

Recovering from the Great Recession

An Economic, Financial & Political Conundrum

**Commercial Banking (MGT 473) &
Management of Financial Institutions (MGT 573)
Lectures**

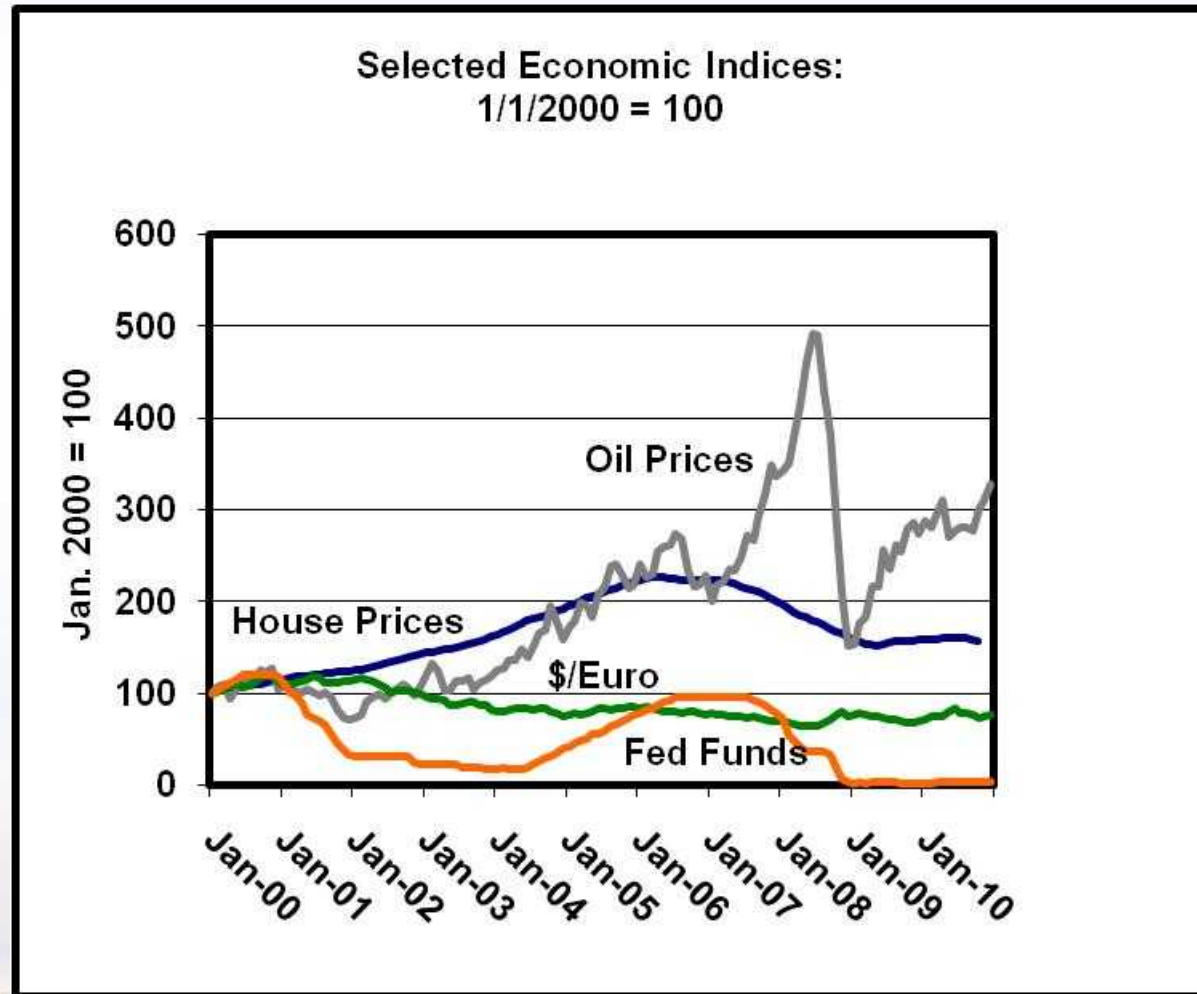
University of New Mexico Anderson School of Management

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Anatomy of a Bubble



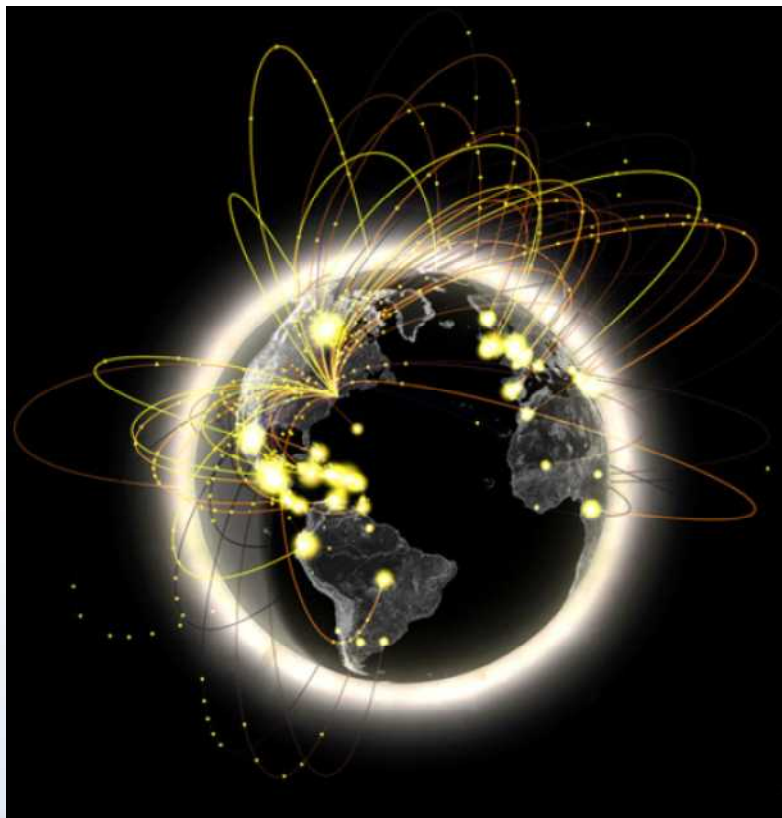
Source: Monthly Data for Effective Federal Funds Rate, Case-Schiller 10 City Housing Price Index, U.S. \$/ Euro, Nominal WTI

Déjà Vu: A Few Previous Bubbles/Financial Crises

YEAR	COUNTRY/ REGION	PRECEDING SPECULATION IN	MONETARY EXPANSION FROM
1636-37	Dutch Republic	Dutch East India Co., Tulips	Coin Debasement
1720	England, France	South Sea Co; Miss. Co.	Sword Blade Bank, John Law Bank
1772	UK/Amsterdam	Housing, Turnpkr, Canals; Dutch East India Co.	Chaining Accommodation Bills, Bank of Amsterdam
1837	U.S.	Cotton, Land	Wildcat Banks, Silver Retention
1873	U.S., Germany/Austria	Railroads, Securities Homesteading	Securities Bought on Margin
1890	England	Argentine Securities, Pvt. Cos. Going Public	Goschen Conversion
1893	U.S., Australia	Silver, Gold, Land	Silver/gold/\$, Capital Inflow
1907	U.S., France Italy	Coffee, Union Pacific, Industrial Bak Borrowing	Trust Companies
1929	U.S.	Land to 1925, Stocks '28-9	Stocks Bought on Margin
1974-75	U.S.	Stocks, REITs, Office Buildings	Eurodollar Mkt. Flooding in 1970-71
1979-82	U.S., World	Third World Syndicated Loans, OPEC Price Rise, \$	Continuation of 74/75
1982-87	U.S.	Stocks, Luxury Housing, Office Bldg., \$	Capital Inflow
1990	Japan	Stocks, Real Estate	1986 Interest Rate Cut
1994-95	Mexico	Deregulation, Boom	Capital inflow, bank lending, Bank Privatization '91
1997-98	Thailand, Korea, Malaysia, Brazil Indonesia, Russia	Deregulation, Capital Inflow, Foreign Borrowing	Bank Lending, Construction Boom, Crony Capitalism

