

The Global Depression: Causes and Prospects for the US and Developing Countries



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Presentation for

**THE INTERNATIONAL WORKING GROUP ON
GENDER, MACROECONOMICS AND
INTERNATIONAL ECONOMICS**

**Knowledge Networking Program on
Engendering Macroeconomics and International
Economics**

WORKSHOP: JUNE 29-JULY 10, 2009

US: Causes of Crisis

- Global savings glut – global imbalances
- Fed left interest rates too low
- Fraudulent lending practices
- Financial innovations: Originate and Distribute
- Faulty Risk Management Practice
- Hedge Funds – Private equity
- Derivatives --- credit default swaps
- Excessive Regulation (CRAs) –
- Faulty Regulation – single variable, micro regulation
- Credit Rating Agencies
- Off Balance Sheet entities
- Poor people (Housing policy – CRA, FNMA)
- NOT ME!

Structural Causes

- International: lack of symmetric adjustment
- Domestic: Unequal Distribution of Income
 - High profits low wages
 - Real wages > productivity growth
- Globalisation: profits invested abroad
 - Imports are from US owned companies
- Demand deficiency:
 - Households could spend only by borrowing
- Finance: Housing finance
 - Commodity speculation

Role of Finance

- Private Equity funds – pressure on profits, wages
 - Outsourcing of jobs and investment
 - Price stability, lower import prices
- Mortgage finance – Fannie, Freddie, subprime
 - Provided financing for rising consumer debt/ commercial real estate
- Real Return Investment Funds
 - Commodity price speculation (biofuels)
 - Energy price speculation
- Rising Demand in Developing countries
 - Rising terms of trade -- Rising Capital Flows
- Rising International Reserves--Reduced US interest rates

US Outlook

- Can the egg be put back together?
- Deleveraging
 - Financial Institutions -- lower financing
 - Households – lower demand
- Decoupling -- Deglobalisation
- Balance Sheet Recession vs Cyclical downturn
 - Insolvency ↔ Liquidity crisis
- Demand Stimulus
 - Currency archeology
 - National accounting – higher household saving

Contentious Issues

- Employment impact of stimulus
- The Deficit is too large
 - Can't borrow any more – rating downgrade
 - Will cause higher interest rates
 - Will cause inflation
 - Exit strategy
- What is Fed Policy?
- What is Treasury Policy?
 - Tarp, PPIP, Nationalisation
 - New Regulatory Structure

Table 2: Summary of recent policy measures

Timing	Measure	Details
September 18	SEC Halts Short Selling of Financials Stocks	Acting with U.K. Financials Services Authority, the SEC will prohibit the short selling in Financial companies until October 2, 2008, later extended to October 8th.
September 19	Temporary Guaranty program for U.S. Money Market Fund Industry	The Treasury will insure holdings of any publicly offered 2a7 fund that pays a fee to participate. One-year program, beginning at close of business on September 19, 2008. Make available assets in Exchange Stabilization Fund for up to \$50 bn. More details forthcoming; and likely scaled back from original proposal.
Announced over the weekend of September 21, passed by Congress on October 3	Troubled Asset Relief Program (TARP)	Government can issue up to \$700 bn of Treasuries to finance the purchase of troubled assets originated before 9/17/08. Full list is to be determined, but it will include at least Residential and Commercial mortgages (securities and whole loans). U.S. financial institutions or those with large U.S. operations can participate in reverse auction. Treasury will have authority from date of enactment for a period of two years. Subject to Congressional add-ons which could slow process.
October 7	Commercial Paper Funding Facility (CPFF)	Fed's CPFF will provide credit to an SPV, which, in turn, will provide "funding backstop" for term commercial paper. The SPV will purchase A-1/P-1 rated, USD commercial paper. The amount purchased from a single issuer will be capped at the greatest amount of CP the issuer had outstanding between January 1 and August 31st of 2008. The program ends on April 30, 2009, unless extended.
October 8	Global Rate Cut	On October 8, the U.S. Fed, together with Bank of Canada, the Bank of England, the European Central Bank, Sveriges Riksbank, and the Swiss National Bank all cut policy interest rates.
October 12	European Bank Debt Guarantee	Euro zone countries adopted a common plan to assist the financial sector: including guaranteeing bank debt through the end of 2009, governments injecting capital into banks in the form of preferred shares, commitment to assist "systemically" important banks in distress, regulator forbearance on accounting standards. Each nation will implement the plan separately.
October 14	US Bank Capital Injection and Debt Guarantee	The Treasury announced plans on October 14th to inject \$250 bn into US banks in a form of a 5% NC3 preferred, under the TARP program. Nine large banks agreed to issue the preferred prior to the announcement. In addition, FDIC will insure newly issued unsecured debt of member banks through June 30, 2012.

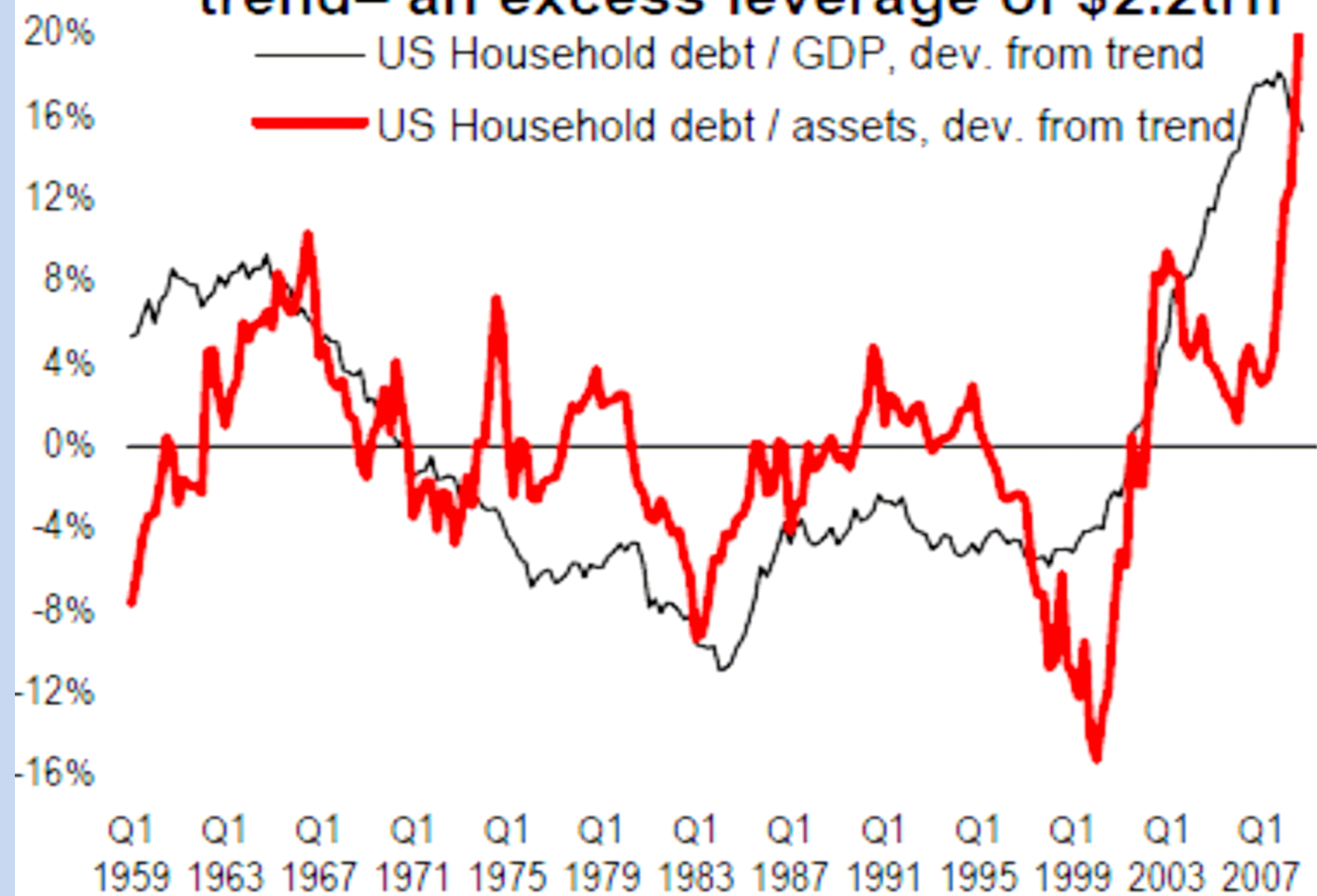
Source: Merrill Lynch.

Table 1: Government assistance to banks: capital and funding

Program	Eligibility	Cost / Pricing	Size	Timing/Period
TARP Capital Purchase Program	U.S. controlled banks and S&Ls	5% NC3 for the first five years, and 9% thereafter. Could be redeemed at any time with proceeds of Tier 1 or common equity capital. Treasury receives 10Y warrants to purchase common in the amount of 15% of the preferred investment.	Between 1 and 3% of risk-weighted assets, not to exceed \$25 bn. Total program size is \$250 bn.	Announced on October 14th. Companies must agree to participate by November 14th, 2008.
Commercial Paper Funding Facility (CPFF)	A-1/P-1 rated, USD commercial paper, including ABCP, from U.S. issuers (including U.S. issuers with a foreign parent)	Unsecured CP: 3M OIS + 100 bps (plus 100 bps "unsecured credit surcharge"); ABCP: 3M OIS + 300 bps.	The amount purchased from a single issuer will be capped at the greatest amount of CP the issuer had outstanding between January 1 and August 31st of 2008.	Announced on October 7th. Starts on October 27, 2008 and expires on April 30, 2009, unless extended.
FDIC Temporary Liquidity Guarantee Program	Member bank senior unsecured debt issued on or before June 30, 2009, including promissory notes, commercial paper, inter-bank funding, and any unsecured portion of secured debt	75 bps to insure new debt issues and 10 bps to insure non-interest bearing deposits above the current limit of \$250,000.	125% of debt that was outstanding as of September 30, 2008 that was scheduled to mature before June 30, 2009.	Announced on October 14th. All FDIC-insured institutions are automatically covered for the first 30 days, and can opt out at the end of this period. Coverage is limited to June 30, 2012, even if the maturity exceeds that date.

Source: Merrill Lynch, Federal Reserve Bank of New York, FDIC, U.S. Treasury.

