With the sub-prime market problems behind us, how to avoid new financial and economic bubbles?

Drs. A.G. Romero
April 8th, 2009
Presentation Orco-bank lunch
Megafraude van 50 miljard met hedgefonds Madoff

Warning: Rating agencies may be harmful to your (financial) health

Brits onderzoek naar bonussen bij banken

Is financial globalisation itself part of the problem?

Meeste pensioenen bevroren!

Rapidly weakening prospects call for new policy stimulus

IMF predicts major global slowdown amid financial crisis

Nederlandse economie krimpt met 3,5%
SEC Charges Stanford in $8 Billion Fraud; Agents Raid Headquarters
Adolf Merckle, one of Germany's wealthiest men, committed suicide after his family business empire began unraveling amid mounting debt.

The suicide of the 74-year-old multibillionaire, whose holding company had roughly €30 billion, or $40 billion, in annual revenue, is one of several deaths of business people tied to the global financial crisis.
Is the cheap monetary policy cause of problems?

Development in the short interest rates USA.
FINANCIAL CRISIS
Could The Liquidity Crisis Be Easing?

The TED Spread

1987 Stock Crash  1990 Thrift Collapse  Asian/LTCM Crises  Enron Crisis  Subprime Crisis

Euro$ Rates Less T-Bill Rates (%)

As of 01/06/2009
Source: Federal Reserve Board
TED Spread: Spread of 3-Month Euro$ Yields over 3-Month T-Bill Yields, using last month of quarter data
Growth and development in the market of “subprime” loans

Subprime loans (US $ Billions) and market shares in % of total.
TARP “Troubled Assets Relief Program”

October 2008 program in the USA

Goals are:

- Purchase or insure up to $700 billion of “troubled assets”
- Enable US capital injection in the banking system and other forms of relief

Blueprint of this program lies in the Swedish experience in the 1990’s

- Incorporation of a public company that took over toxic assets and removed these from the banking system
- Continue with the new “clean” banks

February 2009 program of the new government (Financial Sector Stability plan)

- Goals are:

  - Federal Reserve Bank will buy up $800 billion of “bad loans” from mortgage banks Fannie Mae and Freddie Mac
  
  - Federals Reserve Bank will put available $200 billion for institutions to stimulate car loans + study loans etc.
  
  - Tighter restrictions on banks
    - limiting dividend payments,
    - limiting acquisition
    - limiting executive salaries


- Goals are:
  - Tax breaks $ 300 billion (Reduce taxes for those with income < $ 250,000)
  - Direct aid to distressed states and individuals ($250 billion)
  - Boost Government spending on infrastructure and other public works ($200 billion)
Development housing prices in the USA 2005-2008

Falling off the property ladder

US house prices*, peak=100

US foreclosures, ‘000

Sources: Standard & Poor’s; RealtyTrac

* S&P/Case-Shiller 20-city index
Development housing prices in the Netherlands 2005-2009
CLICO Investment Bank (CIB)

Trinidad

- According to local press reports customers of the now-dissolved CLICO Investment Bank (CIB) will get lower, adjusted interest rates on their deposits with the CL Financial subsidiary. Government is guaranteeing the full principal amount to deposits at CIB in TT and US dollars and these have been transferred to State bank First Citizens.

- Customers will be able to access their funds on February 25 but several conditions will apply, the Central Bank said in a statement yesterday.

- A former UK financial services regulator is predicting harder times for offshore financial centres in the wake of the Stanford scandal. In an interview with the BBC, Howard Davies, now director of the London School of Economics said the clock is ticking for offshore centres. “The days when the offshore centres, with impunity, could host large offshoots of big financial institutions and offer ways of avoiding, or even evading tax, I think they may be running out.” Mr. Davies is not the only one waving the warning flag.

- European banks have reported $321 billion of losses and write-downs since the start of 2007, according to data compiled by Bloomberg.
Companies with exposure to weak consumer spending, such as auto, retail and media firms are among firms with the highest default risk according to Moody’s. Eastman Kodak and casino operator MGM Mirage are just two high profile names in danger of default.

Industrial production plunged in the U.K. and France in January, threatening to push Europe into a deeper recession. U.K. factory output fell 2.9 percent from December and 6.4 percent in the three months through January, the most in at least four decades.

