"Getting Back on Track: Lessons Learned from the Crisis"

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Officially, the recession ended in June 2009, but we haven't had much of an economic recovery. This summer, battles over the debt ceiling in DC and the worsening € crisis prompted fears of a double dip. The economic data since Labor Day has improved the outlook somewhat, but we are not out of the woods. Bankers are gloomy.

Two years ago, there was optimism about prospects for an economic recovery. Economic forecasts based on conventional macro models and postwar economic data were predicting that low interest rates and fiscal stimulus would allow affected economies to bounce back quickly.

But these models were not the right tools for thinking about how economies would perform in the aftermath of a financial crisis -- a crisis that Bank of England Governor Mervyn King recently characterized as not just the worst since the 1930s, but possibly the worst in history. We are living in a R/R world right now.

As we've learned from R&R, the economic consequences of credit busts following credit booms are always painful and protracted. By their metrics, the aftermath of this crisis has been fairly typical despite two rounds of fiscal stimulus and the unprecedented actions the Fed has taken to support the economy. So, how does this event look?

- A decade or more of economic underperformance is common. We are, perhaps, 3 1/2 years in.
- Massive losses taken by banks are typical. US banks set aside $625B in LLPs in '08-10. F/F together have so far lost $170B and expects an additional $50B in losses though 2014. In a worst case

scenario, $142B more. The expected losses alone wipe out their combined annual profits since their inceptions + another $150B.
- Sharp contractions in credit afterward are also typical. Loans and leases held by US banks declined nearly $750B from the peak to mid-2011. Unused loan commitments are down $2.7T.
- And as sure as night follows day, G finances take a big hit. Public debt to GDP ratios tend to double. According to the IMF, aggregate net G debt in the world rose from $21.9T in '07 to $34.4T in '11. Forecasted to rise to over $48T in '16. Virtually all of this growth occurs in the advanced economies.
- Greece is now on the brink of default and others are teetering.

The speed with which the crisis deepened in Europe is stunning. Worries about fiscal sustainability have broadened to infect Spain and Italy. This in turn has spilled over to concerns about the viability of European banks that hold a lot of their debt.

In the aftermath of the G20 meeting in Cannes, the mood was sour. Key elements of the deal struck by M&S remain incomplete. M&S did not get their hoped for assistance from non-€ countries. The G20 statement said only that finance ministers would discuss again in Feb. And the IMF has not been able to get additional financial commitments that would support a bigger role.

The consensus among private sector analysts is that even the proposed new 50% haircut for private sector holders of Greek sovereign debt is not enough given its profound debt and growth problems. The Italian G has not been able to take adequate steps to convince markets.

The ECB has purchased significant amounts of Greek, Italian and Spanish debt to support their financial needs. ECB has purchased 70B€ of Italian bonds alone since August. Greek debt is held at par, and were not subject to haircuts.

At every step, European leaders have underestimated the scope of the problem and the resources necessary to address it. The slow and unwieldy nature of EU governance has raised questions as to its institutional capacity for managing the crisis.

Why do I raise this? First, because of the substantial interdependencies between the US and Europe. The US exported $400B to Europe in 2010. US has > $1T in direct investments. US banks have $2.7T in European loans and commitments. US investors, from MMFs on the short-end to investment banks, pension funds, ins. cos. on the medium to long-end have substantial exposures. MF Global was 1st casualty.

Second, because there are important lessons to be learned about the dangers of excessive credit growth, financial sectors that are large in relation to their economies, fiscal and financial regulatory weaknesses.

How did we get to this point? The IMF has been publishing a heat map – R, Y, G -- assessing various measures of indebtedness and financial leverage for the advanced economies. It illustrates the comparative weaknesses that led to the crisis in Europe and points toward vulnerabilities in the US and Japan.

[Show slide] Overview of the ratios. Of course, these measures don't tell the whole story. E.g., the G measures don't account for unfunded liabilities, nor the relative tax raising capacity of governments. The bank ratios don't account for relative risk among significant bank asset classes nor for OBS exposures. Others. But look:

- Greece's gross G/GDP was the highest in Europe at 166%. IRE at 109%. Port at 106%. The EU at 89%. US at 100%. Japan at 233%
- Primary balance – Japan and US were the two worst.
- HH debt – 1 of 3 red-zoned items for US. Familiar with this story.
- Greece, Ireland and Spain were also "red zoned" for high ratios of both HH debt and nonfinancial corp. debt to GDP.

