The Credit Crunch – Causes, Consequences and Cures

By Roger Bootle

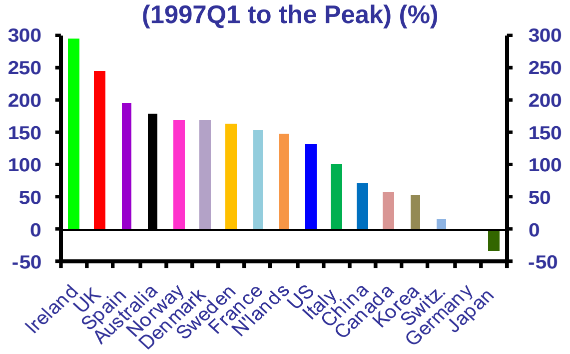
1. Causes of the Financial Crisis

- A bubble in real estate.
- Inadequate capital held by banks.
- Overly-complex instruments which were poorly understood.
- Securitisation and distribution.
- Inadequate liquidity.

2. Who is to Blame?

- The banks and bankers?
- The regulators?
- The ratings agencies?
- The Bank of England?
- Alan Greenspan?
- All of us?
- The Chinese?

3. Cumulative Rise in Average House Prices (1997Q1 to the Peak) (%)



Source: Thomson Datastream

4. Price Falls Needed to Return House Price to Income Ratios to Their Long-Run Average (%)

	Total	Falls to date	Yet to come?
Spain	42	7	37
Ireland	42	11	35
Netherlands	42	0	42
Australia	39	0	39
UK	35	13	25
France	32	0	32
Denmark	28	4	25
Italy	27	0	27
US	26	18	10
Norway	24	0	24
Sweden	23	0	23
Canada	14	0	14

Source: Thomson Datastream & Capital Economics

5. Housing Conclusions

- House price corrections in the US and UK have much further to run.
- But we also expect house prices to fall in a number of other countries.
- Asia may not suffer. But Europe, where most housing markets are overvalued, will.
- Across Europe, house price falls of at least 20% to 30% look the most likely outcome.

6. Quantifying Future Financial Losses Over Next Two Years

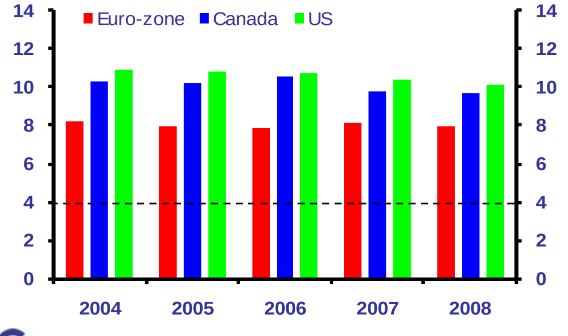
- Falling property values, recession, shrinking profits & rising unemployment will lead to soaring loan losses.
- US losses = $400bn
- Euro-zone losses = $250bn
- UK losses = $100bn

7. Impact of Losses on Bank Capital & Lending

Banks have 4 options:

1. Allow their capital ratios to fall.
2. Sell assets.
3. Raise more capital.
4. Reduce lending.

8. Bank Tier 1 Capital Ratios (As a % of Risk-Weighted Assets) (2004 – 2008)



Source: FDIC, OSFI & Bloomberg

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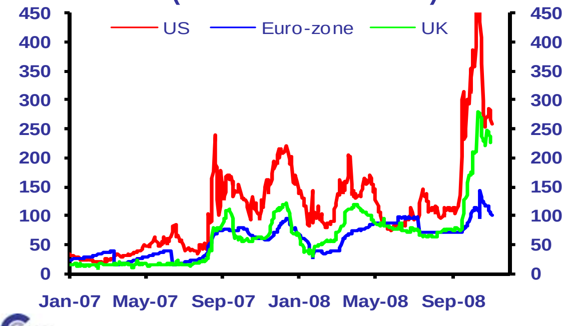
9. Government Recapitalisation

- US to inject $250bn, equivalent to 25% of existing capital base or close to 2% of GDP.
- UK to inject $85bn, equivalent to 25% of capital and 3.5% of GDP.
- Euro-zone to inject $260bn (Germany = $110bn & France = $55bn), equivalent to 25% of capital and 2% of GDP.