Source: Kindleberger, Charles, P and Albert, Robert, *Manias, Panics and Crashes*, Fifth Edition, John Wiles & Sons Inc, 2005, pp 256-265

A More Open and Interdependent Global Framework



- **Countries not immune to effects of domestic policies outside their borders**
 - Food price increases from U.S. corn ethanol
 - Coal, oil, other commodity prices driven by China, India, U.S. economic growth and domestic public policies
 - U.S. housing bubble
- **Scope for national public policies with major economic/financial impact is becoming more limited**
 - Financial markets “über alles”
 - Can’t afford costs/returns out of line with competitor countries
 - Greater need for decision-making speed
 - Cost of mistakes will grow
- **Protectionist pressures**

Source: New York Talk Exchange, Total IP Traffic From New York in 24 hours

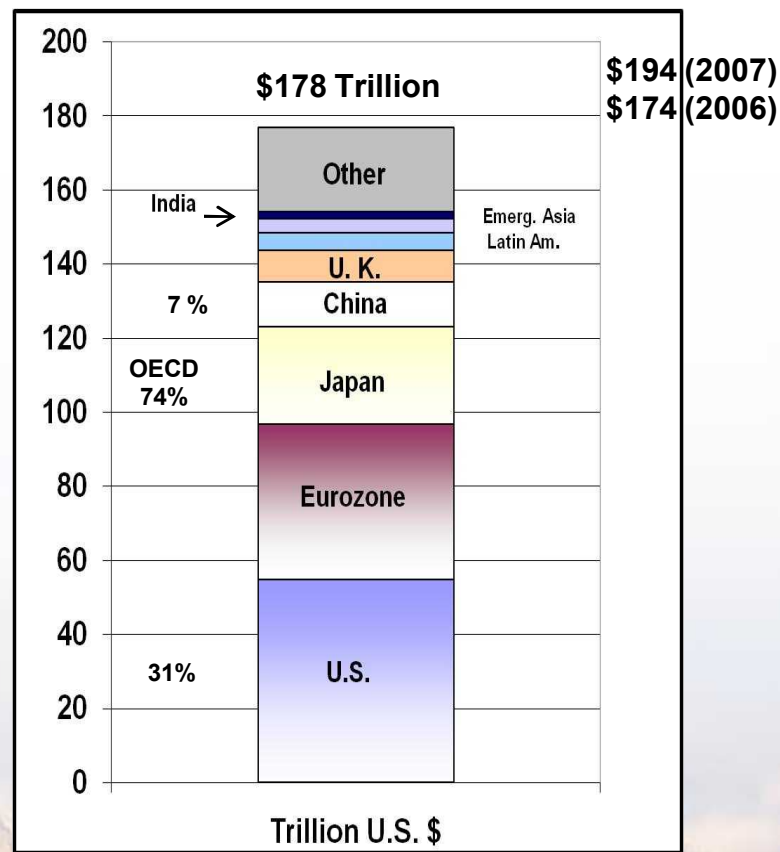
U.S. Is the Center of the World Economy But a Transitional Shift Is Underway

World GDP 2010

(Current Exchange Rates)

<u>Country</u>	<u>\$Trillion</u>
US	14.7 (23%)
China	5.8 (9%)
Japan	5.5
Germany	3.3
France	2.6
U. K.	2.3
Italy	2.1
Brazil	2.0
India	1.6
Canada	1.6
<u>World</u>	<u>62.8</u>
<u>OECD</u>	<u>42.9 (68%)</u>

Global Financial Assets 2008



Source: Global Capital Markets: Entering a New Era, McKinsey Global Institute September 2009. Includes equities, private debt, government debt and bank deposits. 2010 GDP data from Global Insight World Overview, December 2010

World Economy and Population

2010 World GDP

(Current Exchange Rates)

<u>Country</u>	<u>\$Trillion</u>	<u>World %</u>
U.S.*	14.6	23
China	5.8	9
Japan*	5.5	9
Germany*	3.3	5
France*	2.6	4
UK*	2.3	4
Italy*	2.1	3
Brazil	2.0	3
India	1.6	3
Canada*	1.6	3
OECD**	42.9	68
<u>World</u>	<u>62.8</u>	

2010 World Population

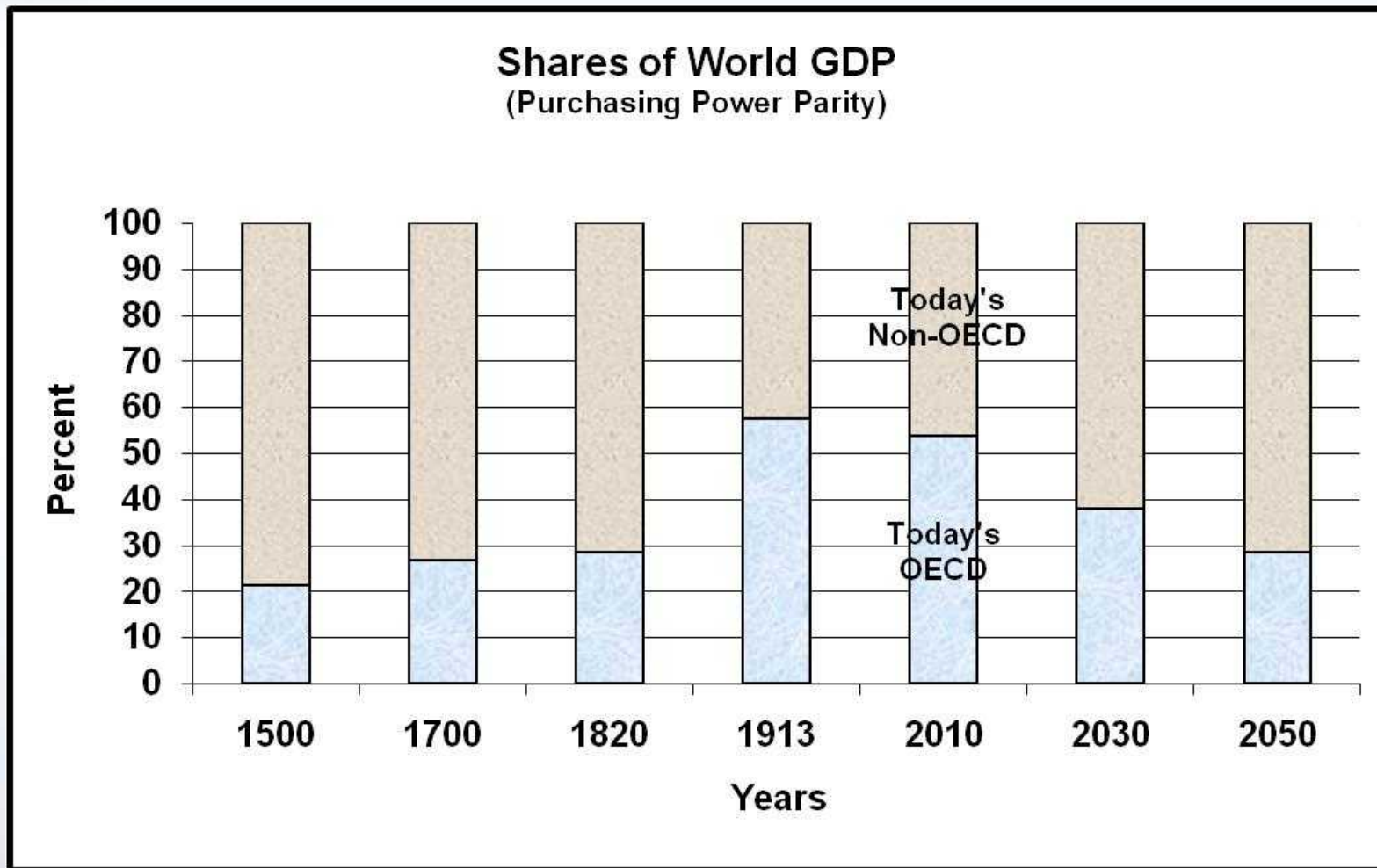
<u>Country</u>	<u>Population</u> (Million)	<u>World %</u>
China	1,343	19
India	1,214	18
U.S.*	311	5
Indonesia	233	3
Brazil	195	3
Pakistan	185	3
Bangladesh	162	2
Nigeria	148	2
Russia	140	2
Japan*	127	2
OECD**	1,226	18
<u>World</u>	<u>6,895</u>	

