The Great Crash of 2008

by Ross Garnaut

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Professor Ross Garnaut's book provides an outstanding explanation and analysis of the causes of the Great Crash of 2008. It also examines the repercussions for the finance industry, economic growth, employment and business bankruptcy, and the costs incurred by governments in their business bailout and stimulatory programs. It is a must-read for all professionals and students concerned with the issues involved in the world's worst financial collapse since the Great Depression of 1929–33.

IMMEDIATELY AFTER completing his *Climate Change Review Report* for the Australian Government in September 2008, Professor Garnaut was prompted to examine the global financial crisis that had just enveloped the world. International financial markets were of great interest to him and he had previously researched extensively into the topic. *The Great Crash of 2008* is an outstanding explanation and analysis of its causes and consequences, and the measures that should be taken to avoid repetition of the catastrophe in the future.

Garnaut explains the complex characteristics of the Great Crash and their interrelated nature, and the several explanations of the financial crisis that have been proffered to date. These include: the nature of human behaviour; global imbalances in trade, savings and investment; the use of 'clever money'; and excessive greed. But no one of these explanations explains the whole picture as although each played a prominent role, their effects are all interrelated. Garnaut examines each one of them and explains how each contributed to the developing crisis. His analysis is largely restricted to the Anglosphere countries (the United States, United Kingdom and Australia) and to China.

His examination begins with an account of the 'Greatest Bubble in History' by presenting background economic information on the Anglosphere countries. It was a period of good economic growth following a recession of the late 1980s, lowering of interest rates, rapid advances in information technology, population growth, and China's spectacular economic growth. He refers to this as the Platinum Age. In particular, the housing markets in the United States, United Kingdom and Australia boomed; they all experienced substantial trade deficits from unrestrained spending in the private sector, and also by governments, which resulted in large budget deficits in the United States and United Kingdom. China's spectacular growth of 10–12% per annum in GDP was concentrated in manufacturing export industries, delivering enormous export surpluses. The surpluses were not spent in China but were largely used in the United States to fund much of the expenditure boom and the resulting borrowing needs of governments, business and consumers.

Garnaut then examines each of the explanations advanced for the Great Crash and shows how each contributed to it, beginning with human behaviour. Traditional economics views people as being rational, wealth-seeking persons acting in response to reliable information and who avoid taking undue risks. However, this approach is challenged by a modern school of behavioural economists who de-emphasise rational behaviour in favour of a herd mentality, excessive greed, quick profits and short-term approaches where there is uncertainty in markets. Booms and busts are characterised by this kind of investor behaviour.

Massive global imbalances occurred between the Anglosphere deficit countries and Asia's export-oriented nations, particularly China. In a world of freely floating exchange rates, exchange rate adjustments would, over time, rectify the situation. But this did not occur because the Chinese yuan is tied to the US dollar, which also acts as the world's reserve currency. Fixing the Chinese–US exchange rate worked to China's export advantage and Anglosphere citizens, firms and governments took advantage of this to spend the massive inflow of funds left there by Chinese owners. They all spent beyond their means and accumulated enormous debts.

Clever Money played a dominant role in the story of the Great Crash. It took two forms — the securitisation of debt and the use of complex derivative securities. Securitisation of debt became widespread practice during the boom years for traditional banks and 'shadow banks' (i.e. investment stock broking firms). Loans and mortgages were converted into securities that were sold to external investors and they became tradeable securities as collateralised debt obligations (CDOs). The practice enabled banks to sell their loans, remove the risks of debtor default and take them off their balance sheets. It enabled them to make more new loans and thereby substantially increase their loan activity and profits without increasing their capital base. However, investors were not informed of the asset backing for the securities and, in the case of sub-prime mortgage loans, most of the mortgagees were unable to meet the required repayments. Banks generated substantial transaction fees from the booming market and passed on the risks to unsuspecting investors. Along with the securitisation of their loan portfolios, the banks developed complex derivative securities (such as credit default swaps — CDSs — which were mainly traded as over-the-counter derivatives, OTCs), ostensibly for risk management purposes. Derivatives enabled them to dramatically increase their leverage, i.e. use of borrowed funds, and thereby the scale of their lending to borrowers. In some cases, such as Bear Stearns, they increased it to 85:1, with most of the borrowing being undertaken in the overnight money market. However, derivatives are not real assets, but essentially betting slips about future movements in security prices, interest rates, foreign exchange rates and loan repayments. Trading in derivatives occurred on a massive scale and became a major source of bank profits and executive remuneration. The Bank for International Settlements estimated that the outstanding value of derivatives was $684 trillion as at 31 December 2008, which is many times the size of the world's GDP.

Garnaut questions whether the massive volume of trade in these derivative securities served any useful purpose beyond generating enormous incomes for their creators and traders. It is a complex and highly speculative market, which is beyond the control of any one regulator or nation. Dealers avoid the need for capital adequacy requirements, they can flood chosen assets on markets with vast capital inflows at a whim, or alternatively starve them of funds, with devastating economic and social consequences. Clever Money factors were the major cause of the collapses of large numbers of financial market firms, including the spectacular collapses of some of the world's largest firms such as Bear Stearns, Lehman Brothers, Merrill Lynch (which was bought out by Bank of America) and the American Insurance Group in the United States and HBOS in the United Kingdom.