10. Banks in the Brave New World

- $1trn in additional losses will put bank capital under even more pressure.
- As it stands, government bailouts are still not big enough. More money will be needed.
- Bank lending to contract by at least 10% in US & UK, and stagnate in the euro-zone.

11. 3 Month Inter-Bank Rates Minus 3 Month Treasury Bill Rates (bps) (2007 – 2008) (Latest = 3 November)



Source: Thomson Datastream

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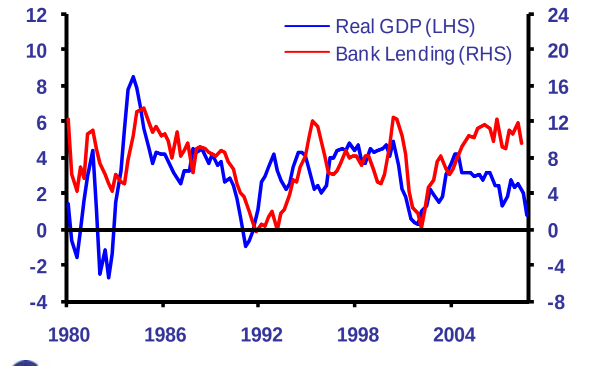
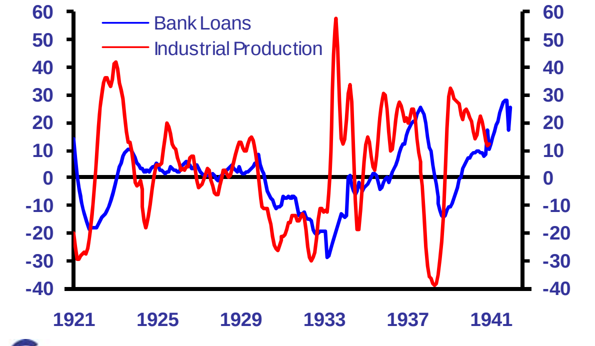
12. US GDP & Bank Lending (% y/y) (1980 – 2008)



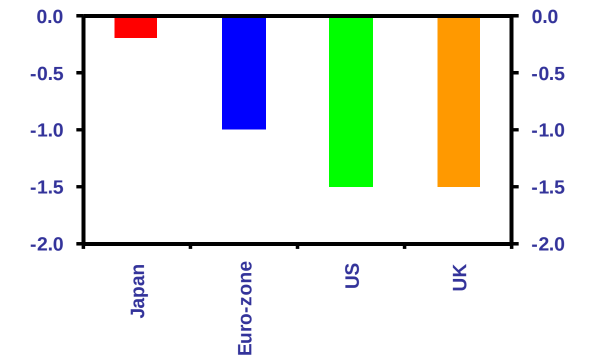
Source: Thomson Datastream

13. US Bank Loans & Industrial Production (% y/y) (1921 – 1941)



Source: NBER

14. GDP Growth (% y/y) (2009)



Source: Capital Economics

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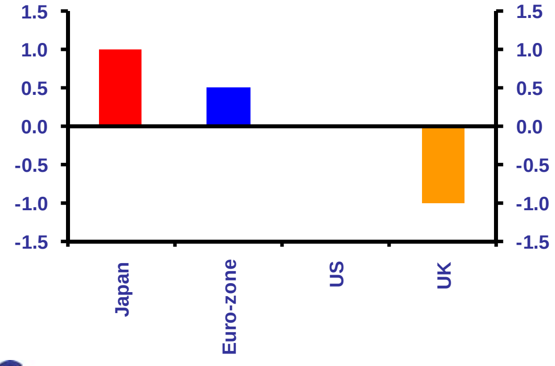
15. GDP Growth (% y/y) (2010)

