still further.

It can be very difficult to transfer money ashore, even to finance a child's education at an overseas university. There are many cases where money owing or pledged to Australian companies has been held up by overseas banks on the flimsiest of excuses.

Hedging strategies, even policies not to hedge, need careful re-evaluation, especially in a world of erratic movement between floor and ceiling.

Governments – especially governments of a potentially fast growing country like Australia – need to worry far more than they have about providing infrastructure. Other policies to promote productivity and international competitiveness need careful evaluation. Governments also need to worry about promoting an entrepreneurial culture. Tax policy needs a total rethink with these objectives in mind.

Central banks need to consider whether or not to take systematic account of asset inflation, and how to do this. System-wide stability needs more attention than it has had, and the problem is inevitably global.

Financial system regulations need careful review. The aim should not be a new set of regulations designed to stifle initiative. Rather, we need to decide whether 'commercial banks' need to be regulated like providers of water and electricity, with 'investment banks' and their clients essentially unregulated and subject to the rule of *caveat emptor* – investor beware!.

No 'investment bank' should be too big to fail, so a stronger version of Australia's Competition and Consumer Commission is needed at home and abroad. Global rules need to be devised and policed to keep inherently risky financial service organisations small enough to fail without putting the prosperity of the world economy at risk.

The most difficult question of all concerns how we should regulate economic life. Booms and busts have always been part of the capitalist system. Failure is not all bad. It punishes the incompetent, the criminal, and breaks up cozy clubs of all-powerful old men.

Wild West economies provide opportunities for the young and adventurous and for brave buccaneers.

But what is also needed is for sections of the capital market where people can feel reasonably sure that their money will be safe when the sun comes up in the morning.

Getting this balance right is the task for the young people of this generation and the next. As said at the start of this paper, these are the views of a guarded optimist!

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