Global Financial Crisis on its Sixth Birthday

Global economic climate remains uncertain but it is still unclear whether continued life support or more expenditure control can drive recovery in advanced economies

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The credit freeze associated with the global financial crisis is usually traced to the collapse of Lehman brothers in September 2008. Many observers hold that but for the monumental failure to bail it out the crisis may never have occurred. Be it as it may, the New Year marks the sixth year since tremors from the subprime segment in the US housing market were first felt in financial markets. These came to a head in August 2007 with a crisis of confidence in the interbank market reflected in a sharp widening in TED and OIS spreads.

The crisis of structured finance was apparent by early 2008, but not yet of financial intermediation itself. Economic growth was still strong. There were lingering doubts whether the so-called subprime crisis would significantly impact the real economy. Subprime was only a small segment of the US housing sector in a putatively deep financial market. Ben Bernanke, Chairman of the US FED, who presciently took preventive action to ward off deflation by aggressively lowering interest rates even as the ECB was still fighting inflation, told the US Congress in August 2007 that toxic assets were in the region of only $150 billion.

The collapse of Lehman brothers in September 2008 put paid to all optimism. The collapse of western financial intermediation fell like a sledgehammer on the global economy, pushing it into recession and a synchronized downturn.

During several quarters following the collapse of Lehman brothers it appeared from charts on industrial output, trade and asset prices put out periodically by Barry Eichengreen on the vox.eu website that the global economy was headed for a second Great Depression. What pulled the global economy back from the brink?

In hindsight, it appears that there were three major saviours, famously coordinated by a resurgent G 20. First, helicopter Ben, the eminent historian of the Great Depression, by happenstance at the helm of the US FED, neutralised the rapid deleveraging and fall in the velocity of money circulation through aggressive quantitative easing to prevent deflation that was a defining feature of the Great Depression.

Second, the long shadow cast on macroeconomic policy by Lord Maynard Keynes countervailed the sharp contraction of private demand through an aggressive expansion of public demand. This stalled a freefall in national income that was the second defining feature of the Great Depression.

Third, Jim O'Neill of Goldman Sachs had given advance notice of the rebalancing that was rapidly increasing the share of large emerging markets in the global economy. During the Great Depression the colonies were so dependent on demand in western economies that they were sucked into recession. Although their growth suffered on the margin this time round, they continued to grow relatively strongly and remained solid nodes of stability in the global economy.

These causes were only proximate as most observers pointed to deeper ultimate causes. First, mounting global imbalances and the associated savings glut put downward pressure on interest rates, veered monetary policy off the tried and trusted Taylor rule, and incentivised leverage by falling returns to capital that inflated asset bubbles.

Second, financial deregulation facilitated regulatory arbitrage that pushed financial activity to lightly regulated shadows. Unlike during the Great Depression, financial panic did not emanate from conventional deposit based banking but from a shadow banking system linked to deposit banking through off balance sheet vehicles.

Observers also pointed to a third ultimate cause, namely the moral hazards of government policy that lowered credit standards to promote inclusive house ownership.

This potent brew was fortified by a fourth toxin. Some euro zone governments exploited a birth defect in the European Monetary Union to overextend their balance sheets. Markets failed to distinguish between countries with weak and strong balance sheets even though there were explicit provisions against bail-outs in the Maastricht Treaty on the one hand, and no central bank backstops on the other. Markets assumed -- and they may well be proved right -- that stronger countries would eventually bail out weaker ones.

Underlying the euro crisis was an increase in both private debt (reminiscent of the US housing bubble, such as in Spain and Ireland) and public debt (as in Greece, and partly Portugal). Unlike Greece, both Spain and Ireland went into the crisis with low and declining public debt/GDP ratios. These ratios deteriorated rapidly on account of the need to bail out (private) banks. The fiscal burden was greater because unlike the US, European banks dwarfed the GDP of individual European sovereigns. As governments scrambled to bail out their financial systems, while simultaneously trying to stimulate their economies against a backdrop of falling revenues, the crisis of public finance became more generalized. Both private and public balance sheets came under greater market scrutiny.

Although public balance sheets in advanced countries outside the euro zone are also overstretched, a combination of central bank backstops and weak private demand is presently keeping their borrowing costs low. There is growing realization however that aging societies with falling growth and generous social contracts will find it more difficult than in the past to grow their way out of high levels of public debt. The euro crisis has only anticipated a generalized structural crisis in public finance in advanced economies. This is a problem that even the US needs to speedily address, and also developing countries like India that are designing social contracts. Europe illustrates how politically difficult it is to renegotiate such contracts.

