The financial crisis: lessons and perspectives

Presentation by Olivier KLEIN at the Cercle Pierre Mendès France in Lyon on 17 April 2014

I will structure my presentation around three main strands:

- The causes of the major financial and economic crisis of 2007-2009

- The causes of the Euro Zone crisis

- The lessons. What lessons can we learn? Have we learned them? Has the crisis been resolved or could it recur?

I) <u>The causes of the major financial crisis of 2007-2009</u>

- Let us travel back in time to try and explain the origin of the crisis. A good starting-point is the violent crash of 2000 caused by the burst of the dot.com technology bubble. In June 2000 the CAC 40 was at 7,000 and in March 2003 it was at 2,300. So we are looking at a gigantic stock market crash. Recall that between 2000 and 2003 – namely in 2001 – the 9/11 attack in the United States further undermined the foundations of confidence. Then in 2002-2003 it emerged that a number of enterprises, including some of the biggest, had given in to the temptations of creative accounting. Remember the falsified accounts of ENRON, WORLDCOM or PARMALAT, for example. This triggered a significant crisis of confidence and a violent credit crisis since in 2003 liquidity almost vanished from the corporate bond market. Almost all major groups were hardly able to borrow at all on the financial markets and their risk premiums increased to dizzying heights.
  This combination of events caused severe recession and real fear of deflation. Fortunately, the US Federal Reserve and various other central banks reacted strongly and fairly rapidly by pumping in liquidity and reducing rates. Remember that in 2000 the Federal Reserve's reference rate was 6%-7% and in 2003 it was just 1%. Interest rates were divided by almost a factor of 7 over a very short timescale. This is also a measure of the extent of the crisis. Thanks to the vital intervention of the Federal Reserve and other central banks, there was a low interest environment until 2004, avoiding an even deeper world recession. The action on interest rates in fact supported not so much the stock markets but the property market, thereby generating a psychological "wealth factor" which enabled the American consumer to serve as the "consumer of last resort". Then, at the end of 2003 and early in 2004, growth was restored.

- The second contextual aspect is globalisation which also contributes to explaining the 2007-2009 crisis. Globalisation was clearly the fruit of the emerging countries which in the 2000s opted for a very different development model from that adopted by the Asian countries and which proved its limits with the 1997-1998 crisis. The latter model was based on domestic consumption but was held back by the constraints of current trade balances and the abrupt fall in previously excessively buoyant capital markets. In 1997, short-term capital investments in emerging countries, made in search of higher yields, were suddenly withdrawn – creating panic. The emerging countries and notably those in Asia learned their lesson and sought another method of development more favourable to them. They adopted a model based on exports by seeking out demand in the developed countries. This was totally legitimate and rationally based on their comparative advantages – i.e. low labour costs and therefore highly competitive prices in certain product ranges. The model was also developed on the basis of undervalued currencies to facilitate exports and therefore support growth dynamics. In the 2000s, the production capacities of the emerging countries increased sharply From then on, world supply was confronted with significant production overcapacity since during the same period the developed countries, which in consequence faced competition for their own production in certain product ranges, did not reduce their own production levels proportionately. Internal demand in the emerging countries was not yet driving world growth via sufficient extra demand.

  World supply of goods and services exceeded demand with, as a corollary, high levels of savings worldwide, exceeding investment. This is what Bernanke, the former president of the US Federal Reserve, when he was still a professor, referred to as the "savings glut". In fact, the emerging countries themselves saved a great deal since they consumed little and enjoyed increasing revenues. They generated significant excess savings which were not sufficiently absorbed by a concomitant increase in domestic investment. Interest rates were structurally low because the world's financing capacities exceeded the financing requirement.

  At the same time, real wages in the developed countries increased very little or not at all, since worldwide wage competition in given sectors of activity and in the product ranges concerned prevented any ongoing regular increases in purchasing power. This resulted in very low inflation and very low interest rates.

