Ten years since the global financial crisis, world still suffers 'debt overhang'

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Published: June 17 2017 - 12:15AM

It is almost exactly 10 years since the financial world began a wobble that would swing into what we now know as the global financial crisis.

On June 22, 2007, the public downfall of New York-based global investment bank Bear Stearns began in earnest.

America's then fifth-largest investment bank was among a number of Wall Street giants exposed to bad bets on the US subprime mortgage market.

Bear Stearns agreed to a plan for a $US3.2 billion ($4.2 billion) secured loan to its hedge funds under pressure from those bad debts.

But in the weeks after financial contagion followed, and, almost a year after the plan, JPMorgan Chase and the US government bailed out Bear Stearns.

The final nail on the coffin came with the collapse of Lehman Brothers on September 15, 2008.

Before these events, most people believed the banks were "too big to fail" and that the financial system would hold.

Today, the scars of the global financial crisis remain. There have been trillions of dollars in losses. And in a world of subpar economic growth, even optimists are downbeat about whether the economic medicine has been taken.

The crisis highlighted a number of key problems which remain unresolved.

Firstly, excessive debt. In the aftermath of the world market crash, rather than pushing for debt destruction, world leaders used fiscal and monetary policy to fan demand. Global debt now stands at a staggering US$215 trillion.

Then there is ineffective regulation. Despite genuine attempts to stop risky lending and products – from tougher financial regulations under Dodd-Frank (now under attack by the Trump administration) to higher capital requirements under Basel III – problems persist.

The controversial pay packets of banking executives are back up in the millions (they did dip after the GFC) and as Michael Lewis, who famously wrote the *The Big Short*, which was adapted into an Oscar-winning screenplay, says "incentives in the financial system are still rotten".

Michael Lewis, author of the *The Big Short*, says "incentives in the financial system are still rotten". Photo: Jonathan Fickies

Finally, the question of accountability. Banks and their regulators should have behaved better. But what about the consumers – could they have known better? And governments, who in times of crisis feel left with little option but to bail-out banks, have found it difficult to make measures stick.

Irrational exuberance

Let's start with the question of debt. Lord Adair Turner, who chaired the UK Financial Services Authority between 2008 and 2013 and helped redesign global banking, says the world since has not addressed this root cause of the crisis and that means it's at risk of another one.

Lord Turner, now chairman of New York-based Institute for New Economic Thinking, says the world is suffering from "irrational exuberance" and "debt overhang".

The latter term refers to countries trapped in a vicious cycle of debt, and when nations ultimately default on that debt – he predicts that the next crisis will come courtesy of China and that's just a number of years away – it ends in their economic destruction.

The Institute of International Finance (IIF) says global levels of debt held by households, governments, and non-financial corporates jumped by over $US70 trillion in the past decade to a record high of $US215 trillion, equating to 325 per cent of global GDP.

"There's been no deleveraging," Lord Turner says.

"Once you've got too much debt in the economy ... it's incredibly difficult to get rid of it.

"If you say, 'I'm going to write it off', your banks go bankrupt ... if you try get rid of it by people paying down that debt ... the attempt to pay it back is what drives the economy into recession."

To avoid that, interest rates then fall, and that simply encourages more borrowing, he says.

Australia's mortgage binge

Property excesses are often found at the heart of financial crises.

And there are many who believe Australia is suffering from one of the worst excesses imaginable.

"Australia is one of the countries closest to recession and financial crisis," says David Levy, an American economist and author and chairman of economic consultancy Jerome Levy Forecasting Center in New York.

US household debt was 98 per cent of GDP in 2008 when the market crashed.

Australia's current household debt to GDP is currently at 123 per cent of GDP – the second-highest in the world (Switzerland has the highest debt to GDP at 128 per cent).

The Aussie debt binge is aided by generous tax concessions – negative gearing and the capital gains tax discount – which encourage housing investors to acquire more property.

But as house prices climb rapidly in Sydney and Melbourne, wage growth is stagnant, meaning the household debt-to-income ratio has climbed to an all-time peak of 189 per cent.

Mr Levy says Australia's "housing bubble is extraordinary" and "its dependence on mining extreme".

"Australia will go through a contained depression – the RBA and rest of the government will not let its banking system collapse – but it will still be a relatively tumultuous process."

Steve Keen says the risk of recession is even higher now that APRA has slightly tightened lending standards. Photo: Peter Rae

Steve Keen, Professor of Economics at Kingston University in London, a long-time doomsayer on Australia's mortgage binge, says simply: "It's dangerous".

