The Crisis, Obama, and Change

Good morning. We are in the midst of the Great Recession; the distress in the financial sector in industrial countries is at its core, and from there problems have spread globally. We have had dramatic global output falls in the last two quarters, commensurate with the pace of decline during the Great Depression. Middle class wealth has been decimated. It is at times like this that I remember the wise words of my Korean friend at the International Monetary Fund – if you want to feel rich, consume less. Indeed, this is what millions of families are doing.

Unlike in the Depression, however, we have had a massive increase in monetary and fiscal stimulus, which is already slowing the pace of decline and stabilizing the world economy. So while worse than any recent recession, matters will almost certainly not get near Great Depression levels.

So are we at the beginning of the end? My sense is that compared to what we have been through, the next few quarters could seem like a recovery. But history suggests that fundamental balance sheet weaknesses tend to act as a drag on growth for considerable periods. Certainly, for industrial countries we may be only at the end of the beginning. For some emerging markets, though, especially those that can rely on their own, or regional, demand, this crisis could result in a dramatic improvement in relative economic power. But let me start by discussing the crisis and current prospects for recovery.

There is some consensus that the proximate causes of the crisis are: (i) the U.S. financial sector misallocated resources to real estate, financed through the issuance of exotic new financial

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1 Remarks delivered by Raghuram G. Rajan, Eric Gleacher Distinguished Service Professor of Finance at the Samsung Global Investors Conference in Korea on May 11th 2009.
instruments; (ii) a significant portion of these instruments found their way, directly or indirectly, into commercial and investment bank balance sheets; (iii) these investments were largely financed with short-term debt. (iv) The mix exploded starting in 2007. On these, there is broad agreement. But let us dig a little deeper.

This is a crisis born in some ways from previous financial crises [Slide 2: Origins of Crisis]. A wave of crises swept through the emerging markets in the late 1990’s: East Asian economies collapsed, Russia defaulted, and Argentina, Brazil, and Turkey faced severe stress. In response to these problems, emerging markets became far more circumspect about borrowing from abroad to finance domestic demand. Instead, their corporations, governments, and households cut back on investment and reduced consumption.

From net absorbers of financial capital from the rest of the world, a number of these countries became net exporters of financial capital – running the current account surpluses you see in the graph. When combined with the savings of habitual exporters like Germany and Japan, there was what Chairman Bernanke referred to as a global savings glut.

Clearly, the net financial savings generated in one part of the world have to be absorbed by deficits elsewhere. Industrial country corporations initially absorbed these savings by expanding investment, especially in information technology. But this proved unsustainable, and investment was cut back sharply following the collapse of the IT bubble.

Extremely accommodative monetary policy by the world’s central banks, led by the Federal Reserve, ensured the world did not suffer a deep recession. Instead, the low interest rates in a number of countries ignited demand in interest sensitive sectors such as automobiles and housing. House prices started rising as did construction.
The United States was not by any means the highest in terms of price growth. Housing prices reached higher values relative to rent or incomes in Ireland, Spain, the Netherlands, the United Kingdom, and New Zealand, for example. Then, why did the crisis first manifest itself in the United States? Probably because the U.S. went further on financial innovation, thus drawing more marginal-credit-quality buyers into the market!

A home mortgage loan is very hard for an international investor to hold directly because it requires servicing, is of uncertain credit quality, and has a high propensity to default. Securitization dealt with some of these concerns. If the mortgage was packaged together with mortgages from other areas, diversification would reduce the risk. Furthermore, the riskiest claims against the package could be sold to those who had the capacity to evaluate them and had an appetite for bearing the risk, while the safest AAA-rated portions could be held by international investors. Mortgages from Phoenix, Arizona, could be sold to investors in Stuttgart, Germany.

The “originate-to-securitize” process had the unintended consequence of reducing the due diligence undertaken by originators. Furthermore, because house prices were rising steadily over this period, lenders became even more lax; If the buyer could not make even the nominal payments involved on the initial low mortgage teaser rates, the lender could repossess the house, sell it quickly in the hot market, and recoup any losses through the price appreciation. In the liquid housing market, so long as the buyer could scrawl X on the dotted line, she could own

It was not entirely surprising that bad loans would be made in the housing boom. What was surprising was that the originators of the complex securities created to finance them, the financial institutions, who should have understood the deterioration of the underlying quality of mortgages, held on to so many of the mortgage-backed securities (MBS) in their own portfolios.
Why did the sausage-makers, who knew what was in the sausage, keep so many sausages for personal consumption?