US household debt to GDP is 15% above trend— an excess leverage of \$2.2trn

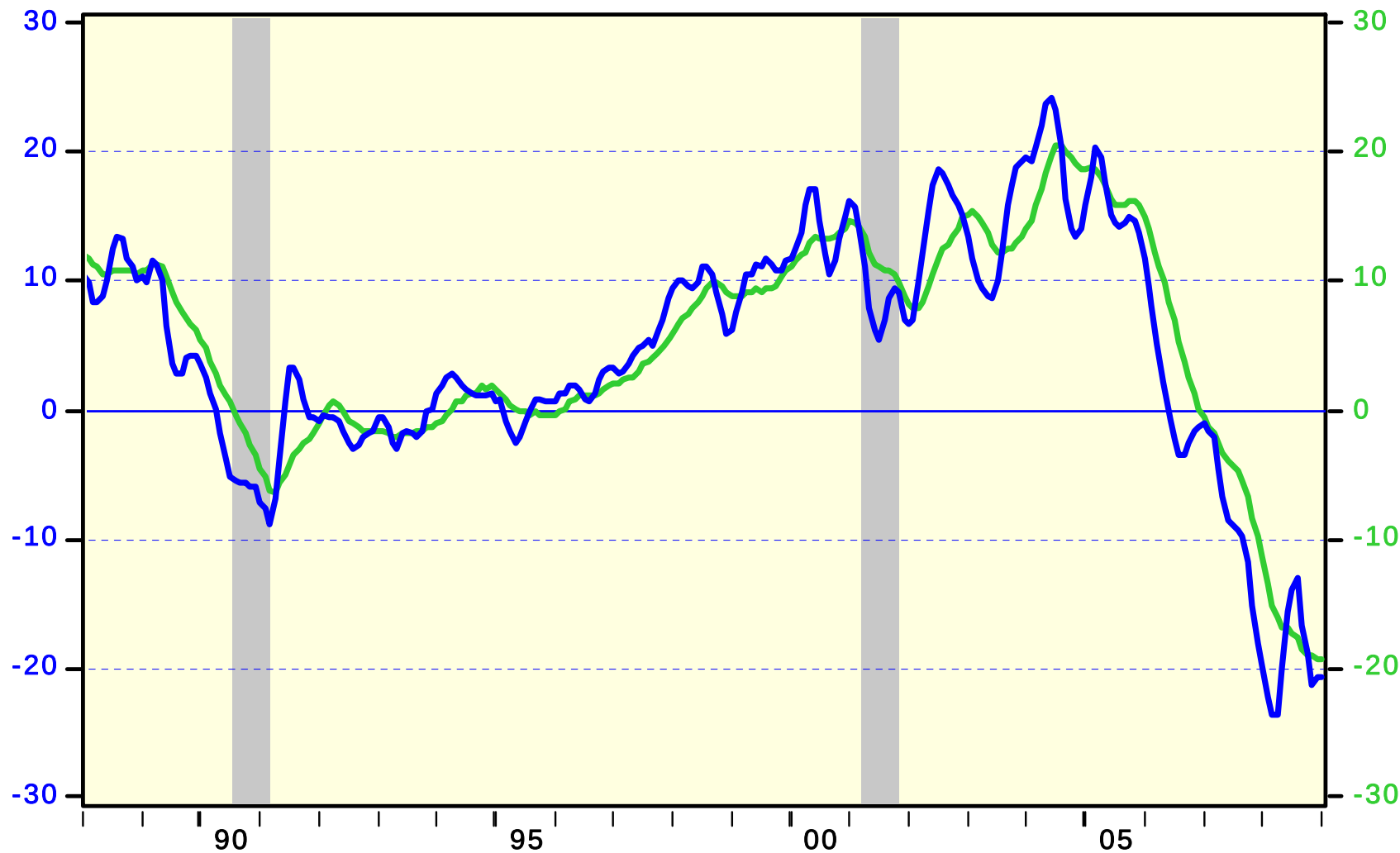


S&P/Case-Shiller Home Price Index: Composite 10

3-month %Change-ann SA, Jan-00=100

S&P/Case-Shiller Home Price Index: Composite 10

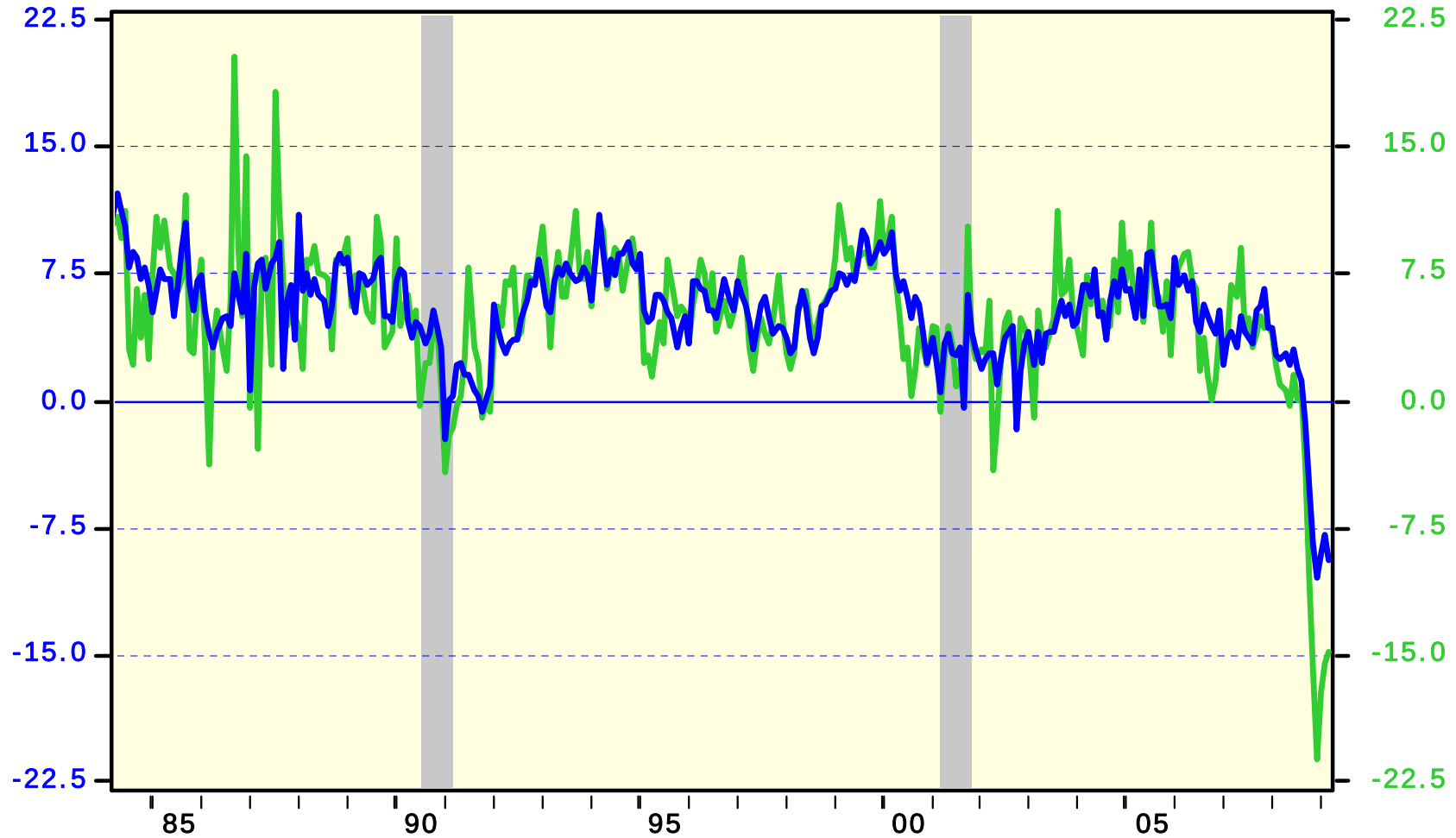
% Change - Year to Year SA, Jan-00=100



Source: S&P, Fiserv, and MacroMarkets LLC /Haver Analytics

Retail Sales & Food Services
% Change - Year to Year SA, Mil.\$

Retail Sales & Food Services
6-month %Change-ann SA, Mil.\$



Source: Census Bureau/Haver Analytics

Real Personal Consumption Expenditures

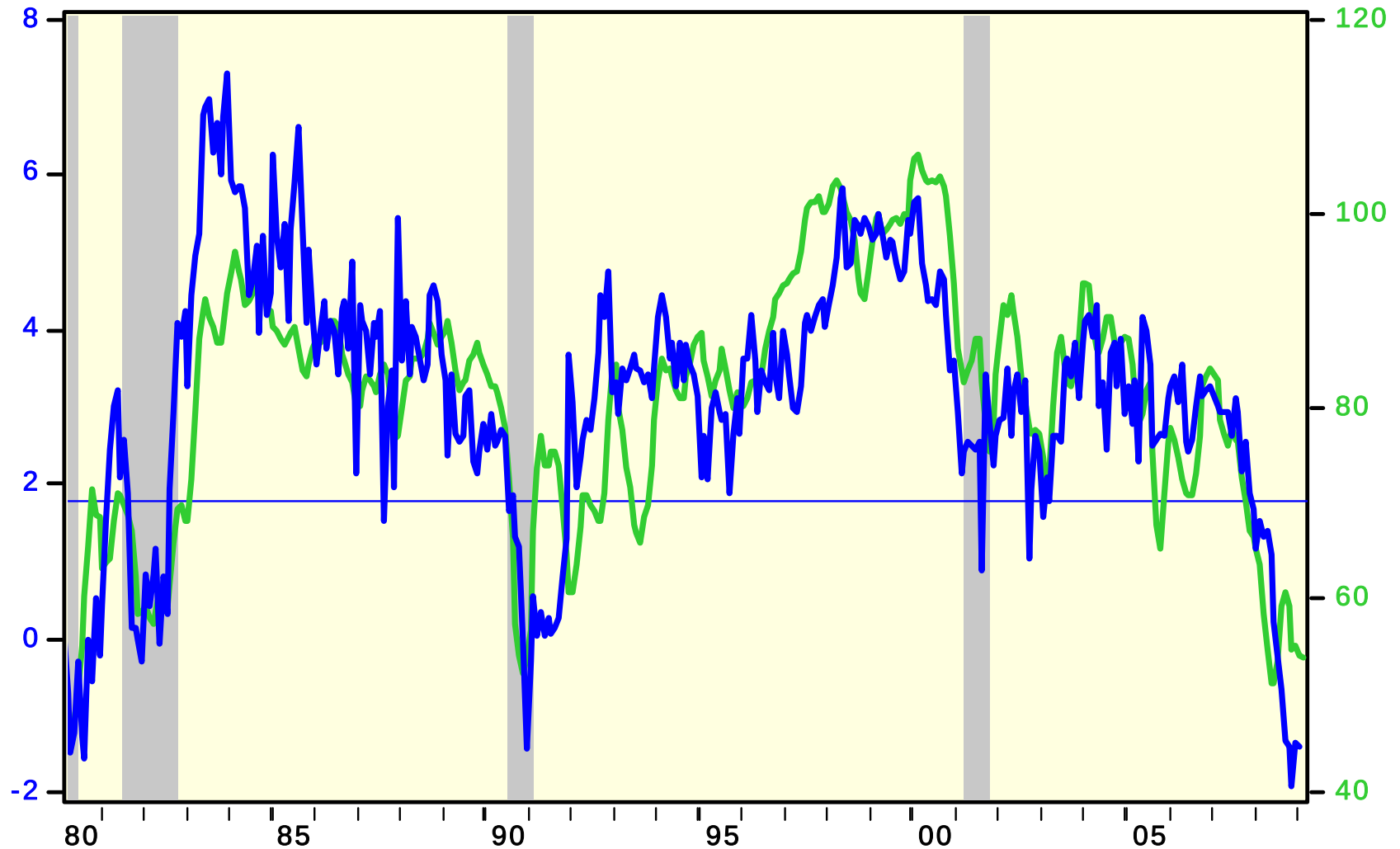
% Change - Year to Year

SAAR, Bil.Chn.2000\$

University of Michigan: Consumer Expectations

3-month MovingAverage

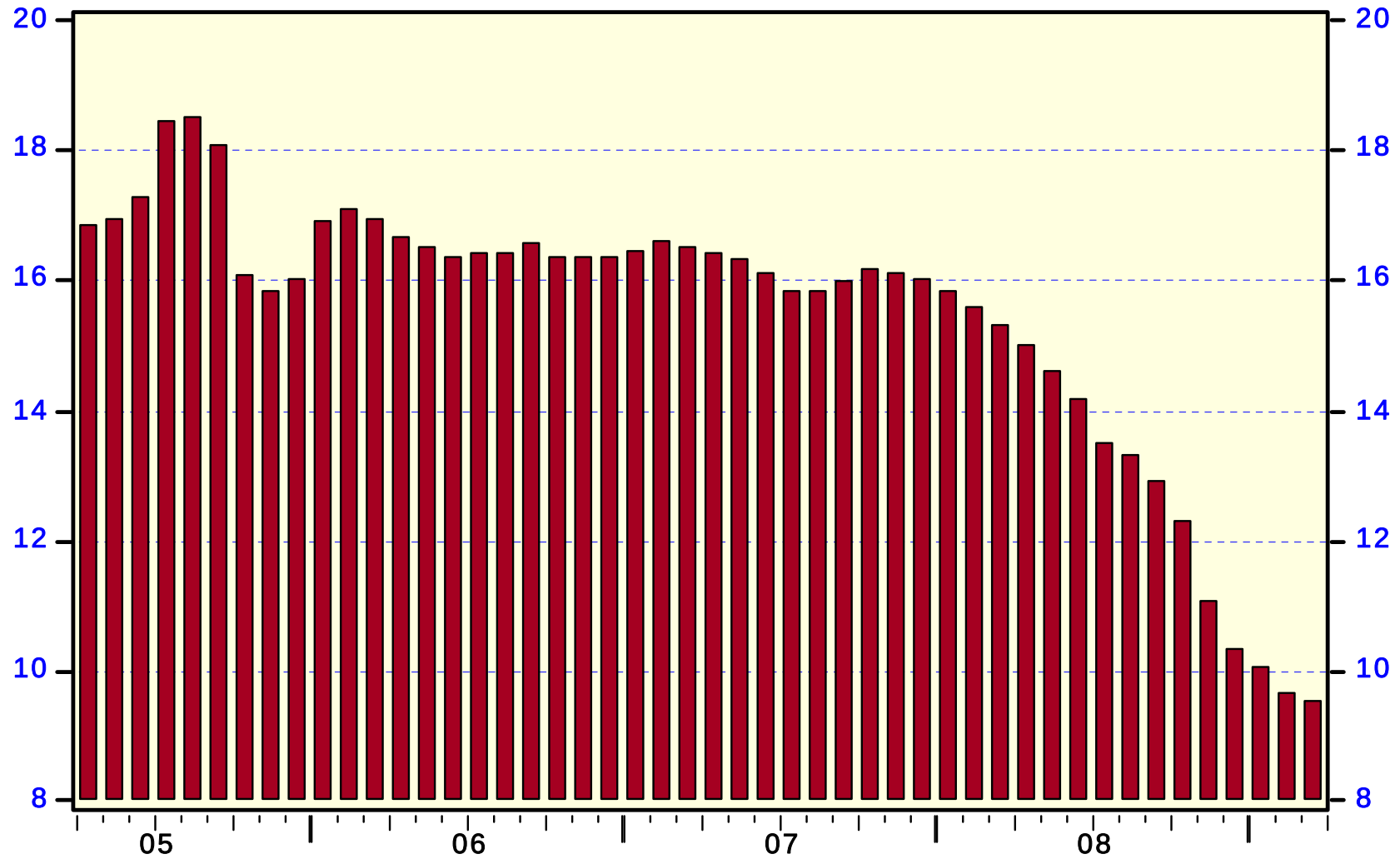
NSA, Q1-66=100



Sources: BEA, UMICH /Haver

Total Light Vehicle Retail Sales {Imported+Domestic}

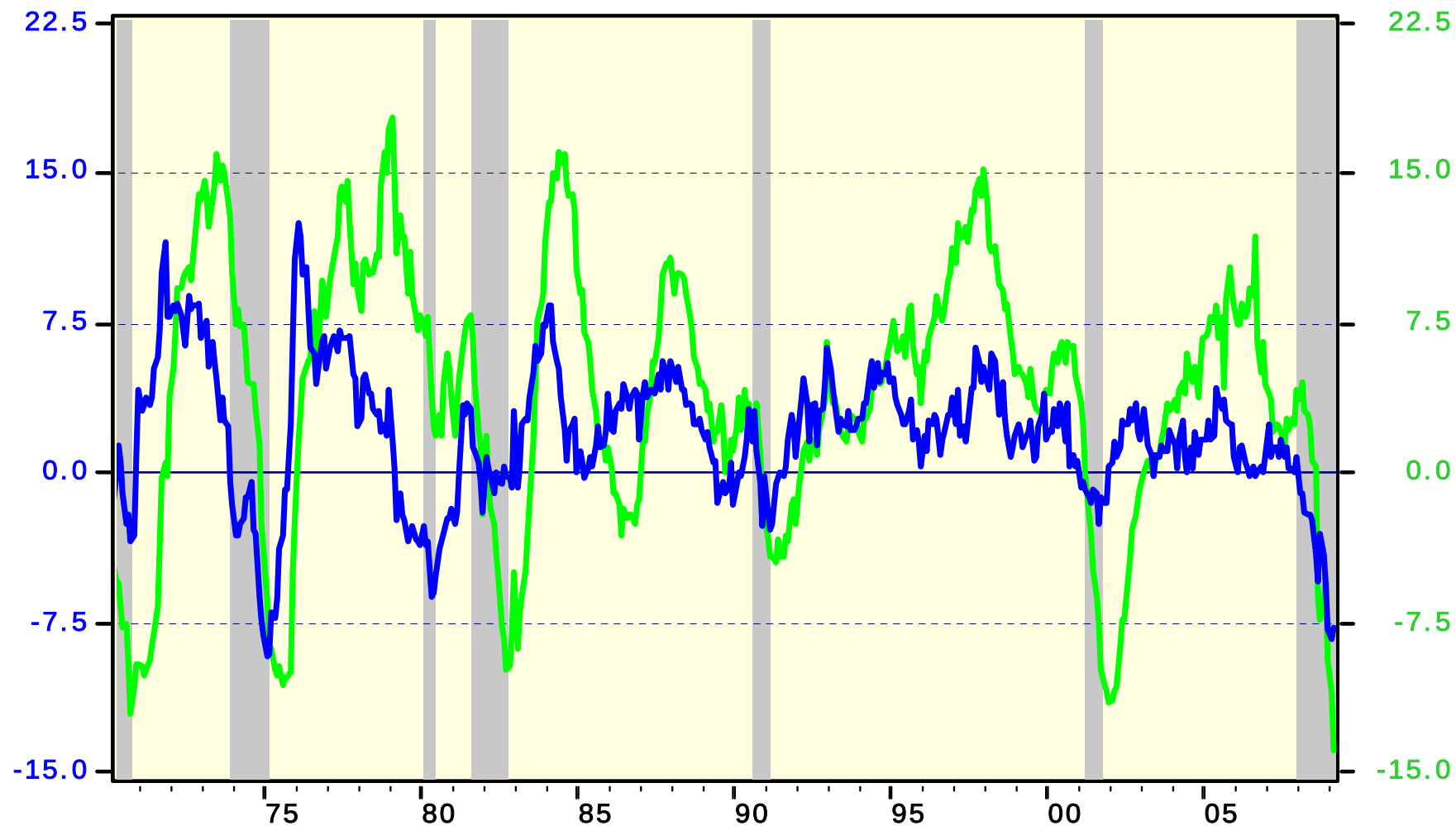
3-month MovingAverage SAAR, Mil. Units



Source: Autodata Corporation /Haver Analytics

IP: Consumer Goods
% Change - Year to Year SA, 2002=100

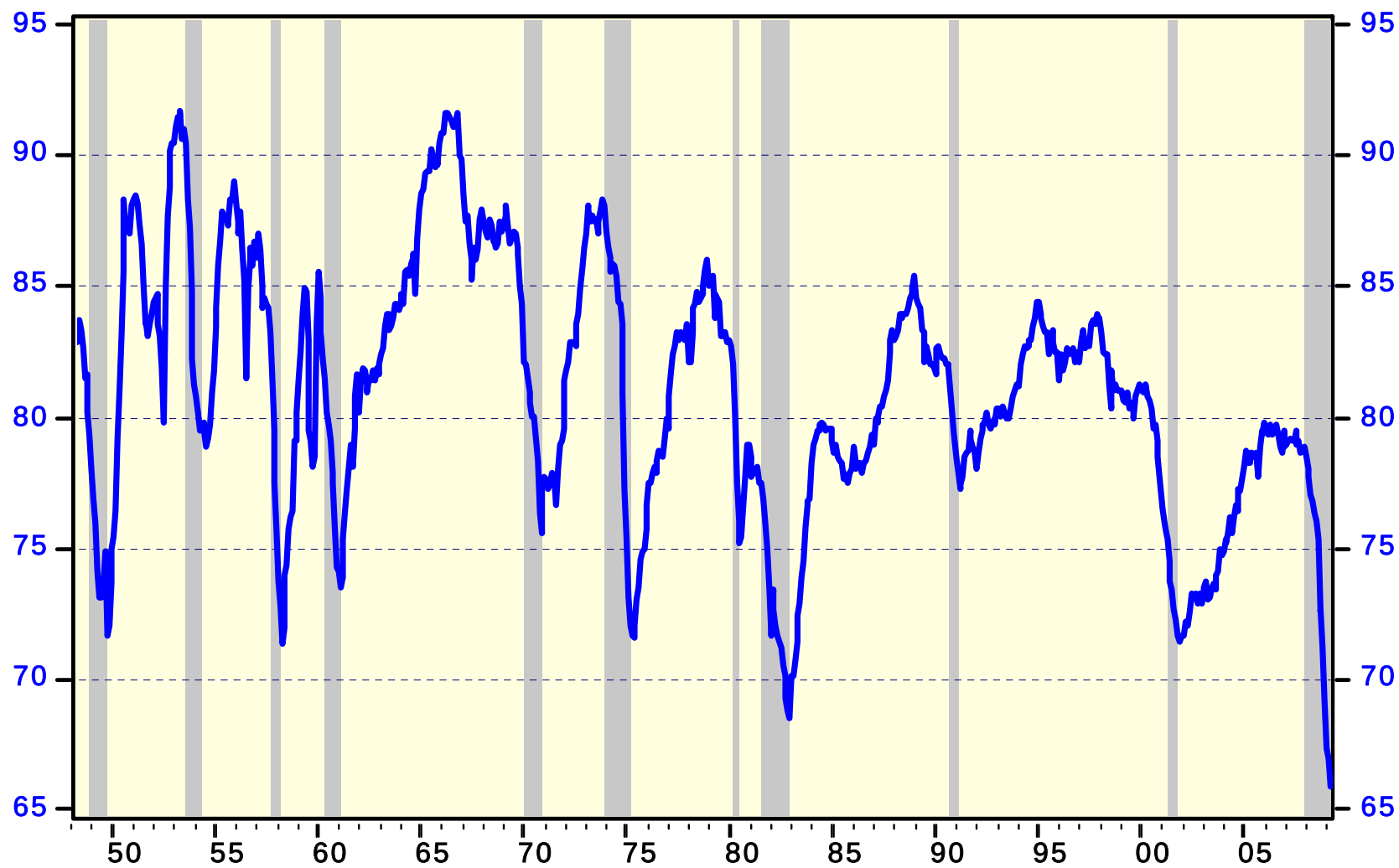
IP: Equipment
% Change - Year to Year SA, 2002=100



Source: Federal Reserve Board /Haver Analytics

Capacity Utilization: Manufacturing [SIC]

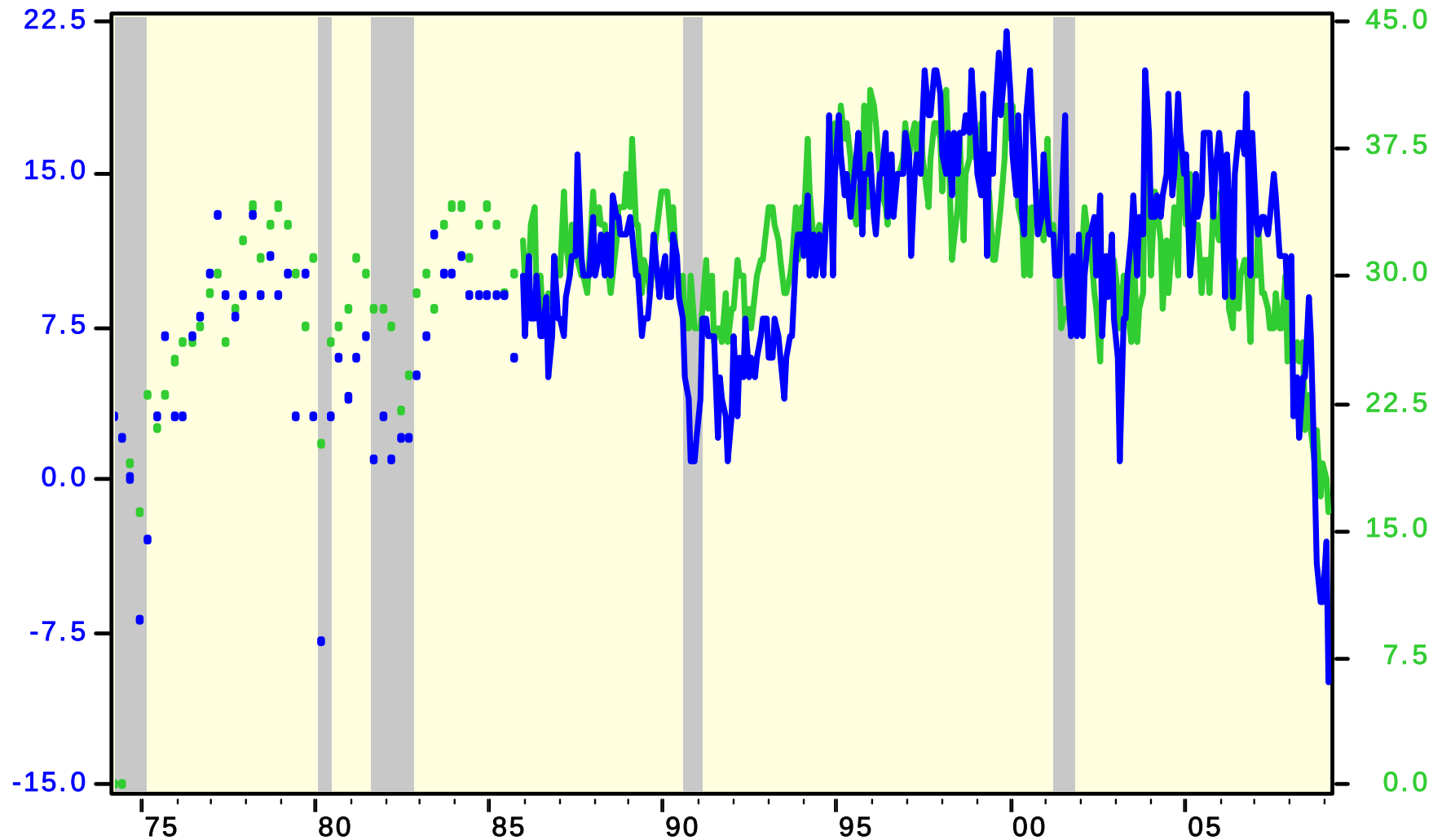
SA, % of Capacity



Source: Federal Reserve Board /Haver Analytics

NFIB: Percent Planning to Increase Employment, Net
SA, %

NFIB: Percent Planning Capital Expenditures next 3 to 6 Months
SA, %



Source: National Federation of Independent Business /Haver Analytics

US Corporate Profit Margin

(Pre Tax, Quality Adjusted, in %)