He says the Reserve Bank and Australian politicians ignore the dangers of private household debt today just as former US Federal Reserve chairman Ben Bernanke did before the GFC.

Keen says the risk of recession is even higher now that APRA has slightly tightened lending standards.

"It's inevitable," he says, sticking to his bold prediction that it will happen before year's end.

The team at LF Economics – a research firm founded by Lindsay David and Philip Soos – have also been sounding strong warnings of a crash.

David, author of *Australia: Boom to Bust*, says, "I don't believe there is another mortgage market globally where a banking system leveraged their household sector as much as ours is without a systemic collapse."

He says Australia's debt profile has a strong resemblance to Ireland's debt profile in the lead-up to the GFC, whereby public debt levels by global standards were relatively low but household debt is extremely high.

"The mistake we have made in Australia's is that we essentially copied Ireland's pre-GFC paper wealth creation model by allowing banks to over-lend and engage in Ponzi finance," Mr David says.

"That is, lending ever-larger amounts of mortgage debt to owner-occupiers and investors to increase leverage and outbid other speculators."

Aussie sub-prime

Another firm warning of an impending housing crash is JCP Investment Partners. It issued a report recently noting that mortgage loans to over-extended borrowers amounted to more than six times household incomes and could wipe out 20 per cent of the major banks' equity base.

JCP's report also accuses banks of hiding the risks.

"We suspect the old three-times-gross-income rule has been fundamentally breached," Matthew Wilson, head of financials research and senior portfolio manager, says in the report.

"Indeed, we believe gross incomes could have been capitalised to well over six times, which would partly explain the rapid increase in Melbourne and Sydney house prices."

The JCP report says interest-only loans could be Australia's sub-prime since "interest-only households tend to have lower incomes and higher amounts of credit outstanding".

"I'm not in the camp that says the economy will crash," says AMP's Shane Oliver. Photo: Louie Douvis

AMP's chief economist Shane Oliver disagrees.

"I'm not in the camp that says the economy will crash," Dr Oliver says.

"To get that we need higher interest rates and / or higher unemployment, and I don't think we will see that."

Dr Oliver anticipates in the next two years house prices will come off their current peaks. He says house prices will fall 5 to 10 per cent and apartments will experience a higher fall of 15 to 20 per cent.

But this won't lead to mass mortgage defaults like the US had. Firstly because "most borrowers seem able to service their mortgages," he says.

"We are not at a point that the US was prior to the GFC where 40 per cent of loans were going to low-doc borrowers," he says.

And secondly, "if the property market looks like it's going to crash the Reserve Bank will cut rates again and offset bank rate hikes."

Saul Eslake says it is dawning on people that slower growth in incomes might be a permanent change. Photo: Jesse Marlow

Economist Saul Eslake also doesn't think "Australia is in imminent danger of tipping over".

But he says it is dawning on people that slower growth in incomes might be a permanent change, rather than a temporary one.

China: the biggest global risk?

Even if you ignore the bears on Australia's housing market, globally there are risks.

James Galbraith, an American economist and academic, says banks are more concentrated than before the crisis, "therefore more powerful and more dangerous".

"The economy of Europe has not recovered; that of the US has recovered growth but has not restored employment, in relation to population. The derivative exposure of a single German bank – DB – is said to be equal to the entire GDP of Europe.

"Non-performing loans in Italy, not to mention Greece, are at crisis levels."

William White is chairman of Economic and Development Review Committee at the OECD. He says US$215 trillion in debt at the end of 2016, is "an unprecedented level".

"Moreover, this increased leverage has come at a time when one might have expected leverage in the 'bust after the boom' to have been going in the opposite direction," Mr White says.

"Whereas emerging market economies were 'part of the solution' post 2009, they are now 'part of the problem'. Overall exposures look worse today than in 2007."

Bank for International Settlements (BIS) data that shows most of the debt accumulated in recent years is from emerging markets like China. UBS analysts estimate that China's debt-to-GDP ratio could exceed 300 per cent within two years, up from an estimated 277 per cent in 2016 and 254 per cent in 2015. The International Monetary Fund this week warned China to work faster to get its debt under control.

New York-based author and economic commentator Sandra Navidi says China is the biggest worry for the world.

Even if China's government steps in to stabilise the system, should things go bad, "it is entirely uncertain whether it will be able to contain it," she says.

Slowing growth and a financial crisis in China, she says, would have an immediate knock-on effect on Australia.

Richard Vague, managing partner of US-based Gabriel Investments, says "China is entering the beginning phase of a five to 10-year financial reversal".