- Japan, Greece, Italy, Portugal and Spain high ratios of nonfinancial corp. debt/equity.
- FIs were largest in relation to the size of their economies in UK and IRE (735, 664). France is at 151%. Japan at 188%.
- Bank leverage ratios – tangible assets to tangible common equity -- were twice as high for the €zone as the US (26 vs. 12). Banks in FR, GER, BEL were the highest (26, 32, 30). (3-4% capital/assets compared with 8%)
- How could this be? Mainly, it appears to reflect an EU Capital Requirements Directive which assigns a risk weight of 0% for exposures to Member States' central government debt.
    - Even though the sovereign debt of many €zone countries has lost its risk-free status, it is still up to country supervisors to enforce this recognition and their performance has reportedly been mixed.
- Eg, French banks' risk-weighted assets are 2.2T€, against a capital base of 167B € – just above 7.5%. But total assets are over 8T€ unadjusted, making equity/assets = 2%.
- Approx 80% of European debt, public and private, is held by its banks vs. 20% in the US. We have a situation in which highly leveraged banks and highly indebted Gs are supporting each other. This co-dependency may not be tenable.
- Ranked by the highest # of red zone indicators (IRE – 10, Port – 9, J & France– 7). US had 3 in red zone (2 measures of G + HH)

Not on the chart is the extent to which banks are funded in wholesale markets vs. deposits. Deposit/asset ratios for the largest banks in Europe hover in the 25% to 35% range. A surprisingly component of that was ST $ funding – selling CDs and CP to US MMFs. This funding source has been under pressure as prime funds have reduced the amount and tenor of their exposures as have others.

Many Euro banks reportedy have experienced deposit run-off and wholesale funding strains. Ordinary depositors in Greek banks are withdrawing money in anticipation of a possible €-exit. Deposits in Greek banks are down almost 20% from beginning of 2010 to 8/11. Bloomberg reports that at Irish banks deposits are down 40%.

Deutsche Bank analysts estimate that collectively they need to finance nearly 2T€ of debt over the next 5 years. They are increasingly relying on secured financing vehicles such as covered bonds.

How serious is the fall in confidence in € banks? The interbank market is dormant. Eurozone banks no longer trust each other. Instead they deposit surpluses in the ECB rather than lend to other banks.

ECB has provided banks with 1/2T € of bank liquidity to compensate. Its decision last month to provide term financing for banks to get them to 2013 stabilized a very dangerous situation.

I bring these markers up to illustrate the damage that credit booms and busts normally cause, and why it is so important we do everything we can to avoid a repeat.

Lessons Learned (Or Relearned)

1st, nearly unimaginable things have happened over the past 3 years. We have all come to expect the unexpected.

Sovereign risk pricing in financial markets follows a well-known pattern: long periods of complacency during which risk premia and risk perceptions are unusually low while risks are building up, followed by a sudden loss of confidence and a sharp widening of spreads. Market disciplines on governments work sporadically rather than consistently.

I fear that the US could be facing a sudden loss of confidence unless we can solve our fiscal problems. USG is spending 25% of GDP and borrowing 40% ot that. The WH forecasts national debt will rise by $10T to $24T by 2021. The policy debates in DC appear to be lagging behind the new realities we face. The refusal of Rs and Ds to give ground could take us to the brink sooner rather than later.

In a speech to the French public on 10/28, Sarkozy said: "we have entered a new world…We have to revise and adapt our budget plan to the new reality. I am waiting for our political leaders to say the same.

Japan has a similar problem. Most of its debt is held internally, but that will become more difficult as its population continues to age.

Sovereign debt is not risk-free and should never have been treated as such by Basel rules. Although Basel II gave banks some encouragement to reserve against sovereign risk, in practice, the zero-risk weight prevailed.

Banks that are too big in relation to the size of their economies pose serious risk to their sovereign governments. European banks' will have to deleverage and become less reliant on wholesale funding.

Ironically it was the Eurozone leaders that argued for a slower schedule for Basle III capital requirements and lower target capital ratios at last Nov's G20 summit. The first casualty was Dexia, one of the larger banks in Europe, and the recipient of the greatest amount of Fed loans after the Lehman collapse of any nonbank lender, and a bank that had passed the €zone stress tests just 3 months earlier.

If additional sovereign defaults do occur in Europe, the ECB itself may need to be recapitalized drawing first on national central banks and then on their governments.

The ECB's shaky balance sheet raises questions about the Fed's own soundness. In the advent of QE1, QE2, and operation twist, it is looking more and more like the balance of an S&L –borrowing short and lending long. Another round of QE is under discussion. As a result of Operation Twist, the Fed plans to lengthen the average maturity of its holdings to 100 mos (>8yrs) from 75 mos currently.

The essential role of our capital markets is to bring together savers and investors and to properly price risk. Aggressive MP is causing serious distortions to risk pricing. Zero interest rates, negative in real terms, may be sustaining spending, notably on C, but they haven't promoted BFI. Corps are awash in cash ($2T). Low rates are killing savers and leading pension funds, FIs foundations and retirees to take more risk. Many MP experts have observed that MP contributed to the housing bubble by keeping interest rates too low for too long. I hope we are not creating an environment for new mistakes in capital allocation today.

In fact, the US, Europe, China and Japan will be going through a sustained period of deleveraging which could have a persistently negative impact on growth.

The financial system which fueled the credit expansion was an accident waiting to happen. FIs had leveraged up to an astonishing degree. Risk management capabilities had not kept pace with their increased size and complexity.   And corporate boards did not have the capacity to understand the risks they were taking at an enterprise level and to properly oversee management.

The US companies don't have a global competiveness problem. They have proved to be very adaptable and profitable in the globally economy. We have many talented and entrepreneurial people contributing to enterprises large and small. It is the average American worker that is struggling. This is evident in stagnant wages for median workers across various demographic groups and in U for < college educated workers.