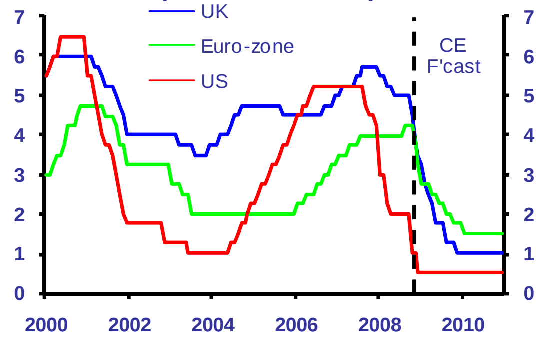


Source: Capital Economics

16. A Five-Phased Policy Approach

1. Interest rates to be pushed down all the way to zero if necessary.
2. Unorthodox monetary policy to be at the ready.
3. A portfolio of possible public sector infrastructure projects, and tax cuts, to be assembled, for possible implementation later.
4. A fiscal stabilisation plan to be prepared to return the public finances to normality once the crisis is over.
5. An Independent Fiscal Policy Committee, mimicking the MPC, to guide fiscal policy.
6. The benefits of announcement and all party commitment.

17. Interest Rate Forecasts (%) (2000 - 2010) (Latest = October)

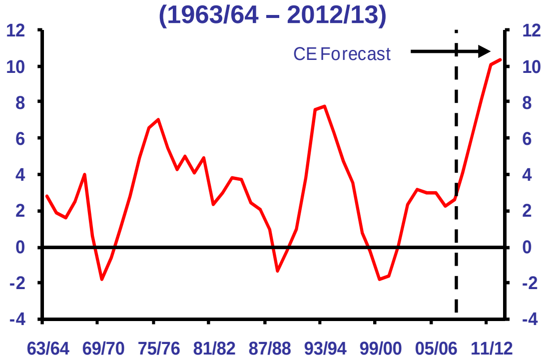


Source: Thomson Datastream & Capital Economics

18. Will Bank Bail-Outs be Inflationary?

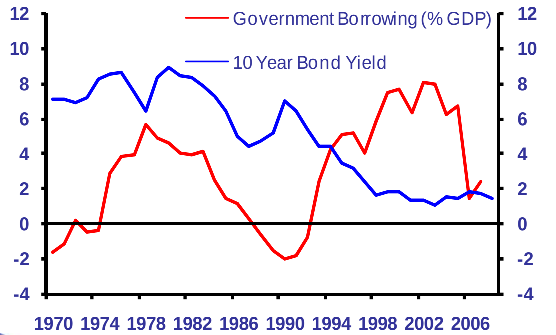
- Wealth has been destroyed; this is simply replacing it – in part.
- Confidence has been shattered.
- Banks are less able and willing to lend.
- The evidence from Japan.

19. UK Public Borrowing (% GDP) (1963/64 – 2012/13)



Source: HM Treasury & Capital Economics

20. Japan Government Borrowing (As a % of GDP) & 10 Year Bond Yields (%) (1970 – 2008)



Sources: OECD & Thomson Datastream

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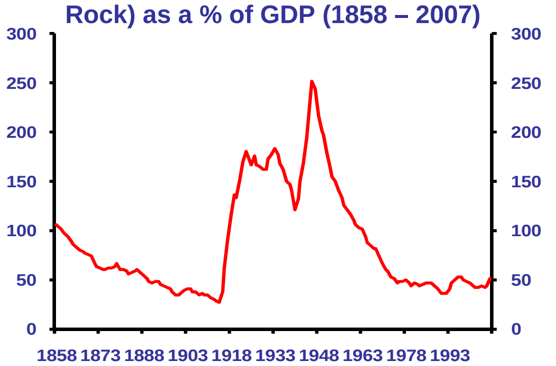
21. Finland CPI (% y/y) (1980 – 2008) (Latest = September)

Sources: Thomson Datastream

22. UK Gross National Debt (Including Northern Rock) as a % of GDP (1858 – 2007)



Source: HM Treasury & Capital Economics

23. Worries About the Money Supply

- Printing money.
- Central bank money and private money.
- How do people respond to monetary changes?
- What happened in Japan?

