

The Great Crash, 2008

A Geopolitical Setback for the West

By Roger C. Altman

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Summary: The financial crisis has called into serious question the credibility of western governments and may precipitate an eastward shift of power.

ROGER C. ALTMAN is Chair and CEO of Evercore Partners. He was U.S. Deputy Treasury Secretary in 1993-94.

The financial and economic crash of 2008, the worst in over 75 years, is a major geopolitical setback for the United States and Europe. Over the medium term, Washington and European governments will have neither the resources nor the economic credibility to play the role in global affairs that they otherwise would have played. These weaknesses will eventually be repaired, but in the interim, they will accelerate trends that are shifting the world's center of gravity away from the United States.

A brutal recession is unfolding in the United States, Europe, and probably Japan -- a recession likely to be more harmful than the slump of 1981-82. The current financial crisis has deeply frightened consumers and businesses, and in response they have sharply retrenched. In addition, the usual recovery tools used by governments -- monetary and fiscal stimuli -- will be relatively ineffective under the circumstances.

This damage has put the American model of free-market capitalism under a cloud. The financial system is seen as having collapsed; and the regulatory framework, as having spectacularly failed to curb widespread abuses and corruption. Now, searching for stability, the U.S. government and some European governments have nationalized their financial sectors to a degree that contradicts the tenets of modern capitalism. Much of the world is turning a historic corner and heading into a period in which the role of the state will be larger and that of the private sector will be

smaller. As it does, the United States' global power, as well as the appeal of U.S.-style democracy, is eroding. Although the United States is fortunate that this crisis coincides with the promise inherent in the election of Barack Obama as president, historical forces -- and the crash of 2008 -- will carry the world away from a unipolar system regardless.

Indeed, rising economic powers are gaining new influence. No country will benefit economically from the financial crisis over the coming year, but a few states -- most notably China -- will achieve a stronger relative global position. China is experiencing its own real estate slowdown, its export markets are weak, and its overall growth rate is set to slow. But the country is still relatively insulated from the global crisis. Its foreign exchange reserves are approaching \$2 trillion, making it the world's strongest country in terms of liquidity. China's financial system is not exposed, and the country's growth, which is now driven by domestic activity, will continue at solid, if diminished, rates.

This relatively unscathed position gives China the opportunity to solidify its strategic advantages as the United States and Europe struggle to recover. Beijing will be in a position to assist other nations financially and make key investments in, for example, natural resources at a time when the West cannot. At the same time, this crisis may lead to a closer relationship between the United States and China. Trade-related flashpoints are diminishing, which may soften protectionist

stances in the U.S. Congress. And it is likely that, with Washington less distracted by the war in Iraq, the new administration of President Obama will see more clearly than its predecessor that the U.S.-Chinese relationship is becoming the United States' most important bilateral relationship. The Obama administration could lead efforts to bring China into the G-8 (the group of highly industrialized states) and expand China's shareholding position in the International Monetary Fund. China, in turn, could lead an effort to enlarge the capital base of the IMF.

AT BOTTOM

Conventional wisdom attributes the crisis to the collapse of housing prices and the subprime mortgage market in the United States. This is not correct; these were themselves the consequence of another problem. The crisis' underlying cause was the (invariably lethal) combination of very low interest rates and unprecedented levels of liquidity. The low interest rates reflected the U.S. government's overly accommodating monetary policy after 9/11. (The U.S. Federal Reserve lowered the federal funds rate to nearly one percent in late 2001 and maintained it near that very low level for three years.) The liquidity reflected, among other factors, what Federal Reserve Chair Ben Bernanke has called "the global savings glut": the enormous financial surpluses realized by certain countries, particularly China, Singapore, and the oil-producing states of the Persian Gulf. Until the mid-1990s, most emerging economies ran balance-of-payments deficits as they imported capital to finance their growth. But the Asian financial crisis of 1997-98, among other things, changed this in much of Asia. After that, surpluses grew throughout the region and then were consistently recycled back to the West in the form of portfolio investments.