The explanation has to be that these investments seemed to be part of a culture of excessive risk taking that had overtaken banks. A key factor contributing to this culture is that, over short periods of time, it is very hard to tell whether a financial manager is generating true excess returns adjusting for risk, or whether the current returns are simply compensation for a risk that has not yet shown itself but that will eventually materialize. This could engender excess risk taking both at the top and within the firm.

For instance, the performance of CEOs is evaluated based in part on the earnings they generate relative to their peers. To the extent that some leading banks can generate legitimately high returns – Goldman Sachs for example -- this puts pressure on other banks to keep up. Follower-bank bosses – a Stan O Neal from Merrill Lynch for example -- may end up taking excessive risks in order to boost various observable measures of performance.

Even if top management wants to maximize long-term bank value, subordinates may not. Given the competition for talent, traders have to be paid generously based on performance. But, many of the compensation schemes paid for short term risk-adjusted performance. This gave traders an incentive to take risks that were not recognized by the system, so they could generate income that appeared to stem from their superior abilities, even though it was in fact only a market-risk premium.

The classic case of such behavior is to write insurance on infrequent events such as corporate defaults, taking on what is termed “tail” risk. If a trader is allowed to boost her bonus by treating the entire insurance premium as income, instead of setting aside a significant fraction as a reserve for an eventual payout, she will have an excessive incentive to engage in this sort of
trade. The traders in AIG’s Financial Products Division just took all this to an extreme by writing credit default swaps, which are insurance against corporate bond defaults, pocketing the premiums as bonus, and not bothering to set aside reserves in case the bonds that were covered by the swaps actually defaulted. Ultimately, the cost has been borne by the taxpayer.

This is not to say that risk managers in a bank are unaware of such incentives. However, if a CEO is asked to choose between a trader who has earned $100 million for the bank every quarter for the last 5 quarters, and a risk manager who has been wrong in warning about risks for the last 5 quarters, whom will he favor? The answer is clear – risk management is at its weakest after a period of relatively buoyant financial markets.

Finally, all these shaky assets were financed with short term debt. This is because in good times, short-term debt seems relatively cheap compared to long-term capital, and the market is willing to supply it because the costs of illiquidity appear remote. Leverage ratios reached 30 and 40 times equity during the boom.

As house prices stopped rising, and indeed started falling, mortgage defaults started increasing. Mortgage backed securities fell in value, became more difficult to price, and their prices became more volatile. They became hard to borrow against, even short term. The highly levered banks became illiquid, and eventually insolvent. Only heavy intervention has kept the financial system afloat, and though the market seems to be believe that the worst is over, it may be early to celebrate. Banking systems need to be cleaned up to support recovery, and while the process has started in the United States it is nowhere near complete. Europe is still in denial that it has a problem.

The impact of the financial crisis can be seen in the United States in two ways. First, the shadow financial system – the process of securitization and
private equity finance that supported the banking system has dried up. As this slide suggests, the sale of asset based securities has virtually stopped, meaning that banks are unwilling to originate new auto loans or commercial mortgages because they have to hold them on balance sheet.

[Slide 6: Bank Lending] Second, banks themselves are lending less, either because there is less demand, or because they are worried more worried about credit risk, or because they do not want to lock up their money long term while they still believe things could get worse. Indeed, some healthy banks like Goldman Sachs are sitting on hundreds of billions of dollars of liquidity, partly because they believe they could buy distressed assets very cheaply if a large bank like Citibank or Bank of America is forced to unload them. The stress tests seem to have given these banks some breathing room, but we could yet see another wave of loan losses.

[Slide 7: Macroeconomic Response] Typically, the macroeconomic response in this kind of environment is to cut interest rates. Interest rate sensitive sectors like housing and automobiles then pick up, and the economy revives. But households, worried about their tremendous loss of wealth, their jobs, and the lack of credit, have started saving more and consuming less. In turn, this has led to rapid cuts in inventory and investment, which account for the awful growth numbers in the last two quarters.