- The third contextual element: automatic refinancing of the American current trade deficit which was the counterpart of the above. China, the oil-producing nations and other emerging countries decided, as we have just seen, to expand growth by increasing exports with domestic consumption remaining low. They experienced growth of their current account balance of payment surpluses. Symmetrically, the United States in consequence experienced current account balances which were increasingly in deficit. But, with in addition exchange rates deliberately kept low, these accentuated deficits did not act as a constraint for a very simple reason: as the Chinese accumulated currency

reserves through the build-up of current account surpluses, they invested them in the United States. So that capital shifted spontaneously to the United States, fundamentally painlessly financing the increase in American debt (of individuals, companies and even States). There was a kind of automatic recycling of surpluses from the emerging countries to the countries running deficits – primarily the United States. Long-term interest rates, here again, remained very low, since additional American debt was refinanced without any difficulty and without tension. Then in early 2004, as growth was restored, although the Federal Reserve increased its short-term rates significantly, up to 5%, long-term rates rose little or not at all. This historic de-correlation between the movement of long and short-term rates aroused a reference by Greenspan, then the head of the American Central Bank, to a "conundrum", that is an enigma. The enigma was as follows: "How come that whereas the Federal Reserve significantly increased its short-term rates, the long-term rates did not automatically increase?". The reason was probably not such an enigma as we have seen.

The consequence for private borrowers was that debt was greatly facilitated by rates lower than nominal growth rates from 2003 to 2007. In a way it all happened fundamentally as if the world overproduction created by unregulated globalisation had been concealed by means of increased consumption in the developed countries, except that it was on the basis of progressively unsustainable debt ultimately resulting in a real situation of excess debt. The all-round increase of debt against a backdrop of stagnating purchasing power in the developed countries sustained – in a highly artificial manner – growth levels which otherwise could not have been achieved.
In 2000 household debt in the United States was 100% of disposable income and in 2007 it was 140%. In Spain or Great Britain it increased from 100% to 170%. In France it increased from 55% to 70% and in the Euro Zone, from 65% to 85%. The only country which did not experience an increase in household debt was Germany: 70% in 2000 and the same in 2007.

Company debt also increased significantly between 2000 and 2007. With the return to growth from 2004, borrowers and lenders entered into a euphoric phase and forgot the traditional rules of prudence both concerning debt levels which exceeded their historic average and risk premiums which reduced dangerously, as for all credit bubbles. This was the effect of a well-known form of cognitive bias referred to as "disaster blindness". In fact, as the last great crisis becomes more and more remote people forget that a new large-scale crisis could recur and they also forget the disastrous consequences. The more time passes, the more probable becomes the return of a catastrophic crisis. As a result, in the financial sphere debts are gradually accumulated along with vulnerable positions which obviously turn out to be dangerous when the bubble bursts after the economic downturn. Banks and market lenders ease the conditions for granting credit, require fewer guarantees and accept lower margins. Selection becomes more lax and leverage increases. In parallel, borrowers forget the elementary rules of prudence.

It should be added that from the mid-1990s there was a phenomenon which accelerated in the 2000s and which facilitated high debt levels: securitization. Securitization consists in removing loans from the balance sheets of lending banks and converting them to packages of debts sold to financial investors or indirectly to individuals. From 2005, securitization experienced exponential growth, notably at American banks. Unregulated securitization occurred in the most anarchic way possible. There was securitization of non-homogeneous debt, securitization of securitization… The complexity contributed to the opaque nature of the practice and made it very difficult to assess the true value of these investments. In addition, securitization allowed certain banks to shrug off any sense of responsibility for the loans they were granting. If a bank grants a loan which it then securitizes and sells shortly afterwards, it can exonerate itself both from any serious risk analysis of the borrower or any monitoring of the borrower. It is part of the economic role of banks to monitor and advise customers, if only to avoid excess debt for both companies and individuals. In certain banks, a kind of conduct known as “moral hazarding” became endemic inasmuch as their own actions generated excess risk for the economic system. Finally the general dissemination of securitization packages, whether to non-professional investors or those who were supposedly knowledgeable, resulted in general uncertainty as to who bore the risks and what were the effects, systemic or otherwise, of the situation: to sum up, there was no prudential supervision. Traditional financial and economic theory, which assumed that a broad spread of risk is better than a concentration of risk at banks even supervised and professionally trained to manage risk, was proved to be totally wrong. The devising of increasingly more sophisticated instruments (CDOs, CDOs of CDOs etc.) enabled many investment banks to reap increasing revenues since they were the financial engineers behind the products. In America, the paroxysm of securitization consisted in setting up various types of subprime loans. In many cases, real estate loans were offered to people without revenue to repay them. These were referred to as NINJA loans “No Income, no Job, no Asset”. Everything was based on the idea that the price of real estate would permanently increase and that it would suffice to sell the asset to reimburse the loan, regardless of regular household income. When securitization was revealed to be problematic, the holders of the securitization vehicles, seeking to obtain reimbursement from the debtors, occasionally realized that even contractual documents did not exist. So it was not only “No Income, no Job, no Asset”, but sometimes “No Document” either.