Facing low yields, this mountain of liquidity naturally sought higher ones. One basic law of finance is that yields on loans are inversely proportional to credit quality: the stronger the borrower, the lower the yield, and vice versa. Huge amounts of capital thus flowed into the

subprime mortgage sector and toward weak borrowers of all types in the United States, in Europe, and, to a lesser extent, around the world. For example, the annual volume of U.S. subprime and other securitized mortgages rose from a long-term average of approximately \$100 billion to over \$600 billion in 2005 and 2006. As with all financial bubbles, the lessons of history, including about long-term default rates on such poor credits, were ignored.

This flood of mortgage money caused residential and commercial real estate prices to rise at unprecedented rates. Whereas the average U.S. home had appreciated at 1.4 percent annually over the 30 years before 2000, the appreciation rate roared forward at 7.6 percent annually from 2000 through mid-2006. From mid-2005 to mid-2006, amid rampant speculation in the housing market, it was 11 percent.

But like most spikes in commodity prices, this one eventually reversed itself -- and with a vengeance. Housing prices have been falling sharply for over two years, and so far there is no sign that they will bottom out. Futures markets are signaling that, from peak to trough, the drop in the value of the nation's housing stock could reach 30-35 percent. This would be an astonishing fall for a pool of assets once valued at \$13 trillion.

This collapse in housing prices undermined the value of the multitrillion-dollar pool of lower-value mortgages that had been created over the 2003-6 period. In addition, countless subprime mortgages that were structured to be artificially cheap at the outset began to convert to more expensive terms. Innumerable borrowers could not afford the adjusted terms, and delinquencies became more frequent. Losses on these loans began to emerge in mid-2007 and quickly grew to staggering levels. And with prices in real estate and other asset values still dropping, the value of these loans is continuing to deteriorate. The larger financial institutions are reporting continuous losses. They mark down the value of a loan or similar asset in one quarter, only to mark it down again in the next. This self-reinforcing downward cycle has caused markets to plunge across the globe.

The damage is most visible at the household level. Americans have lost one-quarter of their net worth in just a year and a half, since June 30, 2007, and the trend continues. Americans' largest single asset is the equity in their homes. Total home equity in the United States, which was valued at \$13 trillion at its peak in 2006, had dropped to \$8.8 trillion by mid-2008 and was still falling in late 2008. Total retirement assets, Americans' second-largest household asset, dropped by 22 percent, from \$10.3 trillion in 2006 to \$8 trillion in mid-2008. During the same period, savings and investment assets (apart from retirement savings) lost \$1.2 trillion and pension assets lost \$1.3 trillion. Taken together, these losses total a staggering \$8.3 trillion.

Such large and sudden hits have shocked U.S. families. And because these have occurred amid headlines reporting failing financial institutions and huge bailouts, Americans' fears over the safety and accessibility of their deposits are now more pervasive than they have been since 1933. This is why Americans withdrew \$150 billion from money-market funds over a two-day period in September (average weekly outflows are just \$5 billion). It is also why the Federal Reserve established a special \$540 billion facility to help these funds meet continuing redemptions.

ROUGH-AND-TUMBLE

It is increasingly evident that the severe recession unfolding in the United States and Europe will be the deepest slump in the world economy since the 1930s. The United States' GDP fell in the third quarter of 2008 and was forecast to drop precipitously, by nearly four percent, in the fourth quarter. Of 52 economists surveyed by The Wall Street Journal throughout last year, a majority expected the U.S. economy to contract for at least three consecutive quarters, which it has not done in 50 years. At least for the medium term, the global roles of the United States and European states will shrink along with those countries' economies.