We are far from the endgame. Experience shows that recovery from balance sheet recessions is long and painful

The recovery of 2010 was short lived and asymmetric. To what extent can this be attributed to differences in policy response? The recovery is more robust in the US, which has also had the most aggressive and sustained policy stimulus. In retrospect, ECB's monetary policy response has been no less dramatic, although it was slower off the blocks. On balance, while nonconventional monetary policy may have prevented deflation, it has also led to a liquidity trap that has emasculated monetary policy and financial intermediation on both sides of the Atlantic. The experience of the Japanese who invented quantitative easing in the nineties has no better. This is constraining the US to increasingly rely on a policy tool — fiscal policy — discredited by its political overtones.

The euro zone has lapsed into a double dip recession. The US recovery remains tepid and uncertain. It could plausibly be argued that the asymmetric recovery is on account of design flaws that deprive euro zone countries of policy tools, such as exchange rate and fiscal space. The IMF has recently estimated that fiscal multipliers are unusually large because of weak private demand and the liquidity trap. We are still far from the endgame.

Historical experience shows that recovery from balance sheet recessions is long and painful. Since high debt was the original sin, it is arguable whether transfer of debt from private to public and tepid growth is a more sustainable combination than accelerated deleveraging and painful adjustment upfront. Hazards associated with withdrawal of policy life support on the revival of private demand dangle overhead like the Damocles Sword. High levels of public debt and monetary expansion could quickly translate into unsustainable debt dynamics through rising interest rates, and inflationary outcomes through acceleration of the money multiplier. The jury is still out on whether continued stimulus or greater austerity can better drive a sustainable recovery, and whether advanced western economies can avoid a return to financial repression.

(The author is a civil servant. Views are personal)

European Debt Crisis is Not Over

EU faces tighter financial constraints & capital flight

SATYAJIT DAS

The European equity and bond markets performed well in the second half of 2012. The rally reflected a growing belief that the eurozone and the European Central Bank (ECB) were, at last, taking correct policy actions. But despite the statement by European leaders, it is premature to claim victory in the European debt wars.

The financial resources remaining to deal with the crisis may be insufficient. The amounts available have not changed for almost two years, with little appetite for increasing commitments.

The major bailout facility — the European Stability Mechanism (ESM) — has total lending capacity of around €500 billion. Financial assistance agreed for Greece, Ireland and Portugal in the form of loans and guarantees is around €294 billion. With around €102 billion coming from the EU budget or bilateral aid to Greece, €192 billion was provided by the EFSF, which will be subsumed into the ESM. €100 billion has been committed to Spain for the recapitalisation of its banks. This leaves the ESM with available lending capacity of around €208 billion. There are increasing constraints on further IMF participation, augmenting the ESM.

Greece, Ireland or Portugal may need additional funding to meet maturing debt and also to finance budget deficits as their economies remain weak and market funding unavailable or expensive. Spain and Italy too may need assistance. Spain has debt of €800 billion (74% of GDP). Italy has debt of €1.9 trillion (121% of GDP). Both countries have significant debt maturities in the near future. Spain has principal and interest repayment obligations of €160 billion in 2013 and €120 billion in 2014. The Spanish government has announced a financing programme of around €260 billion for 2013. Italy has principal and interest repayment obligations of €350 billion in 2013 and €220 billion in 2014.

Capital flight from peripheral nations is a problem. Banks in peripheral countries have lost between 10% and 20% of their deposits, reflecting concern about solvency and the risk of currency redenomination. Additional resources may be needed to finance a deposit insurance scheme to halt capital flight.

Europe has total bank deposits of around €8 trillion, including around €6 trillion in retail deposits. Around €1.5-2 trillion of these deposits are in banks in peripheral countries. An effective deposit scheme would need to cover €1-1.5 trillion of deposits, placing a large claim on available funds. Europe may need bailout facilities of at least €3 trillion to be credible. Potential requirements exceed available resources.

The only other potential source of financial support is the ECB. It has already provided over €1 trillion in term financing to banks through the LTRO programme alone. These programmes mature in late 2014 and early 2015. They may need to be increased or extended to finance the weak banking system.

The ECB has purchased around €210 billion in sovereign bonds under the SMP. In July 2012, the ECB announced the OMT programme allowing purchase of unlimited quantities of sovereign bonds. President Mario Draghi announced that: "within our mandate, the ECB is ready to do whatever it takes to preserve the euro". Markets and investors have assumed that this is the 'big bazooka' — a European version of Quantitative Easing and debt monetisation precedents of the US, Japan and UK. The ECB's announcement underpinned relative stability in Europe in the second half of 2012.