Investors, whether individual or specialist, had been trapped by a classic cognitive bias: the anchoring effect. In fact, until the end of the 1980s, long-term interest rates were set at very high levels. These rates reduced regularly and significantly in the 1990s and 2000s. Investors had in mind (this is the anchoring effect) much higher yield rates than those they were offered which were compatible with the prevailing economic growth rates and inflation rates. They wanted a yield offer satisfying their expectations and they did not trouble to understand how such “abnormal” yield rates were possible, i.e. at the cost of overlooking the level of risk intrinsic in the investment, with high debt levels or cascading debt, for example. Some companies agreed to increase their level of debt to present a return on

equity compatible with investor expectations – sometimes through recourse to accounting and financial acrobatics.

The period 2003-2004 to 2007 was a euphoric phase, not very different in reality from the euphoric phases of the 19th century or the first half of the 20th century. These phases comprised credit bubbles, real estate bubbles and/or stock bubbles. In a recent phase, there was a real estate bubble and a credit bubble, which were self-fulfilling prophecies. During all these euphoric phases, blindness to disaster ("disaster myopia") was amplified. Preventive reactions were dulled as time passed, therefore causing a very real possibility of a return of crisis.

To conclude this first part, note that the 2007-2009 crisis was history repeating itself, aggravated by a new development in the form of securitization. There was an extraordinary real estate crisis notably in the United States, England and Spain. At the same time, there was a debt and leverage crisis, followed naturally by widespread disposal of debt and deleveraging which is still continuing and indicates that for some time, growth will remain very low. Add to the mix the major liquidity crisis which then emerged, intertwined with the real estate crisis, the credit crisis and that of debt.

In 2008, there was a liquidity crisis of extraordinary violence. Confronted by the fundamental uncertainty as to who held what, and on the very content of securitization instruments, no-one was prepared to lend to anyone. Notably the inter-bank market was totally frozen. If the central banks had not intervened on a massive scale, there would have been no more banks. A very serious liquidity crisis also occurred in 2010-2011 for banks in the Euro Zone.

From 1987, badly regulated financial globalisation *de facto* caused the reappearance and repetition of systematic crises combining the aforementioned three types of financial crisis.

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II) Analysis of the Euro Zone crisis

I will now analyse the Euro Zone crisis. It could be said that the Euro Zone crisis was a consequence of the previous world financial crisis. I am not in total agreement with this statement. Although various arguments may hold true: governments were confronted by public debt which increased following the 2008-2009 crisis and some of them contributed funds to their banks to save them, and growth collapsed, so these governments sought to counter the cycle and spent a great deal more, which was relatively legitimate. However, in European countries, the increase in expenditure was combined, in some cases, with long-standing pre-existing public finance deficits. In France, for example, the budget had not been balanced since 1974. I am a great believer in the efficacy of budgetary policy and the utility of public deficits, but subject to one single condition, that they are temporary and that when the economic climate improves, surpluses are generated. This allows incurring debt at an appropriate time and reimbursing the excess debt when times are better. Permanent deficits, in reality, exhaust the budgetary policy for when public debt is too high, the budgetary weapon can no longer be used. The public debt crisis in the Euro Zone was not a simple consequence of the previous financial crisis, since the same increase in the rates of public debt, following that of private debt, did not pose the same fundamental problems in the United States, Japan or elsewhere. This problem was idiosyncratic to the Euro Zone. Why?