[Slide 8: Savings rate and Wealth to Income Ratios] How far can this go? The cuts in inventory should come to an end soon. It is less clear the savings rate will stop climbing unless there is a stabilization of the housing market, and household wealth stops falling. As this chart suggests, the increase in savings rate has mirrored the fall in household wealth (I should note wealth is inverted on the chart, so upward movement on the graph means wealth is falling). Also, fears about job losses are likely to get worse -- most forecasters believe the jobless rate will peak only in 2010.
There is therefore a lot of uncertainty. The optimists believe the household savings rate will not go up much more – it is at about 4.5% of income now. The pessimists believe it could climb much more, given the need for households to build lost savings, especially by those near retirement. The IMF has a wide range of estimates for the US households savings rate -- between 3% and 11.5% -- which is the difference between recovery and depression. This is why there is so much uncertainty about forecasts – no one really knows. My own sense is that the household savings rate will climb some more, which will mean a drag on US growth.

At the start of this recession, arguments about decoupling suggested the US could be buoyed by foreign demand – indeed US exports had been growing steadily. Unfortunately, Europe is, if anything, in a worse state than the US. Housing sectors in some countries like Ireland, Spain, and the UK are in doldrums, and the extent to which they were responsible for recent growth is only now being recognized. Germany, an exporting powerhouse, is likely to slow sharply this year as foreign demand contracts.

In addition, though, Europe is seeing the problems with being economically but not politically integrated. European policy makers are worried about implementing more fiscal stimulus because they fear they will bear the cost while the resulting demand increase will leak out in large part to neighbors. And they have tremendous difficulty agreeing to a common level of stimulus because of differing ideologies across countries. Germany, for instance, is being conservative because of its history with hyperinflation, and also because it knows it will bear a significant portion of the costs of rescue of its neighbors.

Moreover, if anything, European banks may be in worse shape than US banks. Not only did some of them buy sub-prime assets, they have their own version of sub-
prime in loans to Central and Eastern Europe. If these banks start incurring sizeable losses, they will have to be bailed out by their governments, which may in turn need help. As of now, European banks have not recognized sizeable loan losses, but they may be very optimistic.

[Slide 11: Japan] What about Japan, the only large industrial country whose financial sector is relatively unaffected by the credit crisis? The problem is that Japan has historically depended, like Germany, on external demand. Moreover, its government finances are terrible because of its recent crisis. Thus far, Japan has suffered a worse implosion than other industrial countries, but this will likely stabilize in coming quarters. Longer term, though, Japan needs to expand domestic demand, and this will take time.

China certainly is picking up growth again after slowing down. But there are two concerns about the sustainability of this growth. First, the stimulus and the credit expansion is largely going into investment. The real need is more domestic consumption. Second, it is unclear where all the investment is going. While more housing will definitely be of use, more investment in sectors that are already in overcapacity could reduce profits and lead to bad loans.

[Slide 12: US source of demand] In sum then, while there are pockets of growth elsewhere in the world, the US is ultimately going to be the engine that pulls the world out of recession, and in the process pulls itself out. With the U.S. household on strike, the onus is on the U.S. government. And there is a particular reason why the US is more willing to stimulate. Safety nets in the U.S. are thin – many workers do not have insurance outside their jobs, and unemployment benefits run out quickly. So politicians are very sensitive to rising unemployment rates because they hear from their constituents, and they pull out all stops.
In the short run, the US is focused on four areas. First, the Fed has to substitute for the credit that has evaporated from the shadow banking system by using its own balance sheet. Second, the administration has to clean up the financial sector by removing toxic assets off bank balance sheets and getting weak banks to recapitalize where necessary. Third, the housing sector has to be stabilized. And fourth, an effective fiscal stimulus needs to be implemented. None of these tasks have been, or will be, easy. Nevertheless, my sense is that we will see the economy stabilize reasonably soon, and perhaps even see a couple of quarters of reasonable growth. Two leading indicators are the stock market and continuing job losses, both of which have started turning up.

But unemployment will continue increasing, and the housing market may overshoot on the downside, even though house prices in the US are commensurate with fundamentals now. This means that even if the financial sector is cleaned up – a very important but politically difficult task because there is so little political sympathy for bankers-- growth will still be fairly muted for some time. And history tells us that recessions induced by financial sector problems tend to last longer, create deeper loss in output, and lead to more tepid growth, than ordinary recessions, as these charts suggest.

So in terms of possibilities for the U.S. economy, I would suggest between a V shaped recovery where we rebound quickly, a U shaped recovery where we stabilize and then grow relatively slowly for some time, and a L shaped recovery where we stay low for a long time, I would put my weight on a U shaped recovery. We are probably at the beginning of the stabilization, we may have the odd quarter of rapid growth, but more likely
to see slow growth for a while. If there are no further financial sector surprises, we should be back to trend growth in a couple of years. This is certainly what history suggests.