Finally, greed provided a strong incentive for the asset price bubble by exploiting Clever Money instruments and practices. Income was generated promptly from the transactions undertaken rather than over the term of the loans, and securitisation enabled a massive increase in the number of loans provided. Generous management incentives were provided to stimulate and improve upon the success of business activity. Executive remuneration schemes were repackaged to focus on immediate profit generation (quick profits) and short-term share price growth, and there was a five-fold increase in their value over the boom period. The increasing prosperity of financial institutions was also enhanced by their 'capture' of the regulatory authorities. Many senior staff of the Federal Reserve Board and Treasury were appointed from Wall Street firms who opposed the regulation of their industry. As well, 'money politics' supported regulatory capture. Donations to both political parties from financial firms and lobbying activities increased substantially during the boom.

As history has shown, boom times do not last for long, and the Platinum Age came to a sudden end in September 2008. The market went into freefall with the collapse of Bear Stearns, Lehman Brothers and others, and the shadow banking system went into a state of 'cardiac arrest'. Commodity prices plunged and economic recession spread rapidly. This caused further business collapses, growing unemployment and large contractions in global trade. Governments felt obliged to bail out most of the large financial companies, at enormous cost, to avoid complete collapses in their economies. The firms were considered to be 'too big to be allowed to fail', or as the phenomenon is known in economics, 'moral hazard'. The bailout cost incurred by the US Government by late 2008 amounted to $10.5 trillion; bailout costs were also incurred in other Western countries (excluding Australia). In addition, governments provided substantial budget stimulus support for their economies to raise business and consumer expenditures and thereby increase economic activity to reduce the extent of growing unemployment and business bankruptcy.

Overall, the above measures were successful in warding off a major depression like that of 1929, and modest economic growth resumed in many nations. However, the fundamental problems in the financial markets still have to be resolved, both within nations and globally.

The story was rather different in China. Its economy temporarily stalled from the substantial decline in its exports. However, provision of substantial monetary and fiscal stimulus and a redirection of its manufactured products into domestic markets were successful in reviving GDP growth to around 8% by late 2009.

The aftermath of the Great Crash is then examined in both its economic and political contexts. Garnaut expects that the substantial external and internal debt burdens in the Anglosphere nations will delay their recoveries, and they will need to redress their domestic spending/savings imbalances. China will need to continue redirecting its economic growth into internal markets, allow the yuan to appreciate, and become less dominant in world export markets. Politically, a realignment of world powers is required, as the United States cannot remain as the world's superpower and its dollar as the only international currency in which most trade is conducted. China must be brought into the supreme structure, along with several other powers such as the European Union and, in due course, other nations such as India, and there must be constructive cooperation between them.

Importantly, the need to regulate national and global financial markets must be accepted in order to chain the Great Crash elephant. Financial markets cannot be allowed to remain unregulated because of the dependence of all parts of the economy and society on their smooth and stable functioning. It is not an easy task to do so. Garnaut advocates a Keynesian approach to regulation of financial markets to protect the economies of the world. It will require: regulatory controls over Clever Money securitisation and securities practices and hedge funds; separating traditional banking operations from those of shadow banking; abandonment of the 'too-big-to-fail' principle for all firms other than traditional banks, which will be more closely regulated including prescription of minimum capital adequacy ratios for them; reforming management incentive schemes that focus on long-term performance; and reducing the influence of vested interests in policy making. Finally, business and governments should acknowledge that a successful open market economy requires that the public interest must be taken into account in all economic activities. Garnaut refers back to the eighteenth-century writings of the first great economist, Adam Smith, a strong advocate of free markets, who placed their successful operation within a system of moral philosophy that emphasises the public interest.

Ross Garnaut's treatise is a most comprehensive and outstanding analysis of the Great Crash of 2008 and the possible options to prevent similar booms and crashes in the future. Furthermore, it is written in a clear and stimulating style. Each chapter begins with a thought-provoking anecdote relevant to the chapter's topic. For example, he uses the analogy of a large elephant lumbering around causing the crash; he quotes J.K. Galbraith on the delusion of the Clever Money and Bernard Madoff concerning greed. Madoff had spoken elegantly to a New York conference on the virtues of the then financial regulatory system. He was a respected Wall Street operator at the time and a former Chairman of the NASDAQ stock exchange, but is now better known for his other activities. The analysis of each topic is supported by its historical evolution and extensive statistical information. The interactions of the factors causing the Great Crash and their effects on financial markets and economies are clearly explained. Garnaut exhibits his singular knowledge of the Chinese economy in his analysis. Finally, he provides an outline for the solutions to the factors causing the problem. In the words of a World Bank reviewer, Ross Garnaut's book presents a 'masterly analysis' of the problem. It should be studied seriously by all members of the finance industry profession, government treasury and financial regulatory bodies, and economics and finance academics, and be widely used as a text book.