

Overcoming Recession and Financial Meltdown
Address to The Council on the United States and Italy
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We just revised our forecasts through the end of 2010. They show a steep drop in economic activity though mid 2009, followed by a hesitant recovery over the following year and a half. Even that unsatisfactory outcome requires a combination of unimagined monetary policy easing and sizable support from federal government fiscal policy.

How did we get into this miserable situation?

1. **Housing boom led to a housing bust.** Since there are still 10 months of unsold homes clogging the markets, driving down prices, and thus destroying household sector wealth, there won't be much home-building over the period ahead. Some European countries face similar problems. Italy, by comparison, has been hit less hard mostly because of an underlying more conservative behavior of households (less debt) and banks (less financial engineering).

Solution for the US: stop the foreclosures, which doom neighborhoods and add to unsellable supply.

2. **Consumption is falling fast**, faster than at any time since the modern GDP figures were created. Try to find three successive quarters of negative PCE growth. You can't. But the combination of sharply reduced net worth in housing and a record fall in stock market wealth slices spendable resources.

Solution: big tax cuts, especially for low and middle income families.

3. **Business investment is tanking.** Talk to business managers in a variety of industries as I try to do as often as possible. What's their attitude? No one can forecast demand. Take wind farms. Why build a new factory to build next-generation wind turbines? At \$43 a bbl and cheap coal, the only investment that makes much sense today in the energy sector is upgrading coal-fired power plants.

Solution: government has to overcome short-termism in decision making with targeted subsidies, even though some of that will be redundant or wasteful.

4. **Net export improvement is over.**

An unpredicted contribution to GDP growth from net exports took place in 2007-8 when global activity was off the charts (and thus unsustainable). But now that we have global slowdown (that is starting to include China, experts tell me), US,

European, and Japanese exporters face much tougher market conditions. In this country, export orders are actually falling, according to the ISM PMI. Shipments of capital goods, sold to both domestic and international customers, are also plunging. Other countries are facing a similar loss of export sales and orders.

Solution? There may not be one.

In short, positive actions are needed to break the vicious circle that we are embroiled in. There is no magic bullet. Will there be some wasteful spending? Certainly, but kept to a minimum, it won't kill us.

What about the financial meltdown? Have we learned anything?

1. Deleveraging is a painful process that can't be stopped by lower interest rates alone. Forced selling breeds a vicious downward spiral. Who has been hit by forced selling? Numerous hedge funds, for example. Many have been forced to close. Can the survivors make money in a climate in which leveraging is more disciplined? Big question.
2. Just as decoupling in the global economy is mostly a myth, in the financial markets everything and everybody got entangled. People who understood that made money. Most lost.
3. Ignoring warnings, even if early and/or vague, breeds losses. It is simply a falsehood for bankers and some government officials to assert that "no one could have foreseen... ." But the broad contours of the debacle **were** foreseen by a number of objective observers. Few took those warnings seriously, even fewer changed their investing behavior before it was too late.
4. Bankruptcy looks better in textbooks and political speeches than in reality. Case in point: pushing Lehman into it cost the stock market \$3 trillion. A \$50 bn package would have been more than sufficient to let them survive -- and would have obviated the need to put three times that amount into AIG.
5. Avoiding unpleasant tasks is ultimately pointless. The fate of the US car makers was sealed years ago. A restructuring plan needed to be developed, ready to go, by 2005, maybe earlier. If you can't make money in a boom, you can't survive a recession.
6. Words matter. Repeated assurances in 2007 that the subprime mortgage problem would be "contained" and not have a broader financial and economic impact were unfortunate, since they delayed necessary adjustments.

In conclusion, the chances of getting things back to anything like normal soon are not high. Deleveraging isn't over, and a downward multiplier effect is in motion.

Thinking ahead:

What can be done about the global recession? Monetary policy has done about all it can in the US and Japan. Europe still has some room left. So do large emerging market countries like Brazil, Mexico and China.