Let me finally turn to Obama’s policy emphasis. [Slide 18: Obama’s Policies] President Obama realizes that while the crisis is the short-term problem, there is a longer term political problem that the United States has to fix. Ordinary people increasingly feel they do not have the access to the education and healthcare that they need to get good jobs, and they are growing angrier as they continue to be left out of the growth process. Even before this crisis, some studies show the median income has been virtually stagnant, even while the incomes of the very rich have gone up substantially. The crisis only brings this issue to a boil as people feel there are two sets of rules – one for the ordinary citizen whose house is foreclosed, and another for the banker who gets an enormous bonus even while his bank is bailed out by taxpayers.

The natural way to appease this anger is through leveling down – more taxes on the rich and on large corporations, more regulation, and more rights to labor. Obama is doing some of this – last week he announced plans to tax overseas profits made by US corporations more effectively, and there is a bill before Congress to make unionization more easy —but he has to be very careful for he risks making the United States far less attractive for business.

An alternative approach is to increase opportunity for those that have been left behind. This is where President Obama seems to be putting more of his focus. One priority of his administration is to expand the reach and quality of education. The administration aims to improve access to pre-schools such as nurseries – which have been shown to be an important reason why rich kids do better than poor ones. It also wants to toughen learning standards – Obama often points out that his high school educated grandmother wrote better than his graduate
students at law school, suggesting the quality of education in the US has fallen because US schools pass students easily without requiring minimum standards. The administration also wants to improve the quality of teaching including through performance pay, something unions have been against. And finally, it wants to improve access to higher education by increasing financial aid and tax credits.

An equally important priority is to fix healthcare, not just by making it universally available, but also by containing costs. There is a proposal for a new public insurance plan that will compete with private ones. There is also money set aside in the stimulus package to reduce the cost of healthcare administration by paying for improving information technology in hospitals, allowing health care records to be portable across hospitals, and allowing patients to be better able to make choices across hospitals and treatment procedures. All this is sensible, but perhaps too ambitious. Healthcare costs have been rising for decades (though less rapidly in the last decade) and no one knows whether Obama can fix it – for instance, more government provision of insurance may drive private sector providers out and increase costs.

[Blank slide] More generally, more social benefits will mean higher government expenditures. This will come on top of the substantial stimulus and expenditures needed to help households and financial firms recover from the crisis. Debt to GDP in the US is likely to go above 80 percent. Typically governments have one of two obvious responses to such high debt levels once the recovery is under way. Behave responsibly, increase taxes and cut spending even though the political environment has increased the need for social expenditures or behave irresponsibly, continue increasing spending until markets stop accepting your debt, and have a large inflation to reduce the real value of government debt.
President Obama, faced with these two unpalatable choices, is trying a third way -- to spend as well as rectify government finances. On the one hand, he believes that the increase in productivity and a reduction in social conflict as a result of the investment in people (and, I should add, in new technologies like renewable energy) should help the US pay for the spending. Equally important, he wants to revisit the entire system of entitlements including social security and Medicare so as to put the U.S. economy on a long term sustainable path. As he correctly points out, the shortfalls in social security and Medicare dwarf recent deficits. The longer the fix to these entitlement programs is postponed, the more the burden of adjustment will fall on future generations. The issue is particularly urgent because with the fall in wealth, many Americans have become more anxious about their retirements, and few at present have confidence that they will get the social security and Medicare they have been promised.

In many ways, therefore, this vision is bold and compelling. If it works, the United States will have refashioned itself once again. But it is also very risky. For it requires holding on to what is good about the U.S. economy – its innovation and flexibility – even while creating stronger safety nets and labor unions to allow a wider distribution of the benefits to growth. Are the two always compatible? For instance, will stronger unions allow the labor flexibility that has kept US industry vibrant? Will stronger safety nets not diminish incentives to work? Moreover, it could well be that productivity does not keep up with the higher costs, and US competitiveness is reduced. As some have argued, the US could become Europe without the culture or the charm.

At the moment, though, there is enormous support for what Obama is trying. One important example of his success at enthusing people is his plan for energy where he has managed to capture the support of both environmentalists and the security conscious. The stimulus bill seeks to fund an array of renewable energy projects, and also has set aside money to
improve the energy efficiency of homes. The center piece is a cap-and-trade proposal for carbon emissions. If this is implemented, along with a gasoline tax which is not on the cards just now, it could be the single most important step yet towards climate control. It would also provide enormous incentives for U.S. innovation in reducing carbon emissions.

