

Understanding the Financial Crisis of 2008 – 2011

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Part 1 - The Illusion of Prosperity

To even the casual observer of the global economy it is painfully obvious that all is not well economically, both here in Bermuda and abroad. Daily economic headlines in our local newspapers and websites read almost verbatim with headlines found in overseas publications. News reports of economic dysfunction are rife, with almost daily reports of layoffs, bankruptcies, business relocations to other jurisdictions, intractable government budget deficits, falling asset prices, high levels of private indebtedness, and highly volatile capital markets.

Throughout the western developed economies average middle class people are at a loss to explain what is happening to their living standards (in Greece especially I imagine), having never experienced this level of economic fallout before in their lives. Even elected political leaders and senior government finance officials in these countries are at loss to explain how their economies have managed to arrive at the precarious position they find themselves at today. I believe that the best explanation is simply that a great deal of the prosperity experienced since the early 1980s was an economic illusion created by a global credit bubble that burst in 2008. The fallout from that burst credit bubble is what is driving today's news headlines of economic dysfunction.

Let me first describe the path that led the world's developed economies to the current crisis.

Roots of the crisis

The roots of the economic dysfunction we are living through today could be said to have originated in the early 1960's when many western governments expanded access to what are now considered core social programs – free public primary and secondary education, expanded access to subsidized university education, national pension systems for the elderly, and government funded or subsidized health care benefits. The introduction of these programs in North America and Western Europe during the late 1950's to mid-1960's represented a large expansion of the role of government in the economy and helped widen and broaden the middle classes.

The best example of this socio/economic, and ultimately political, dynamic is the United States. From 1964 to 1968 US President Lyndon Johnson, following on from Roosevelt's Great Depression-era "New Deal" initiatives and Kennedy's unfinished "New Frontier" social initiatives, introduced a set of domestic social reforms aimed at reducing the level of poverty in the United States. These reforms and initiatives were known as the "Great Society" programs and included initiatives to create, reform, and or expand the role of the US federal government in the following areas: ending racial discrimination against Blacks, Hispanics, and Native Americans; expanding

access to primary, secondary, and university education; funding increased access to health care (via Medicare and Medicaid), employment training (the Job Corps), reducing hunger (food stamps), increasing social security pensions, providing funding for development of the arts and humanities, the creation of the public television system, the funding of US cultural centers and museums, development of a national transportation system (air, rail, and highway), developing a consumer protection framework (such as cigarette warning labels), and increased protection of the environment.

However, at the same time the Johnson administration was expanding both the war in Vietnam and the arms race with the Eastern Bloc communist nations. Thus, US military spending was increasing at the same time as the government was expanding spending on social programs. Both initiatives competed for the same finite financial resources of the US government at the time. The US essentially decided to pay for both “guns and butter” by increasing its deficit financing rather than raising taxes. Ultimately some of the new social program initiatives had to be trimmed back or eliminated as the military incrementally consumed more US financial resources. This decision was a historic one as it was critical in setting the direction of the financial conduct of the US (and other countries, like Bermuda) for the following three and a half decades.

By the late 1970s the Vietnam conflict had ended, but was still unpaid for. The cost of waging the cold war increased steadily, and the US was forced to face the new reality pushed onto the global economy by OPEC’s higher oil prices. It was at this time that the US began to show signs of financial stress - wrought by a combination of the decision to expand its reliance on deficit financing throughout the previous decade, and rising inflation. The US dollar came under downward pressure and was forced to float versus the price of gold. The era of “paper money” had fully arrived, and the US began to run larger annual budget deficits and, for the first time, trade deficits with the rest of the world that grew larger by the year.

This national descent into indebtedness was hastened in the 1980s by the Regan-era increases in deficit spending, and the slow but steady movement of US goods manufacturing (and the jobs that it supported) overseas to countries such as Mexico, China, and other Asian countries. Goods that were formerly made in the US by US workers (textiles in North Carolina for example) began to be imported from overseas in ever larger quantities instead, which further exacerbated the structural US trade deficit.

Credit Expansion Fuels Economic Growth

By the mid-1980’s many countries, most notably the United States and the United Kingdom, had grown tired of paying the costs of maintaining the actuarially calculated solvency of demographically determined social programs. Those governments, lead at the time by Ronald Regan and Margaret Thatcher, acted to lower the income tax burdens (for both economic and political reasons) on their citizens and corporations. Ultimately both countries were forced to further increase their reliance on deficit financing as government expenditures outpaced tax revenues. During this period the size of outstanding debts, and the interest payments connected with them grew further, both in outright terms, and in relation to GDP. This behavior was repeated in many other countries during the 1980s.

At the same time, in the private sector, in the US (and elsewhere) the banking industry was deregulated by legislative changes in 1980 which allowed banks (and some categories of non-

banks) to expand their credit card business and other financing activities. By the end of the 1980's an American family with a household income of USD 75,000, for example, could easily expand their consumption by as much as USD 10,000 (13%), or more, via credit cards. The more liberal distribution of credit cards seen in the late 80's to mid-90's period allowed US households to increase their consumption of goods and services, but only by a relatively small fraction of their incomes.

However credit card use, as source of consumer credit, was later both enhanced and trumped as an economic driver in the late 1990's when a combination of significantly lower US interest rates and steadily rising home prices fueled a housing boom. The housing boom, driven by huge levels of mortgage refinancing, home renovations, house price appreciation, and new housing development and sales, boosted US economic growth tremendously, and was in play nationally across the entire United States. That is, until the credit bubble burst in 2007.

To illustrate this phenomenon we can look at the imaginary American household with USD 75,000 income in 1989 referred to above. They would have (with a 2.5% growth in income per year) seen their household income grow to USD 108,600 in 2004. A house that they might have purchased for USD 125,000 in 1992 would have been worth USD 224,000 (with 5% annual price appreciation) in 2004. And assuming a 20 year amortization schedule for their mortgage, they would have owed approximately USD 50,000 in 2004 when they decided to refinance their mortgage (at a 1.5% lower rate than before) and borrow USD 75,000 (70% of their current income) for renovations to their home...and to pay off their credit cards!

The illustration above shows how from the mid-90s up to the collapse in 2007 the combination of falling market interest rates and rising housing (and other assets) prices allowed US consumers to borrow huge percentages of their incomes, far larger amounts than they ever could borrow utilizing credit cards. The consumption that this housing-fueled credit bubble enabled created an illusion of prosperity that was entirely dependent upon the expectation that housing prices would continue to rise into perpetuity.

So there is my position on the origins of the financial crisis: that cumulative increases in borrowing and spending by governments and households in the period 1965 through 2007 allowed the US and other western industrialized countries (Greece, Italy, and Japan, to name a few) to increase consumption at a time when many millions of jobs in the developed west were being cut and transferred to developing countries in Asia and elsewhere.

With the transfer of jobs to Asia and elsewhere now virtually complete, and the housing boom a distant memory, western economies from Japan to the US are left to contemplate the legacy of those now long-past decades of economic expansion and growth – structurally high levels of unemployment and mountains of debt which may never be repaid.