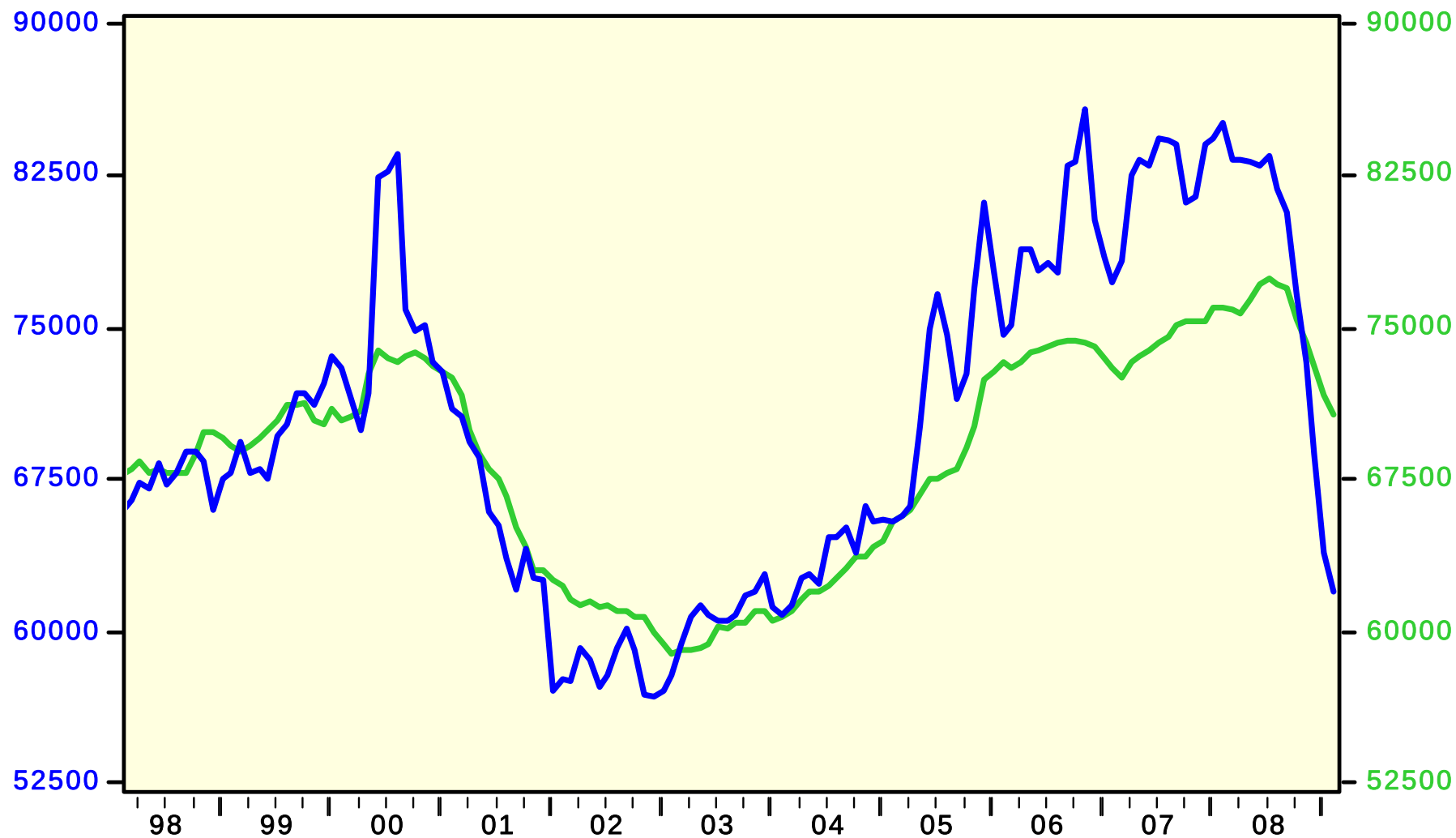
Source: Haver Analytics

Manufacturers' New Orders: Capital Goods

3-month Moving Average SA, Mil.\$

Manufacturers' Shipments: Capital Goods

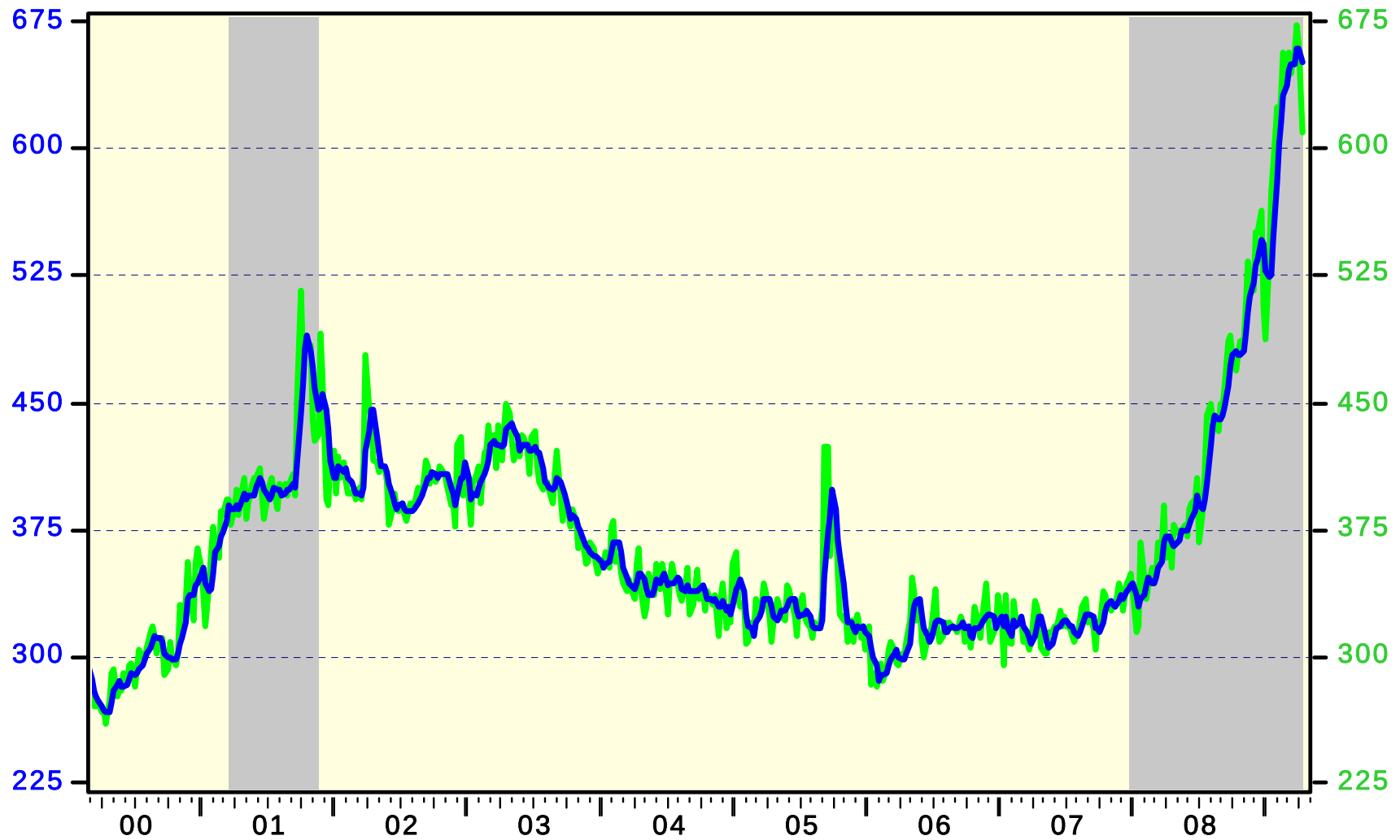
3-month Moving Average SA, Mil.\$



Source: Census Bureau /Haver Analytics

Unemployment Insurance: Initial Claims, 4-Week Moving Average SA,Thous

Unemployment Insurance: Initial Claims, State Programs SA, Thous



Source: Department of Labor /Haver Analytics

All Employees: Goods-Producing Industries

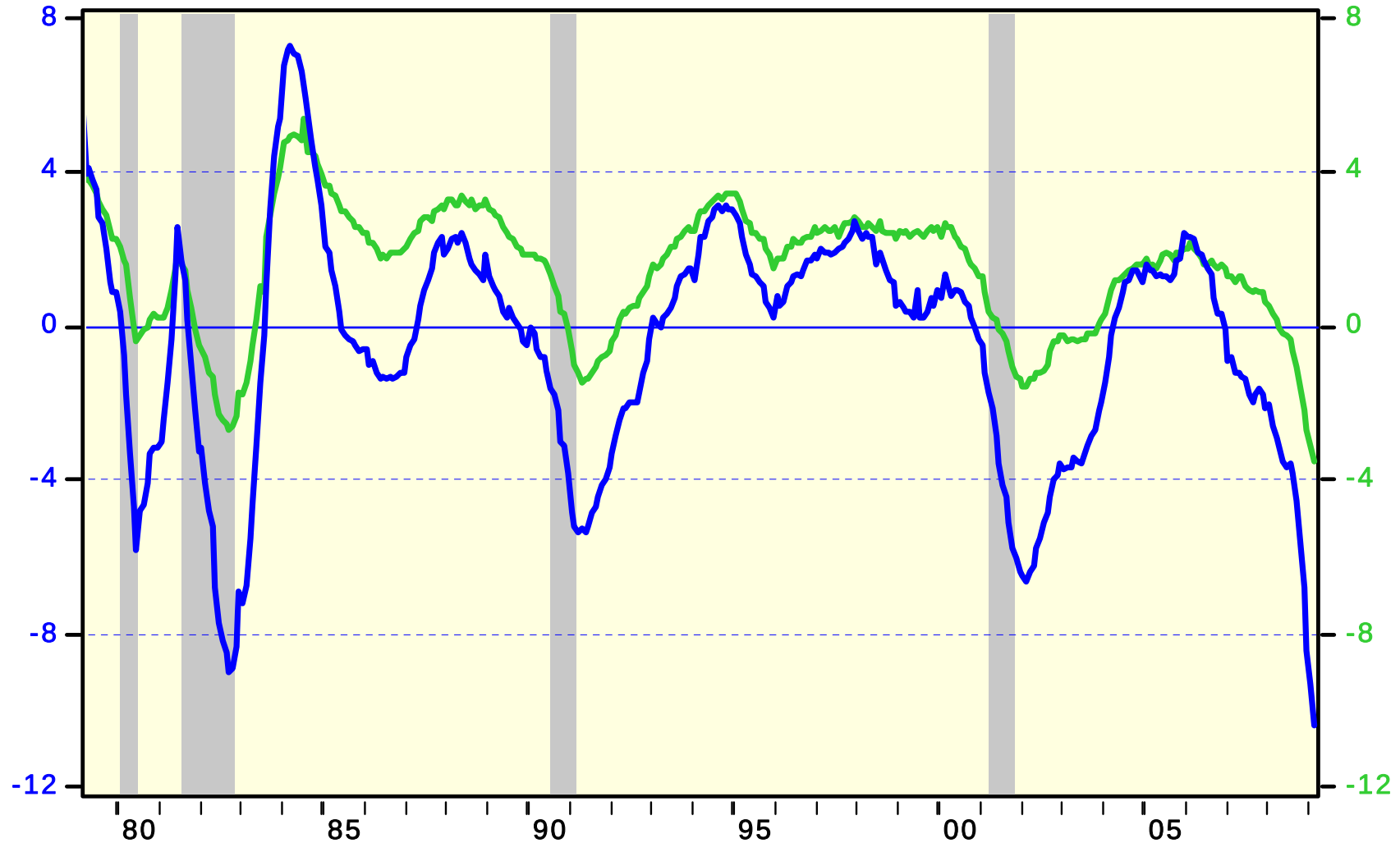
% Change - Year to Year

SA, Thous

All Employees: Total Nonfarm Payrolls

% Change - Year to Year

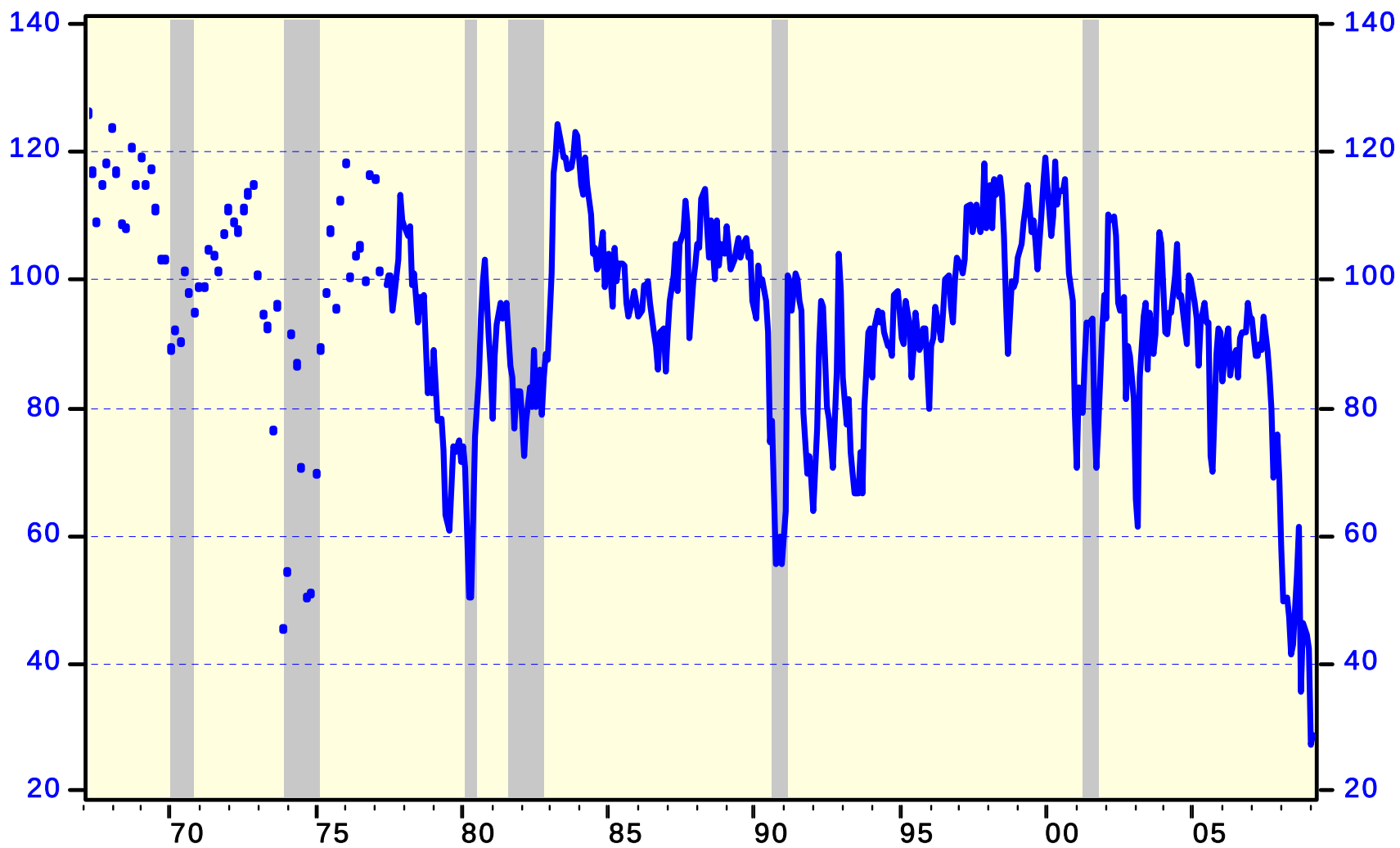
SA, Thous



Source: Bureau of Labor Statistics /Haver Analytics

Consumer Confidence: Expectations

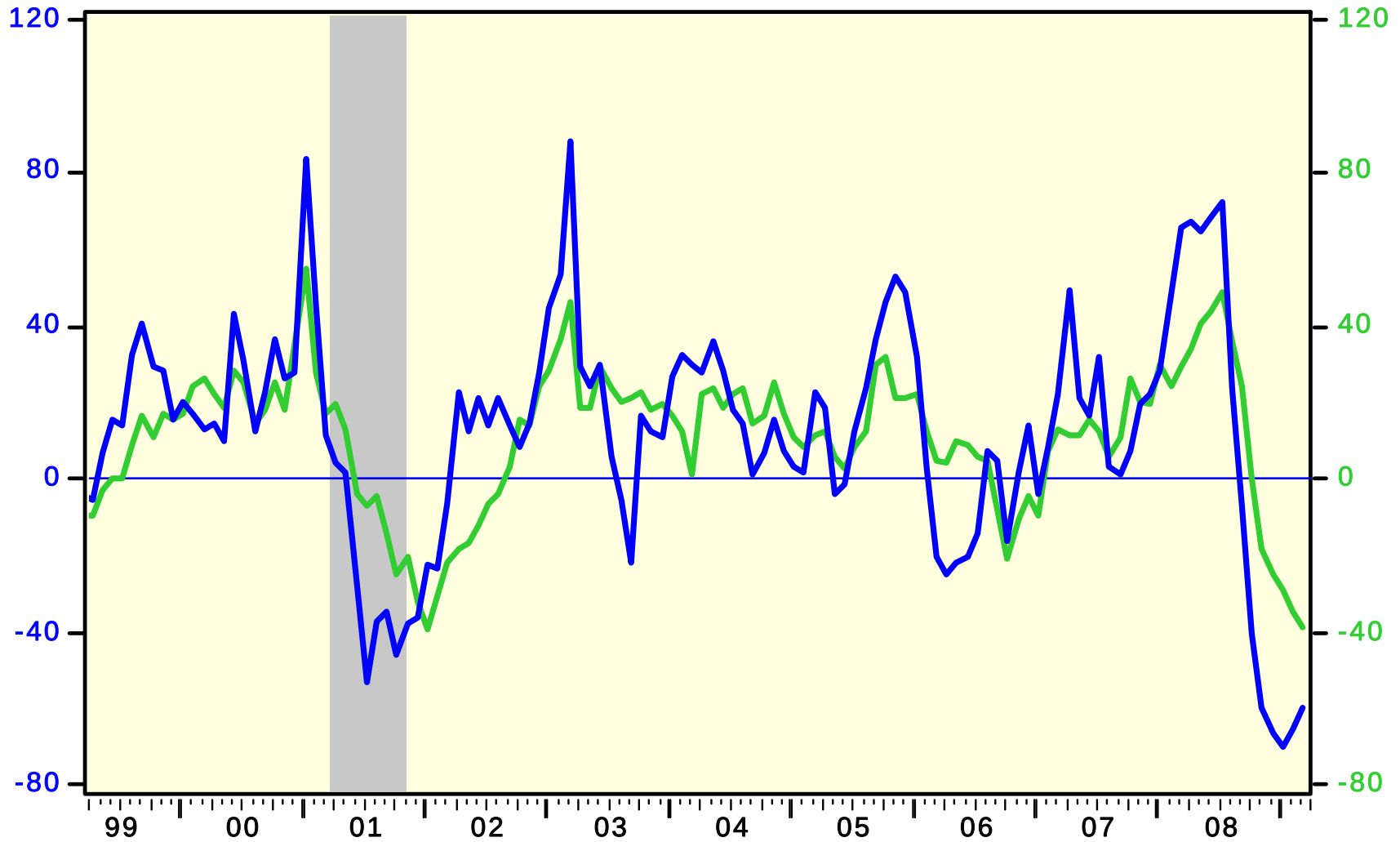
SA, 1985=100



Source: The Conference Board /Haver Analytics

PPI: Crude Materials
6-month %Change-ann SA, 1982=100

PPI: Crude Materials
% Change - Year to Year SA, 1982=100

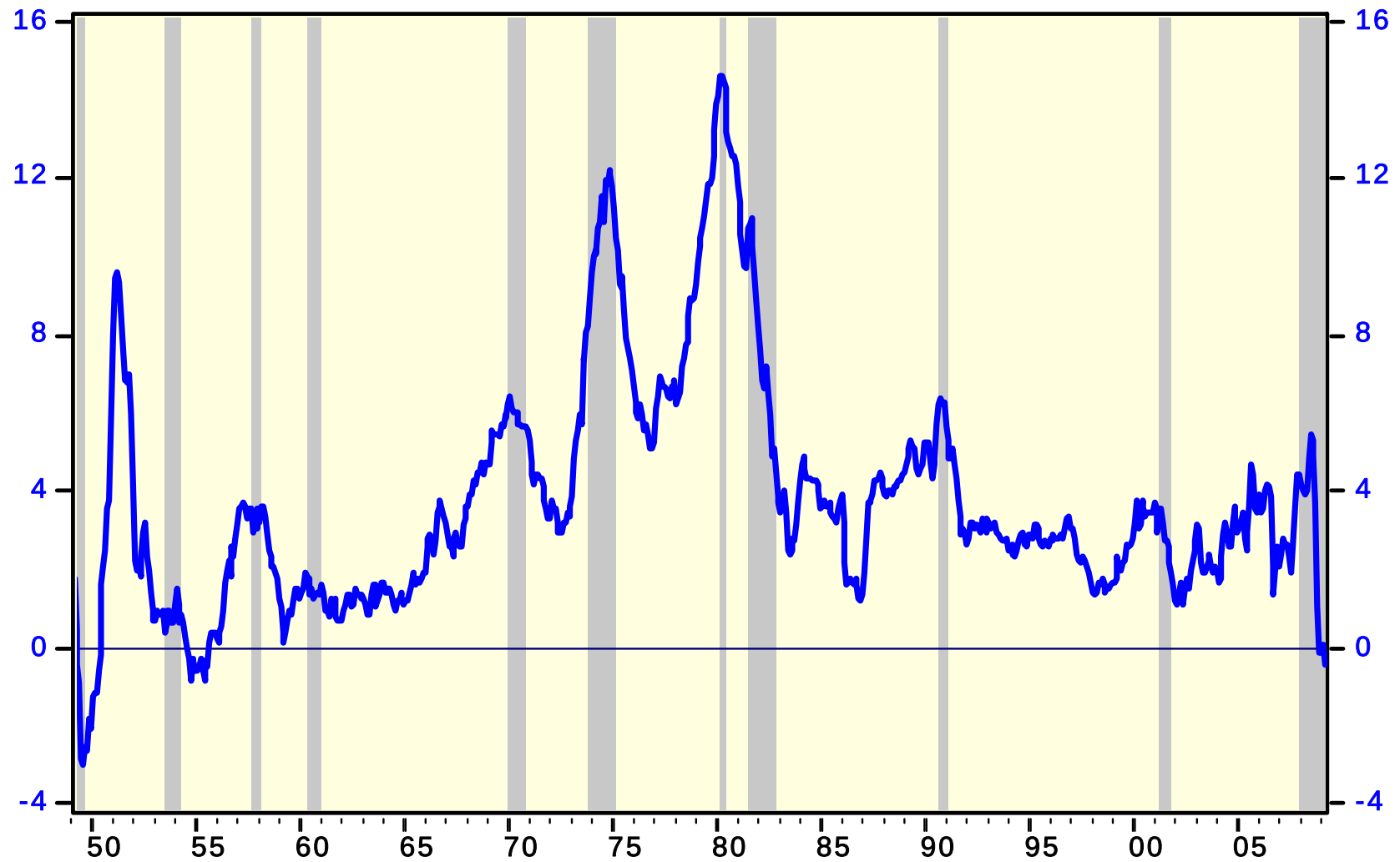


Source: Bureau of Labor Statistics /Haver Analytics

CPI-U: All Items

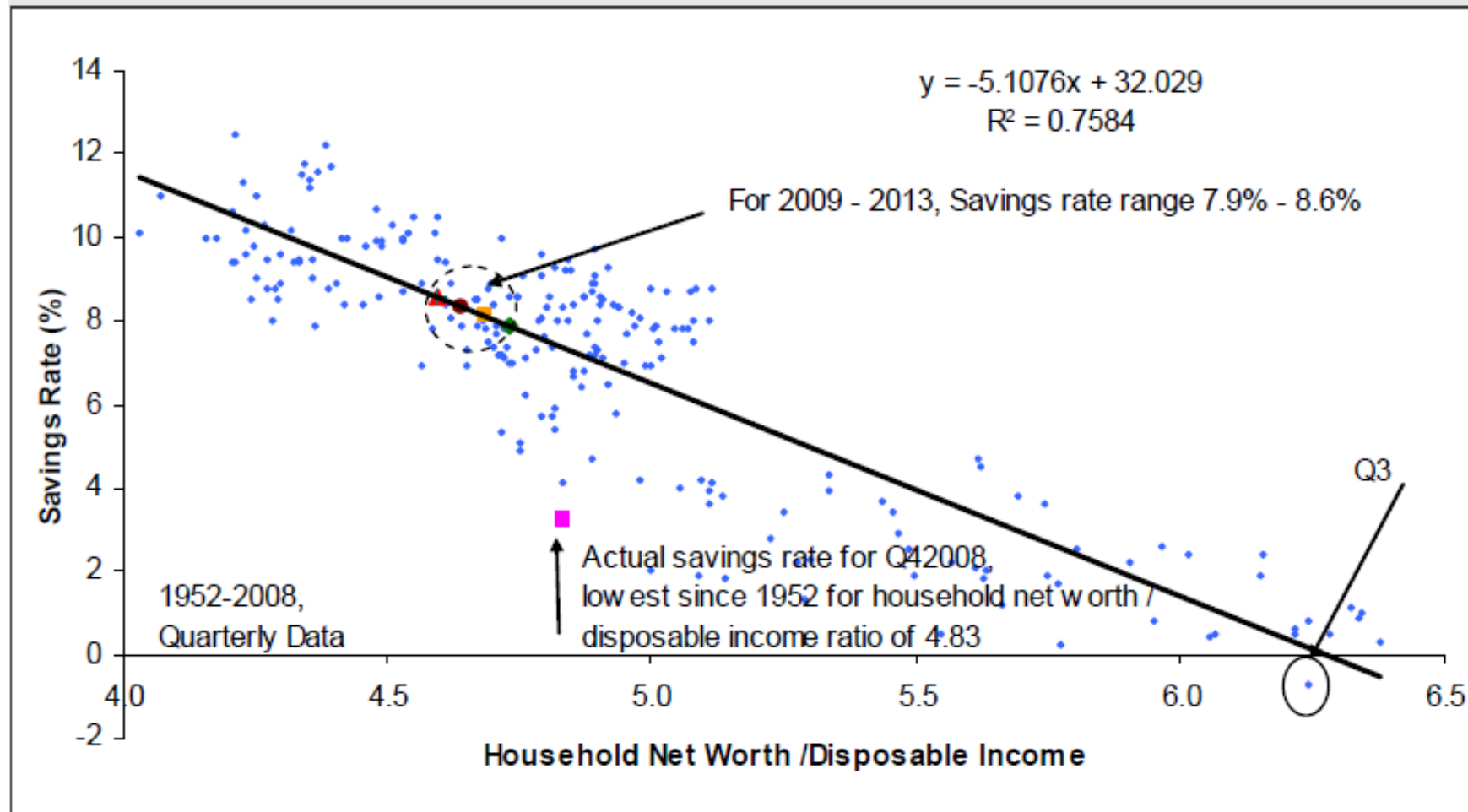
% Change - Year to Year

SA, 1982-84=100



Source: Bureau of Labor Statistics /Haver Analytics

<Figure 21> The US household savings rate to rise to 8-9% as net worth/income ratio declines (1952 – present)

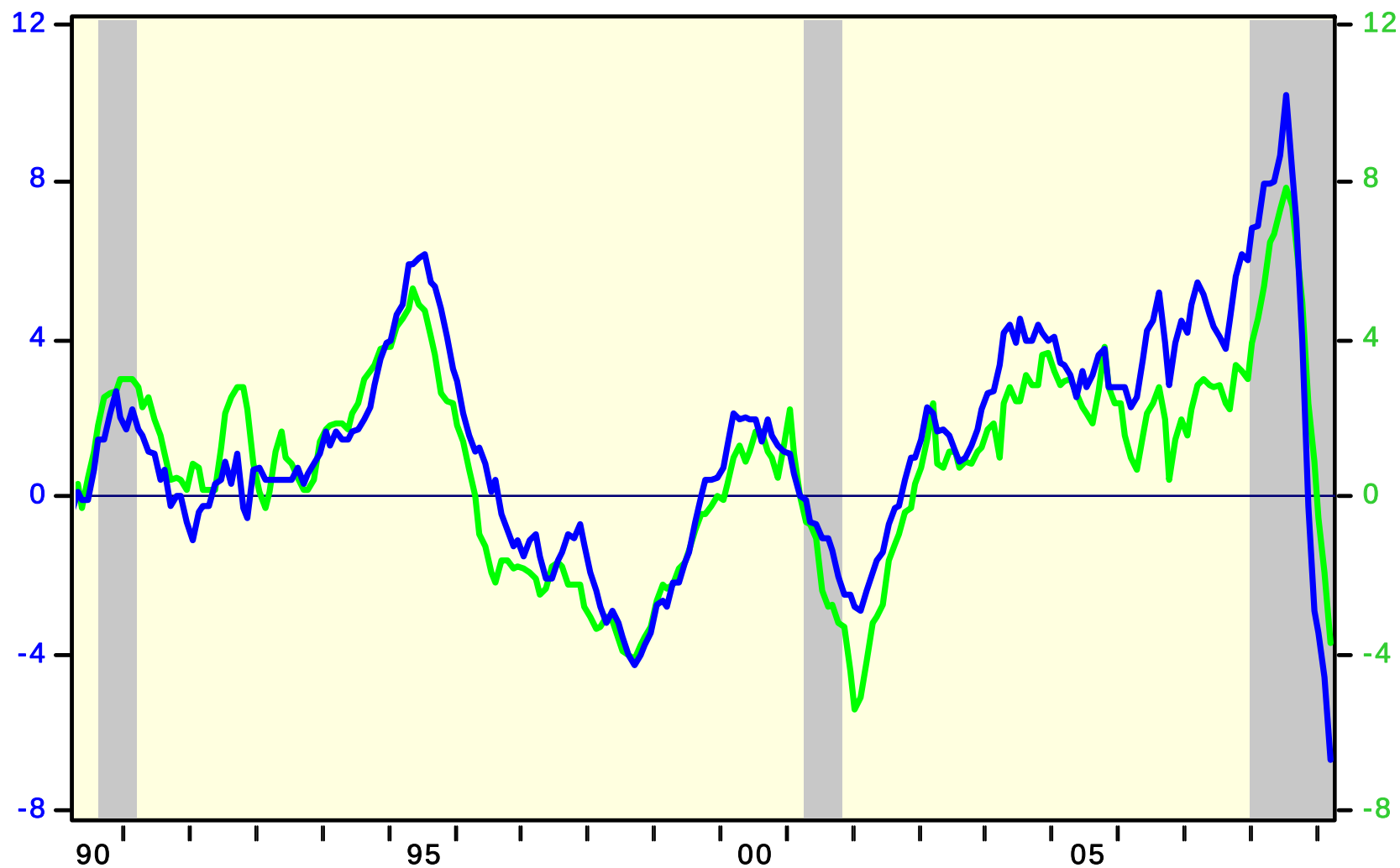


Note: Household Savings rate is based on assumption that net worth would decline by 5% in 2009, appreciate by 5% in 2010 and at 4% in 2010-13. The personal disposable income is assumed to be flat for 2009 and to grow at 2% in 2010 and at 5% in 2011-13.