Trinidad

Economist and head of the Sir Arthur Lewis Institute of Social and Economic Studies at UWI, St Augustine, Dr Patrick Watson believes the local economy will go into recession by as early as next year. “It is my own feeling this year we are going to have low but positive growth rate but next year, unless there is a serious turnaround in the US economy, we will go into negative growth which, in every sense of the word, is a recession,” he said.
Lessons learned from the current financial crisis # 1

- Refine + re-assess current risk models and risk control mechanisms by financial institution
- Revise role “Rating Bureau’s/ Agencies”
- Shortcomings in the implementation of “Accounting Standards (IFRS)”
- Improve Central bank’s liquidity control
- Supervisors had no good control over the risks associated with financial derivatives (MBS, CDO, Credit Default SWAPS, Interest SWAPS). Risks were underestimated based on the risk-profiles.
Lessons learned from the current financial crisis # 2

- Bonus systems (fixed + variable compensation of top-management)
Exponentieel

In het jaar voor de uitbraak van de kredietcrisis keerde Wall Street bijna 33 miljard dollar aan bonussen uit. In 1985 - de eerste meting - lag dat bedrag nog op 1,9 miljard dollar. Topjaar was 2006 met een uitkering van iets meer dan 34 miljard dollar. De groei vertoont een exponentieel karakter.
Lessons learned from the current financial crisis # 3

The special case of Iceland!

  - Conclusion:
    A. the (3 largest) banks in Iceland did not get into trouble due to solvency and/or liquidity problems.
    B. Banking assets as % of GDP was 900% by 2007. So even if the government of Iceland was willing to bail-out the banking sector it was not in a position to do so because of fiscal constraints
    C. Central Bank of Iceland lacked the international reserves to effectively perform its task as “lender of last resort”.
    D. The introduction of the EURO would have cushioned such a crisis in Iceland but would not have taken away the concerns of the market participants
USA GDP trend 1980-2007

USA: Real GDP Growth,
Percent change

Source: IMF World Economic Outlook Database
USA Labor productivity trend 1980-2007

Source: OECD Statistical Database
Japan GDP trend 1980-2007

Source: IMF World Economic Outlook Database
Euro area GDP trend 1992-2007

Source: IMF World Economic Outlook Database
Euro zone Labor productivity trend 1996-2007

Source: OECD Statistical Database
Emerging markets GDP trend 1980-2007

Emerging and Developing Economies: Real GDP Growth, Percent change

Source: IMF World Economic Outlook Database
Share of US dollar as reserve currency

Percent of U.S. Dollars in Official Foreign Exchange Reserves

- 1999
- 2000
- 2001
- 2002
- 2003
- 2004
- 2005
- 2006
- 2007
- 2008*
Euro versus US dollar as reserve currency
The crisis in the Neth. Antilles and the World economy?

- **IMF projections July 2008 Neth. Antilles (Article IV consultation):**
  - Economic growth (GDP) in 2008 3.7%
  - Economic growth (GDP) 2009-2011 of 2.5%
  - Prosperous development in the tourism and the transportation sector.
  - Adjusted projections for 2008 and 2009 now is +1.9% and +1.0%

- **Revised projections IMF and OECD; World Economic Outlook 2009 (February) and OECD World report (March):**
  - World economy will contract by -2.75% in 2009 (OECD)
  - Economy of the USA will contract by -4.0% in 2009 (OECD).
  - Economy of the Euro area will drop by -4.0% in 2009 (OECD).
  - Brazil and Mexico economies will expand by +2.2% and +0.2% in 2009 (IMF)
  - Latin America and the Caribbean +1.9% (2009 / IMF)
Economic outlook 2009 and 2010

Figure 1. GDP Growth by Country Groups

(in percent)

Emerging and developing countries

World

Advanced countries

Source: IMF
Figure 3. Cumulative Output Loss Relative to Potential during Global Downturns

(Percent)

Source: IMF staff estimates.
Projections unemployment rates

Sooner or later
Unemployment rates, %, latest

Spain
France
Euro area
United States
Germany
Italy
Britain
Japan

Sources: National statistics; Eurostat

Latest
Year ago
Dow Jones jan. 1998 - jan. 2009
USA in a recession?