So fiscal policy stimulus will have to play a greater role. That is accepted in principle in this country, but it's hard to get agreement on what it should include. Europeans are split, both in terms of what individual countries can do and what individual countries think they should do. And Japan has only recently faced up to the reality of its own recession. My guess is that there will be some convergence in assessment but not right now. So recessions will get worse.

Let's assume that some useful steps are taking to break the back of the recessionary forces now at work.

Then we're left with the difficult job of fixing what's wrong with the financial system. That will take years but some useful first steps will be needed.

First, we need to calm down the stock market and encourage greater risk-taking. That will take a number of complementary steps: for instance, cuts in capital gains taxes; diplomatic overtures to risk-averse official and private institutions, mainly in Asia and the Middle East, to encourage diversification into stocks.

Second, we need to lay the foundation for a more trustworthy financial system. The bail-outs that have occurred here and in other countries in recent months are leading in the direction of greater concentration of financial power and decision-making in the hands of fewer and fewer entities. Governments and central banks have to deal candidly with the adverse competitive effects of this trend.

So how do we insure that the largest and systemically-important financial institutions that probably are "too big to fail" become "too strong to fail," without penalizing customers?

Here are a few suggestions for what the priorities for the incoming administration should be:

Learning more about leveraging. That will have a number of dimensions. But it certainly will entail delicate negotiations to get hedge funds to report their leverage to an impartial international organization like the BIS in Basel. It also means fuller information on exposures created through financial derivatives and on the leverage of private equity firms.

Dealing with flaws in the credit ratings system. The business model is defunct or should be so regarded. We need more ratings agencies, especially outside the US. And we have to stop the conflicts of interest that are inherent when the sell-side pays for ratings, rather than the buy-side. We may have to have a new or existing official organization provide ratings for systemically-important financial institutions, as Henry Kaufman has frequently suggested.

Establishing an FDA for complex financial products. Why do we test drugs so thoroughly? Because unintended side effects can make innocent people sick, or even kill them. But analogously, doesn't the freezing-up of a huge portion of the securities market hurt innocent investors, costing them their savings and indirectly exposing them to economic peril? Why shouldn't bank regulators insist that originators of complex products prove that they understand what they're doing? It was perfectly clear with collateralized debt obligations, for example, that many senior executives had little idea how they would perform in the marketplace under stressful conditions. Next time they better think ahead or else the regulatory authorities should declare issuance an unsafe, unsound banking practice.

Improving the technological infrastructure of major financial institutions and markets. Numerous large financial institutions have long boasted of their technology. But one doesn't have to look hard for unequivocal evidence that top management actually starves their post-trade execution departments of world-class IT. Here's a vivid example: credit default swaps. The market grew like topsy earlier in this decade and top management essentially ignored the IT demands that growth would put on their systems. They did almost nothing about it as simple trade matching was done primitively, essentially by hand, until the backlogs were an embarrassment. Even then they stalled in taking remedial action. Tim Geithner, our Treasury Secretary designate, has received, and genuinely deserves, a lot of praise for prodding, cajoling or shaming the leading banks into investing in a modern system that was developed by DTCC. But while much progress has been made, a fully automated clearing and settlement system for credit default swaps is still a ways away.

Improving both management and corporate governance of financial institutions. I hear stories of top management leaders who needed tutoring on the elementary attributes of CDOs or CDSs – long after the bank in question had committed hundreds of billions to the business. That should be unacceptable and bank regulators ought not to accept it. To be a stock broker or a commodities future adviser, you have to pass tests. That makes sense. Why shouldn't candidates for senior management also pass tests? Plus, board members must know the business, at least those who oversee three important board responsibilities: audit, risk, and compensation. They ought to be pre-qualified, too

Other analysts, like the distinguished economist of the Peterson Institute for International Economics Morris Goldstein, have even more comprehensive action

programs they would like to see installed. Those recommendations deserve careful study.

But I would end with this simple warning. Let's get a few things done quickly, because even a partial remedy to what went wrong in the past decade will help to rebuild confidence in the financial markets -- and start protecting taxpayers here and elsewhere from even bigger bail-outs in the future.