Source: Federal Reserve Board, Mirae Asset Research

Export Price Index: All Exports
% Change - Year to Year NSA, 2000=100

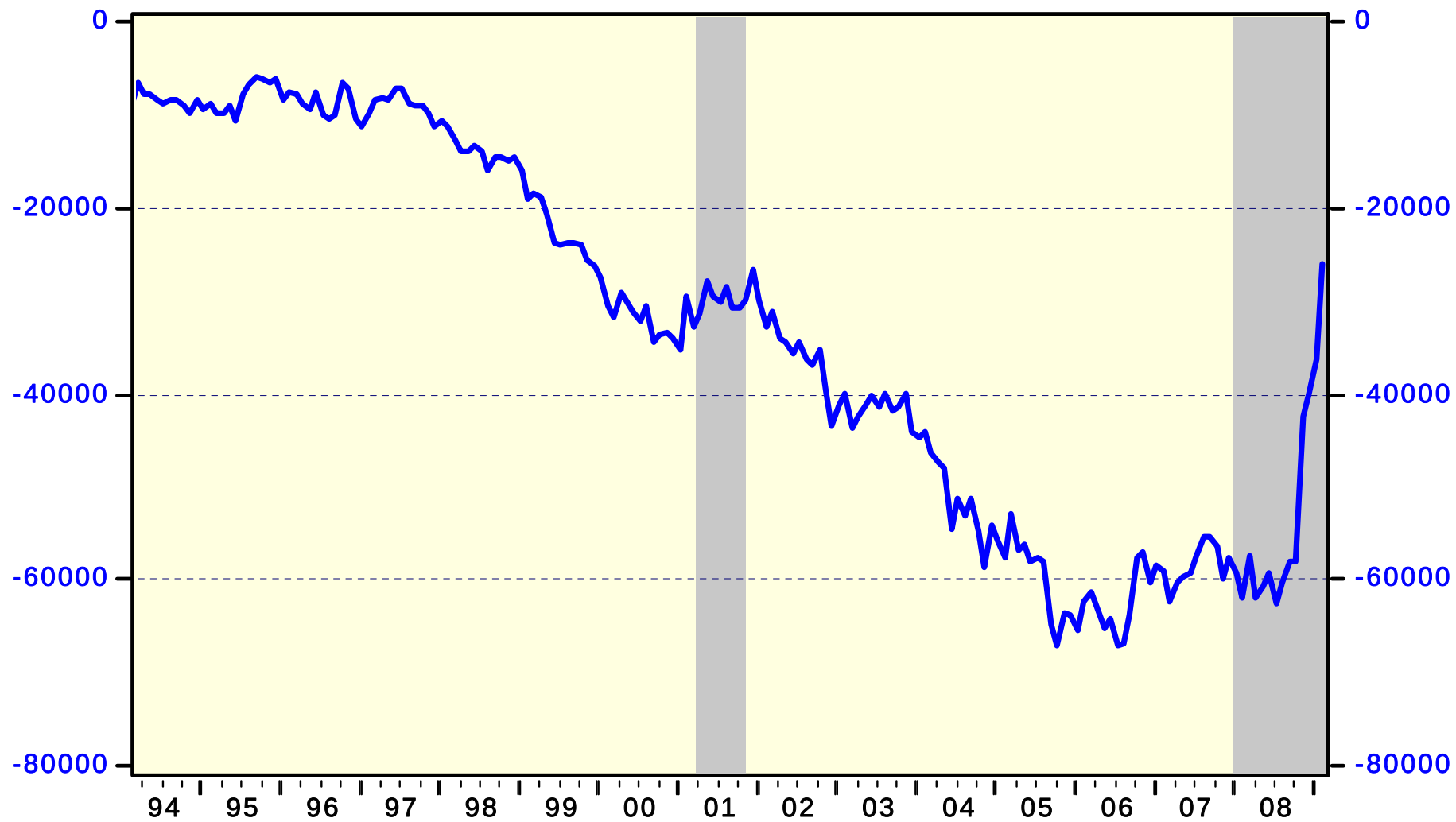
Import Price Index: Nonpetroleum Imports
% Change - Year to Year NSA, 2000=100



Source: Bureau of Labor Statistics /Haver Analytics

Monthly US Trade Balance

Goods and Services (\$, in millions)



Source: Haver Analytics

Imports of Goods and Services, Census Basis

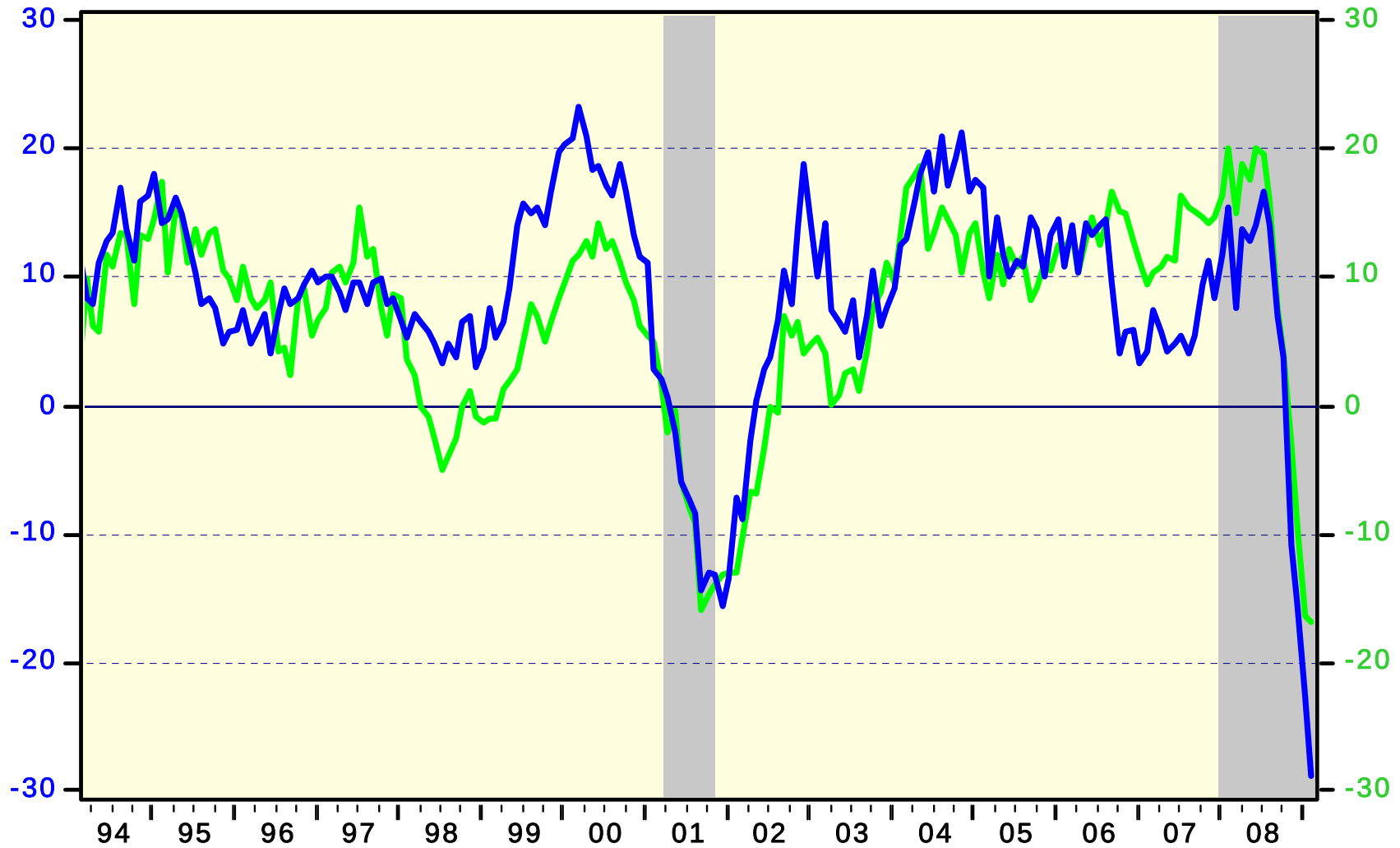
% Change - Year to Year

SA, Mil.\$

Exports of Goods and Services, Census Basis

% Change - Year to Year

SA, Mil.\$



Source: Bureau of the Census /Haver Analytics

Machine Tool Orders

[bn Yen]

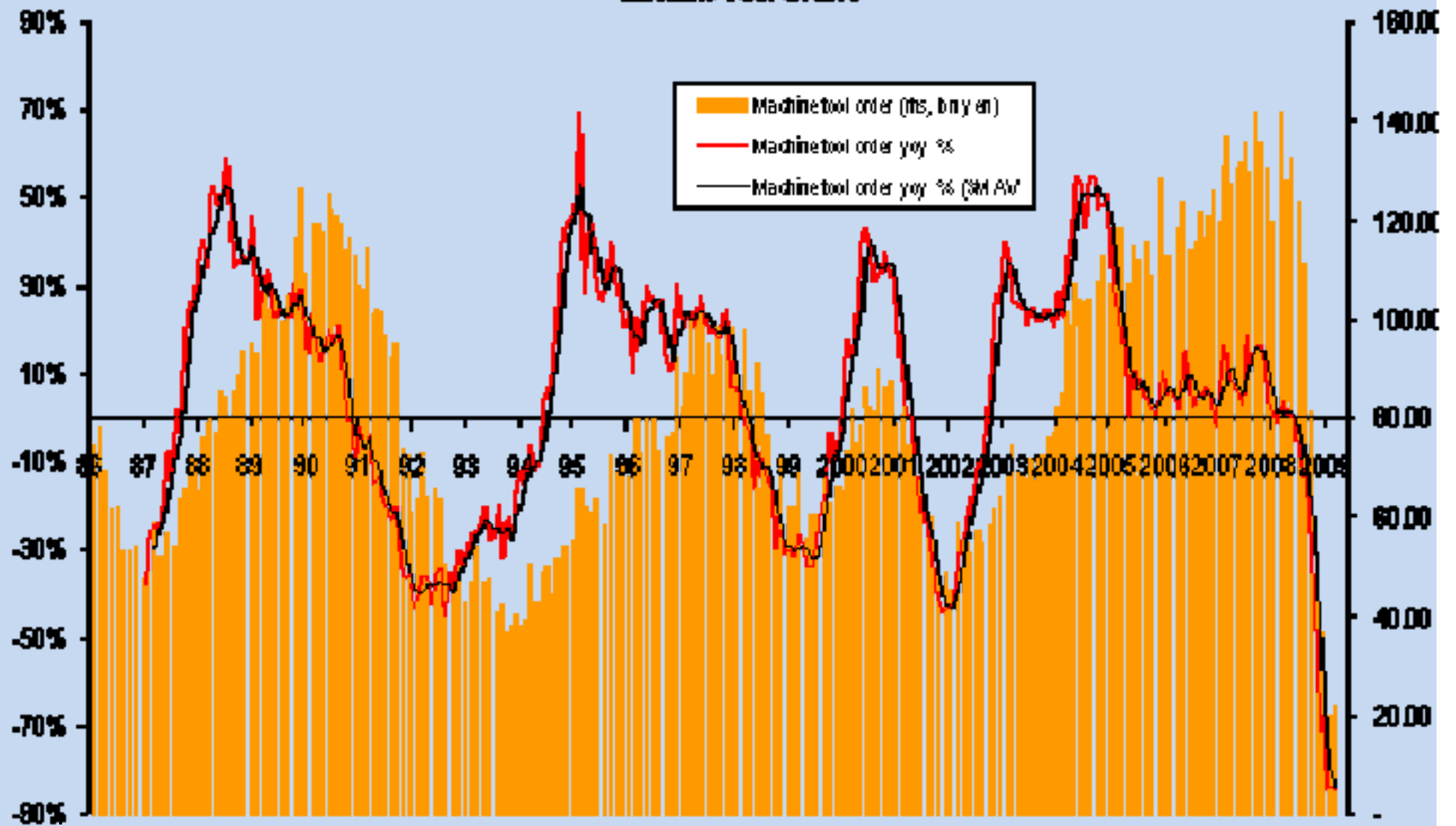
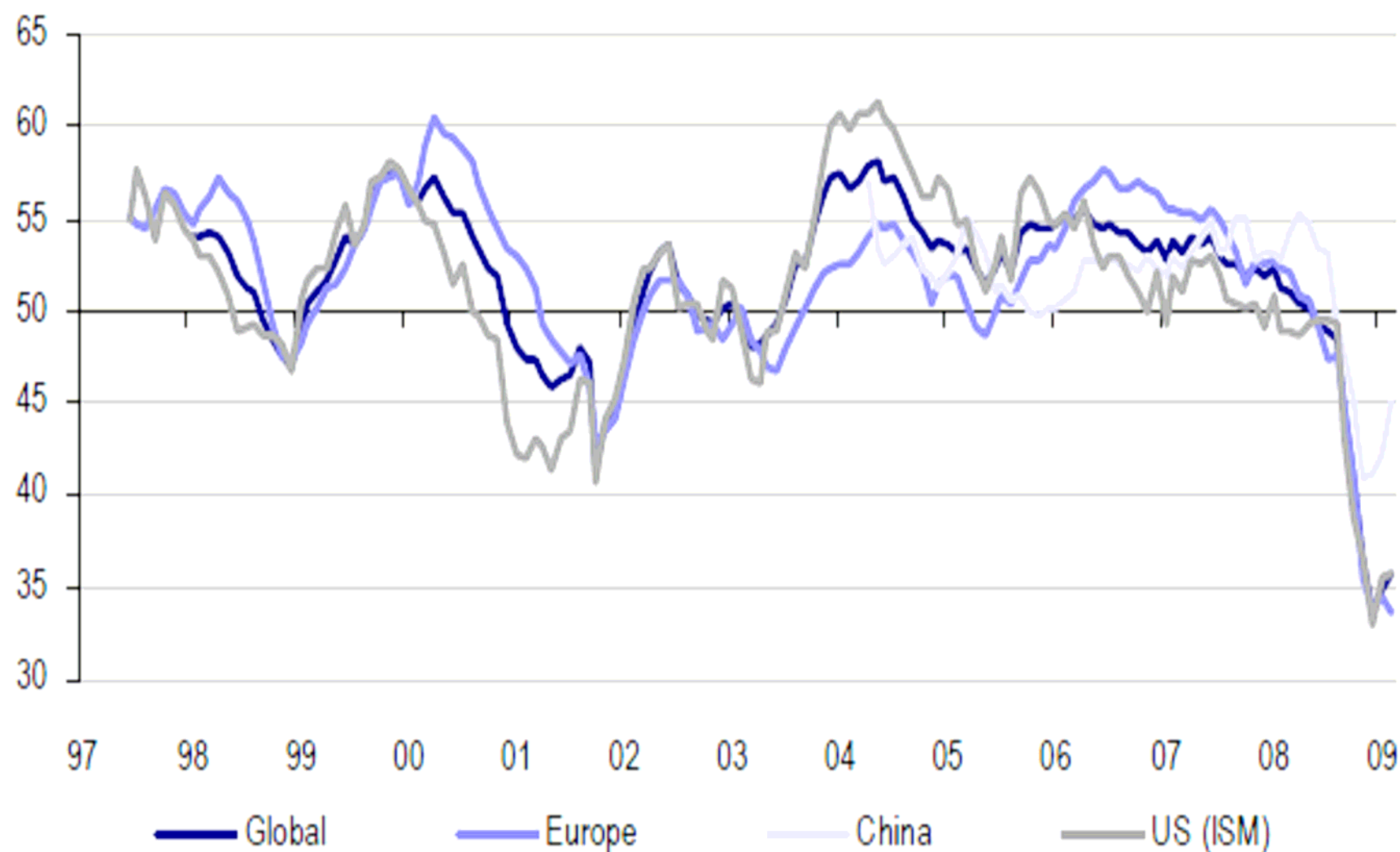