Length of recession in the USA Source National Bureau of Economic Research Month

In months

Aug 1929: 43
May 1937: 13
Feb 1945: 8
Nov 1948: 11
July 1953: 10
Aug 1957: 8
April 1960: 10
Dec 1969: 11
Nov 1973: 16
Jan 1980: 6
July 1981: 16
July 1990: 8
March 2001: 8
Dec 2007: 15
### Macroprudential indicators of banks in the Netherlands Antilles

<table>
<thead>
<tr>
<th>Macroprudential indicators (at year end in %)</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
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<tbody>
<tr>
<td><strong>Capital adequacy</strong></td>
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<tr>
<td>Total capital/ total assets</td>
<td>7,7%</td>
<td>7,9%</td>
<td>7,9%</td>
<td>8,7%</td>
<td>8,8%</td>
<td>10,1%</td>
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<td><strong>Asset quality</strong></td>
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<tr>
<td>Non-performing loans/ total loans</td>
<td>5,9%</td>
<td>3,6%</td>
<td>2,6%</td>
<td>3,6%</td>
<td>4,6%</td>
<td>5,0%</td>
</tr>
<tr>
<td>Provisions for loan losses/ non-performing loans</td>
<td>61,1%</td>
<td>93,5%</td>
<td>106,0%</td>
<td>87,3%</td>
<td>66,8%</td>
<td>59,1%</td>
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<td><strong>Earnings</strong></td>
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<td>Gross-earning-assets yield</td>
<td>7,4%</td>
<td>7,3%</td>
<td>7,5%</td>
<td>7,1%</td>
<td>6,9%</td>
<td>6,9%</td>
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<tr>
<td>Net interest margin</td>
<td>4,7%</td>
<td>4,9%</td>
<td>5,1%</td>
<td>4,5%</td>
<td>4,4%</td>
<td>4,6%</td>
</tr>
<tr>
<td>Return-on-assets</td>
<td>1,5%</td>
<td>1,7%</td>
<td>2,3%</td>
<td>2,2%</td>
<td>1,8%</td>
<td>2,2%</td>
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<tr>
<td><strong>Liquidity</strong></td>
<td></td>
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<tr>
<td>Total loans/ total deposits</td>
<td>66,3%</td>
<td>64,9%</td>
<td>61,9%</td>
<td>64,2%</td>
<td>61,4%</td>
<td>57,7%</td>
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</table>
How to solve the SUB-PRIME problem?

“The man who removes a mountain begins by carrying away small stones”.

Chinese Proverb

“Around here, however, we don't look backwards for very long. We keep moving forward, opening up new doors and doing new things, because we are curious...and curiosity keeps leading us down new paths”.

_Walt Disney_
Explanation of the economic stimulus bill
Shortly after class, an economics student approaches his economics professor and says, "I don't understand this stimulus bill. Can you explain it to me?"

The professor replied, "I don't have any time to explain it at my office, but if you come over to my house on Saturday and help me with my weekend project, I'll be glad to explain it to you." The student agreed.

At the agreed-upon time, the student showed up at the professor's house. The professor stated that the weekend project involved his backyard pool.

They both went out back to the pool, and the professor handed the student a bucket. Demonstrating with his own bucket, the professor said, "First, go over to the deep end, and fill your bucket with as much water as you can." The student did as he was instructed.

The professor then continued, "Follow me over to the shallow end, and then dump all the water from your bucket into it." The student was naturally confused, but did as he was told.

The professor then explained they were going to do this many more times, and began walking back to the deep end of the pool.
The confused student asked, "Excuse me, but why are we doing this?"

The professor matter-of-factly stated that he was trying to make the shallow end much deeper.

The student didn't think the economics professor was serious, but figured that he would find out the real story soon enough.

However, after the 6th trip between the shallow end and the deep end, the student began to become worried that his economics professor had gone mad. The student finally replied, "All we're doing is wasting valuable time and effort on unproductive pursuits. Even worse, when this process is all over, everything will be at the same level it was before, so all you'll really have accomplished is the destruction of what could have been truly productive action!"

The professor put down his bucket and replied with a smile, "Congratulations. You now understand the stimulus bill."
HET GELOOF IS TERUG