He says two main factors lead to crisis. First, a high ratio of private debt to GDP in a short period "our research would suggest an increase of 15 to 20 percentage points in a five-year period".

"Second, absolute private debt levels have to be high – our research suggests 150 per cent or more. If those two things are true, there's an 80 to 90 per cent chance of a financial crisis."

Regulation ebbs and flows

Post Brexit and in the uncertain days of Donald Trump, the tide of regulation may be turning, and not for the better. That's if it ever really turned at all.

Mr White says there have been genuine attempts to address risks following the GFC but "below the surface, problems lurk".

"Most of the regulatory measures proposed are only marginally stronger and more detailed versions of existing measures that failed to prevent the crisis in the first place," he says.

"Moreover, institutions seem likely to continue successfully gaming the regulatory system as they have done for decades."

"The danger also remains that regulation will simply drive risky business further into the shadows."

"I don't think anyone wants to deregulate Wall Street," says Deloitte's Kevin Nixon. *Photo: Louise Kennerley*

Kevin Nixon, global and Asia-Pacific leader at Deloitte's Centre for Regulatory Strategy, says there is a mantra of "we can never let this happen again".

He says the Basel III reforms which aim to improve the banking sector's ability to absorb shocks and increase transparency will prevent another Lehman-style collapse.

Under Basel, "big global banks hold five times more common equity than they did going into the crisis," Mr Nixon says.

To avoid the potential of taxpayers bailing out troubled banks, global regulators now require a "recovery resolution plan" from financial institutions. Moves are afoot in Australia but the big four banks still don't have plans in place.

Nixon isn't worried about US President Donald Trump's attempts to dismantle or roll back financial regulations under the Dodd-Frank Act. He says massive changes are unlikely to pass US Congress.

"I don't think anyone wants to deregulate Wall Street," he says.

But Lord Turner says that's exactly what Trump intends on doing.

"I'm concerned that the attack on Dodd-Frank is about undoing necessary regulation that was brought in after 2008," he says.

Lord Turner says post-crisis reforms have largely stopped outrageous 100 per cent loan-to-value mortgages and rubbish products like synthetic CDOs.

But what one always sees over time, he says, is banks loosening credit standards.

"I would prefer higher [capital] buffers still," Lord Turner says, and even goes as far as advocating banning loans above a certain level.

Lord Adair Turner (left) pictured with former British PM Gordon Brown, middle, and CBI president Sir Colin Marshall, says the world is suffering from "irrational exuberance" and "debt overhang".

Janet Tavakoli, president of Chicago-based risk consulting firm, Tavakoli Structured Finance, and author of several books about the GFC, says regulations to prevent financial fraud have always existed. The problem is that regulators don't enforce them.

After Enron's bankruptcy the USA passed securities laws known as Sarbanes-Oxley that address the issues raised by financial fraud and overreach.

But "Sarbox and Dodd-Frank are cosmetic cover-ups of the fact that the USA chooses to not enforce its laws," she says. "That's why we keep seeing more of the same."

Local lending limits

Locally, regulators are more attuned to risks. Although, as with their global counterparts, there are questions as to whether moves go far enough.

In March the Australian Prudential Regulation Authority imposed tougher limits on lending which saw some big banks increase their lending rates to borrowers – including to limit the flow of new interest-only lending to 30 per cent of total new residential mortgage lending.

Mr Eslake says APRA has clamped down, "for the most part successfully," on risky lending.

"However, I doubt that all forms of risky lending or borrowing, or other types of investment vehicles, have been completely eliminated," he says.

The heads of RBA and APRA declined to be interviewed for this story.

Both have made clear in public speeches that financial risks exist because of indebted households.

APRA has in recent years been running what it calls "stress tests" testing the development of crisis scenarios.

Its disclaimer about the tests is that it can't actually with accuracy "predict the probability of a period of stress, let alone the precise scenario by which it will arrive".

Nevertheless, it examines hypothetical cases of the housing market falling by about 40 per cent, and unemployment and interest rates rising.

Its 2014 stress test results found that "banks may well survive the stress, but that is not to say the system could sail through it with ease."

Keen says these stress tests use the same "DSGE" models that in 2007 christened 2008 as a great year for the world economy.

"These models do not have a banking sector – or even money – in them," he says.

He says they do not reflect the real economy. "Cascade events just aren't possible in these models," he says, "but they are in the real world, chain-reactions occur."

David says Australian lenders are "chronically undercapitalised relative to the risks they have taken".