But the OMT is conditional. ECB action is contingent on the relevant government formally requesting assistance and agreeing to comply with the conditions applicable to assistance from the ESM/ EFSF. Instead of avoiding market pressures, the triggering mechanism requires that financing problems of 'at-risk' countries get worse before the ECB will act.

ECB purchases will be confined to short or intermediate maturities. This condition is designed to make intervention similar to traditional monetary policy. It is also designed to reduce the cost of bank loans which is driven by shorter-term interest rates.

The ECB can also nominate a cap on yield or the size of its purchases in advance of any intervention. There is uncertainty as to whether the ECB will relinquish its status as a preferred creditor on such purchases in the event of default or restructuring.

The OMT programme revealed significant divisions within the ECB. Jens Weidmann, the head of the German Bundesbank and a former advisor to the Chancellor, opposed the measure. Other eurozone members are also known to be uncomfortable.

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The legal basis of the OMT programme remains uncertain. Article 123 of the Lisbon Treaty prohibits the ECB from directly buying national governments' debt. Future legal challenges cannot be ruled out. Overcoming legal issues would require time consuming treaty changes, support for which is not assured. The ECB President's statements have been dominated by two words: 'may' and 'adequate'. Market analyst Carl Weinberg neatly summarised this as: "A promise to do something unspecified at some yet-to-be-determined time involving yet-to-be-invented programmes and institutions, in a yet-to-be-decided way".

The OMT has not been activated to date. In 2008, US Treasury Secretary Hank Paulson's argued that if everyone knows that you have a bazooka in your pocket it may not be unnecessary to use it. The ECB has gambled that the announcement that it has prepared to intervene will restore market access of peripheral borrowers and reduce the interest rate demanded by the market. After an initial sharp fall, the borrowing cost of weaker countries increased and remains above sustainable levels.

Dr Draghi, the *Financial Times*' 2012 Person of the Year, operatically stated that the OMT programme would: "And believe me, it will be enough". Markets will undoubtedly test the ECB's resolve. As Yogi Berra knew: "In theory, there is no difference between theory and practice. In practice there is."

(The author is a former banker and author of Extreme Money)

Perspectives

No Parivartan Without Police Reform

The Usha Mehra Commission should focus on prevention, prosecution and policing strategies

MUKUL SANWAL

The Nirbhaya case should be is a catalyst for reform and not just 'change' that increased number of PCR vans and CCTVs signify.

The Supreme Court in 2006 framed police reform in terms of autonomy; the Mehra Commission should frame measures for public safety in terms of police responsiveness and review the interplay between policing strategies and fear of crime in public places.

First, the report should not lead to the usual response to public concern by increasing police numbers and establishing new goals. Delhi, with a population three-fourth that of New York and London, has more than two times the number of police. But why is it that only half of police boots are on the ground? Should there be greater reliance on beat constables to prevent crime? Why have criminal investigation and law and order not been separated? Should woman police be located in police stations or in the crime branch? Why are guidelines for treatment of rape cases not followed?

Second, the situation in Delhi was alarming even before the recent incident. In Delhi, 453 rape cases were recorded in 2011 under Sec 376 of IPC compared with 221 in Mumbai, with a larger population, and with an increase of 17% over last year. Understanding the causes of the high incidence of rape in Delhi requires research and hypothesis-building techniques of social science in order to develop effective strategies. The Parivartan programme had shown that this is the way to go, and why it was discontinued needs to be analysed.

Third, the way police respond is crucial to the outcome and to the way the victim feels the system has responded. The Union Home Secretary commended the police for prompt response, but has now set up an inquiry on the circumstances and nature of that response. Protecting the population using public areas depends on strict application of 'control room' or 'FIR recording' procedures and on applying penal law after a crime has occurred.

Integrating police more closely with the state administration with the objective of moving towards community policing can go a long way

Fourth, dealing with crime in and around city transport networks is also complex. In London, for example, the government dealt with high levels of sexual assault by unlicensed taxi drivers through a public awareness campaign. City planners and administrators contributing to urban safety and thought should be given to integrating Delhi police more closely with the state administration with the objective of moving towards community-policing and solving problems through active dialogue between elected representatives, administrators, law enforcement officers and the population. The Home Secretary's Task Force is no substitute for integrative policies that have helped to control crime in metros across the world.

Fifth, at the national level too, the statistics maintained by the National Crime Records Bureau show a disturbing trend. After Independence, rape cases have increased 10 times, while total cognisable crime under the IPC has increased by less than a third as the conviction rate in cases of rape has come down from 44% in 1973 to 26%, and is now amongst the lowest for all crime.