* Indicates a developed country

** Organization for Economic Cooperation and Development

Source: 2010 GDP data and population from Global Insight World Overview, December 2010

A Transitional Shift



Source: *The World Economy, OECD 2001, Angus Maddison; IHS Global Insight Detailed Forecast, Dec. 2010, extrapolated to 2050, \$2005 PPP basis*



Two Equations & Two Important Assertions

Two Equations

- Macroeconomic Accounting: $Y = C + I + G + (X-M)$
- Quantity Theory of Money: $MV = PT$

Two Important Assertions

- Financial markets “über alles”
- Caveat emptor



International Monetary System: A Confidence Game

- **Nation based, run by central banks (167, 1/10/2011) with varying degrees of independence**
 - Sweden (1668), Bank of England (1694), Banque de France (1800), Federal Reserve System (1913), ECB (1998)
 - Central bank mandates differ, but generally aim to
 - ◆ Control inflation; prevent recession; provide financial stability
 - Bank for International Settlements (1930)-- bank for central banks
 - Financial Stability Forum (1999)--improve coordination/info exchange
- **Money historically tied to gold/silver**
 - Most major countries adopted a gold standard during 1700s-1800s
 - ◆ On again, off again until early 1970s
 - US abandoned the gold standard in 1971; every major international currency followed suit
- **Money today is “fiat” money—that is, backed by confidence in the issuing government**

“You can’t deal with the problems of global financial markets within national systems of regulation” U.K. Prime Minister Gordon Brown, October 14, 2008



The “Great Recession”

- **Globally integrated financial markets, fueled by liquidity, in competitive pursuit of profits**
 - No international financial regulatory system; national financial/monetary regulation
- **Home ownership was the “tulip”**
 - Encouraging home ownership was “good”
 - Rising house prices a “sure thing”
- **Creative financial institutions outgrew well intended regulations**
 - Securitize debt to create an asset, avoid reserve requirements, get higher leverage, provide a global risk hedge
 - Securitized assets knit together by hedge funds, but lost in the fog—no transparency
 - Unraveled when house prices started to fall and subprime borrowers began to default
 - Unraveling aided by mark-to-market rules
 - Financial losses led to credit tightening in key countries, which slowed economic growth, creating additional financial losses--negative feedback loop
- **To avoid “depression,” Federal Reserve & other central banks provided liquidity; U.S. government & other governments provided stimulus**

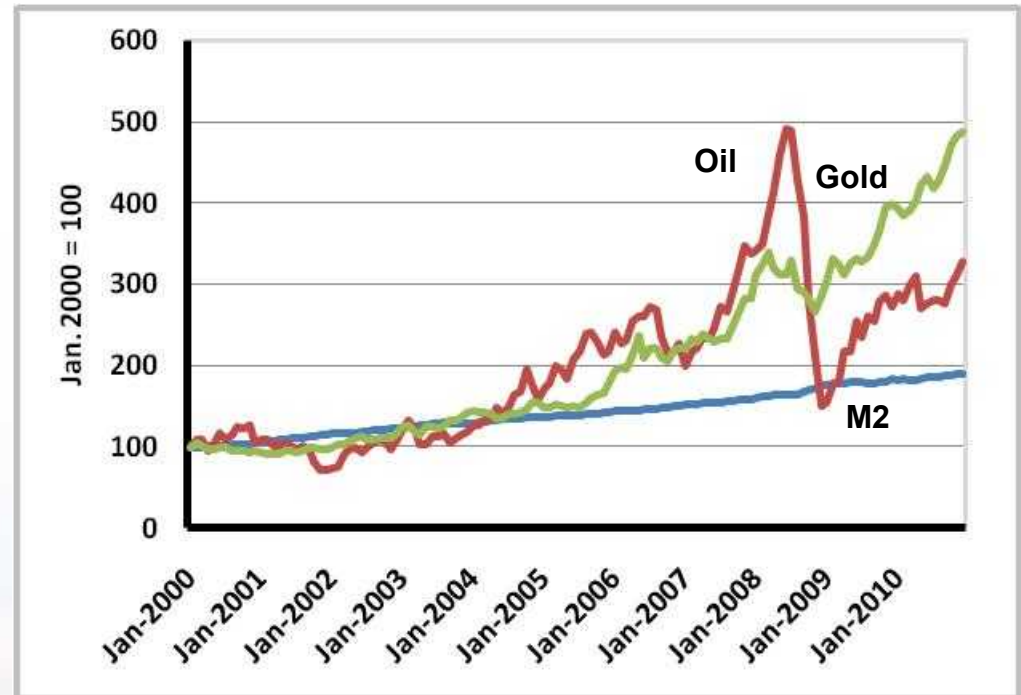
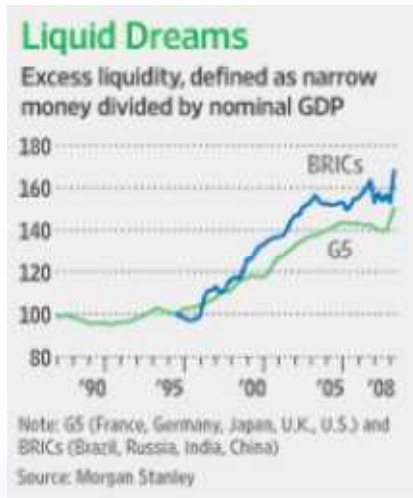


Current Situation

- **Things are looking up**
 - **Economies & expectations have turned around**
 - **Financial markets are functioning reasonably well**
 - **A continued recovery is the central scenario**