As a consolidated entity, in fact, the Euro Zone did not experience a problem. Its situation would have been even better than that of the United States and significantly better than that of Japan. The creation of the Euro Zone was an interesting and forward-looking gamble, provided the missing vital ingredients were added or that only countries experiencing long-term strong economic convergence were admitted.

Two schools of thought opposed creation of the Euro. One imagined that, according to the history of the creation of Europe from the outset, economic progress would drive political progress. In fact, if a monetary zone incorporates countries which are not all similar in terms of economic standards or their economic climate it is vital, if the monetary zone is to function effectively in the long term, for it to possess three attributes:

- Coordination of the economic policies of the countries comprising the monetary zone;
- A fiscal transfer system which allows, as in the United States, assisting a State in temporary difficulty thanks to the existence of a federal budget;
- Mobility of labour between the various countries according to the development of their reciprocal economic climates, to prevent building up unemployment zones in countries experiencing more difficult economic times.

Under these conditions, creation of a single currency facilitates both intra-zone trade and stable expectations of economic players. But above all, it is strongly advised to analyse the current account balance in the periphery of the monetary zone and not that of each constituent State. This would immediately avoid restricting the growth of a country experiencing a more favourable economic climate than the others, for example given its demography, whereas if an external constraint is exercised within its own boundaries, the growth differential would immediately result in a deficit in the current account balance that sooner or later would require a restrictive policy to restore its balance of imports and exports. A good example is the various States in the United States.

Unfortunately the Euro Zone does not have any of these attributes:

- Mobility of labour: in Europe this is hindered because different languages are spoken. In the United States everyone speaks English. This facilitates mobility. Historically, geographical mobility is stronger in the United States than in Europe;
- The coordination of economic policies: in Europe there is no economic government. Only France seems to desire a European Economic Government, irrespective of the political shade of that government. There is therefore, properly speaking, no well-constructed mandatory coordination of economic policies, which would allow, if applicable, organising recovery in Germany while obliging the Southern European countries to slow down to restore their budget balance, thereby reducing the economic and social effects of the slowdown;
- Budgetary transfers: the European budget is approximately 1% of the GDP of the European Union. And none of its countries and populations exhibit solidarity with the others or accept the idea of the transfers necessary for satisfactory operation of the monetary zone. Obviously for such transfers to occur, a necessary but unfortunately insufficient condition is establishing federalized supervision of national budgets. In fact, no population can exhibit solidarity if it believes there is no basis for that solidarity, or may even encourage other populations to exercise no self-discipline and promote morally hazardous forms of behaviour. But the supervision condition is not adequate and manifestly for historical reasons and certainly for reasons of political will, Europe lacks both the desire to share and to manifest solidarity between Nations, any sense of belonging to the same community of shared interests.

Without mobility of labour or coordination of monetary policies and budgetary transfers, the only method of adjustment in the event of an asymmetric shock between countries within the zone is for countries in difficulty to seek out the lowest-cost social, economic and regulatory solutions. Internal devaluation is the only option since adjustment by movement in exchange rates is no longer possible. This new method of regulation and adjustment leads to a lack of sustainable growth in the Zone and to medium or long-term social and political difficulties given the permanent obligation to adjust downwards.

This does not at all imply that countries in a zone of full monetary union can allow themselves to become lax or avoid structural reforms essential to the search for competitiveness and an increase in their growth potential. Nor would full monetary union in the zone exempt them from efforts to eliminate the unsustainable nature of their deficits and public debt. But even assuming that all countries had carried out structural reforms, it remains the case that an incomplete monetary zone, i.e. one without the aforementioned attributes, inevitably leads to deflationary pressure within the zone. The Euro Zone is incomplete and has dangerous bias.