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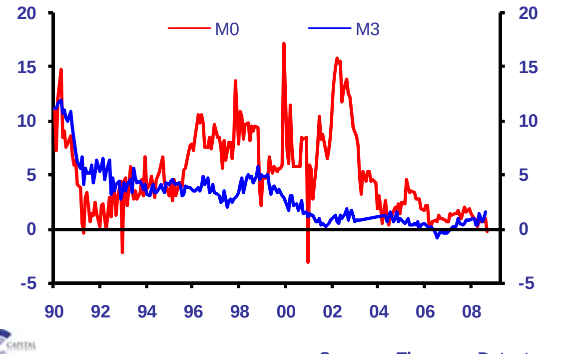
24. Japanese Money Supply (% y/y) (1990 – 2008) (Latest = September)

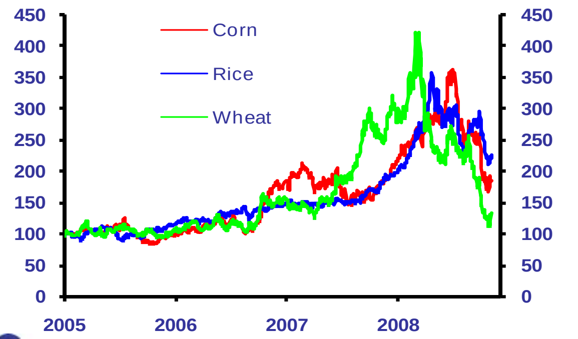


Sources: Thomson Datastream

25. Crude Oil Price ($ per Barrel) (2005 - 2008) (Latest = 3 November)

Source: Thomson Datastream

26. Agricultural Commodity Prices (Jan 05 = 100) (2005 – 2008) (Latest = 4 November)



Source: Bloomberg

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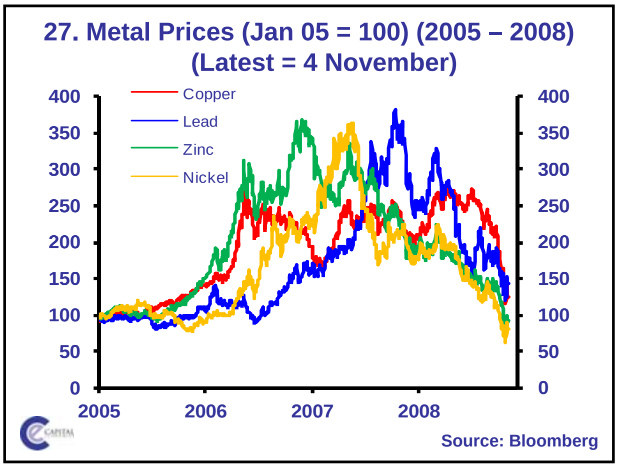
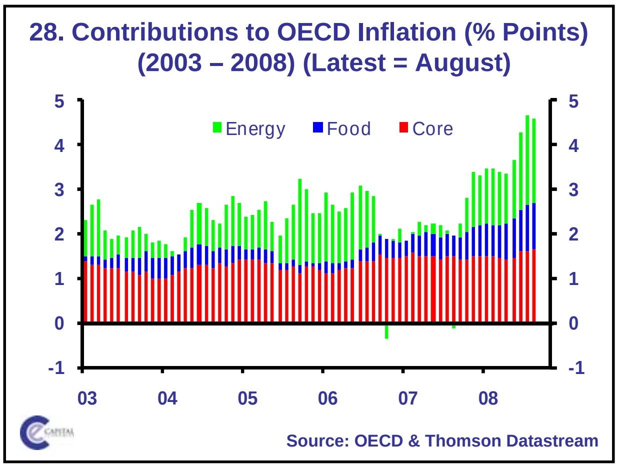
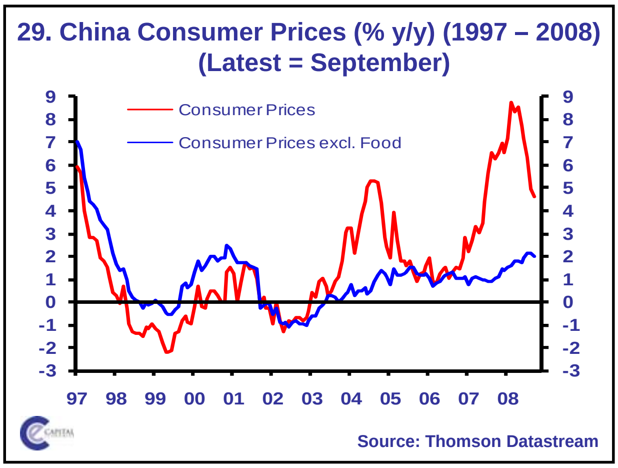
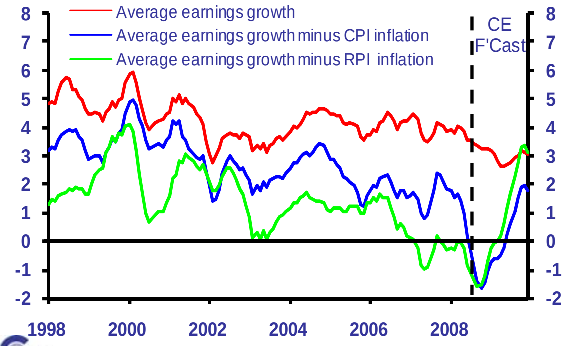




