

Policy Reforms after the Crisis

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The title of this session is supposed to be policy reforms after the 2008–09 financial crisis. I think there's a big question about the title because I'm not quite sure the crisis is over yet. But in order to discuss policy reforms, it makes a lot of sense to try to understand the causes of the crisis. If you can't diagnose the root causes of the crisis, it will be very hard to try to prescribe the right kind of medicine to cure the problem.

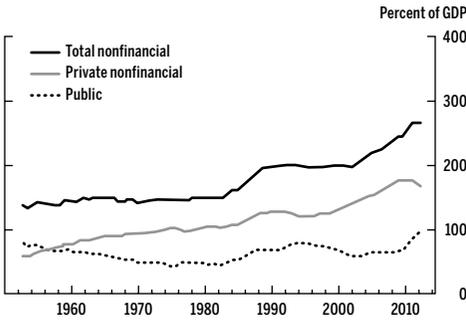
There are a lot of theories, books, and articles written about the crisis, why it happened, when it did, and the kind of lessons to be learned. I'm offering an Asian perspective from Hong Kong, several thousand miles from here. We may not see things exactly the way you see it here, but I think it's worthwhile to offer my perspective on the root cause of the global financial crisis and the more recent European debt crisis.

Figure 1 shows that the average debt level of the United States, United Kingdom, Germany, and France in 1980 was 165 percent of GDP. But by 2010, the average ratio in these industrial countries had risen to roughly 320 percent. The chart also shows that the rising indebtedness of these economies was attributable sometimes to household debt, sometimes to corporate debt, and sometimes to government debt. The question it raises for me is, What are the underlying reasons for this rising indebtedness? Why did people begin borrowing a lot more than they used to?

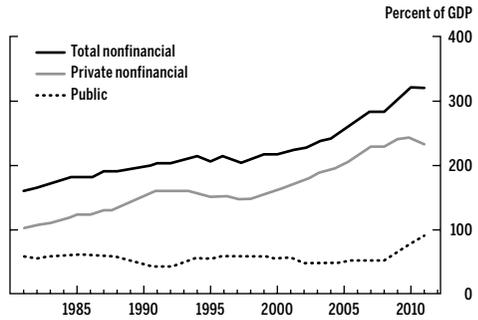
Many theories place some of the blame on financial innovation, referring specifically to securitization providing greater ease in obtaining credit, especially households seeking home finance. Interest rates also were following a declining trend since the 1990s, therefore increasing the affordability of leverage. During this period of great moderation, economic prosperity, job security, and employment income grew and were taken for granted, which in turn led to increased excessive risk-taking by households and corporations. Another theory, articulated by Ken Rogoff, is that the widespread practice of giving tax concessions to companies using finance over equity increased reliance on borrowing and led to excessive leverage.