The second school of thought on creation of the Euro Zone was based on the premise that any form of federalism was not desirable and not realistic. The attributes of a complete Euro Zone could not, in their view, be envisaged. The solution was to ensure that all countries participating in the zone were similar and shared the same economic climate. This required respecting convergence criteria (on rates of inflation, public deficits and public debt) at the time of entry to the zone and subsequently. By adopting this view the second school of thought also made several errors as has been proved over time.

The first error was to allow entry to the zone of countries which were not convergent. Either because they were “creative” with their statistics and people were unaware, or even because that was the case and was known to be the case.

The second error was the failure to grasp that a monetary zone would probably result in industrial polarisation. With a single currency, by definition there is no more variation in exchange rates between the participating countries. This gives companies the possibility of producing exclusively in a single country in the zone to take advantage of optimum production conditions. These companies need not be located in the major countries with a view to avoiding exchange rate fluctuations capable of vitiating the competitiveness of their production plants.

We should add that a single monetary policy for countries experiencing divergent situations can aggravate the divergence. In Spain, for example, which experienced a higher inflation and growth rate than Germany, the interest rate fixed by the European Central Bank for the whole zone was below that desirable for Spain itself, which permitted painless debt and fostered the property bubble. In the long term, the growth rate was driven in Spain by growth of household and corporate debt.

The third error was a market error. Financial markets, contrary to the traditional theory, are not omniscient. They are not permanently wrong, but they are frequently wrong. In this case, with the creation of the Euro Zone, they believed that the Greek or Spanish current account balances did not need to be supervised as such. In fact they conflated the long-term rates of all the countries in the Zone towards the German rate. In consequence, there was market seism, no warning concerning the unsustainable trajectories of certain countries in the zone. The markets failed to play their role. If, prior to occurrence of the crisis, the

markets had sounded the alarm bells by increasing long-term interest rates to warn that the risk was increasing, given domestic debt and current account deficits that were difficult to sustain, macro-financial constraint could have been exercised upstream and avoided all or a part of the crisis.

In 2010, the markets suddenly became aware of the increasing divergence in the Euro Zone and of its incapacity to self-regulate. Both schools of thought had in fact been proved wrong. No solution for this type of situation had been envisaged by any of the public authorities within the Euro Zone. As a result, for too long, the Greek crisis was simply denied. When it was acknowledged as a serious problem, too much time had elapsed to deal with it.

But above all, given the absence of the aforementioned attributes constituting a full monetary zone, we have not experienced any true economic coordination or assumed transfers of public subsidies from the more favoured countries to the less favoured countries, as occurs to good effect in the United States. Apart from the specific question of Greece, which had failed to respect the basic rules and to show economic common sense, the only method of adjustment in the Euro Zone was to ask for a considerable effort in each country in difficulty to reduce public expenditure, increase fiscal pressure and restore competitiveness through internal devaluation of the zone by reducing costs. This certainly resulted in a weakening in demand which, in turn, reduced imports with a drastic reduction of the current deficit. But this type of policy, in addition conducted by several countries at the same time, inevitably results in a widespread slowdown in growth. Tax receipts are linked to growth levels. This creates a kind of high-speed chase with on the one hand, a reduction in public expenditure combined with compression of costs and increased taxes and, on the other, reduced tax receipts caused by the induced slowdown of growth. However, this does not mean that structural reforms were not strictly essential for the countries concerned, for only these reforms could increase growth potential and bring about an underlying restructuring of the situation with a change from growth driven by debt to growth based on productivity gains, innovation and mobilisation of the working population. However such structural reforms, to be successful and accepted, must be accompanied by an economic policy which is not in itself depressive.

The Euro Zone, confronted by the lack of institutions permitting regulation, experienced two vicious circles.

The first vicious circle was that of public debt and interest rates. The domestic competitive devaluation policies and reduction in public expenditure, as described above, reduced demand and weakened growth which, in turn, prevented collection of taxes at the anticipated levels and therefore any reduction in budgetary deficits. Public debt continued to increase and the financial markets became increasingly mistrustful of the sustainability of the trajectory of public finances of the countries in question, then suddenly increasing the long-term interest rates in these countries, thereby causing a spiralling increase in their

public deficits since governments were obliged to borrow at increasingly high cost. The first vicious circle was then fatally formed.