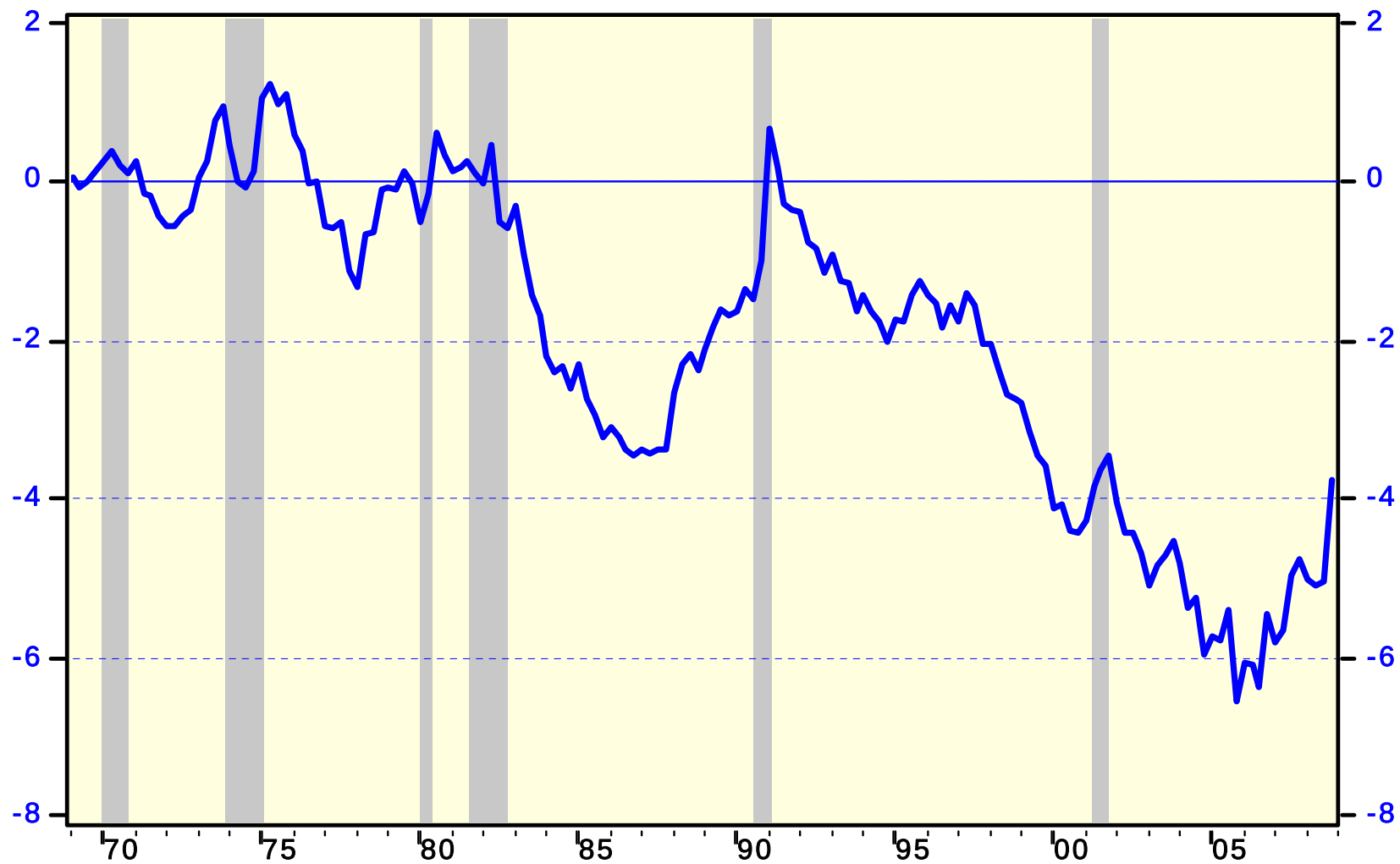
Chart 16: Global Manufacturing PMIs



Source: Markit, Haver, Thomson Datastream

Balance on Current Account as a % of GDP

SAAR, %



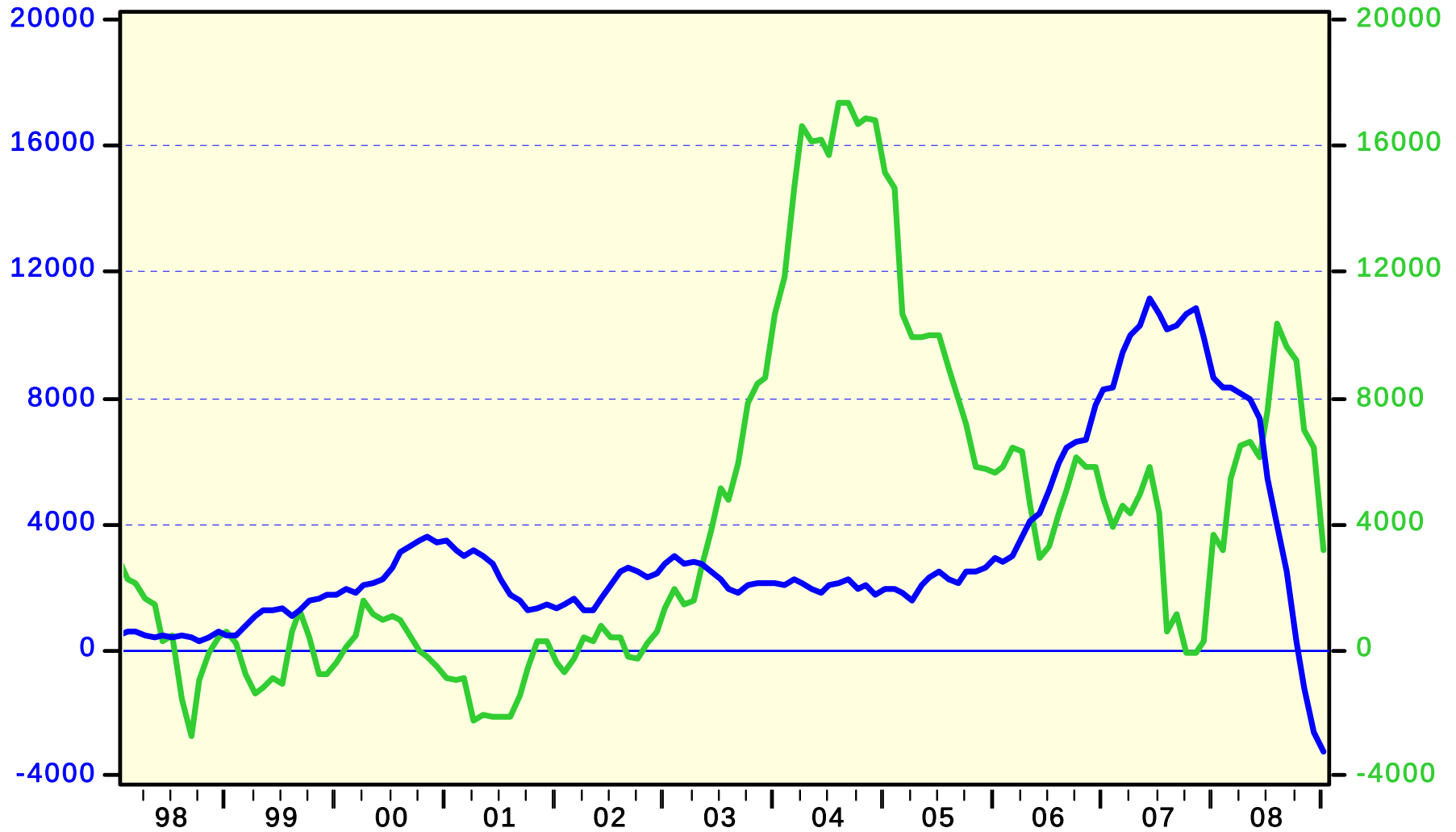
Source: Haver Analytics

Net Foreign Official Purchases: Government Agency Bonds

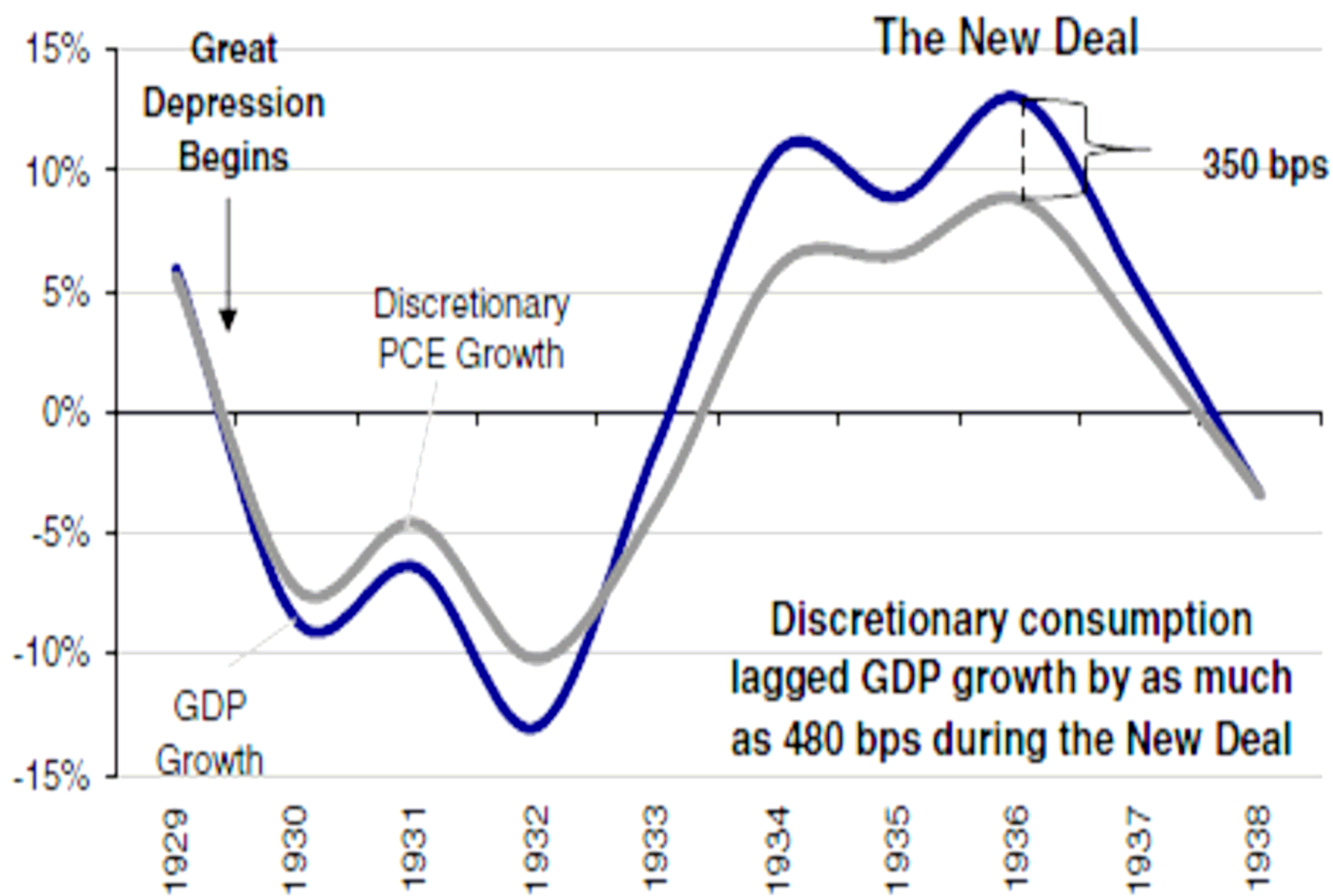
12-month MovingAverage NSA, Mil.\$

Net Foreign Official Purchases: Treasury Bonds & Notes

12-month MovingAverage NSA, Mil.\$

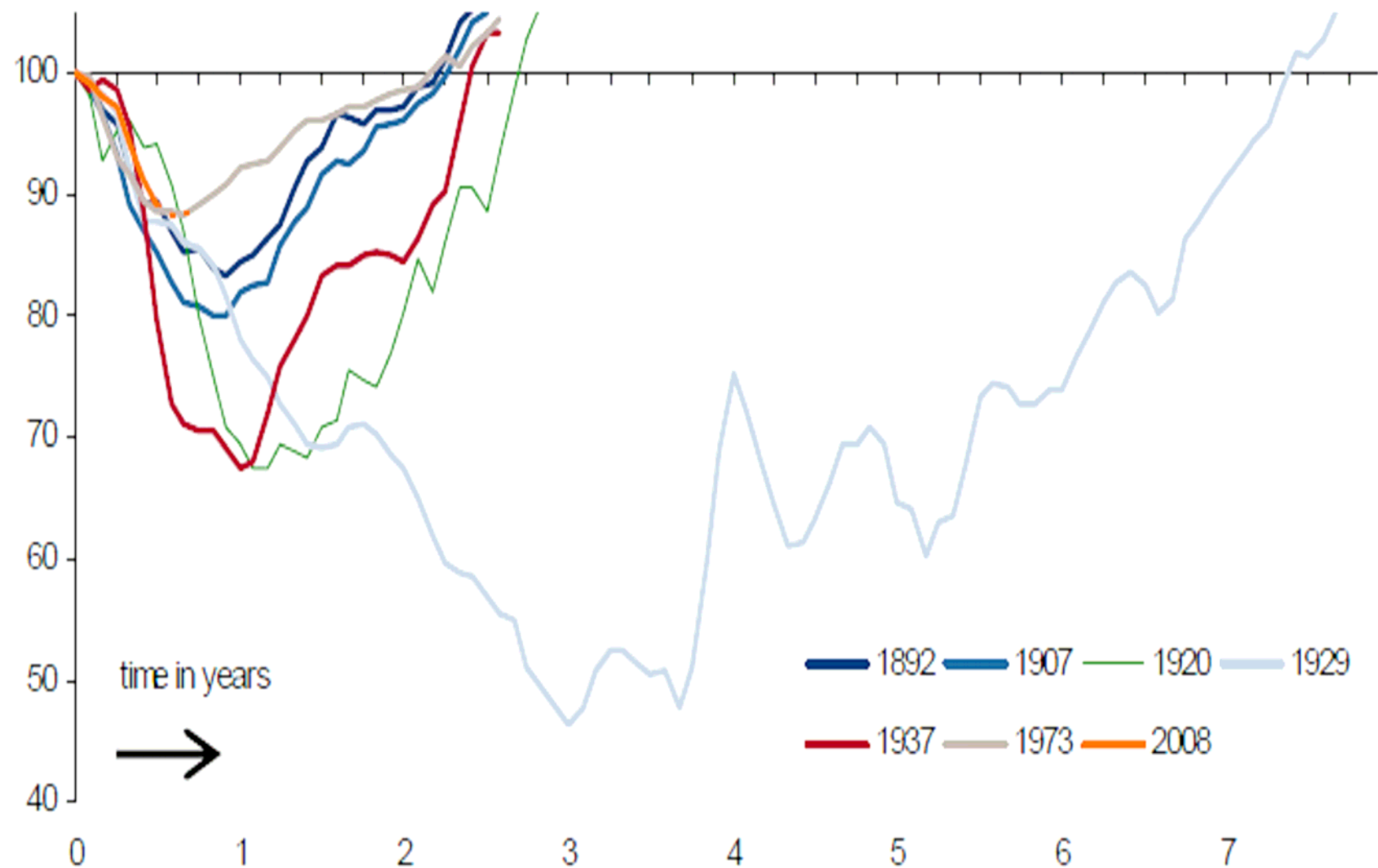


Source: US Treasury /Haver Analytics



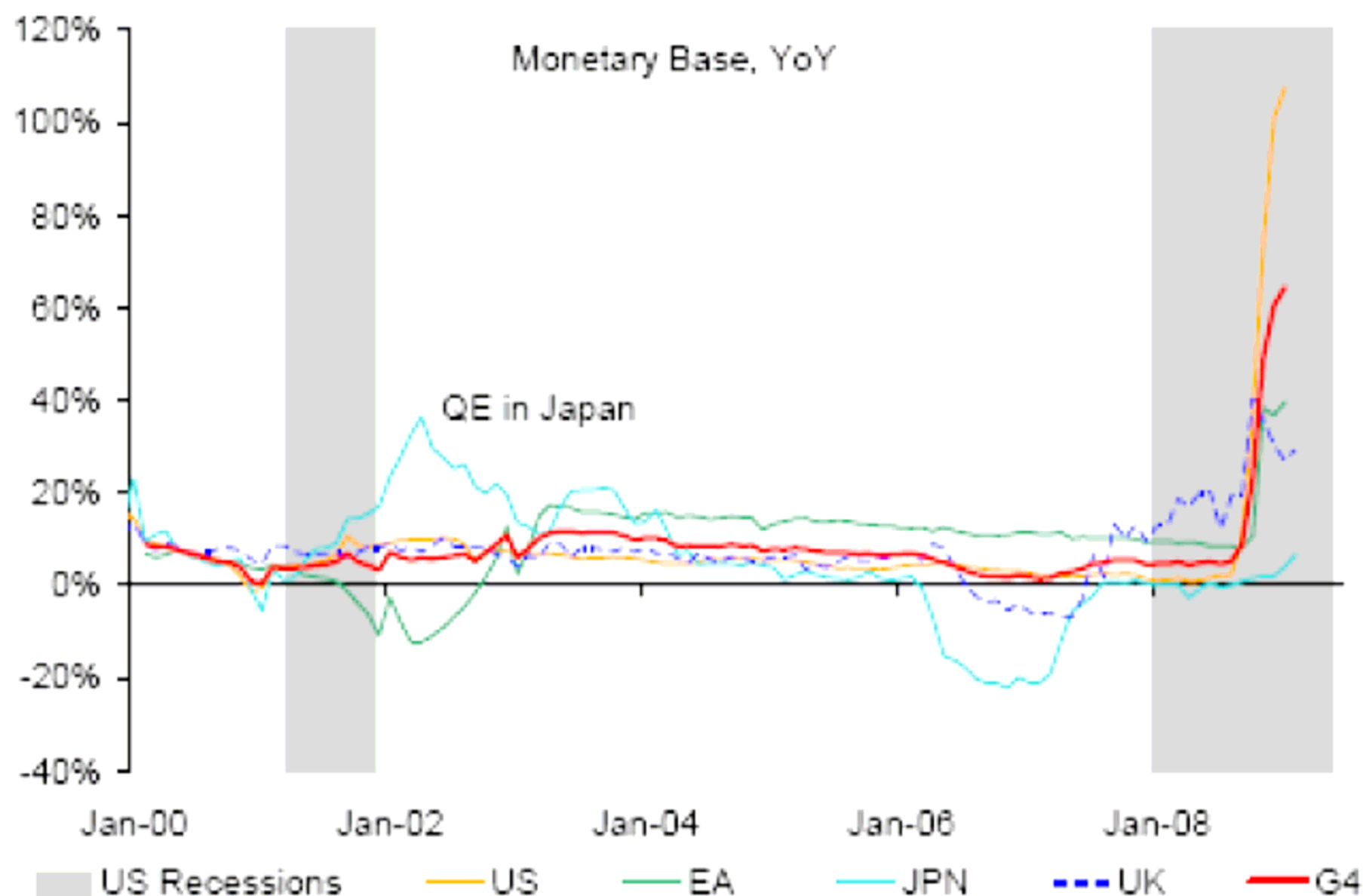
Source: Bureau of Economic Analysis, FactSet, Company data, Credit Suisse estimates

Exhibit 9: Global IP Cycle vs. Major Historic US IP Cycles



Source: Credit Suisse

Exploding Money Bases



Source: Joachim Fels, Haver; Morgan Stanley Research

Why did US Finance go Bad?

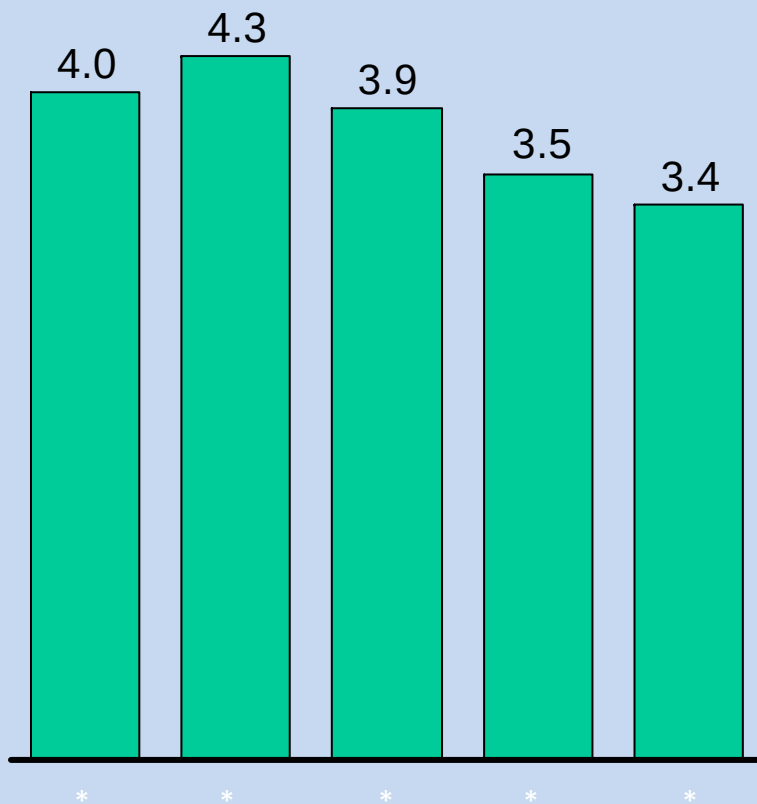
Evolution of US Financial Structure

- The Decline of Commercial Deposit Banking
- Financial Deregulation
- The Shift to Fee and Commission Income
- Mortgage Backed Bonds and Securitisation
- The Collapse of the Savings and Loan Banks
- The 1980s Real Estate Collapse
- The Private Sector Response – Securitisation
- The Basle Committee Capital Adequacy Standards
- The Financial Modernisation Act
- The Collapse of the Dot Com Bubble
- The Shift to Real Estate

Traditional lending and product sales have seen severe margin compression

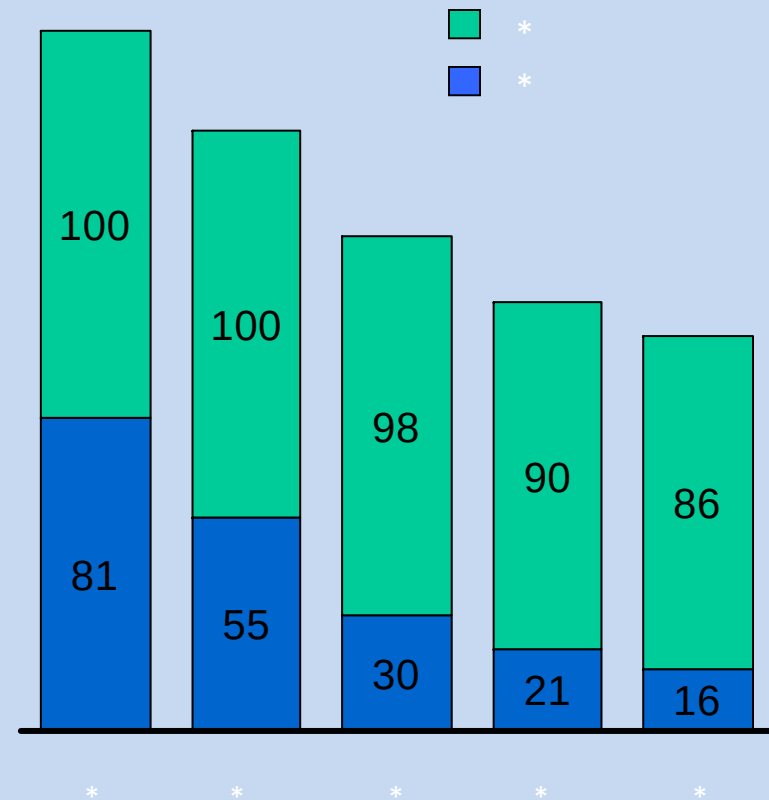
US banks net interest margin

Percent

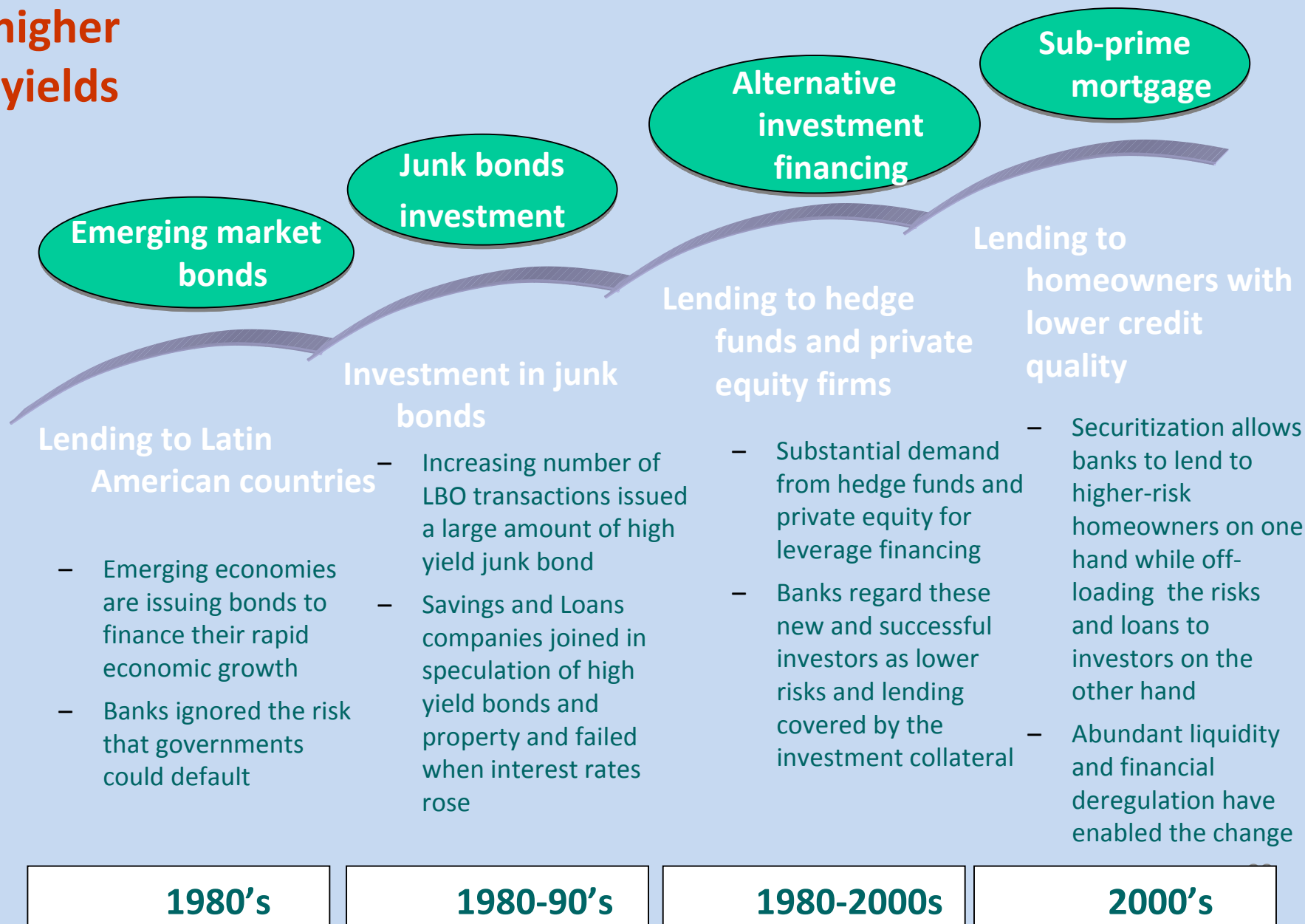


US mutual fund distribution fee

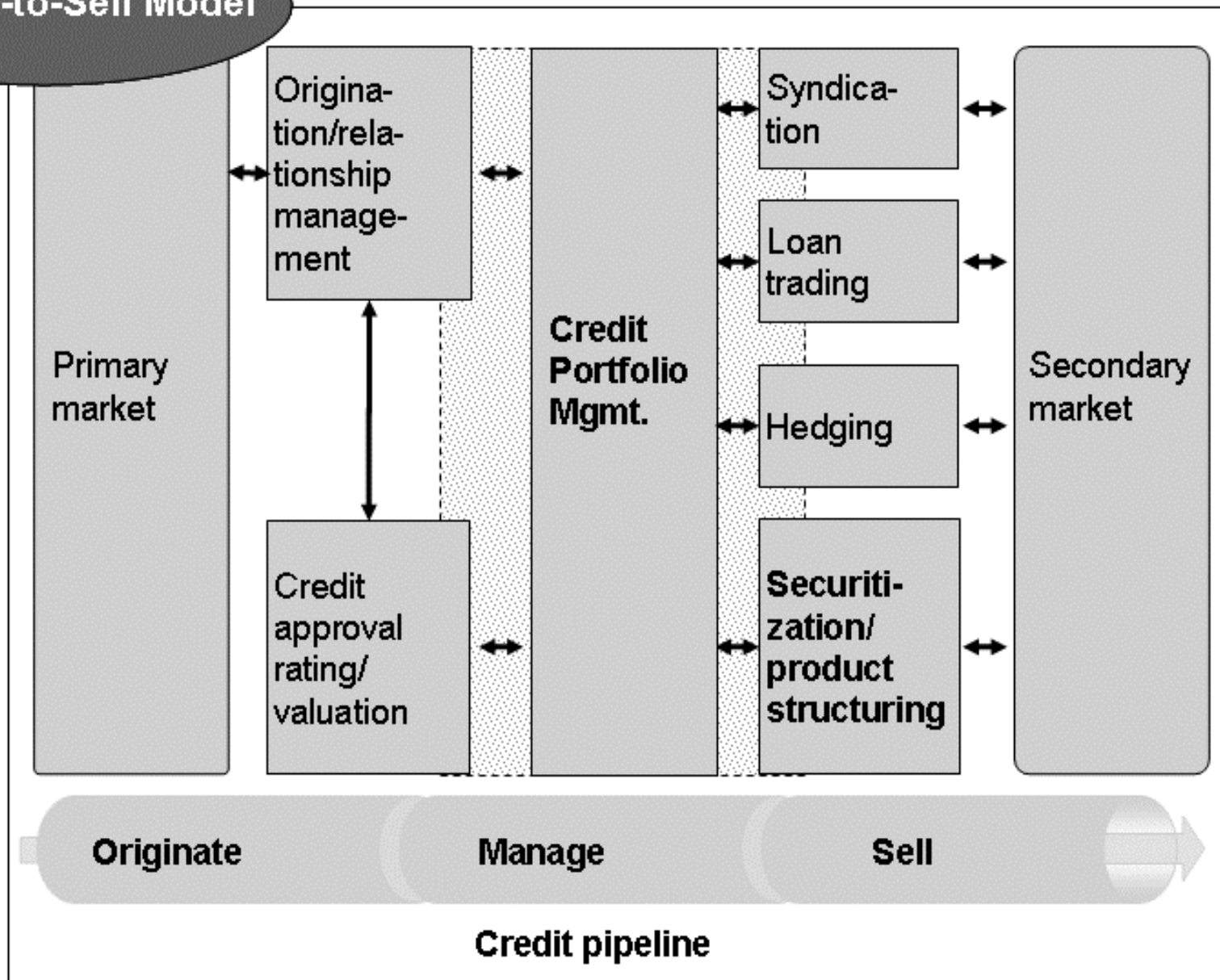
Basis points on Avg. AUM



Banks have been changing their business models to generate higher yields



Originate-to-Sell Model



Capital relief

- Freeing up economic or regulatory capital through risk transfer to third parties

Regulatory capital arbitrage

- Reduction of regulatory capital requirements with apparent reduction of economic risks

Restructuring balance sheet

- Sale of portfolios that do not have strategic fit

Funding

- Attractive (additional) financing source through sale of ABS tranches to investors against cash