FIGURE 1
Rising Indebtedness of Industrial Economies

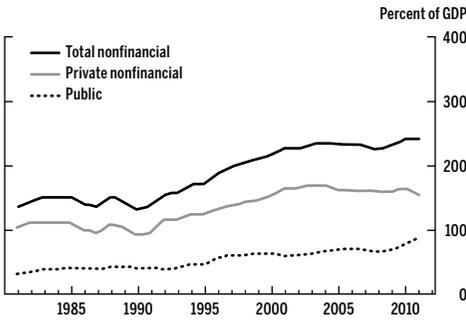
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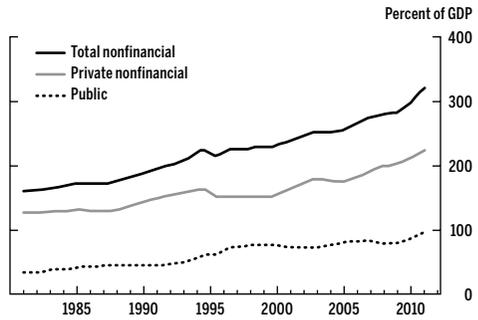
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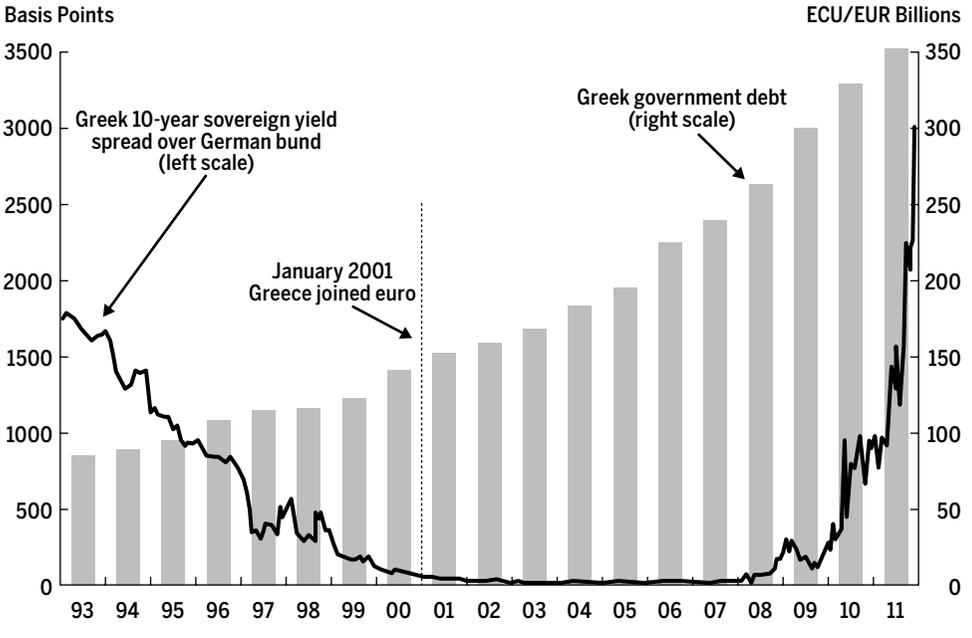


Source: Bank for International Settlements.

But I would highlight another factor, which I would call market failure. Figure 2 illustrates the Greek situation by plotting the spread of 10-year Greek common bonds over the German bund together with the level of Greek government debt. During the early part of the 1990s the market demanded a very high premium for lending to the Greek government, about 18 percent, but this spread gradually came down as Greece made moves toward joining the euro. Once Greece joined the euro zone in 2001, the convergence play kicked in, and, strangely, the market treated Greek sovereign debt as a triple-A rated entity. In fact, Greece's spread was only 20 basis points over the bund for a prolonged period over a couple of years. It's only after the collapse of Lehman Brothers in early 2010, when the market suddenly woke up to the fact that the Greek fiscal position was not sustainable, triggering the European debt crisis.

Some would call this a prolonged period of mispricing of risk, but I would call it market failure. What does that mean? My view is that this situation