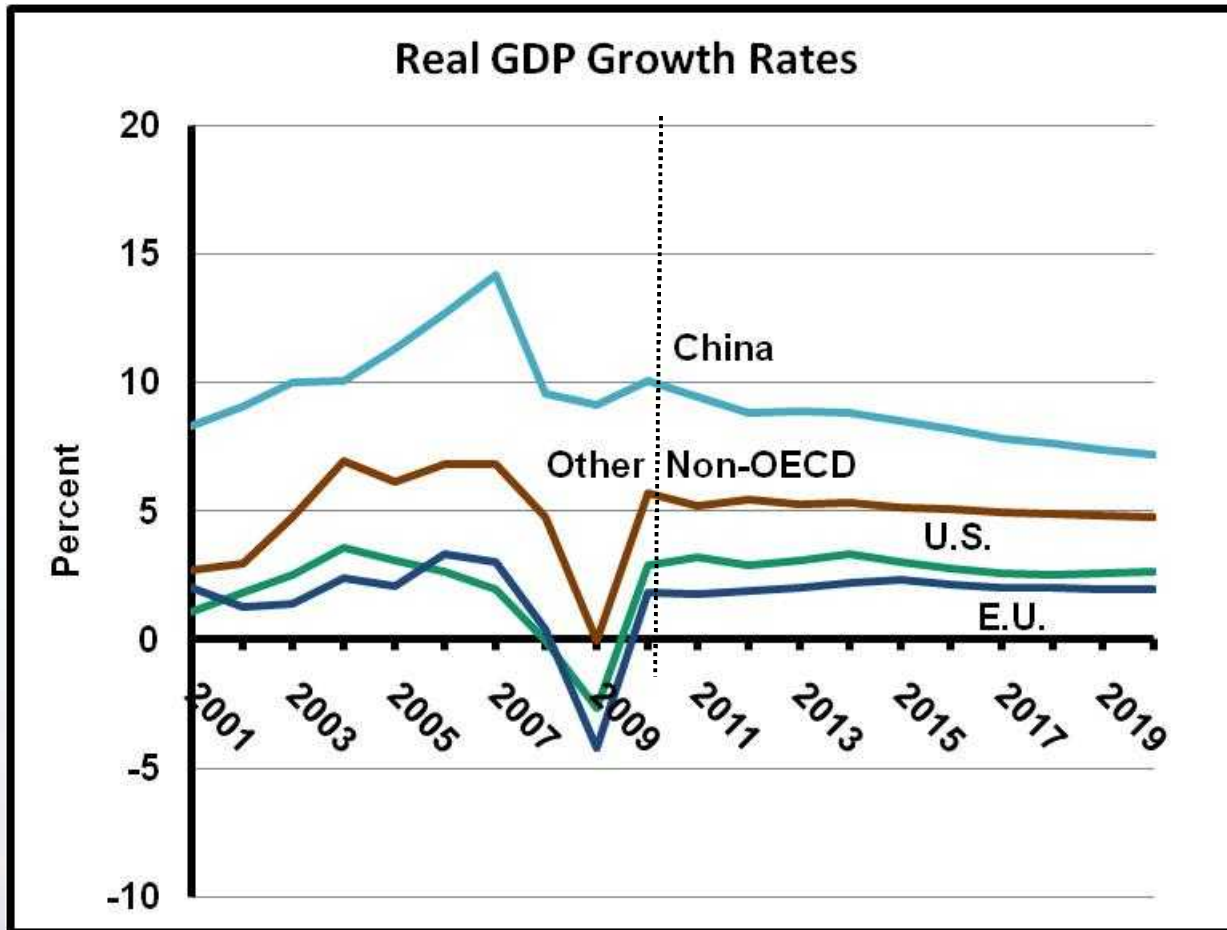
- **But cautions remain**
 - **Consumer remains under stress**
 - **Growing concern about debt/deficits in the U.S. and some EU countries**
 - **A two speed world—OECD versus China & developing world**
 - **Uncertain approach to global financial market management (G20/US financial reform law)**
 - **Uncertainty about U.S. Administration/new Congress**
 - **Emerging inflationary concerns from excess liquidity and oil/commodity prices**

Emerging Inflationary Concerns



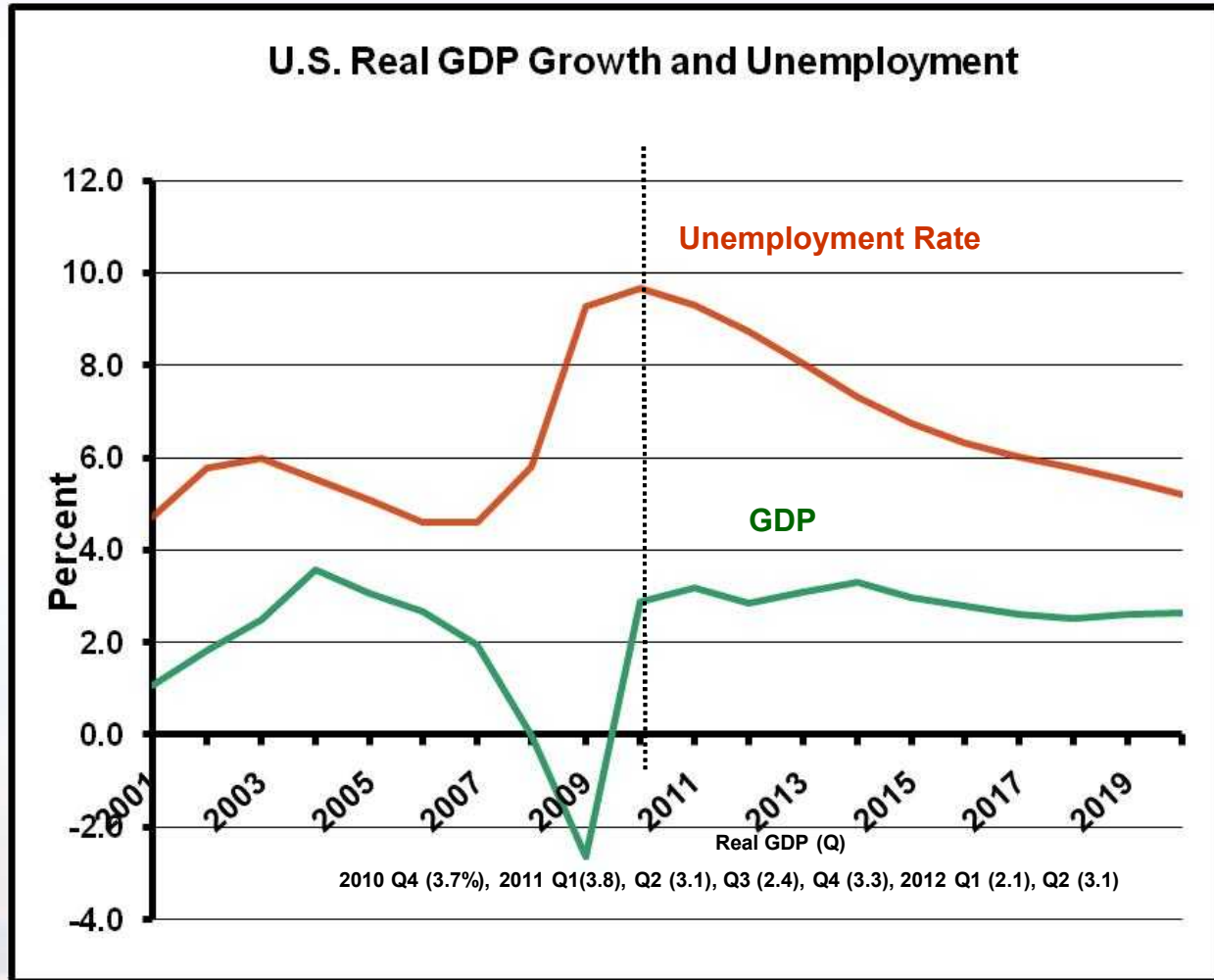
Source: WSJ 6/4/09 P C12; Federal Reserve, EIA, London Gold Exchange data

