The Financial Crisis: Causes, Effects, Policies, Reforms, and Investment Strategies

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As part of GE Asset Management's White Paper, we are pleased to present this exclusive article written for GEAM by Dr. Dominick Salvatore, the Distinguished Professor of Economics and Director of the Ph.D. Program in Economics at Fordham University in New York. The article is part of the GEAM team's ongoing efforts to draw on our extensive network of resources to provide investors broad and diverse perspectives on issues relevant to global investing.

I. Introduction

Advanced countries are today in the midst of a serious financial crisis and deep economic recession, and emerging markets are experiencing a sharp slowdown in economic growth. In this paper I will first examine the causes, effects, policies, and prospects for the financial crisis and how the financial crisis led to recession in advanced countries and a sharp slowdown in emerging markets and finally, I will re-evaluate the validity of some time-honored investment principles (such as buy stocks and go global) in the context of the present financial and economic crisis.

II. The Financial Crisis Causes of the Financial Crisis

The present financial crisis started in the U.S. sub-prime mortgage market in 2007 and then spread to the entire financial and real sectors of the U. S. economy in 2008, and from there to the rest of the world. The initial causes of the financial crisis are clear: huge and increasing amounts of home mortgages -- often based on weak underwriting including no down payment or checking credit histories – were given to individuals and families that clearly could not afford them. These mortgages were made at variable rates when rates were the lowest in 50 years. It was only to be expected that a rise in interest rates would cause many homeowners to be unable to make their mortgage payments and default. This crisis may have been avoided if housing prices had continued to rise at the unrealistic high rates of 2000-2005.

These sub-prime home mortgages were then repackaged into mortgage-backed securities (MBS) and sold to credit market investors. Rating agencies, such as Moody's and Standard & Poor's, gave some of these financial instruments various credit ratings, sometimes triple A ratings, depending on the tranche.

Although the problem of sub-prime mortgages greatly expanded during the presidency of George W. Bush, the practice started in 1999 during the Clinton Administration when Fannie Mae and Freddie Mac were pushed to grant home mortgages to people who clearly could not afford these mortgages in order to "promote the American dream" of owning a home.

Effects of the Crisis

However, that is history now. The outcome of the current financial crisis is clearly evident to all. Stock markets crashed all over the world, with declines ranging from 35-40% over the past 12 to 18 months in developed countries and even more in most emerging markets. The crisis also has brought significant limitations to investment banking, as we have known it in the United States during the past decade, and a severe recession in most advanced countries and much slower growth in emerging markets. This is likely to be the worst economic recession since the 1930s. With a decline of this magnitude, it almost seems of small consolation for a manager to have posted strong relative performance or earned a spot in the top quartile among the institutional and mutual fund peer groups. However, active management skill has helped to shield some portfolios from the full force of the market's declines and this approach has the potential to continue to add value in U.S. equities.

Policies to Overcome the Crisis

The United States and Europe did almost everything possible to avoid the recession, but their efforts may have only succeeded in preventing a deeper recession or depression. The United States:

- Introduced a $168 billion dollar stimulus package at the beginning of 2008, which contributed to a 2.8% growth of real GDP in the second quarter of last year, but its effect soon faded away
- The Federal Reserve lowered interest rates from 5.25% in September 2007 to 1.0% in October 2008, and to practically zero in December 2008
- The U.S. government brokered a deal to rescue Bear Sterns with a $29 billion debt guarantee which allowed it to be acquired by J. P. Morgan Chase at a deeply discounted price (to avoid the accusation of moral hazard -- a situation where profits are private and costs or losses are public)

- Acquired $100 billion of (nonvoting) stock of Fannie Mae, $100 billion of Freddie Mac, and a total of $145 billion from American Investment Group (AIG)
- Encouraged and facilitated the acquisition of Merrill Lynch by Bank of America and approved the conversion of Morgan Stanley and Goldman Sachs into commercial banks
- Increased insurance on bank deposits to $250,000 (up from $100,000); and adopted a $700 billion rescue plan, with half of the money spent by the end of the year, to recapitalize the banking sector and purchase money and commercial paper from firms to make up for the drying up of this lending activity by commercial banks

More recently, in November 2008, in the most ambitious rescue operation to date, the Treasury injected another $20 billion of new capital (on top of the $25 billion provided in September) to Citigroup and together with the Fed provided guarantees against excessive losses on $306 billion of toxic assets (mostly sub-prime personal and commercial loans owned by Citi) to prevent its collapse. In January 2009, the Treasury again injected $20 billion of new capital (on top of the $25 billion injected in September) to Bank of America and Merrill Lynch, and together with the Fed provided guarantees against excessive losses on $100 billion of toxic assets to prevent Bank of America from withdrawing from the purchase of Merrill Lynch after it discovered that the latter had even more toxic assets than it realized at the time Bank of America initially agreed to purchase it.