Profit generation

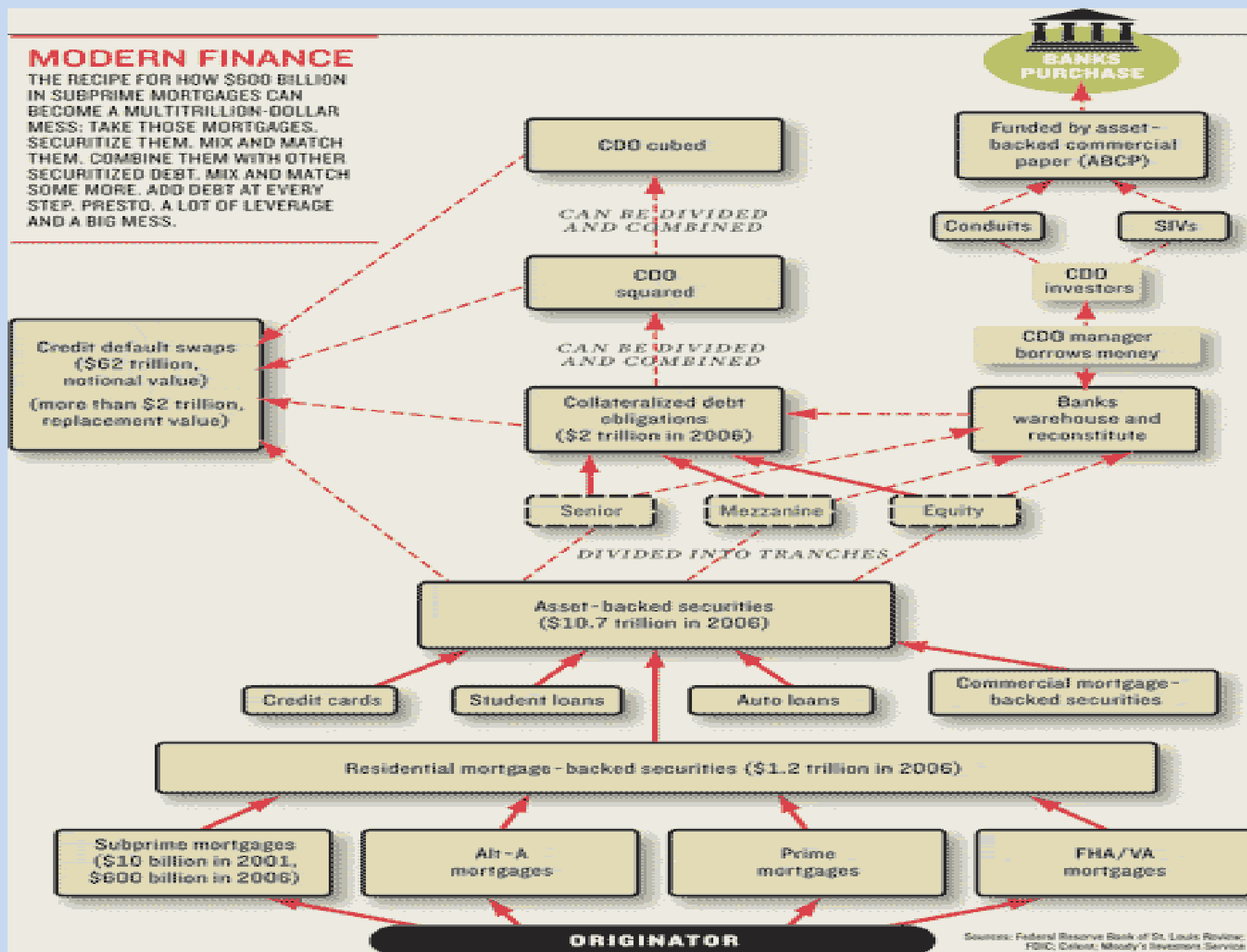
- Higher profit from higher asset turnover, creation of new asset classes, fees for structuring or management

Leading banks have reaped handsome profits on the new model



MODERN FINANCE

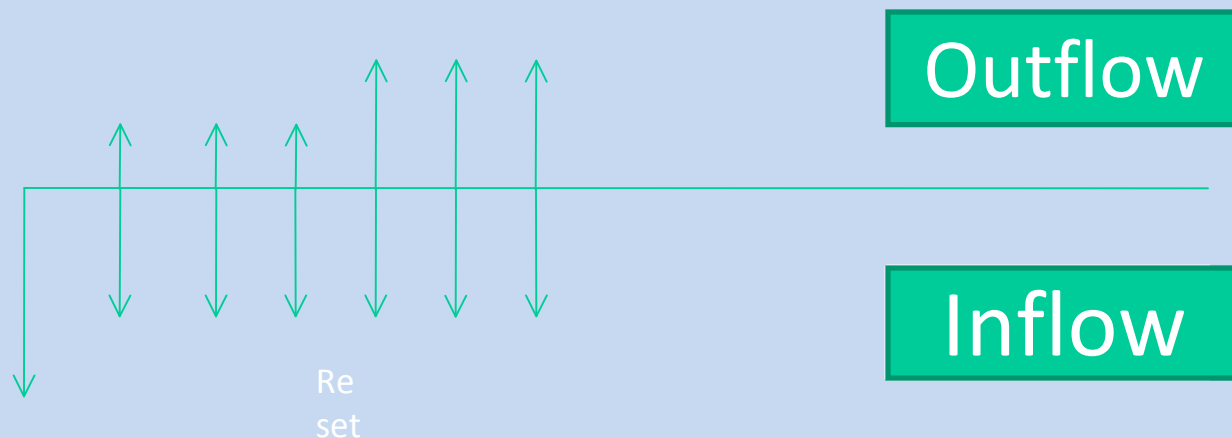
THE RECIPE FOR HOW \$600 BILLION IN SUBPRIME MORTGAGES CAN BECOME A MULTITRILLION-DOLLAR MESS: TAKE THOSE MORTGAGES, SECURITIZE THEM, MIX AND MATCH THEM, COMBINE THEM WITH OTHER SECURITIZED DEBT, MIX AND MATCH SOME MORE, ADD DEBT AT EVERY STEP. PRESTO, A LOT OF LEVERAGE AND A BIG MESS.

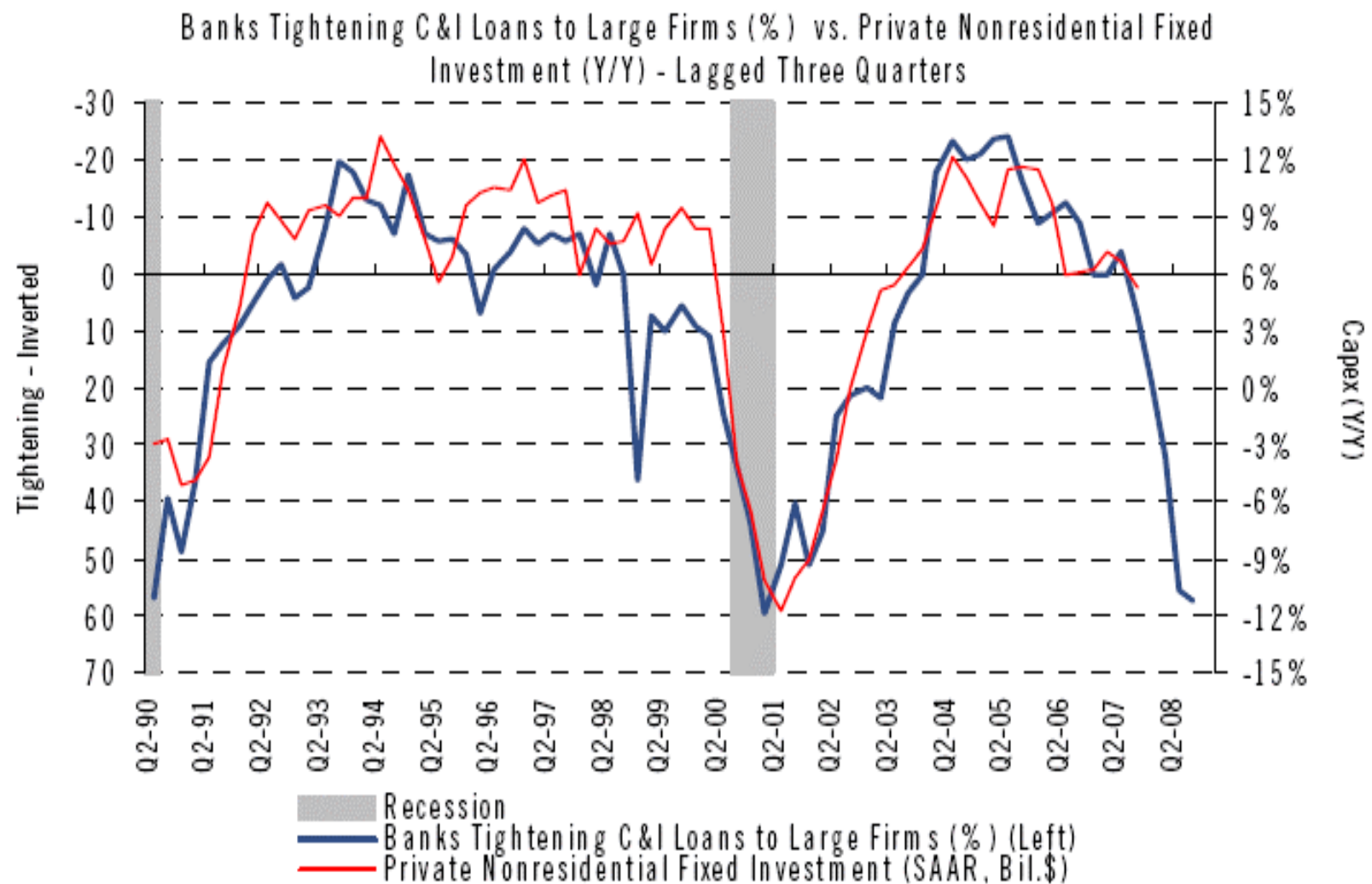


Sources: Federal Reserve Bank of St. Louis Review; FDIC; Census; Moody's Investors Service

Where were the Margins of Safety in Adjustable rate Sub Prime Mortgages?

- Cash Flows of ARMs
 - Option ARMs
 - 2/28, 3/27
- Designed to Look like Hedge Finance in early years
 - Income covered payments
- At reset the margins of safety are automatically reduced





Source: CIR – US Equity Strategy and Haver Analytics

Interest Rate Spread: 10-Year Treasury Bond Less Fed Funds Rate

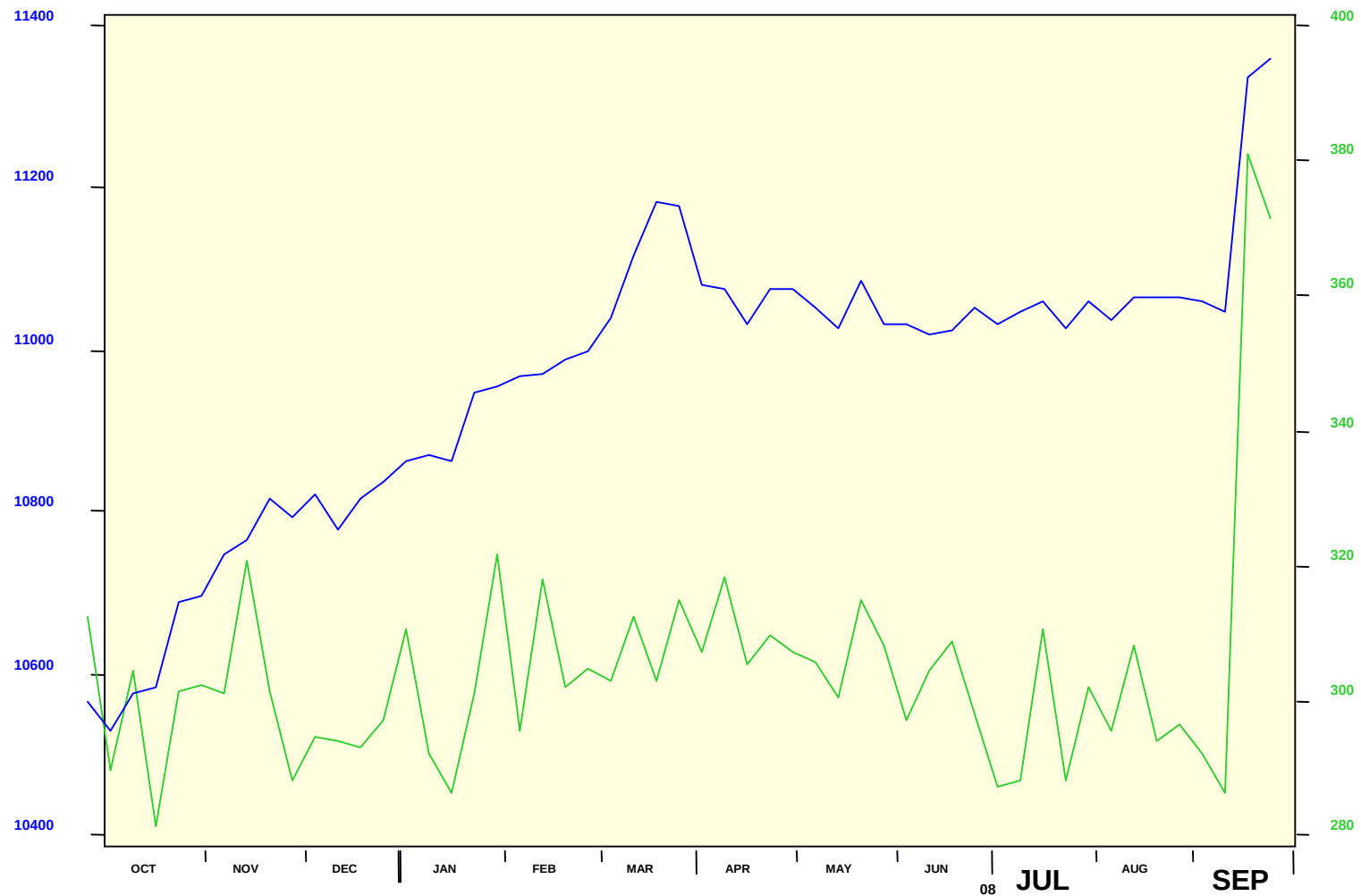


Total Assets: All Commercial Banks

SA, Bil.\$

Cash Assets: All Commercial Banks

SA, Bil.\$

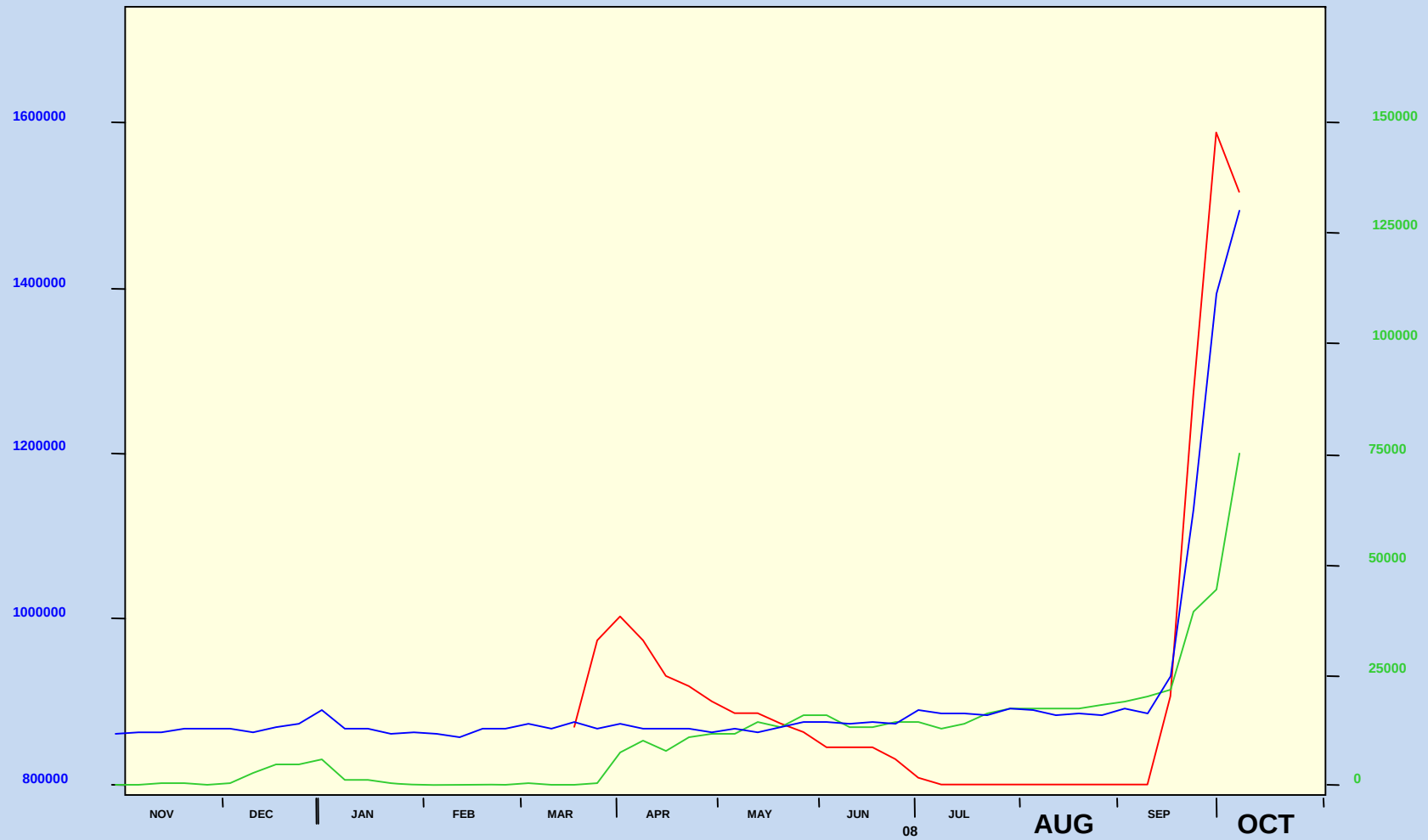


Source: Federal Reserve Board /Haver Analytics

Reserve Bank Credit Outstanding (Avg, Mil.\$)

Reserve Bank Credit: Primary Credit to Depository Institutions (Avg, Mil.\$)

Reserve Bank Credit: Primary Dealer Credit Facility (Avg, Mil.\$)



Source: Federal Reserve Board /Haver Analytics

CDR Counterparty Risk Index

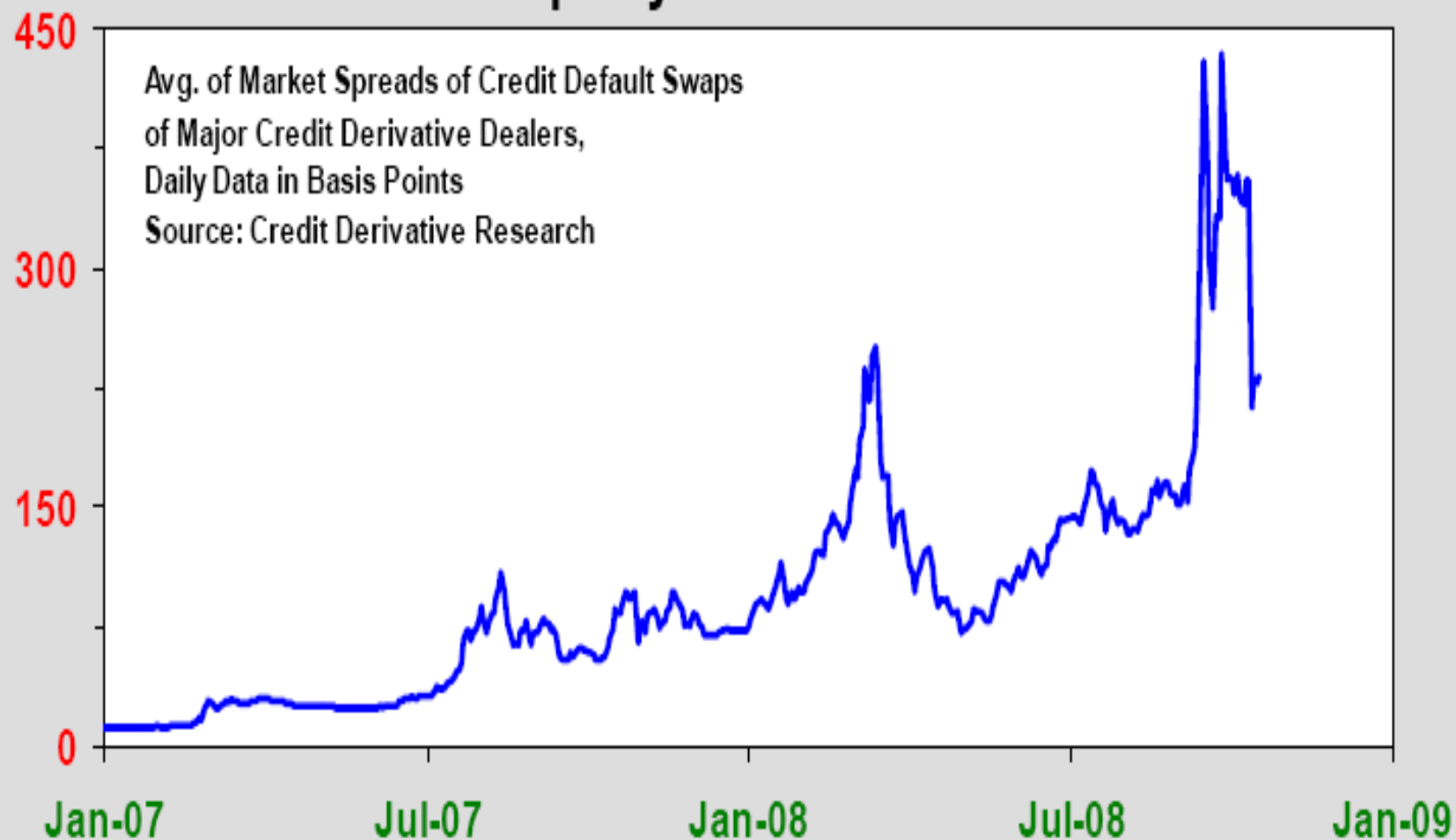
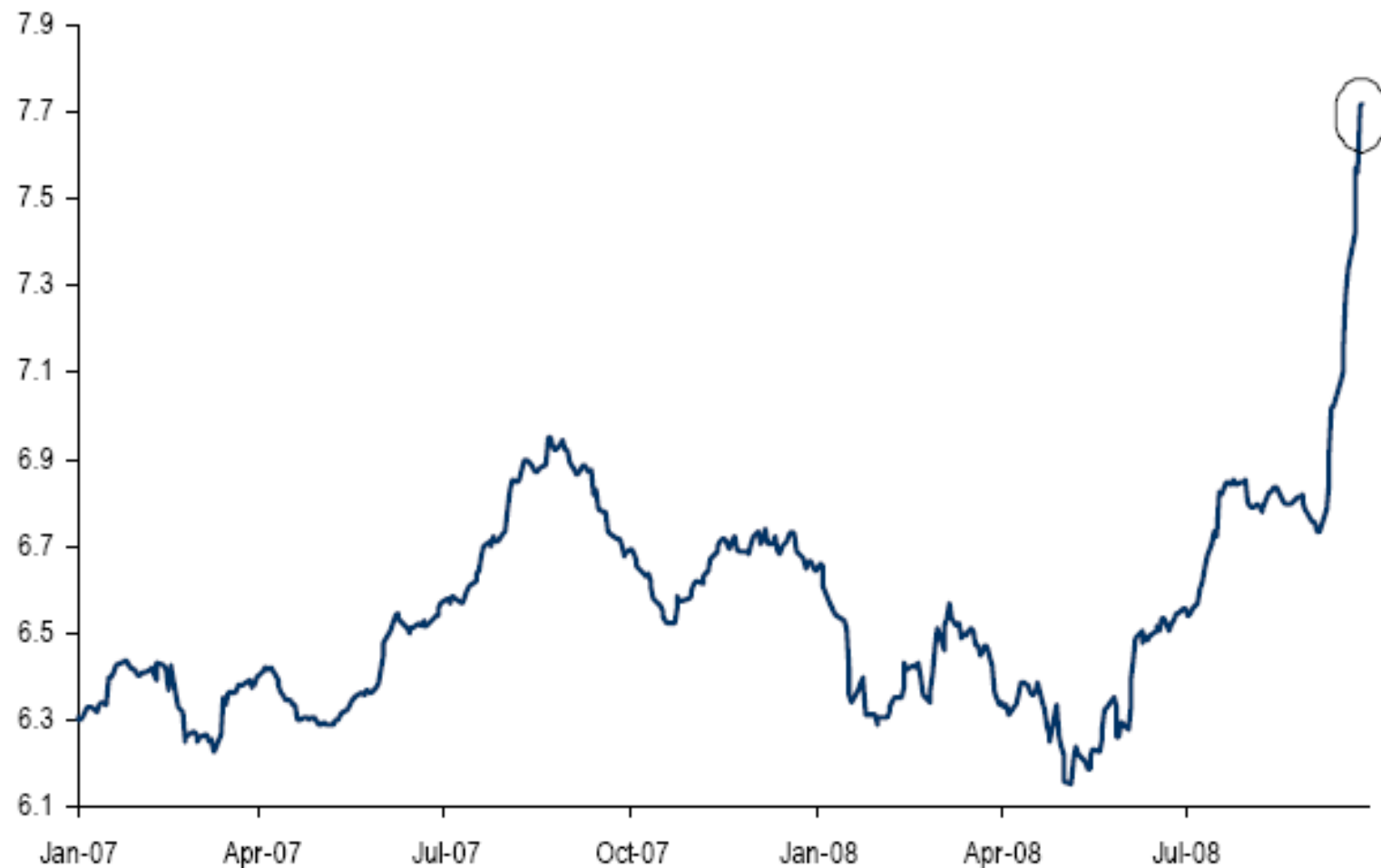