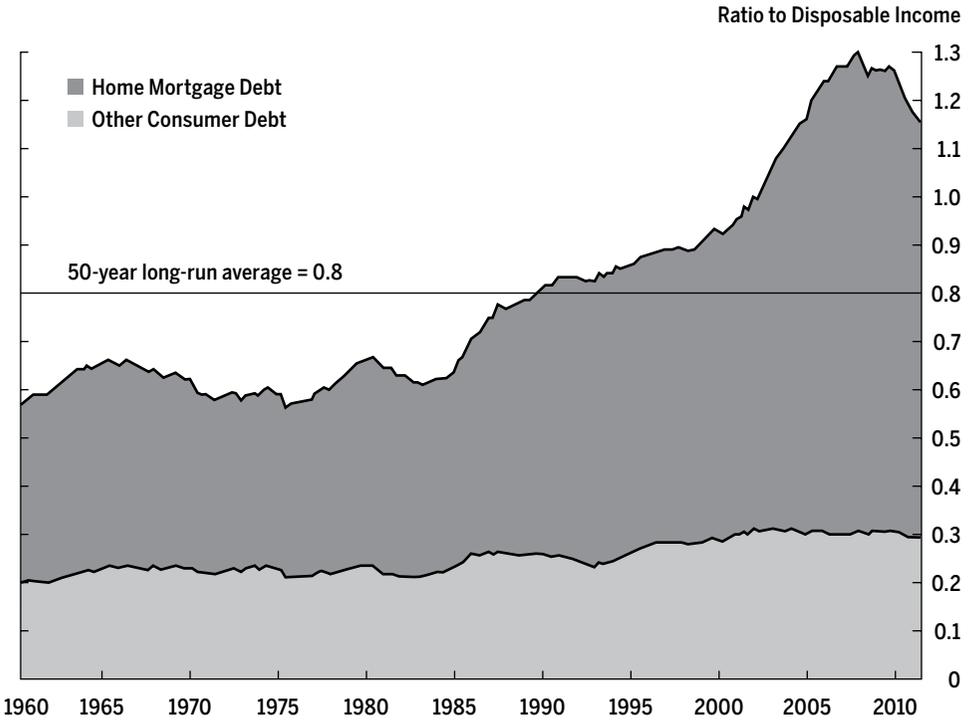
FIGURE 2
Market Failure: The Greek Example



created tremendous problems for Greece, not only for the capital market and for creditors, but also for the debtor, Greece. Why? Because Greece for a long time was under an illusion—based on feedback from the markets—that piling up bigger and bigger debt was okay, and it was very affordable because the market was demanding only a few 20 basis points over the cost of German bunds. So borrowing by the government was pretty okay. That led to even weaker fiscal discipline over the years, and the result, as we now know, has been devastating.

Figure 3 shows the indebtedness of U.S. households, as measured by the ratio of home mortgage and other consumer debt to disposable income. The debt-to-income ratio started to rise steadily in the 1980s. The pace picked up after 2000, mainly due to home finance, not consumer credit. The ratio peaked at 1.3, compared to a 50-year average of 0.8. After the bursting of the housing bubble in 2006 and 2007, household balance sheets were badly damaged. To repair the balance sheets, households need to deleverage, save more, and spend less unless there’s a rapid growth in household income, which is not happening yet. So in my view, household deleveraging in the United States will still have some way to go, although I cannot tell at what level it will reach a stable equilibrium.

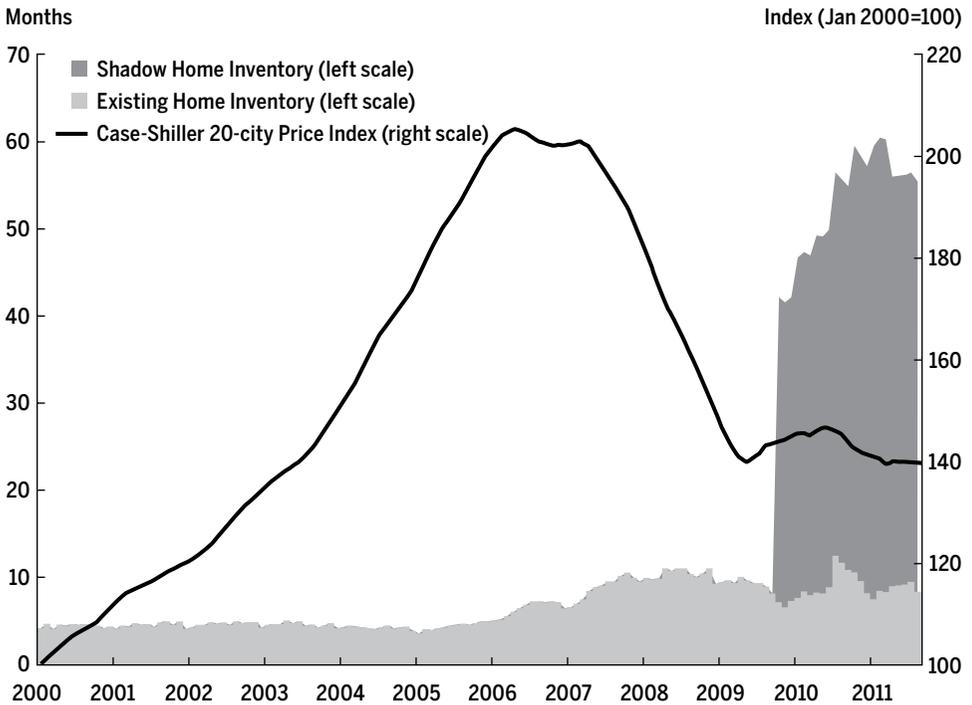
FIGURE 3
U.S. Balance Sheet Recession
 Household Deleveraging Still Ongoing