In mid-February 2009, Congress passed a $789 billion stimulus package of increased expenditures on infrastructure, education, health, and the environment, as well as tax reduction (demanded by Republicans), in an attempt to stimulate the U.S. economy and prevent the current deep recession (the deepest since the recession in 1982) from becoming a depression. The plan is to use the remaining $350 billion from the $700 billion rescue plan adopted in September 2008 as a down payment on the purchase toxic assets from banks so that they could resume lending to businesses -- essential for jumping-starting the economy.

At the same time, many European countries adopted similar but less ambitious policies to stimulate their economies. In January 2009, the European Central bank cut the interest rate to 2.0% (down from 4.25% in July 2007) and indicated that it was ready to cut it again to 1.5% at its next meeting in March 2009, but that it would not follow the U.S. and Japanese counterparts down the path of practically zero interest rates. The Bank of England cut the interest rate more drastically to 1.0% in February 2009 (the lowest since its creation in 1694). All of these measures, however, did not prevent recession in Europe either.

When Will the Financial Crisis Come to an End?

We will know the crisis may be reaching its end when certain factors are visible in the market:

- Housing prices stop falling,
- American banks need no further recapitalization,
- Firms start investing again and their profits rise

These events will likely be preceded or anticipated by stock markets becoming less volatile and rising. This may occur in the second half of 2009, with health care and the consumer-staples industry leading the way. However, even when growth returns, it is likely to remain slow for another year or two until the financial excesses experienced during the past decade wind down entirely. In the meantime, investment banking as we have known it in the United States during the past decade no longer exists – none of the five large investment banks that existed in the United States at the beginning of 2008 existed in their original business model by year end. Going forward, investment banking will be conducted mostly by commercial banks under more highly regulated and less speculative conditions permitted by the Fed.

The crucial event that led to the demise of investment banks was the failure of Lehman Brothers. Lehman was allowed to fail presumably because its assets were less solid than those of Bear Sterns and because there were no buyers after Treasury Secretary Paulson refused to provide $60 billion of loss guarantees to Barclays and Bank of America, firms that had shown interest in acquiring Lehman. However, he subsequently admitted to having underestimated the size of Lehman and the problems that its failure would create in the United States and around the world. At the time of its failure, Lehman had sold nearly $700 billion in bonds and derivatives, of which about $160 billion was unsecured. Rescuing Lehman would likely have only postponed the crisis, not prevented it.

Reforms to Prevent Future Crises

Important reforms are clearly needed to avoid future financial crises. Reforms need to be comprehensive but also broad and general. Comprehensive because inadequate regulations on investment banking and improper application of existing regulations contributed to the current financial crisis. Regulations, however, also need to be broad and general rather than specific and pointed because money is fungible and when a specific regulation closes one avenue of creative financial excess, soon operators find other ways to bypass the regulation. In my opinion, regulations should also restrict or prohibit the use of exotic derivatives. These are derivatives for which the correct price is difficult or impossible to determine and which sellers cannot clearly explain and/or buyer understand how they are supposed to work. Reforms are likely to include the requirement that credit default swaps be traded on organized exchanges and issuers put up reserves to cover the risk of default.

Savings rates in US vs. other countries

In the medium term, the United States needs to save more and learn to live within its means. Studies have shown that Americans save little relative to individuals in other developed countries and the U.S. government is a large net borrower. In fact, U.S. corporations are really the only savers at this point. However, these factors did not quash demand for profitable investment opportunities in the United States. The result was a huge inflow of funds from abroad, which led to an overvalued dollar, and unsustainable U.S. trade deficits. Substantially raising the personal savings rate in the United States will be difficult, however, with Americans addicted to overspending. However, it is a goal the United States can hope to achieve gradually over the years.

Some economists blame the operation of the international monetary system for the present financial crisis, but, in my view, the present crisis has a domestic origin. A more efficient and effective international monetary system would not prevent contagion across the world because some of the same financial excesses that occurred in the United States had also taken place in Europe, Japan and elsewhere.

Some economists blame deregulation as the primary cause of the crisis. Indeed, the repeal of the depression-era Glass-Steagall Act in 1999 (pushed by Alan Greenspan and Robert Rubin when Larry Summers was Treasury Secretary during the Clinton Administration), that had separated commercial banking from other financial activities, such as insurance, underwriting, and investment banking, made possible some of the financial excesses that led to the present crisis. But it was Greenspan, Rubin and Summers who objected to the imposition of any regulation on credit default swaps in 1998.

So, there are many factors that could have contributed to the cause of the present financial crisis: deregulation or inadequate regulation of investment banking, unfortunate economic policies (granting home mortgages to people who could not afford them), outright fraud (such as the $50 billion Madoff Ponzi scheme), and economic greed.