Chart 1: Monetary relief not filtering through to private sector
(Private sector interest rate*)



*An equal weighting of jumbo mortgage rates, new car loan rate, home equity loan rate, 5-year ARM, 3-month LIBOR rate, high yield bond rate, and bank rate (5-10 year duration)

Source: Merrill Lynch

Global Evolution of the Crisis

- Mid 2006 – house prices stop rising
- Early 2007 Countrywide, New Century losses
- June 2007 SIV, and Conduits lose funding
- Summer 2007 Banks recapitalise, meet guarantees
- European holding CMOs, or financing US construction also hit – covered bond market
- 2008 Second 9/11 Bear Stearns, Lehman Brothers AIG
- Liquidity crisis – Hits Emerging market countries
 - Capital flight, exchange rates, industrial production
- Collapse of global Trade finance– China needs export financing
- Collapse of Global demand
- Hits least developed countries' exports --

Developing Country Experience during the Dot-Com and Sub-Prime Bubbles

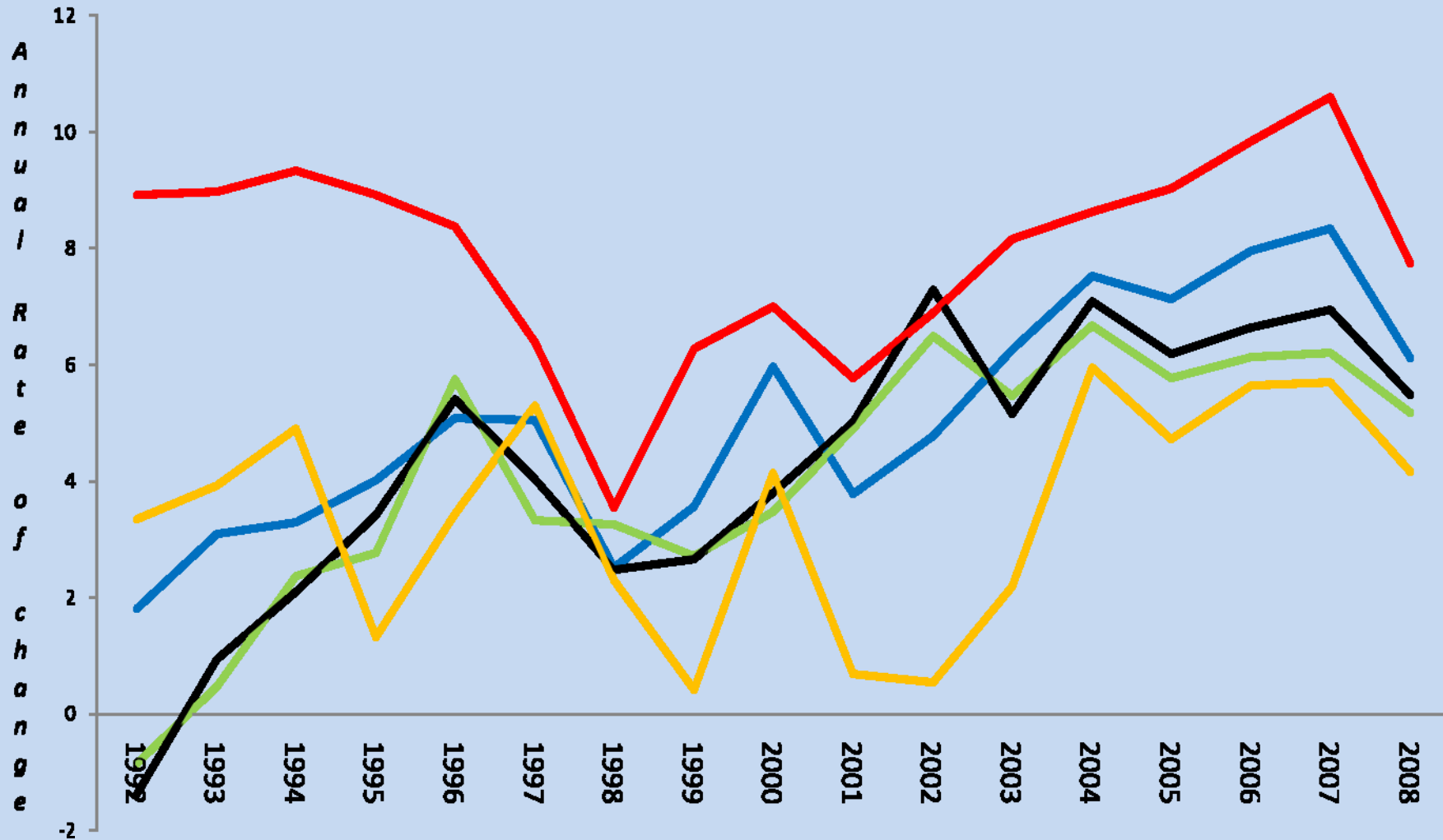


- Exceptionally Positive Performance
 - Rising growth rates
 - Low, stable inflation rates
 - Improved external (surplus) balances
 - Improving debt burdens
 - Rising FDI Inflows (primarily in emerging market economies)
 - Rising employment levels

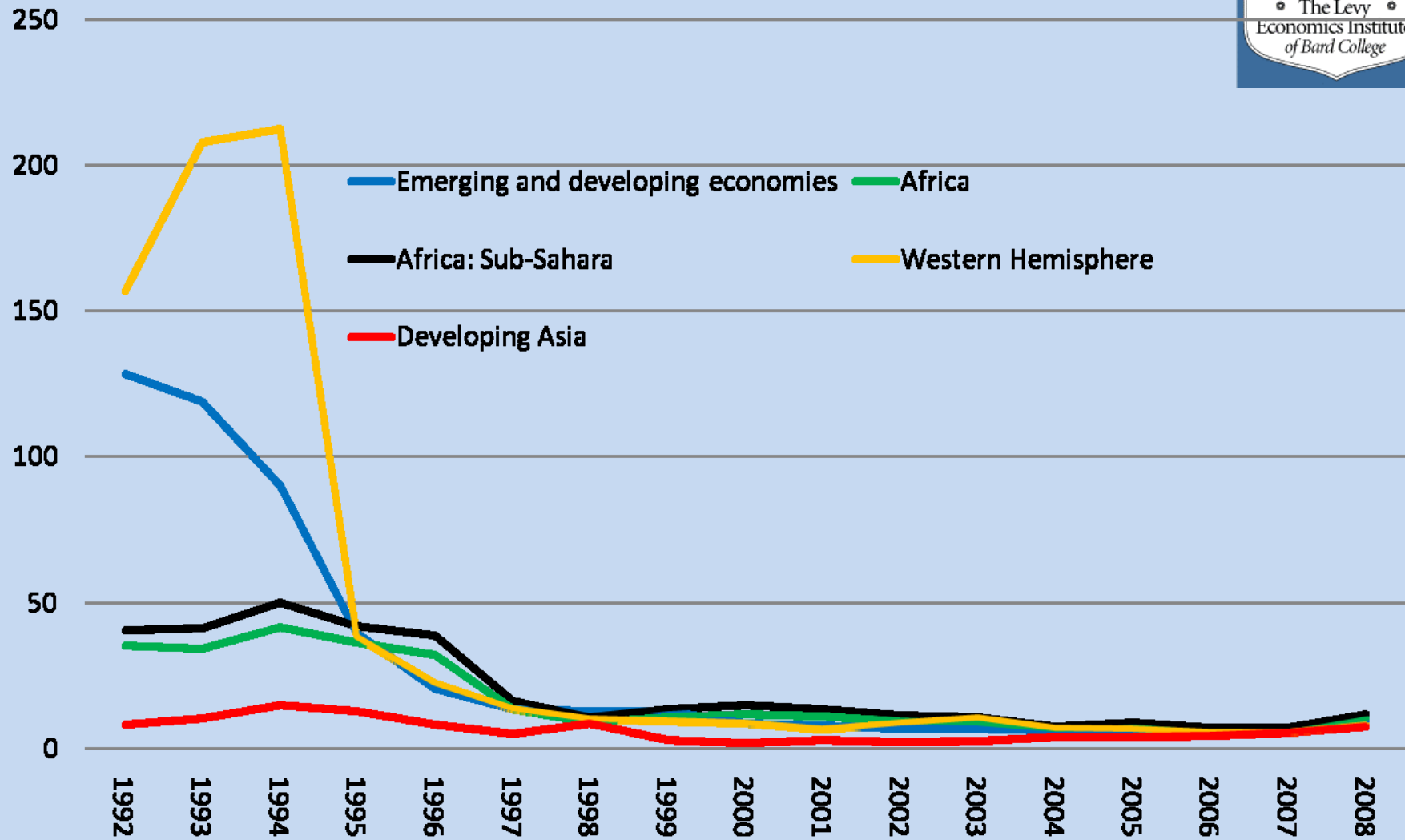
GDP Constant Prices 1992-2008

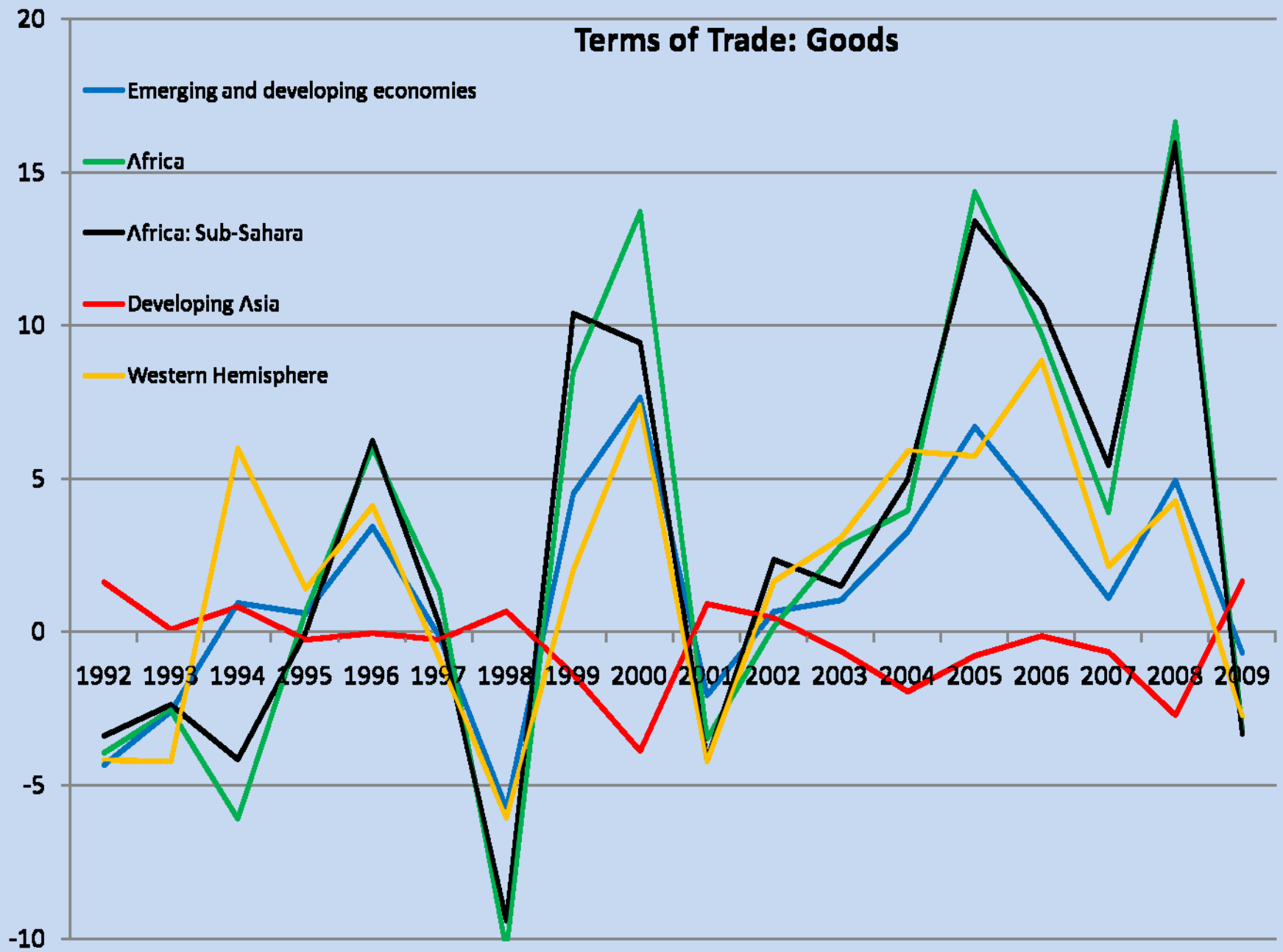


- Emerging and developing economies
- Africa
- Africa: Sub-Saharan
- Western Hemisphere
- Developing Asia