Stock markets in the United States and globally are signaling a brutal economic period ahead. By early November 2008, the broadest of the U.S. market indices, the S and P 500, was down 45 percent from its 2007 high. That is a considerably steeper fall than occurred in 1981-82, which, until now, was the worst recession period since the 1930s. The only logical explanation for the plunge is that the market is anticipating an even worse drop in corporate profits for 2009 than occurred almost three decades ago.

Such a major drop in corporate profits might occur because U.S. consumers are deeply frightened and have stopped spending on discretionary items. Shocked by the financial crisis, fearful about the security of their bank and money-market deposits, and rocked by the sense of doom pervading Washington and the U.S. media, they have quickly raised their savings by curtailing spending and paying down debt. The result last September was the biggest monthly drop ever recorded in the widely followed Conference Board Consumer Confidence Index. That month also saw the sharpest monthly drop in consumer spending since 1980 -- and the drop in October was even worse. The chief executive officer of Caterpillar and other business leaders have described these conditions as the worst they have ever seen and are cutting back severely on capital spending.

As former Treasury Secretary Lawrence Summers has observed, this recession will be prolonged partly because of the unusual nature of this downward financial spiral. As the value of financial assets fall, margin calls are triggered, forcing the sale of those and other assets, which further depresses their value. This means larger losses for households and financial institutions, and these in turn discourage spending and lending. The end result is an even weaker economy, characterized by less spending, lower incomes, and more unemployment.

This recession also will be prolonged because the usual government tools for stimulating recovery are either unavailable or unlikely to work. The most basic way to revitalize an ailing economy is to ease monetary policy, as the

U.S. Federal Reserve did in the fall. But interest rates in the United States and Europe are already extremely low, and central banks have already injected unprecedented amounts of liquidity into the credit markets. Thus, the impact of any further easing will probably be small.

Another tool, fiscal stimulus, will also likely be used in the United States, Europe, and Japan - but to modest effect. Even the \$300 billion package of spending increases and tax rebates currently under discussion in the U.S. Congress would be small in relation to the United States' \$15 trillion economy. And judging from the past, another round of stimuli will be only partially effective: the \$168 billion package enacted last February improved the United States' GDP by only half that amount.

The slowdown in Europe is expected to be every bit as severe. European consumers are spending less for the same reasons American consumers are. The financial sectors of European countries, relative to those countries' GDPs, have suffered even more damage than that of the United States. The British government reported a contraction of its economy last fall, and the eurozone countries are now officially in recession.

The international financial system has also been devastated. The IMF estimates that loan losses for global financial institutions will eventually reach \$1.5 trillion. Some \$750 billion in such losses had been reported as of last November. These losses have wiped out much of the capital in the banking system and caused flows of credit to shut down. Starting in late 2007, institutions became so concerned about the creditworthiness of borrowers, including one another, that they would no longer lend. This was evidenced by the spread between three-month U.S. Treasury bills and the three-month LIBOR borrowing rate, the benchmark for interbank lending, which quadrupled within a month of the collapse of the investment bank Lehman Brothers in September 2008.

This credit freeze has brought the global financial system to the brink of collapse. The IMF's managing director, Dominique Strauss-

Kahn, spoke of an imminent "systemic meltdown" in October. As a result, the U.S. Federal Reserve, the European Central Bank, and other central banks injected a total of \$2.5 trillion of liquidity into the credit markets, by far the biggest monetary intervention in world history. And the U.S. government and European governments took the previously unthinkable step of committing another \$1.5 trillion to direct equity investments in their local financial institutions.

THE ROAD TO RECOVERY

As of this writing, there has been a modest thaw in credit-market conditions. But a return to normalcy is not even on the distant horizon. The West's financial system is already a shadow of its former self. Given ongoing losses, Western financial institutions must reduce their leverage much more just to keep balance sheets stable. In other words, they will have to withdraw credit from the world for at least three or four years.

In a classic pattern of overshooting, markets are swinging from euphoria to despair. Now, the psychology of financial institutions has swung to a conservative extreme. They are overhauling their credit-approval and risk-management systems, as well as their leverage and liquidity ratios. Stricter lending standards will prevail for the foreseeable future.