The second vicious circle was that which links countries to banks. European banks, in general, hold the debt of their State but also, given the financial integration caused by creation of the Euro Zone, that of other States in the zone. When some of these States are considered as excessively in debt, the corresponding assets of the banks are considered as potentially toxic. This then triggers the following vicious circle: the financial markets are distrustful of the banks in question and lend to them at much higher rates, or lend far less capital, which makes them far more vulnerable. This makes the States appear even weaker, and eventually under an obligation to save their own banks. This triggers increased distrust vis-à-vis the same banks.

We have broken out of these two fatal vicious circles thanks to two measures. The first: Mario Draghi launched a vast programme for supplying liquidity to European banks (VLTRO) and, in 2012, announced that the European Central Bank could buy public debt of States in the Euro Zone if their interest rates were too high and speculatively moving away from a balanced rate. Mario Draghi added: “Whatever it takes”. By this announcement, the President of the European Central Bank successfully calmed the markets, allowing the long-term interest rates of countries in difficulty to return to a more sustainable trajectory, i.e. to a level closer to that of nominal economic growth. Ultimately the European Central Bank holds significantly less public debt of Member States than reciprocally the Bank of England or the US Federal Reserve.

The second measure was the establishment of European Banking Union. This incorporates three elements. First of all, so that solidarity really works, federal supervision must be accepted. Therefore, supervision of the major European banks has shifted from the national to the federal level, i.e. to the European Central Bank in Frankfurt. Solidarity operates on two levels. After having applied the “bail-in” rules, i.e. to re-float banks in difficulty via their own shareholders and creditors, a pooled fund between European banks to save any bank still in serious difficulties may be established. The second pillar of solidarity: an inter-bank guarantee fund for customer deposits.

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To conclude, is it possible to believe today that all the fundamental problems of the Euro Zone have been resolved? Short-term confidence is in order principally because the European Central Bank is credible in its determination to intervene if the situation should deteriorate. But can the Euro Zone countries concerned recover thanks to the time Mario Draghi has so skilfully bought for them? Many so called “peripheral” countries in the zone have significantly improved their current account balances. Time seems on their side. But, on examining the situation more closely, as we have noted previously it was essentially the

reduction in demand which had an effect. Restructuring of production facilities and reindustrialisation, if it occurs, will only be slow. Debt reduction of economic players, whether public or private, also takes time. The consequence is a very low level of growth for a significant period, with correlated unemployment rates. The question is therefore one of the patience of populations regarding these long-term phenomena. The increase in populist movements and anti-European feelings is not unexpected. Once again, this is not a calling into question of structural reforms which were put off for too long and were strictly necessary, but merely underlines the difficulty of reducing expenditure and reducing the debt of many countries simultaneously and rapidly.

Finally, will there be other financial crises? Our opinion is that these are inevitable in the world as it currently is. On the one hand, because finance is intrinsically unstable and we have long experienced, for the last thirty years, financial cycles followed by euphoric phases with credit bubbles and asset bubbles – notably involving equities and real estate – and then depressive phases with the bursting of these bubbles, reappearance of a liquidity crisis and then a major financial crisis.

Financial and banking regulation is necessary, but even assuming it to be perfectly efficacious, it would simply smooth over the ups and downs without eliminating the sequence of up and down phases. On the other hand, prudential regulations themselves are not exempt from errors. From time to time, they seek to correct the causes of a previous crisis but underestimate future causes. Finally, in some cases excessive or poorly judged regulation can itself increase the cyclical propensity of finance, or even trigger the next crisis.

In our opinion it is possible to attenuate financial instability through good measures and prudential good regulation, but it is illusory to imagine instability can be eliminated. Also, it is absolutely vital to regulate the banks. But it would be dangerous to seek to reduce the risks they take to excessively low levels, since their economic and social utility resides in the fact they are risk centres – for credit, interest rates, liquidity etc. – and that they are responsible for professional management and supervision of those risks. It would probably cause even greater instability to shift the risks outside banks into "shadow banking" and hedge funds not subject to much or any control or to individual companies and households which are not armed to manage such risks.

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