Outlook For World Economic Growth



Source: IHS Global Insight World Overview Base Case, January 2010

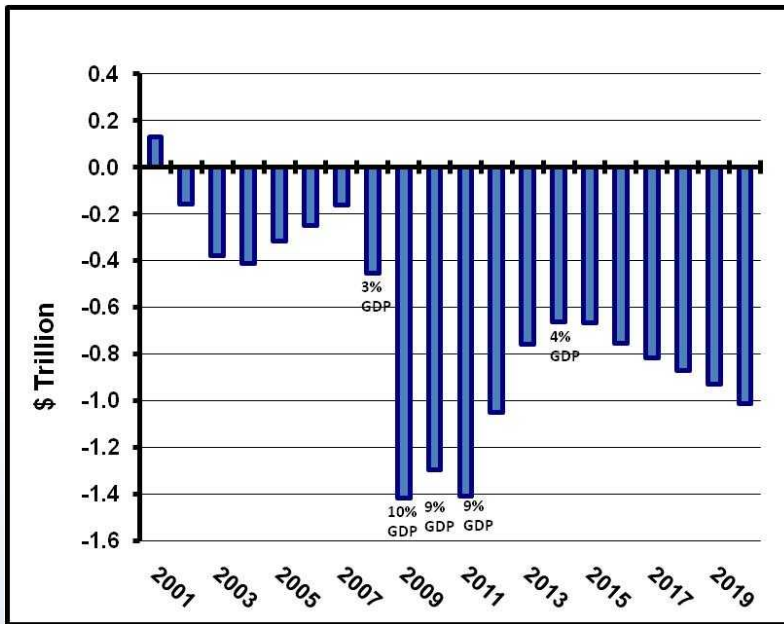
Outlook for U.S. Economic Growth & Unemployment



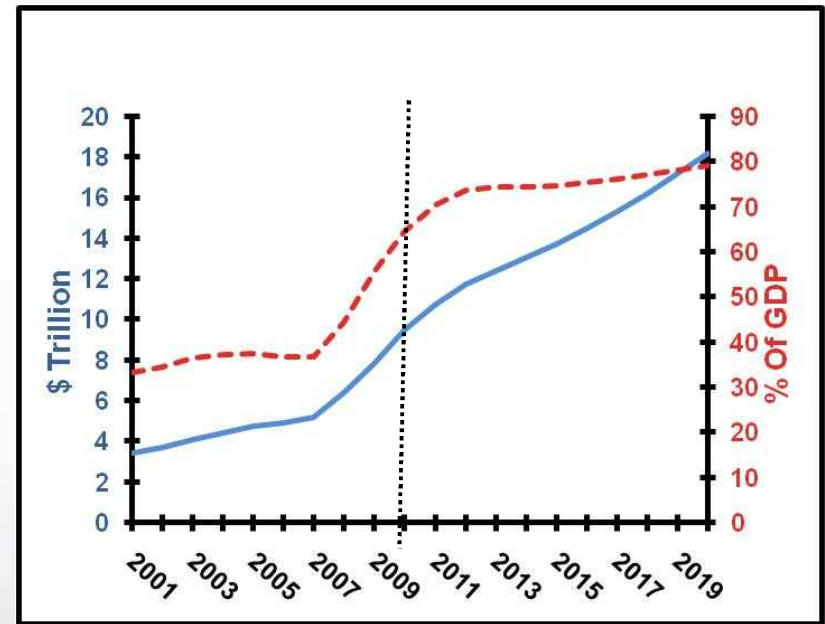
Source: IHS Global Insight, Short Term Forecast January 2011

U.S. Federal Budget Deficit and Debt

Budget Deficit



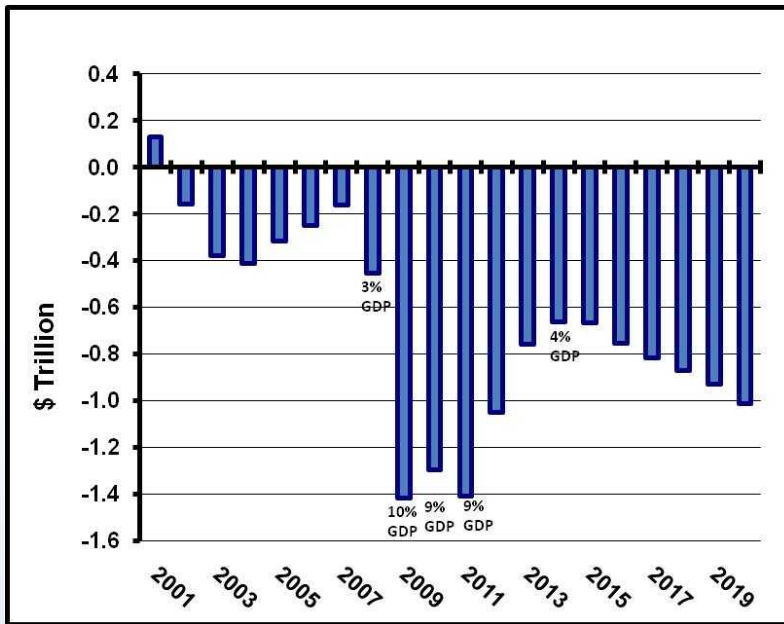
Publicly Held Federal Debt



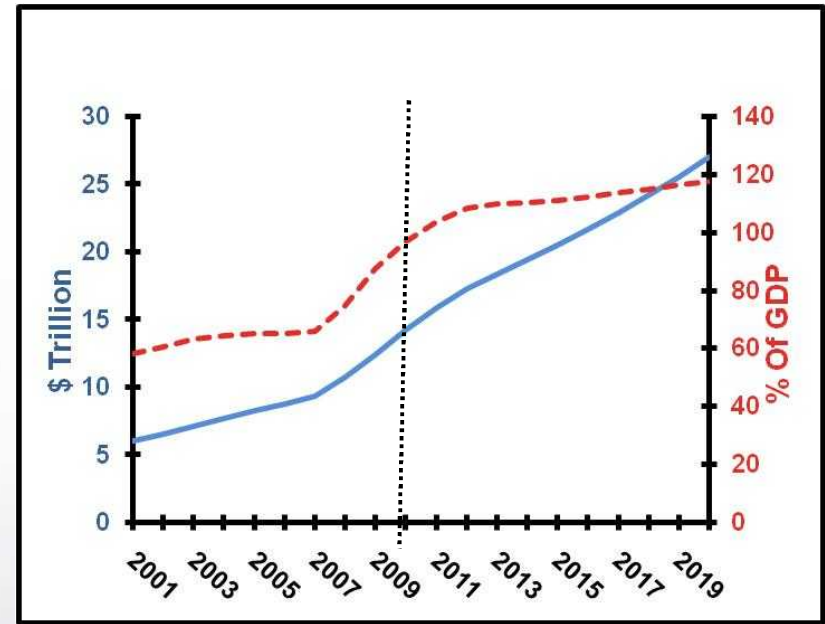
Source: IHS Global Insight Short Term Forecast January 2010

U.S. Federal Budget Deficit and Debt

Budget Deficit



Total Federal Debt



Source: IHS Global Insight Short Term Forecast January 2010



2010 Fiscal Balance as a Share of GDP

	<u>Country</u>	<u>Percent</u>
1	Ireland	-32.0
2	Tanzania	-13.3
3	Mozambique	-13.2
4	Botswana	-12.0
5	United Kingdom	-10.1
6	Spain	-9.3
7	Kyrgyzstan	-9.1
8	Japan	-9.1
9	United States	-8.8
10	Iran	-8.1
11	Egypt	-8.1
12	Greece	-8.0
15	France	-7.7
26	Pakistan	-6.3
34	India	-5.3
43	Canada	-4.8
44	Russia	-4.7
63	Germany	-3.6
76	China	-2.7

Source: Source: IHS Global Insight World Overview & U.S. Short Term Forecast Base Case 1/17 & 1/11 . Based on available data for 120 countries.