These new lending patterns will be further constrained by sharply tightened regulation. It is widely acknowledged that this crisis reflects the greatest regulatory failure in modern history -- a failure that extended from bank supervision to U.S. Securities and Exchange Commission disclosures to credit-rating oversight. The recriminations, let alone the criminal prosecutions, are just beginning. There is unanimity that broad regulatory reform is necessary. Obama and the new U.S. Congress will surely pursue legislation to implement reform this year. European authorities will undoubtedly take similar steps. Minimum capital and liquidity standards for

regulated institutions will likely be tightened, among other measures.

If history is any guide, however, financial reform will go too far. The Sarbanes-Oxley legislation that followed the collapse of Enron and WorldCom is an example of such an overreaction. Should something like this occur again, tighter restrictions on the U.S. and European banking systems could delay their return to robust financing activity.

The United States will be further constrained by gigantic budget deficits, the product of sudden government spending designed to fight the financial crisis and of the sharp drop in revenues caused by the recession. It now appears that the United States' deficit for the fiscal year that began in October 2008 will approach \$1 trillion, more than double the \$450 billion for the year before. This would be by far the largest nominal deficit ever incurred by any nation and would represent 7.5 percent of U.S. GDP, a level previously seen only during the world wars.

THE IMPACT

There could hardly be more constraining conditions for the United States and Europe. First, the severe recession will prompt governments there to focus inward as their citizens demand that national resources be concentrated on domestic recovery. The priorities of Obama, as expressed in his campaign, fit this mold. If the matter has not already been handled in the lame-duck session of Congress in late 2008, Obama's first major act as president will be to introduce economic-stimulus legislation. He is also likely to take steps to further alleviate the financial crisis, address the plight of U.S. automakers, and begin the complex task of reforming health care and energy policy.

European leaders will also be focusing on the home front. They, too, will be implementing stimulus programs and trying to manage the financial damage. This past fall, French President Nicolas Sarkozy and Italian Prime

Minister Silvio Berlusconi were already making fiery speeches about protecting their domestic companies from being acquired by foreign interests -- hardly a message consistent with modern economics.

Second, unprecedented fiscal deficits and difficulties in the financial systems will also preclude the West from embarking on major international initiatives. If Obama inherits a \$1 trillion deficit, and temporarily enlarges it to \$1.3 trillion with a stimulus program, there will not be much of a constituency calling for increased U.S. spending on endeavors abroad. Indeed, the country may be entering a period of forced restraint not seen since the 1930s. Should a crisis like the 1994 collapse of the Mexican economy present itself again, it is doubtful that the United States would intervene. And even in the event of economic crises in strategically important areas, such as Pakistan, major economic assistance from the United States or key European nations is unlikely. Instead, the IMF will have to be the primary intervenor.

On the private side, Western capital markets will not return to full health for years. For the indefinite future, large financial institutions will shrink as losses continue and as they reduce their leverage further. The overshooting pattern that occurs after crises will also make markets averse to risk and leverage for the foreseeable future.

Historically, U.S. capital markets were far deeper and more liquid than any others in the world. They were in a league of their own for decades, until European markets also started developing rapidly over the past 10-15 years. The rest of the world was dependent on them for capital, and this relationship reinforced the United States' global influence. They will now be supplying proportionately far less capital for years to come.

Third, the economic credibility of the West has been undermined by the crisis. This is important because for decades much of the United States' influence and soft power reflected the intellectual strength of the Anglo-Saxon brand of market-based capitalism. But now, the model that helped push back

socialism and promoted deregulation over regulation -- prompting the remaking of the British Labour Party, economic reforms in eastern Europe, and the opening up of Vietnam in the 1990s -- is under a cloud. The U.S. financial system is seen as having failed.