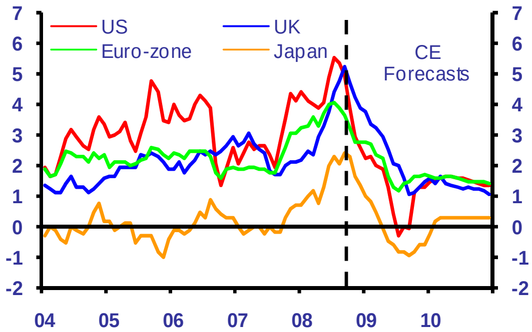


30. UK Average Earnings (1998 – 2009) (Latest = August)



Source: Thomson Datastream & Capital Economics

31. Inflation Forecasts (% y/y) (2004 - 2010) (Latest = September)



Source: Thomson Datastream & Capital Economics

32. The Circumstances Most Propitious for Deflation

- A downward shock to aggregate demand.
- Enfeebled banks.
- Heavy indebtedness.
- Flexible pricing.
- Weak commodity prices.
- Political weakness.

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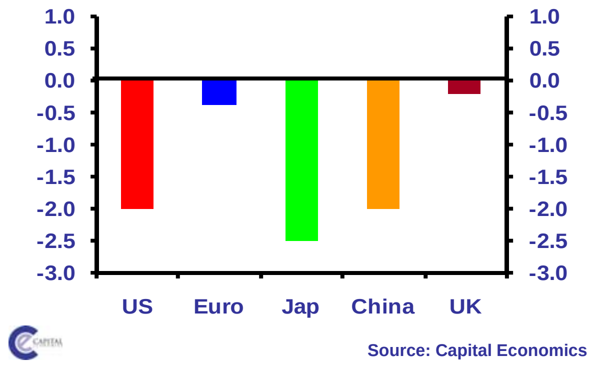
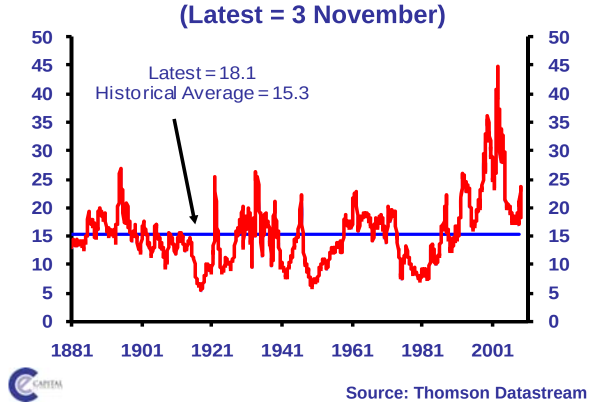
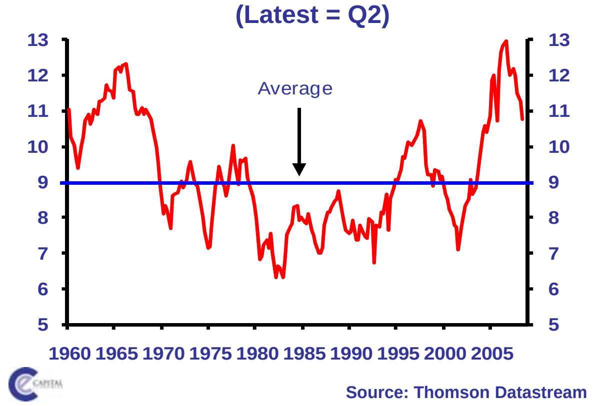
33. Trough in Inflation if Oil Prices Fall to $50pb and Agricultural Commodities Fall by 30%