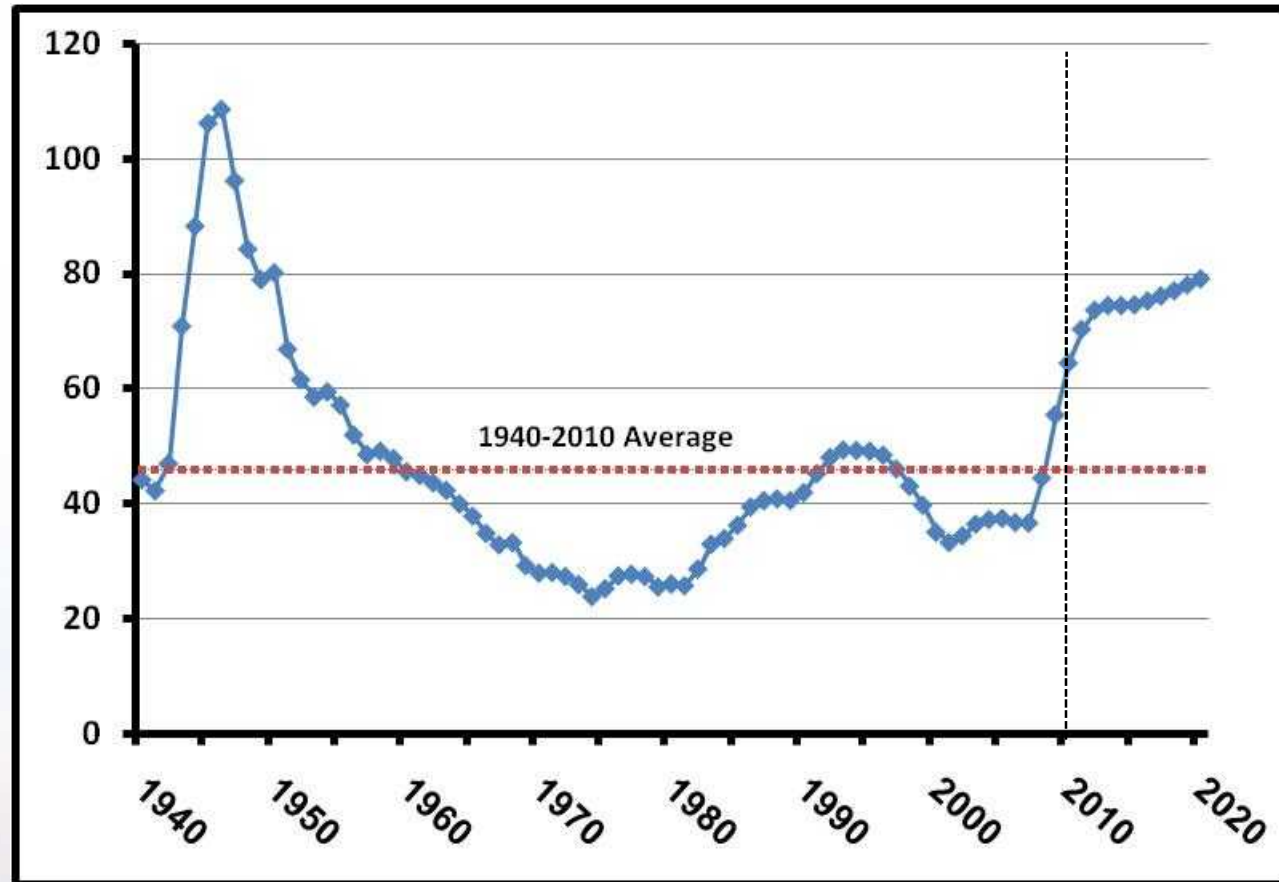
Estimated 2010 Public Debt/GDP Ratios

Rank	Country	Debt*/GDP
		Percent
2	Japan	196
5	Greece	144
8	Italy	118
11	Ireland	99
14	France	84
15	Portugal	83
16	Canada	83
21	U. K.	77
22	Germany	75
26	U. S.	65
27	Spain	63
31	Brazil	61
38	<u>World</u>	<u>58</u>
42	India	56
112	<u>China</u>	<u>18</u>

* Public Debt

Source: CIA World Factbook On-Line; IHS Global Insight Short Term Forecast January 2010