He also believes banks are still issuing mortgages that are too large for borrowers to service over the life of the loans.

"For APRA to assume the Australian banking system can survive living within its own means despite its high dependency on cheap, and easy to roll over, foreign-derived debt is nothing short of hilarious," Mr David says.

Mr Wilson says the four majors only have $162 billion of real equity to support their entire balance sheets. "A mere 5 per cent housing loss rate destroys 50 per cent of bank capital," he says.

Limits on lending, while necessary, could be the very factor that tips us over.

JCP's analysis shows the buffers mostly impact low-risk households that hold only 30 per cent of total mortgage debt of $1.6 trillion.

"The borrowers who need the buffers don't have them," Wilson says. "Needless to say, the system looks vulnerable."

Flawed incentives

Another problem highlighted during the crisis was the big pay packets received by Wall Street bank chiefs who behaved badly.

And post crisis, a lack of accountability for their mistakes.

In the US, pay packets of bank CEOs are akin to those of celebrities, and "virtually all the dangerous practices remain in place", says Randall Wray, a senior scholar at the Levy Economics Institute of Bard College in New York.

He has authored several books criticising orthodox monetary theory and policy and says "the whole thing will again collapse", even if it's sometime off.

Wray points out that "no top executive of any of the fraudulent financial institutions was prosecuted."

"No lessons were learned – except that no crime is too big if you work at a too big to fail institution," he says.

"If anything, the bigger the fraud, the bigger the bonus."

JPMorgan's Jamie Dimon "got a pass", says Janet Tavakoli. *Photo: AP*

Tavakoli says after the crisis, bankers simply connected, gave huge campaign contributions to Congress and were "protected".

Financial executives are still not held accountable, she says, pointing to JPMorgan Chase's London Whale debacle in 2012 as another example of executives getting away with bad behaviour.

"JPMorgan CEO Jamie Dimon got a pass after the London unit that reported directly to him made credit derivatives bets and lost $6 billion representing years of profits for that unit," she says.

"It was the poster child for worst practices in risk management. Jamie Dimon had signed off on documents stating risk management was fine. Yet he wasn't held accountable under Sarbox regulations or anything else."

White says there needs to be more and tougher prosecutions of financial criminals, including tougher fines and prison.

"Here the problem is assigning individual blame and also proving the intent to commit a criminal act rather than simply a stupid one," he says.

Navidi says "flawed incentives, lax personal liability laws and skewed ethics" encourage risk taking.

And, "US banks have become even larger and more systemically important and have the luxury of operating with an implicit guarantee by taxpayers," she says.

Taking responsibility

Wayne Swan says governments should not be seen "simplistically as guardians against individual irrationality". *Photo: Alex Ellinghausen*

The GFC raised questions about who was ultimately to blame when things turn sour.

Former treasurer Wayne Swan defends the massive stimulus package he and former prime minister Kevin Rudd and the then treasury secretary Ken Henry pulled together to stop Australia plunging into recession.

But Swan concedes there's a "moral hazard" whereby "if banks expect they will be bailed out, they may engage in riskier behaviour".

He says governments should not be seen "simplistically as guardians against individual irrationality".

Swan says ultimately everyone has a role to play.

"Governments in setting the policy framework to promote growth in incomes and economic stability, banks to do their due diligence in lending and ensure they meet lending and regulatory standards, regulators to enforce those standards and individuals to be honest in their disclosures and prudent in their approach to debt," he says.

As economist Hyman Minsky explored in his work on financial instability, there is such a thing as macroeconomic risk.

Eslake says governments will always feel obliged to "step in" to protect depositors in the event that any bank is at risk of failing – as they did in Australia. The political consequences of failing to do so – large numbers of people losing potentially all their life savings – are simply too great, he says.

Lord Turner says even if regulators had spotted the problems before they occurred in 2007-08 and tried to stop it, they would have faced intense lobbying from banks, and media stories saying such moves will send us into recession.

He criticises regulators who pretended things were rosy when they weren't. But overall, he blames an "intellectual failure" that accepts excessive debt so long as the economy keeps ticking on.

"You have to understand the dominance of bad economic ideas, which did not allow us to critically analyse how bad it was [before the GFC]," he says.

"It's very difficult when everyone believes one thing – they can't see the problems coming."

Levy says as economist Hyman Minsky explored in his work on financial instability, there is such a thing as macroeconomic risk, and individuals cannot protect themselves from it.

"Had we left all to individuals to handle in 2008, we would be desperately foraging for food or dead," Levy says.

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