Furthermore, the United States and countries in the eurozone have resorted to large-scale nationalist economic interventions that undermine free-market doctrines. The U.S. government has taken equity stakes in more than 20 large financial institutions and, according to Treasury Secretary Henry Paulson, may eventually invest in "thousands" of them. In addition, it has temporarily guaranteed the key debt of its entire banking system. France, Germany, and the United Kingdom have intervened even more extensively, each in a slightly different way, with Germany, for example, backing the full amount of all private deposits. The British government's banking interventions, when measured in relation to the country's GDP, are even larger than those of the U.S. government relative to U.S. GDP.

All these interventions will stop the global shift toward economic deregulation. As President Sarkozy put it, "Le laisser-faire, c'est fini." Or, as Chinese Vice Premier Wang Qishan said more diplomatically, "The teachers now have some problems." This coincides with the natural and very long-term movement away from the U.S.-centric world that started after the fall of the Berlin Wall two decades ago.

CHINA'S GAIN

This movement also reflects the rapid rise of other economies, especially China and India. The U.S. share of world GDP had been declining for seven years before the financial crisis hit. And it looks increasingly likely that China's GDP will surpass the United States' at some point during the next 25-30 years. The rising nations' growing economic strength brings increased global influence and competition with it. The result, in the words of Richard Haass, president of the Council on

Foreign Relations, is the emergence of a "nonpolar world."

China, for example, will suffer a lesser blow from the global crisis. It is experiencing some economic pain. Its export markets, led by the United States and Europe, are slowing dramatically. China is also suffering from price declines in certain urban real estate markets. Its growth slowed to nine percent during the third quarter of 2008 -- a rate that other nations would envy but was China's slowest in five years. These factors explain why the Chinese leadership is implementing a multiyear economic stimulus plan worth over \$500 billion, or approximately 15 percent of GDP. Still, the IMF is projecting that the country's economy will grow by 8.5 percent in 2009.

In financial terms, China is little affected by the crisis in the West. Its entire financial system plays a relatively small role in its economy, and it apparently has no exposure to the toxic assets that have brought the U.S. and European banking systems to their knees. China also runs a budget surplus and a very large current account surplus, and it carries little government debt. Chinese households save an astonishing 40 percent of their incomes. And China's \$2 trillion portfolio of foreign exchange reserves grew by \$700 billion last year, thanks to the country's current account surplus and foreign direct investment.

This means that although China, too, has been hurt by the crisis, its economic and financial power have been strengthened relative to those of the West. China's global influence will thus increase, and Beijing will be able to undertake political and economic initiatives to increase it further. China and the Association of Southeast Asian Nations are just concluding an agreement that would create the world's largest free-trade area, and Beijing could take additional steps toward Asian interdependence and play a stronger leadership role within the region.

China could also expand its diplomatic presence in the developing world, in order to further its model of capitalism and, in places such as Angola, Kazakhstan, and Sudan, satisfy its thirst for natural resources. In the

midst of this crisis, it might also help finance emergency loans, either directly, through bilateral financing arrangements, or indirectly, by creating an additional facility at the IMF that could expand the organization's available credit beyond what current quotas allow. China should also be expected to make strategic investments through its sovereign wealth funds. Given China's appetite for natural resources, this is one likely area of interest; its relatively underdeveloped financial-services infrastructure is another.

THE FALL OF THE REST

India may also survive the crisis relatively unhurt. There, as in China, the financial system plays a small role in the overall economy. India also remains a fairly closed economy in terms of foreign investment, and so it is less dependent on external capital. Close observers expect India's growth to continue, perhaps at an annual rate of 6.5-7 percent. But India does not have nearly the wealth or the internal cohesion of China. This past fall, the government of Prime Minister Manmohan Singh narrowly avoided losing a parliamentary vote of no confidence and having to dissolve itself over opposition to the nuclear agreement it signed with the United States in 2005. The overall result is that India is inwardly focused and not particularly equipped to advance its geopolitical standing.