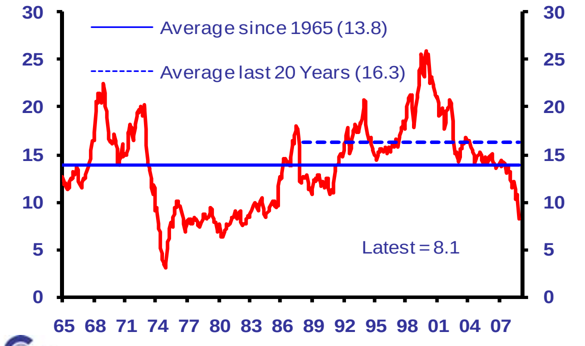
34. US S&P 500 PE Ratio (1881 – 2008) (Latest = 3 November)



35. US Profits as a % of GDP (1960 – 2008) (Latest = Q2)

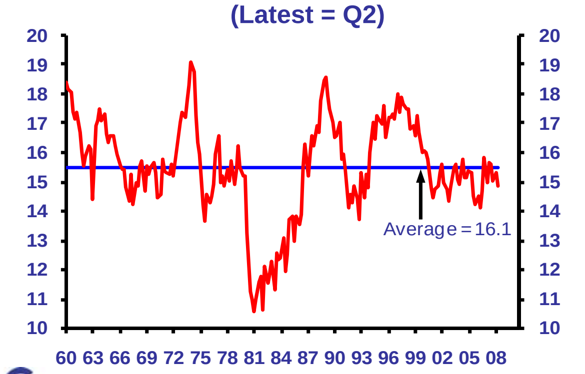


36. UK PE Ratio (Datastream All Share) (1965 – 2008) (Latest = 3 November)



Source: Thomson Datastream

37. UK Profits as a % of GDP (1960 – 2008) (Latest = Q2)



Source: Thomson Datastream

38. The Shape of the New Financial World

- Banks hold much more capital.
- Variable capital requirements.
- Banks hold more liquid assets.
- Pay is lower and militantly structured.
- Investment banking curtailed.
- The “originate and distribute” model to be closely circumscribed.
- The Tripartite arrangements for supervision to end?
- The role of institutional shareholders.
- Narrow banking?

39. The New Policy Regime

- Asset prices now central to monetary policy.
- The prevention of bubbles to be a key objective.
- Inflation to be targeted over a much longer time horizon.
- Inflation to be more variable over short periods.

40. Conclusions

- This is not a normal recession.
- Low inflation will worsen the impact of falling asset prices.
- Public confidence – in politicians and in financial institutions – is shattered.
- In type, this downturn has similarities with Japan in the 1990s, if not the Great Depression.
- Interest rates here will fall to 1%, or even 0%.
- Over the next five years, the big worry is not inflation, but deflation.

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