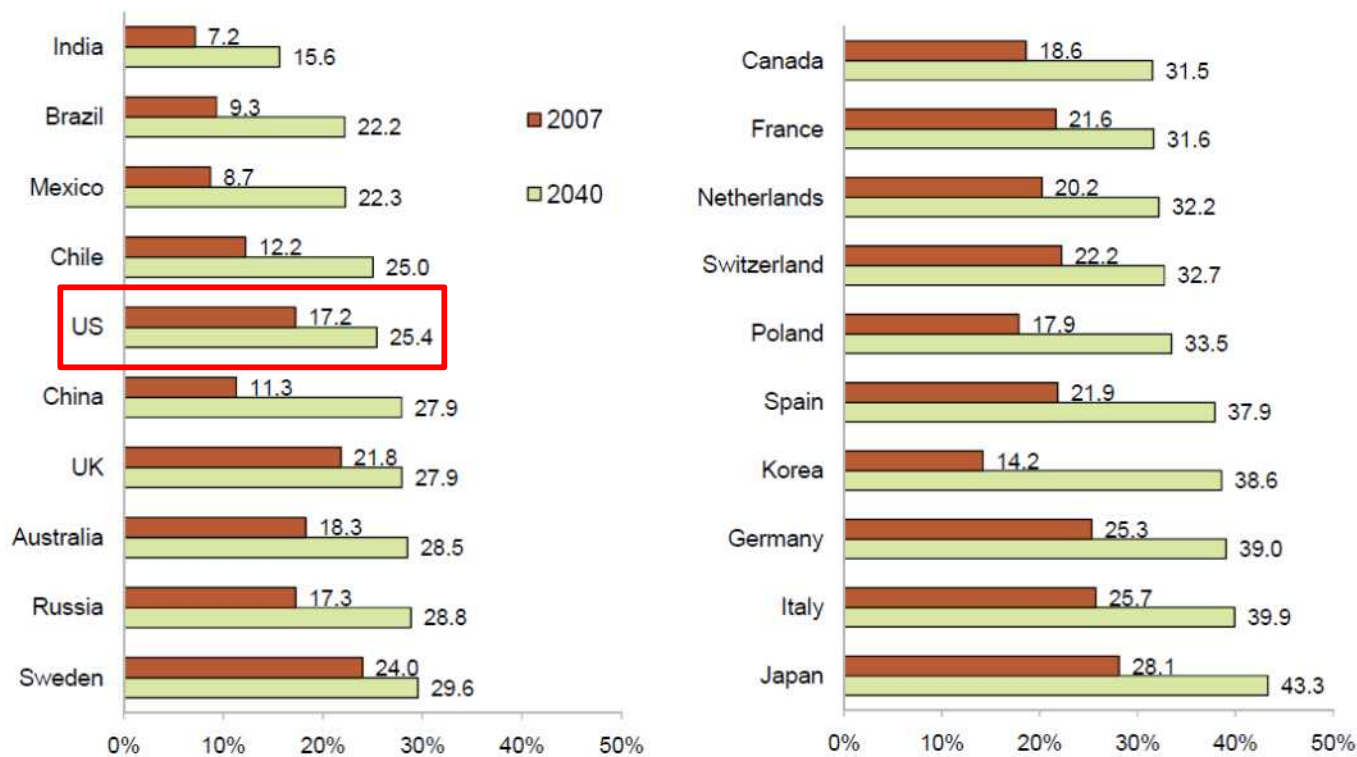
U.S. Public Debt as a Percent of GDP



Source: Budget of the United States Historical Tables and IHS Global Insight Short Term Forecast January 2010

Aging Populations Will Require Growing Social Safety Nets

Elderly (Aged 60 and Over), as a Percent of the Population in 2007 and 2040



Source: The Global Aging Preparedness Index, CSIS, 1/10/11

States Are In Financial Crisis Too



- 38 states are projecting FY11 budget deficits exceeding 9 percent of their budget
- Almost half of the states (22) are facing FY11 budget deficits of \$1 billion or more.
- Nine states with the largest budget gaps (\$billions)
 - CA (\$18), IL (\$14), NJ (\$11), NY (\$9)
 - FI (\$5), PA (\$4), GA (4)
 - AZ (3), MA (\$3)
- Some 40 states are currently projecting budget gaps for FY12
- State pensions & health care commitments are the big items on the spending side
- Rise in muni bond risk raises interest costs
- Who bails out the states?

Mounting Pressure

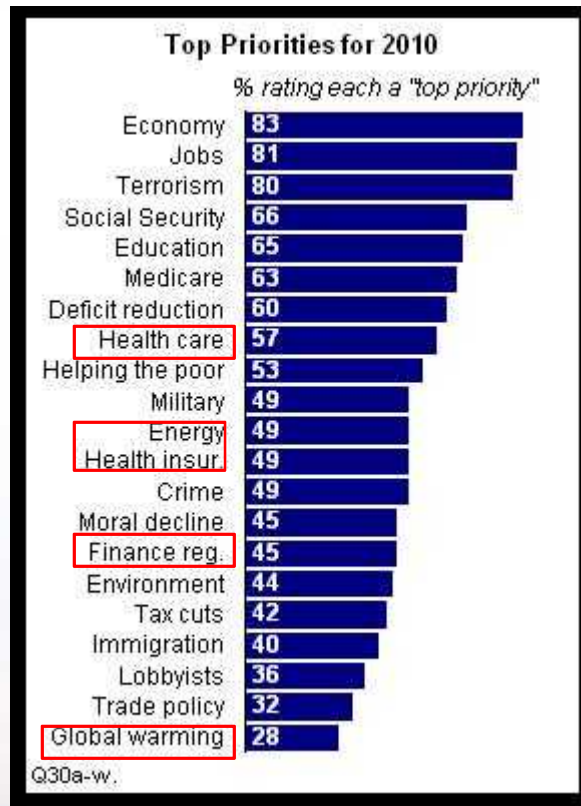
Yield on 30-year triple-A rated general obligation municipal bonds



STATE	FY2012 BUDGET GAP amount	% of budget	BOND SPREAD OVER 10-YEAR AAA MUNICIPAL-BOND INDEX
Illinois	\$17 billion	50.9%	2.15 pct. pts.
California	\$17.2 billion	20.3	1.25
Michigan	\$1.4 billion	6.5	0.8
Nevada	\$1.3 billion	37.1	0.8
Rhode Island	\$290 million	9.9	0.5

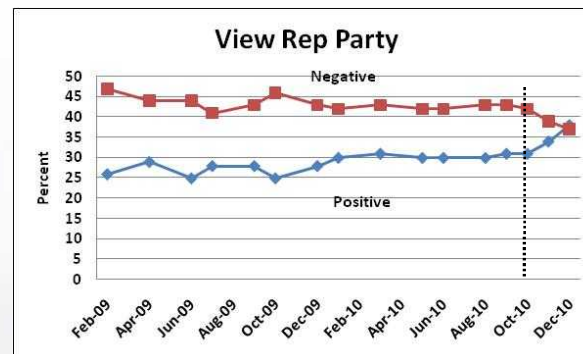
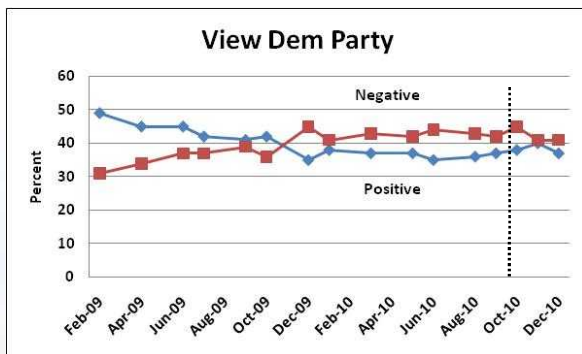
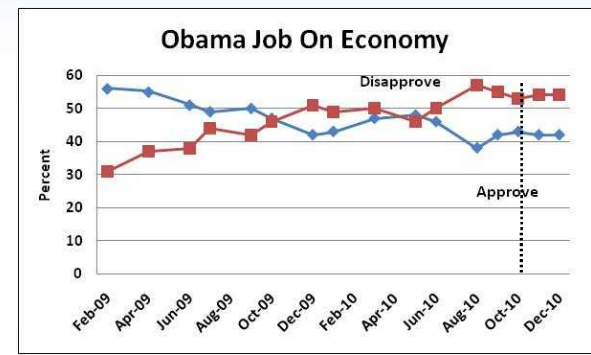
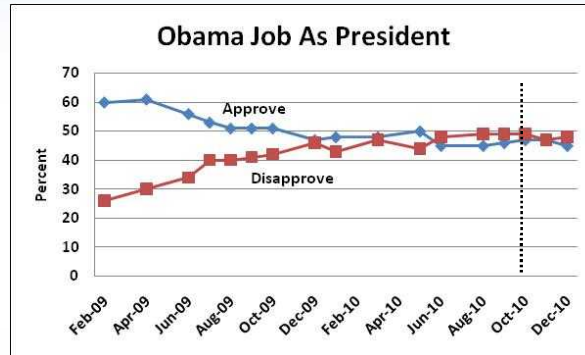
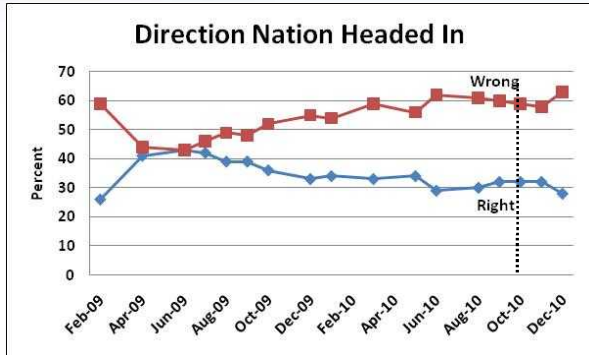
Source: WSJ 1/13 P A3, 1/14/2011 P A1; Center on Budget Policy and Priorities 12/16/10, Table 1, on-line
NM projected FY11 deficit of \$333 million, 6.1% of budget