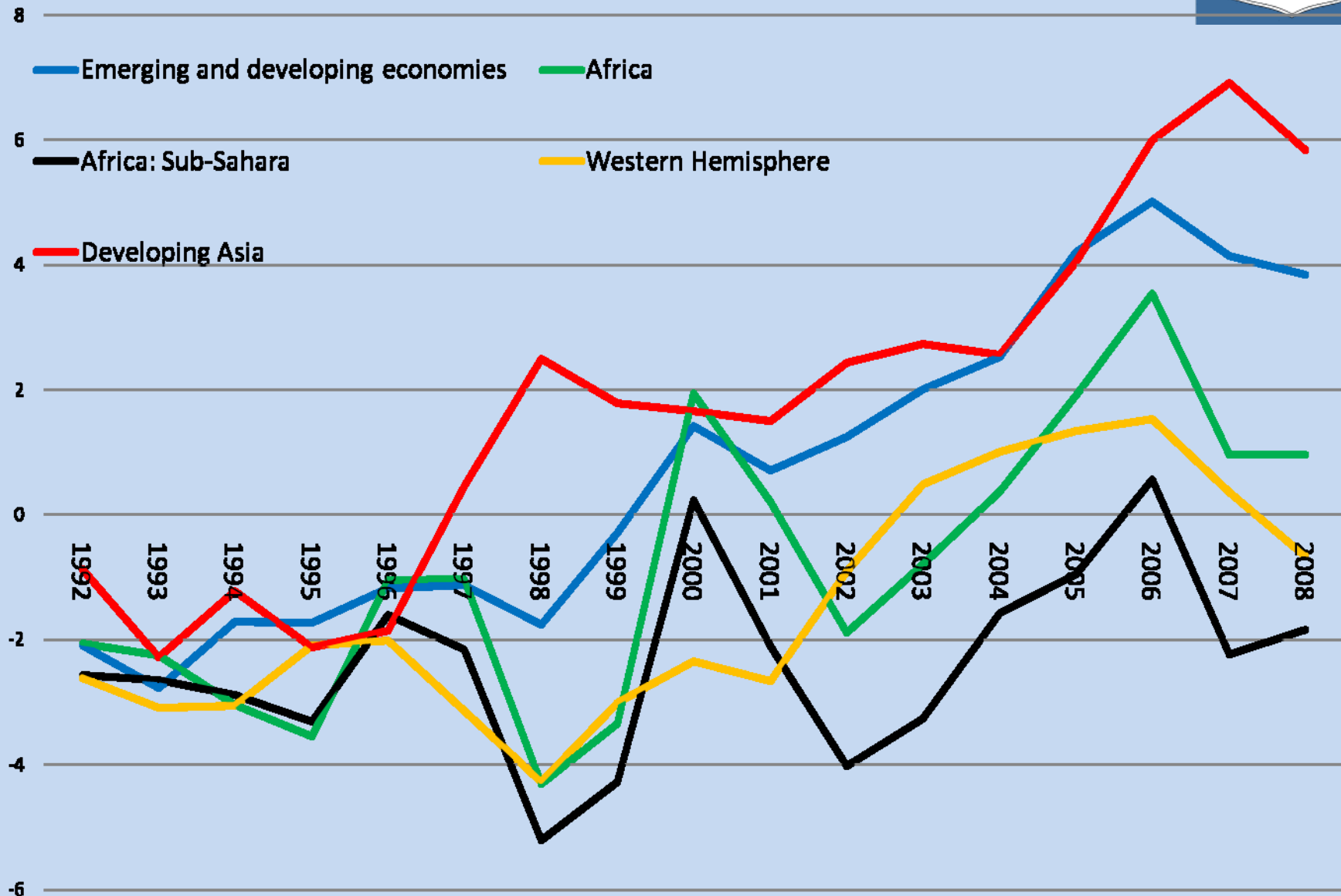


Annual Rate of Consumer Price Inflation

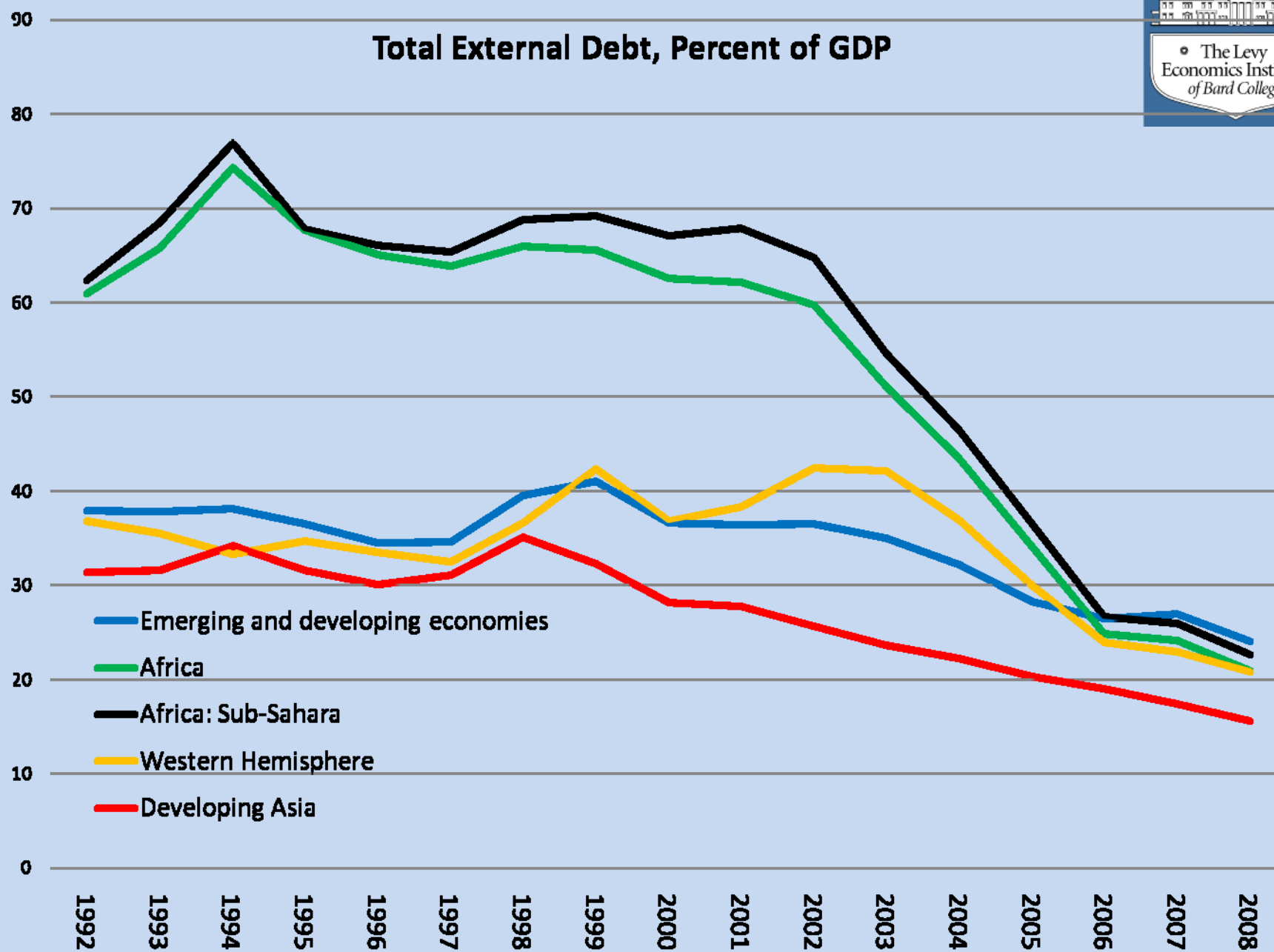




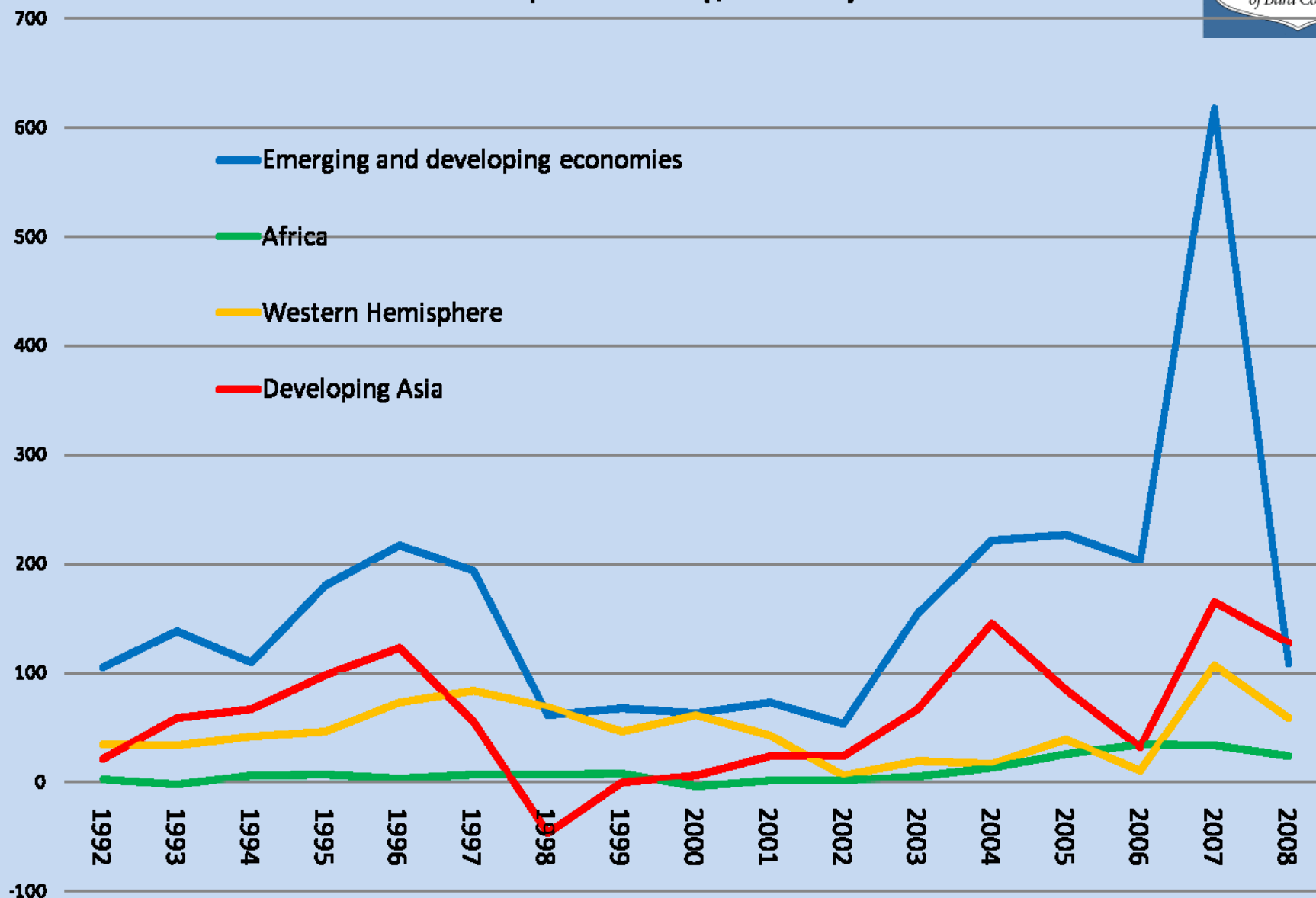
Current Account Balance % GDP



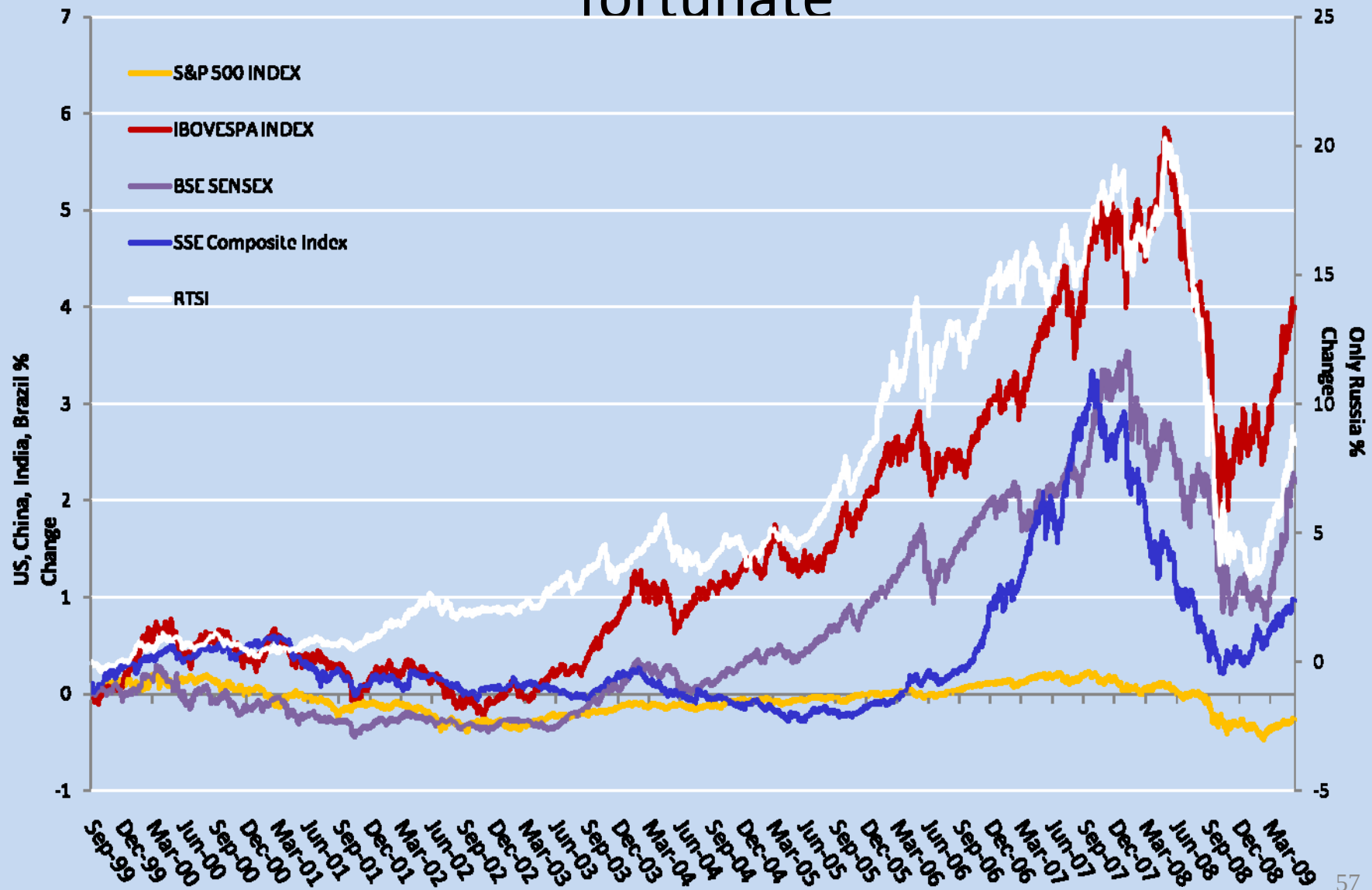
Total External Debt, Percent of GDP

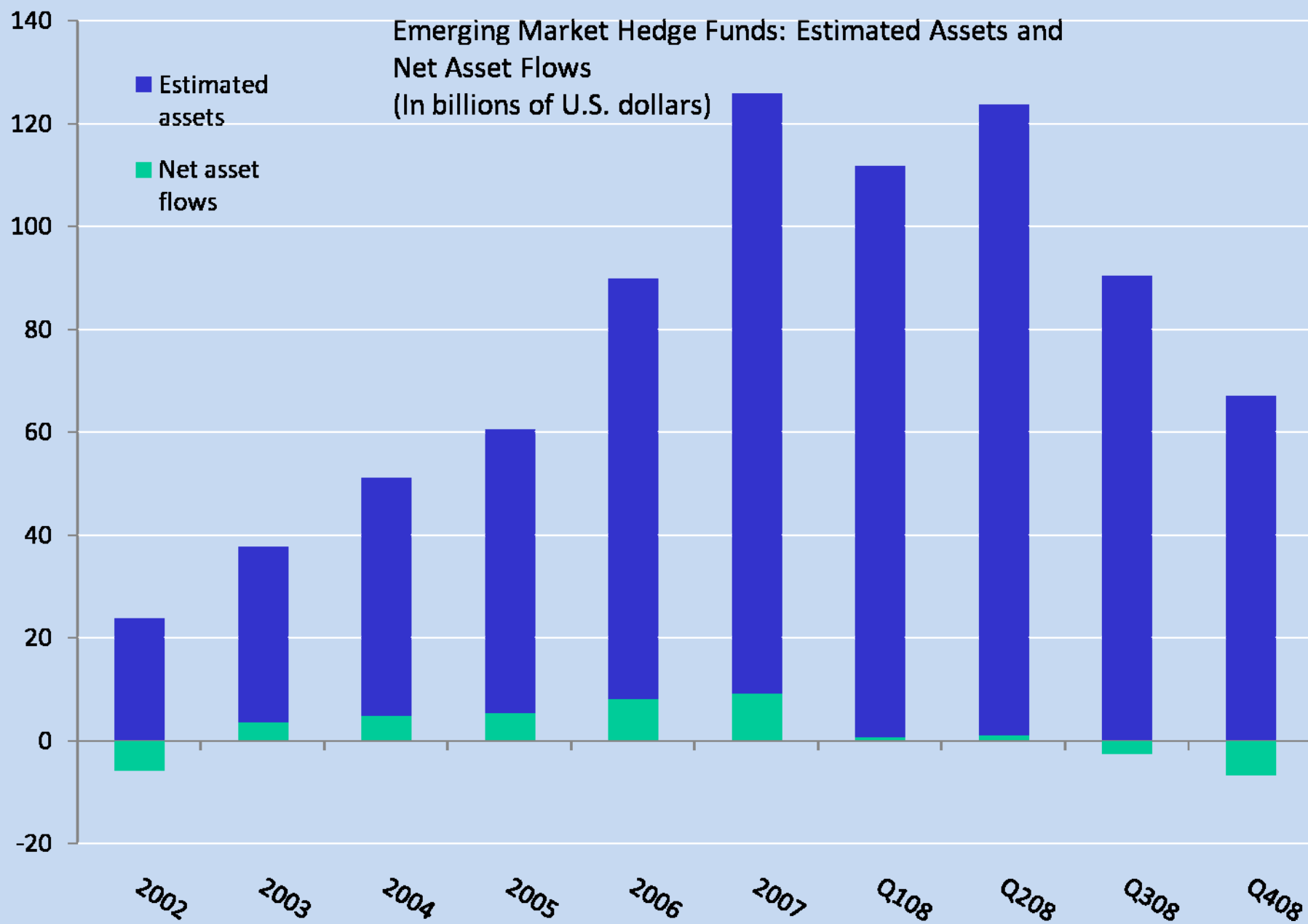


Net Private Capital Flows (\$ billions)

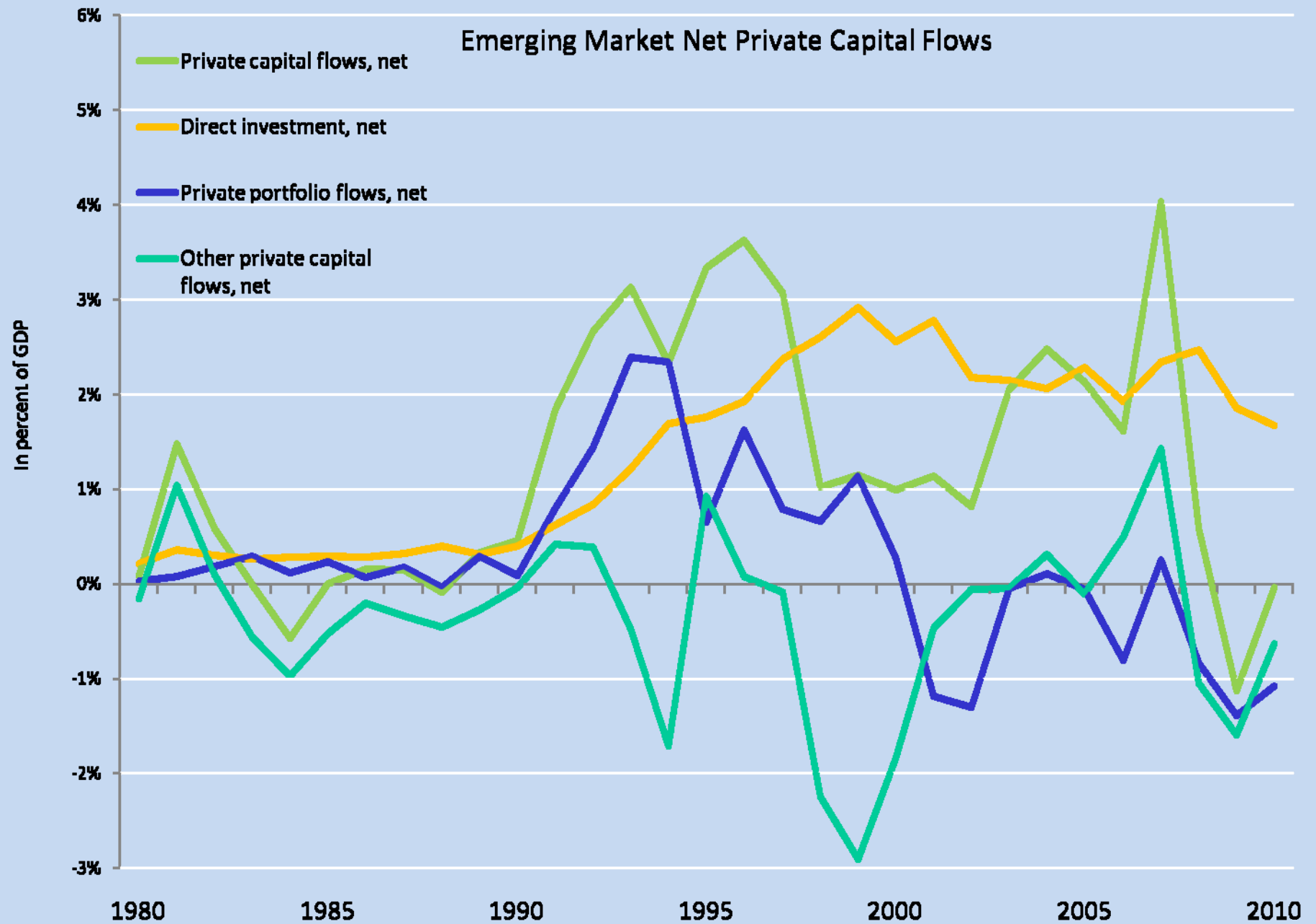


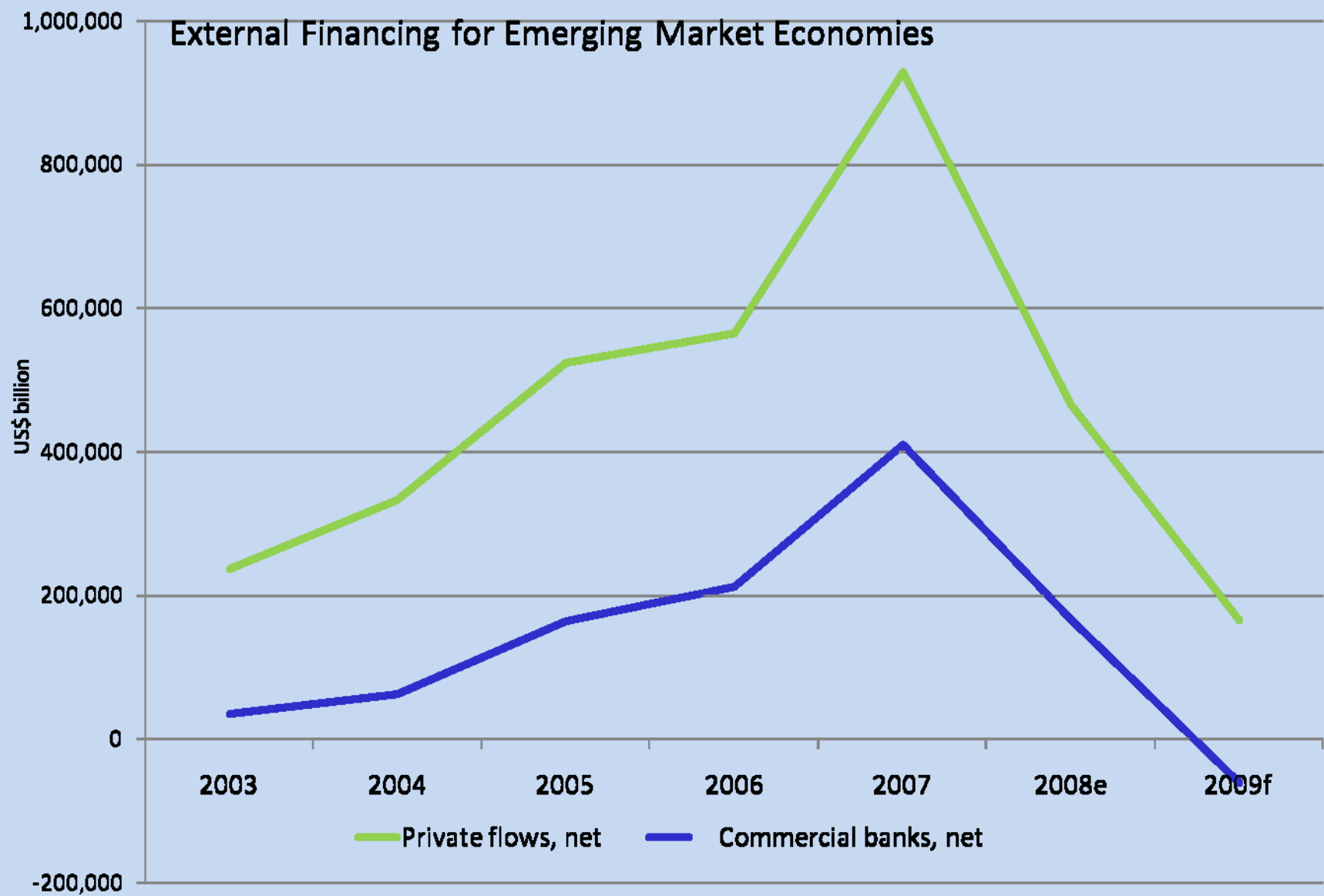
Emerging Markets BRICs were especially fortunate





Emerging Market Net Private Capital Flows





What caused this good performance?

- Washington Consensus Policies?
- Or deregulated developed country financial systems?
 - Private Equity Funds – driving shareholder value
 - Outsourcing of production and employment
 - Rising foreign direct investment
 - Rising US household mortgage debt
 - Rising demand for developing country exports
 - Commodity Index Funds + Speculation
 - Rising Commodity Prices
 - Improved developing country terms of trade
 - Rising energy prices
 - Most developing countries are now petroleum producers
 - Investment in biofuels also improved soft commodity prices
 - Interest Arbitrage – carry trade
 - Short-term capital flows to emerging markets
 - Lower interest rates / lower risk spreads – lower debt service

Is this pattern likely to continue?

- The Bubble turned developing countries to export-led growth dependent on primary commodity exports and semi-manufactured processed goods
- Large external surpluses = Large global imbalances
- US demand made trade the engine of global growth
- US Financial System financed the growth of global demand

Global Response to Crisis

- Global stimulus packages to offset decline
 - Need Coordinated response
 - Surplus countries should lead to avoid aggravating global imbalances
 - But Europe declines coordination or additional stimulus
 - Only Japan and China have major stimulus
 - Most developing countries do not have financial resources
 - IMF will not approve financing for stimulus

In absence of Global Coordinated Response

- US will adjust
 - Households will delever
 - Higher savings rates,
 - lower demand for imports
 - Financial institutions will delever
 - Reduced foreign investment
 - Reduced outsourcing
 - Reduced foreign financing
 - Global trade and finance will contract
 - Developing countries will again face external constraints – IMF conditionality returns

What stimulus Response?

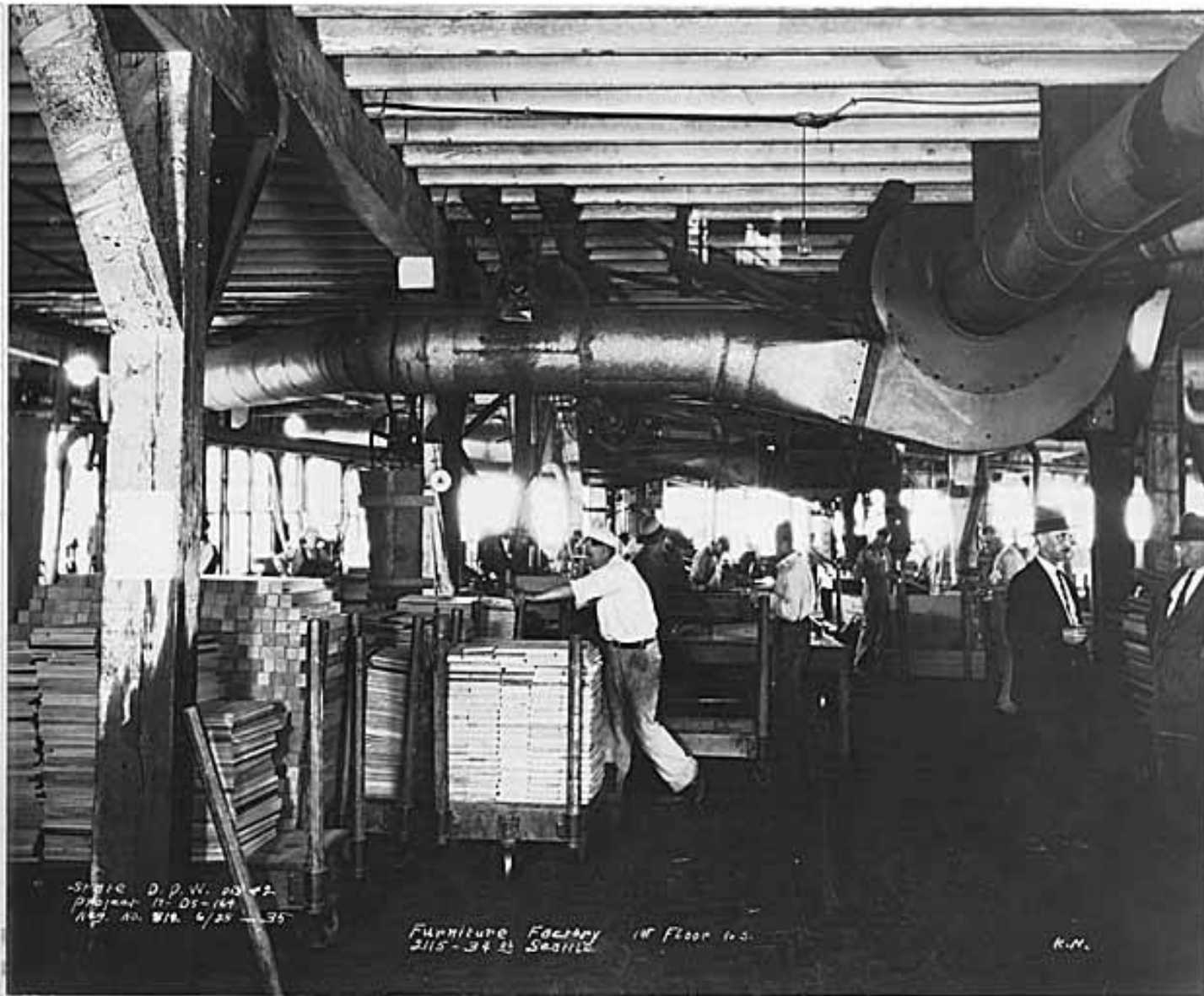
- Hydraulic Keynesian deficit spending
 - Financial Bailouts
 - little impact on incomes
 - impact of balance sheets
 - Government expenditures
 - take time to implement
 - are politically sensitive
 - Are designed for cyclical downturns
 - Designed to reduce excess capacity
 - Not to make redundant capacity profitable

Is there an alternative stimulus policy?

- Roosevelt example
 - increase incomes and employment directly
 - TERA used by Roosevelt when Governor of NY
 - CCC, FERA, PWA-WPA
- Argentina example
 - First used by Duhalde as Intendente of Lomas Zamorra
 - 1980s
 - Jefes de Hogares after the crisis
- Keynes's example
 - Targetted sectoral demand

Federal Emergency Relief Administration - - Hopkins

- Direct grants to States (with 3:1 matching)
- Hired unemployed teachers
 - to teach adults literacy
 - to provide vocational training
 - to provide rural schooling
- Jobs to students in laboratories, libraries and museums
- Rural rehabilitation -- seed fertilizer and live stock to provide self-sufficiency
- Non-farm family subsistence gardens
- School lunches provided by women on work relief



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Keynes's concerns

- With unemployment over 10%

“We are more in need today of a rightly distributed demand than of a greater aggregate demand”
- Facing a collapse in major export industries: unemployment was in iron, shipbuilding, coal
- Replacing foreign demand to support these industries would maintain excess capacity and create inflation
- Better use demand to make transition to new industries

For emerging market developing countries

- Facing loss of export-led growth : New National Development Strategy
 - Use external surplus to support domestic demand-led growth
 - This is not easy – example of Japan
- How employment guarantee can help resolve this problem
 - It can reduce domestic saving – income security
 - It can reduce reliance on exports – sector programs – example of Brazil's Medium Term Plan
 - It can reduce reliance on investment – financial stability of consumption led domestic growth
- Employment Guarantee can also alleviate inflation threat: Training – buffer stock

For Least Developed Countries

- A suitably designed ELR programme to provide employment can also be designed to satisfy:
 - MDG Goal 1: Eradicate Extreme Hunger and Poverty
 - MDG Goal 2: Universal Primary Education
 - MDG Goal 3: Promote Gender Equality and Empower Women
 - MDG 4 and 5: Reduce Child Mortality and Improve Maternal Health

Employment Guarantee

- Crucial Component of
 - Stimulus policy
 - Anti-inflation policy
 - National development strategy
 - MDG policy
- Emergency or Structural Policy?
 - Antecedents precede crisis
 - Provides structural support to labour market

Thank you