But Obama’s energy plan also demonstrates the enormous political difficulty in what he is trying to do. It is likely that there will be little political appetite to pass the cap-and-trade proposals in Congress. What we will be left with then are a variety of subsidies for various forms of renewable energy, which will, in my opinion, have little long term positive effect.

Let me sum up. Obama is trying many big things, each of which could consume a presidency. He is starting a number of fights with vested interests. Perhaps he can divide and conquer. Many hope he will. Perhaps, he will fail spectacularly. That will be a loss to all. [Slide 20: Public Debt] Regardless of whether the US surmounts its problems, this crisis will leave industrial countries in a much more weakened state, with very high debt loads, and higher tax burdens. There will also be more regulation and possibly less competition, as well as a greater willingness to enact protectionist measures. All this will probably mean higher costs and higher inflation in the medium term, though the short term effects from the crisis are disinflationary.

[Slide 21] [Blank Slide] Emerging markets will not be immune to the crisis. If the slow growth persists, we could see some emerging markets that are either heavily dependent on foreign finance or on exports implode. Central and Eastern Europe is, of course, a prime candidate. But there are obvious danger spots around the world including Argentina, Pakistan, Ukraine, and Venezuela – these are countries that typically also have political difficulties and a geopolitical crisis emanating from the recession cannot be ruled out. A persistent global
downturn could also affect countries that are not yet on the radar screen, including some industrial countries that have unsustainable budget deficits or heavy exposures to emerging markets. In this regard, I am glad East Asia is strengthening regional agreements to support each other with liquidity.

But the crisis will also imply change. While industrial country governments can substitute fiscal stimulus for household demand in the short run, in the longer term demand will have to come from elsewhere. The obvious source is the emerging markets and developing countries, and this is also likely to be the more environmentally sustainable, with poorer countries increasing consumption growth and richer countries slowing. An important question for the world economy is whether the required strengthening of emerging market currencies will take place smoothly, or whether frictions like trade wars impede progress? Time will tell.

Equally important, though, the shift in demand to emerging markets, the potentially worsening business climate in industrial countries, and the relatively weak state of government finances there suggest opportunity for emerging markets and developing countries. To see why, think about where value added comes from in a $200 Apple Ipod. Manufacturing costs between $30-50 and is largely done in East Asia. But the real profits lie in overall design, branding, marketing, and even financing.

Industrial countries have typically dominated here because they have been more innovative, their companies have historically owned the known brands, and they have had a historical presence in the most important market, their own. But as markets shift, competitive advantage will shift to emerging market companies who have a dominant presence in the markets
of the future. But to exploit this change fully, they will have to shift focus, much as Samsung has done – to move from just cheap production to innovation, branding, marketing, and finance.

One example of such a shift is the Indian company Tata with their $2500 Nano car, who have recognized that the emerging middle classes need a reliable low cost car, not an over-engineered behemoth. The question the consumer in India or Bolivia or Kenya asks is, “Is it safer than my motorcycle in transporting my family?” not “Is it safer than Volvo?”. And while focusing on this market in India, Tata understands there is a worldwide middle class market – in Africa, in Latin America, and in Asia -- that the industrial countries have ignored.

This shift in focus will not be easy, and will require drawing on the best that industrial countries have to offer, including their universities, their institutional experience, and their human capital. And there will be competition as emerging markets attempt to position themselves for this new era. Approaches will differ. China is building first class universities to build human capital. By contrast, Chile is outsourcing higher education, offering scholarships to any of its citizens who get admission to a first rate foreign university. Regardless of what approach is followed, the winners as global competition is remade will be those countries who are able to imitate some of the virtues of the industrial countries, including openness and a good business environment, while avoiding the mistakes of allowing unregulated markets and excessive concentration of incomes and wealth.

In sum, this crisis could accelerate the shift in world economic power to those emerging markets that are willing to be bold. In Asia, this will mean a movement away from export-led Western-oriented manufacturing growth towards more regional trade and domestic demand growth. It will mean that the world will not just look to Asia for electronics but also for lawyers,
financiers, and marketing experts. And it is a rebalancing that we will all benefit from – a silver lining to the doom and gloom that I have otherwise been speaking about. I would now be happy to take questions. [Thank You]