Public's Top Priorities January 2010



Source: "Public's Priorities for 2010: Economy, Jobs, Terrorism," The Pew Research Center for the People and the Press, 1/25/10, on-line

Trends in Public Views



Source: NBC-WSJ Survey, 12/9-12/13
 +/- 3.1% Margin of Error

Apparent U.S. Government Leadership Approach To Economic Policy: 2009-10

- **Government intervention and complexity**
 - “Redistribute” income
 - ◆ Tax “rich” and spend on “poor” and “middle class”
 - **Change market direction**
 - ◆ **Industry: reign in/regulate**
 - Commodities trading, pay czar, GM-Chrysler bailouts with “direction”
 - ◆ **Energy: shift toward renewables/efficiency, and ... nuclear?? & offshore O&G??**
 - R&D and deployment, regulation; tradable CO₂ permits-fees/EPA regulation
 - ◆ **Healthcare: Patient Protection and Affordable Care Act--inject more federal government**
 - Focus on insurance rather than healthcare fundamentals
 - ◆ **Banking/Finance: international collaboration; domestic regulations**
 - G20/IMF oversight; Consumer Credit Protection Act; Dodd-Frank Wall Street Reform & Consumer Protection Act
 - **Protectionism to “save” U.S. jobs?**
 - ◆ “Buy America” in stimulus bill; “hire American” in TARP
 - ◆ U.S. carbon tariff in House passed climate bill
 - **Fiscal stimulus/government spending**
 - ◆ ARRA; budget deficit necessary to accomplish objectives



November 2010 Mid-Term Earthquake

Senate

Old **59 D 41 R**
New **53 D 46 R**

House

Old **257 D 178 R**
New **186 D 240 R**

State Governorships

Old **26 D 23 R**
New **20 D 29 R**



Debt/Deficit Panels (November 2010)

- **National Commission on Fiscal Responsibility and Reform (President's appointed commission; Bowles/Simpson)**
- **Bipartisan Policy Center Debt Reduction Task force (Domenici/Rivlin)**
- **Both had non-binding recommendations to**
 - **Cut federal spending, reform the federal tax code**
 - **Control costs of social safety net (health care, social security)**
 - **Domenici/Rivlin added 6.5 % national Debt Reduction sales tax**
- **In theory, “everything is on the table,”; in practice, a political food fight**

Reducing Budget Deficit as a Top Priority Over time

Partisan Views of the Budget Deficit

	<u>Rep</u>	<u>Dem</u>	<u>Ind</u>	<u>R-D</u> <u>diff</u>
<i>% rating deficit 'top priority'</i>	<i>%</i>	<i>%</i>	<i>%</i>	
Barak Obama Jan 2010	61	60	60	+1
George W. Bush Jan 2009	51	52	57	-1
Jan 2008	52	64	57	-12
Jan 2007	42	57	53	-15
Jan 2006	45	62	56	-17
Jan 2005	48	64	54	-16
Jan 2004	44	57	55	-13
George W. Bush Jan 2003	38	48	33	-10
Jan 2002	27	41	38	-14
Bill Clinton Jan 1997	66	54	62	+12

Q30bF1.

Source: "Public's Priorities for 2010: Economy, Jobs, Terrorism," The Pew Research Center for the People and the Press, 1/25/10, on-line



How to Reduce the Deficit ?

- **Raise taxes**

- After mid-term elections, tax raising philosophy seemingly on hold in favor of spending cuts. Bush tax cuts into 2012, but role/shape of higher taxes TBD
 - ◆ Higher taxes/fees (tilting toward “the rich”?)
 - ◆ Limit tax deductions (“tax expenditures”)
 - ◆ VAT? Other?

- **Cut spending**

- Administration FY11 budget request (2/2010) proposed \$3.8 trillion spending & \$1.3 trillion deficit
 - ◆ Budget: 57% mandatory spending (Medicare/Medicaid & Social Security); 7% interest on debt; 19% defense; 17% non-defense
 - ◆ Administration proposed freezing government spending 2011-2013 on the 17% non-defense spending
- Spending cuts TBD

- **Accelerate economic growth**

- Underway, but increased government intervention/uncertainty goes against it
- Streamline federal regulations (1/18)?

- **Reducing deficit “too soon” could abort recovery...**



So Where Are We Heading?

- **Economic recovery, but some fragility**
 - U.S. still has high unemployment, consumer debt overhang; housing, commercial real estate, bad bank assets; states under economic stress
 - Europe has weak economic growth and fiscal uncertainty (debt/deficits) in fringe countries (e.g., Greece, Portugal, Ireland, Spain) that could trigger bond market responses/need for bailouts
 - ◆ EU is a monetary union, not a fiscal/financial one
 - ◆ Difficult domestic political decisions on spending/taxes for “social” oriented economies
 - ◆ Even “stronger” economies—U.K., France, Germany—could see bond market stress
 - ◆ How much must Germany/France “give” to bailout EU?
 - Asian/developing countries strong economic dynamism is a driver, but a delicate balance among growth, inflation and interest rates
- **U.S. government policy uncertainty**
 - Two year Bush tax cut extension will provide economic boost, but 2012?
 - Where are the Administration and the new Congress on:
 - ◆ Debt & deficit reduction, debt ceiling extension, tax/spending priorities?
 - ◆ Health care and banking & finance law implementation?
 - ◆ Medicare, Social Security ?
 - 2012 election campaigns will start in 2011
 - When will the markets and/or the Fed raise interest rates (reduce money supply growth)?
 - Is the U.S. (and U.K, France, Germany) AAA debt rating at risk?
 - ◆ Moody’s & S&P bond raters; bond “vigilantes”



Economic Policy “Boundary Conditions”

- In our increasingly integrated global economic & financial system
 - “Bad” policies will be undone by the market place
 - Expectations will lead markets
 - Confidence in U.S. public policy and policy-makers will be critical



A Few Things to Watch in 2011+

- **Near term: political**

- How well & where will the Administration & new Congress come together to make the difficult economic/financial policy decisions?

- **Near term: economic/financial**

- Unemployment
- Federal budget deficit & debt
 - ◆ FY11 federal budget—when/what; FY12 Presidential budget proposal expected 2/17
 - ◆ Federal debt ceiling expected to be hit by March
 - ◆ U.S. debt rating/market confidence in U. S. Government policy
- State deficits (and pensions & health care)

- **Near to medium term: economic/financial**

- U.S. monetary policy -- interest rates, inflation & exit strategy (2011+)
 - ◆ US dollar value; \$, Euro & Yuan roles in international monetary system
- U.S. fiscal policy (2011-2012+ budgets)
 - ◆ Dealing with budget deficits & debt, health care & financial reform implementation, expiration of Bush tax cuts, Medicare, Social Security, etc.
 - ◆ U.S. debt rating/market confidence in U. S. Government policy
- U.S. policy toward business and regulation
- Restructuring, regulation, performance of U.S. & global financial markets
- Unanticipated national security events, natural disasters, etc.
 - ◆ Budget capacity?