The danger is that, in the present crisis atmosphere, many nations may over-regulate and impose excessive restrictions on financial activities that would be detrimental to future growth. There is also the danger that the large injection of liquidity into the United States and in other advanced countries to jump-start their economies will lead to hyperinflation in two to three years time that would then require a sharp tightening of monetary policy. As an example, we can look to Paul Volker's use of monetary policy in the early 1980s to tame double-digit inflation leading to another deep recession.

III. Investment Strategies during the Present Crisis

During the present financial crisis, some time-honored investment principles and strategies are being called into question. With bonds earning more than stocks and domestic markets falling less than foreign stock markets, the two pillars of investment theory – buy stock and go global – seem to have lost their traditional validity.

Stocks vs. Bonds

Stocks are, by their very nature, more risky than bonds and thus have more potential to provide higher returns over time than bonds. This has generally been true in the past. Over the past 10 years, however, equity performance has trailed that of bonds and, indeed, that of almost every other asset class, including gold and real estate. Seven years after the first seven of the eight bear markets since World War II, average stock prices had risen an average of 12%. Since the 2001 bear market, however, average stock prices are still more than 20 percent lower. The collapse of the banking system and the ensuing unprecedented government intervention to rescue it makes it difficult to compare the present financial crisis with previous ones.

It now would seem to make sense that after a miserable year (the DJIA fell 34% in 2008 and 38% since its October 2007 record) stocks may be due for a good year to find the traditional balance. In December 2008, a dozen experts polled by Barron's indicated that they expected stocks to gain between 5% and 38%, with a median of 13% gain, by the end of 2009. Although not always true (stocks fell 23% in 1932 after falling 53% in 1931), stocks usually do rebound sharply the year after a bad fall. Whether this will occur during second half of 2009 (as many analysts believe) or later depends, however, on:

- The success of the stimulus package in stabilizing the economy;
- Whether banks no longer need to recapitalize and begin to lend more broadly;
- Whether companies that return to profitability are willing to take risks by borrowing and investing.

These are the key factors to watch, as they will likely signal a recovering equity market.

Global Diversification

Diversification also remains a valid investment principle despite the bad reputation it earned during the current crisis. Of course, we now know that investors would be in a better position if they had stuck with bonds instead of stocks and domestic stock instead of foreign ones, but there was no way for any one to know that a-priori. The purpose of diversification is precisely to try to avoid deep losses at the expense of possibly larger gains. It is like hedging against a foreign-exchange risk -- the firm or investor incurs a small cost to avoid the risk of a large loss (but also the possibility of a large gain). Diversification, therefore, seems to remain a valid investment principle. The only important and difficult decision remaining is what asset allocation and the specific mix of assets (stocks, bonds, and other assets) to hold in a particular market in order to properly diversify an investment portfolio.

The same is true for global diversification. Investors buy domestic and foreign stocks, bonds and other assets to avoid missing returns generated in foreign markets that may be greater than gains in domestic markets. If investors knew for certain whether the domestic or foreign markets performed better, of course, they could earn a higher return on investing only in the market that performed better. As it is, global diversification, as a basic investment principle, still seems to make just as much sense now as in the past. Some U.S. investment experts and specialized publications called into question the principle of global diversification because in 2008 the U.S. market performed relatively better than foreign markets. Indeed, at the present time, current global market valuations in some battered emerging markets seem attractive. Of course, global diversification may also require hedging the inherent foreign exchange risk involved, unless one wants to speculate.

Investment Performance during the Financial Crisis

Optimal investment decision making involves the proper balance among financial theories that deal with fundamental underlying forces that move markets in the medium term, real-world knowledge of the actual operation of financial markets necessary for investors to understand the day-to-day forces at work, and a solid dose of common sense.

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Dr. Dominick Salvatore is Distinguished Professor of Economics and Director of the Ph.D. Program in Economics at Fordham University in New York. He is a Fellow of the New York Academy of Sciences and was Chairman of the Economics Section. Professor Salvatore is a consultant to the United Nations, the World Bank, the International Monetary Fund, Economic Policy Institute and international corporations and global banks. He received his Ph.D. from the City University of New York in 1971. Dr. Salvatore has given more than 400 lectures around the world. He was Visiting Professor at the Universities of Vienna, Rome, and Triest; and at American University in Cairo and the Universities of Shanghai and Hunan in China. He has also organized more than 40 panels at the Annual Meeting of the American Economic Association. Dr. Salvatore has published 47 books and more than 150, articles in scholarly journals and edited volumes on international economics and microeconomics. He serves as Co-editor of Journal of Policy Modeling and Open Economies Review; Associate Editor of The American Economist; Board of Editors of Frontiers in Finance and Economics; and Past Editor of the Handbook Series in Economics of the Greenwood Press. He is also a regular contributor to several financial newspapers.

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