Much of the rest of the world, however, has been hit hard by the crisis. The damaged Western banks, which had consistently supplied credit to businesses in the developing world, have abruptly stopped providing it. As foreign capital has been withdrawn, currencies, local banking systems, and stock markets in already poor states have weakened sharply. Eastern European countries that had been running exceptionally large current account deficits and had built up substantial foreign debts are particularly hurting. Hungary, Latvia, and Ukraine are prominent examples, and Hungary and Ukraine have already secured emergency loans from the IMF.

In Russia, the plunge in oil and other commodity prices has caused a near collapse of the ruble and of local share prices. The government of President Dmitry Medvedev has been spending huge amounts, perhaps \$200 billion so far, to prop up the currency, Russia's financial system, and several highly leveraged state-controlled enterprises. With \$500 billion in foreign exchange reserves, Russia remains in a strong financial condition even after these rescue efforts. Yet these sobering events will make some of its renewed geopolitical ambitions harder to achieve. In theory, this could permit a thaw in U.S.-Russian relations if Obama were to make an overture. Before that happens, however, Moscow might try the "get tough" approach that Soviet Premier Nikita Khrushchev used with U.S. President John F. Kennedy in Vienna in 1961.

The outcome of the crisis will be more serious for Iran and Venezuela, which, like Russia, have suffered from the fall in oil prices but, unlike Russia, have limited foreign exchange reserves. Iran's economy was already rickety, and internal pressures are now likely to grow. Venezuela, which has been spending freely to advance President Hugo Chávez's international agenda, is facing an even more severe problem.

A SCALPEL, NOT A HATCHET

This historic crisis raises the question of whether a new global approach to controlling currencies and banking and financial systems is needed. Many economists and leaders are advocating such a reordering and calling for a Bretton Woods II. But creating a wholly new global financial order would be unworkable. Financial and currency markets are too large and too powerful to be contained; the days of managed exchange rates are over. Global financial regulation would probably cause more problems than it would solve, if only because the reforms needed in the West differ too much from those required elsewhere.

A better approach is to focus on a few key measures. First, the crisis is an opportunity to

strengthen and reshape the IMF. The organization has \$250 billion in unused lending capacity, but this capital base has not been adjusted since 1997 and may not be large enough to help the many developing nations currently suffering balance-of-payments and liquidity crises. (Hungary, Iceland, Pakistan, Ukraine, and six other countries have negotiated or are currently negotiating emergency-financing packages with the IMF.) This should be remedied. The IMF can also be made more flexible. Historically, it has conditioned its assistance to borrowing countries on their tightening their belts, by, for instance, reducing their budget deficits. Conditionality remains necessary over the long term, but with this crisis still unfolding, the IMF is rightly moving toward temporarily suspending it. Furthermore, high-surplus countries, such as China and the oil-producing states in the Persian Gulf, should be made larger shareholders in the IMF. It would be logical, for example, for these nations to lead any new and separate lending facility established by the IMF.

Second, the G-8 framework is increasingly obsolete. The economic power and wealth of China mandate that it, at a minimum, be included in the group. Because it is more representative, the G-20 framework (19 of the

world's largest national economies plus the European Union) should be used more often, and the G-8 less so.

Third, the Basel II guidelines regulating the capitalization of banks should be revised. They proved severely inadequate at protecting banks against the balance-sheet crises that have befallen them. A better approach would be to build capital cushions for banks during prosperous times that could be depleted during crises.

The United States will remain the most powerful nation on earth for a while longer. Its military strength alone ensures this. But the crash of 2008 has inflicted profound damage on its financial system, its economy, and its standing in the world; the crisis is an important geopolitical setback. The international acclaim that greeted Obama's presidential victory may soften its effects, but even this enthusiasm cannot wipe those away. This is partly because the crisis has coincided with historical forces that were already shifting the world's focus away from the United States. Over the medium term, the United States will have to operate from a smaller global platform -- while others, especially China, will have a chance to rise faster.