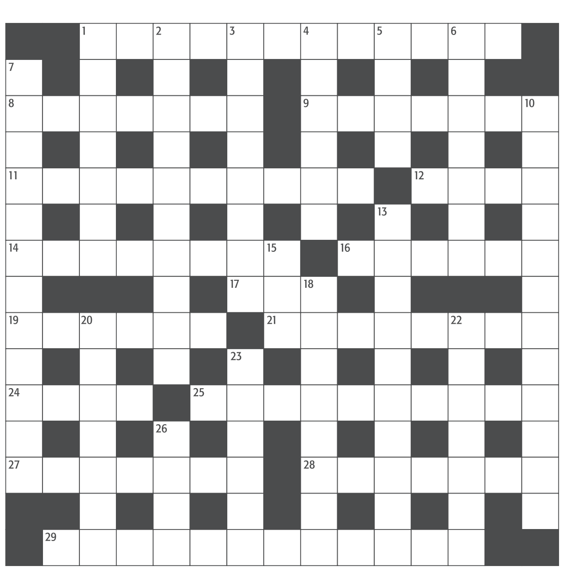
Stringent laws and fast-track courts will be ineffective if investigation is shoddy. Delhi can provide a useful case study with respect to the time taken at each stage of the process, the reasons for acquittal of the accused, the adequacy of medical and forensic centres, role of prosecutors and measures needed in courts to minimise the trauma of the complainant, in order to establish composite guidelines to increase conviction rate. The Crime Branch recognises robbery as a special category but not rape.

Sixth, in addition to prevention and punishment, the 'victims' perspective' of needing support has to be recognised to give greater confidence to report cases and help them recover. There is also a view that women are in some way to blame for being raped. Such attitudes can affect the way rape cases are dealt with by police, prosecutors and judges. Instead of Crime Against Women Cells under the police, victims need support through specially trained Social Welfare Officers, including a role for Sub Divisional Magistrates, to make sense of the police and prosecution processes, and the psychologically gruelling process of preparing to give evidence.

Seven, there are also wider issue of the failures of implementation. For example, in August, the Supreme Court ordered the police to take action on use of tinted glasses in vehicles; effective implementation of the law would have prevented the horrific crime. Why legislation where there is ordinarily no complainant is not effectively implemented needs to be studied.

Police officers must be held accountable for the way in which they exercise the powers and use resources. Expertise other than policing is now essential in developing strategies to promote citizen's safety. The colonial model of incident-based policing is inadequate in metropolitan areas. A more effective and efficient crime control strategy involves developing preventative measures that incorporate links with city administrators and wider societal collaboration.

Crossword 4804



ACROSS

1 Late history gets a new day started (4,8)
8 One I run as a way of getting together again (7)
9 Bigger ends should be delivered (7)
11 Throwing dirt on is to make misrepresentation (10)
12 In truth she needs somewhere to live (4)
14 Tell again about a lock being turned back (8)
16 Makes one use tin for repair (6)
17 Snowman not having got one so far (3)
19 Starting play in back court can be a skilful move (6)
21 Smell a low bar and go straight down (8)
24 Standing in line (4)
25 Tried clean break but got involved (10)
27 States need for someone wise to go round offering food (7)
28 A pub backed by man from the Middle East (7)
29 Both ends of a journey in various places (4,3,5)

DOWN

1 Quietly land somewhere else in Europe (7)
2 It makes a child appear as one of the crew (6,4)
3 Not much time for a politician making threats (8)
4 One has to pay for rubbish lying up (6)
5 One old traveller much admired (4)
6 Good to see she can turn in success of top quality (7)
7 Business comes back when profits appear (5,7)
10 Trends can net new moves that beat all others (12)
13 Down where money offers no difficulty for accommodating arrangement (10)
15 Catch up with the significance of X (3)
18 Charitable to artist in fast time (8)
20 Study explosive device that may cause bewilderment (7)
22 Tend not to be on the level (7)
23 Sister worried about diocese not visited (6)
26 Beginning to crack when given time in confinement (4)

Solution to 4803

ACROSS: 1 Callous. 5 Praise. 9 Thunder. 10 Resolve. 11 Ace. 12 Cheerleader. 13 Lucre. 14 Endeavour. 16 Procedure. 17 Pants. 19 Scintillate. 22 Ado. 23 Orisons. 24 Baptist. 26 Pruned. 27 Regency.

DOWN: 1 Catcall. 2 Laurence Olivier. 3 Odd. 4 Spree. 5 Partridge. 6 Aisle. 7 Solid foundation. 8 Bearer. 12 Crete. 14 Equalised. 15 Apple. 16 Pastor. 18 Shortly. 20 Thorn. 21 Amber. 25 Peg.

The Daily Mail

Dilbert

by S Adams