Source: CEIC.

Figure 4 shows the Case-Schiller index for 20 U.S. cities, together with the inventory of existing homes and the shadow home inventory estimated by Standard and Poor's. As we know, since the bursting of the housing bubble, house prices have come down quite a lot in many places, but the housing market remains very weak, and there's no short-term prospect of a rebound because of this supply overhang. The supply overhang is daunting, and adds up to 16 months of supply. Of course this is a dynamic relationship, because if investor appetites pick up, the inventory will come down very quickly. Nevertheless, this is a depressing situation because the housing market is very weak, and has become a huge negative drag in repairing household balance sheets. That, in turn, has a negative drag on consumption and consumer confidence. I think this explains my view of why large fiscal stimulus packages and unconventional monetary easing measures have not created the desired result of sustaining a stronger economic recovery in the United States.

FIGURE 4
U.S. Balance Sheet Recession
 Huge Drag from Housing Inventory



Sources: CEIC, Standard and Poor's.

So, what are the policy lessons? First, avoid excessive borrowing, clearly, because it was the reason for the 2008–09 crisis and the current crisis facing Europe. Of course, that's easier said than done, because many fiscal authorities around the world have, until recently, faced a lot of political pressure to increase spending in good times. And in bad times they have even more reasons to increase spending. As a result, public debt has piled up along with the problem of sustainability and fiscal position. But, given what we've seen in Europe, we hope we have learned from this latest crisis that even the biggest and most advanced economies in the world are not immune from the devastation that can result from excessive indebtedness.

The second point I want to mention as a policy lesson is to beware of the breakdown of market discipline, which is supposed to be the final line of defense for preventing excessive borrowing. Market discipline can and did break down for a considerable period of time during the crisis, thereby exacerbating the problem of excessive leverage.

The third point about quality and effective market regulatory structure has been talked about by many. There's a long menu of things to do on this particular point, but I think the priority is to work on rating agencies. The problem in the United States was amplified by the flawed models used by the rating agencies in assessing the creditworthiness of some exotic financial derivative products, such as CDOs, CDO-square, and CDO-cube. The Basel committee has done a lot of work to raise the quality and quantity of capital—they talk about capital buffer, conservation buffer, and also the liquidity coverage ratio and stable funding ratio. All of these are designed to reduce excessive leveraging by the financial sector and thereby in the economy, and maintain financial stability.

I'm not sure my fourth point is generally understood or accepted. I think because the root cause of the crisis is excessive leveraging, the only way out is deleveraging. Deleveraging is painful, but it's inevitable. Speaking from the Hong Kong perspective, we had a big, exaggerated housing bubble. When the bubble burst after the Asian financial crisis in 1997, we had fast and huge deleveraging in the Hong Kong financial system. It was very painful, I can assure you that. GDP contracted in Hong Kong in five quarters by 8.7 percent. The unemployment rate rose from 2.1 percent to 8.5 percent; deflation, over five years, amounted to a cumulative 15 percent, and housing prices fell 70 percent. So, a huge pain was inflicted on Hong Kong and the Hong Kong economy. But we have recovered and become a stronger, more resilient economy.

My final point is that deleveraging itself is not enough. Deleveraging must be accompanied by restructuring at the same time, because the financial system and the real economy must be restructured to generate greater productivity and competitiveness going forward.