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Global Financial Crisis – the world is again vulnerable to a major financial crisis.
By Warwick McKibbin

The 10th anniversary of the September 2008 events that heralded an unprecedented collapse of global financial markets has prompted many to look back. But what have we learnt in the past decade?

In a very real sense the global economy today looks very much like the global economy in 2006 – but worse.

There has been a long period of low interest rates and a large build-up of public and private debt. The large Trump fiscal stimulus has generated a spurt in US economic activity. However, **as interest rates rise, the distortions in the world economy built up over many years will begin to show signs of increasing stress.**

The US housing market is not overextended in this financial cycle, but **the US sharemarket and other asset prices appear to be overvalued. On these high asset valuations has been built a huge tower of debt.**
There are now many triggers that could ignite the next crisis including President Trump's fiscal policy or a trade war.

The problem this time around is that many countries, including Australia, have not addressed the fundamental internal structural problems and these countries have used excessively loose monetary and fiscal policy in an attempt to sustain economic growth.

Eventually, debt can only be a saviour for a slowly growing economy if the assets that are created with the debt lead to higher productivity growth.

This has not been the case globally.

With depleted fiscal positions, weak productivity growth, a populist backlash against an open global economy, and low but rising interest rates, ***the world is again vulnerable to a major financial crisis.***

Huge weak point went unnoticed

Back in September 2008, the RBA was ready for a US adjustment at least two years before it happened.

When and how it would occur was uncertain, but the signs were clear.

The slow-motion unwinding of the US housing boom from 2006 at a time of exuberant equity markets had long been a cause of worry.

Andy Stoeckel and I wrote a paper in mid -2006 on why the housing market collapse in the US could cause a recession. This departed from the view at the RBA and in the US Federal Reserve Board that, because the value of housing assets at risk from a US housing crash would be relatively small compared with the size of the US economy, the effects on GDP would be minor.

We based our study on the analysis by Nouriel Roubini, which we implemented in our global economic model.

Roubini had worked with me in the 1980s on developing my global economic model as fellow PhD students at Harvard. I had a lot of respect for his views and decided to implement his scenario into our model.

I was surprised at how large the negative impact on US GDP of a housing crash was in our model, through the channels of falling equity markets and negative wealth effects on investment and consumption spending. Nonetheless, we did not appreciate the extent to which the exposure to the securitised assets debt obligations had created an enormous vulnerability in the global financial system.

The problems could be traced back to a number of US policy changes, but particularly the long period of low interest rates in the US from 2001 to 2004 which generated a search for higher yielding assets by global investors.

With the removal of regulatory oversights, securitised assets were created that somehow could take high-risk debt and package it into an apparently low-risk security.

Higher interest rates proved a buffer

Sitting on the RBA board from 2001 to 2011 was a fascinating experience. A major lesson I learnt was that, without the correct information, it is easy to ignore systemic vulnerabilities in an increasingly interdependent and complex global economy.

While Australia was well positioned with policy space and well-regulated financial markets, the knowledge about the systemic interlinkages in financial markets, particularly outside Australia, was woefully inadequate.

The staff at the RBA at the time, and today, are some of the best central bank economists in the world.

They understood the risks in the global economy from US policy mistakes and kept the RBA Board fully informed as events unfolded.

What they didn't know was also what the policymakers at the Federal Reserve Board didn't know. This was the extent of unpriced risk generated by the vast expansion of mortgage-backed securities.

The dilemma the RBA faced in 2008 was that rising inflation (4.4 per cent annual over 2008 and 5 per cent in the September quarter 2008) and strong housing demand and rising house prices in Australia needed to be addressed in real time, while knowing there was a rising probability of a potential US housing crash.

More disturbing was that non-traded goods inflation was rising much faster than traded goods inflation. Thus, domestic price pressures, which were more affected by RBA policy, were rising more than the overall inflation rate.

The RBA cash rate was raised from 4.75 per cent to 5 per cent in November 2003.

The US Federal Funds rate at the time was 1 per cent. This action by the RBA limited the distortions to asset prices in Australia that had been experienced in the US.

The RBA cash rate then rose to 7.25 per cent by March 2008.

It stayed at 7.25 per cent until September 3, 2008, when it was cut to 7 per cent after US interest rates had started to respond to a deteriorating US housing market.

Then in October 2008, after the September 16 collapse of Lehman Brothers, it was cut to 6 per cent. It was down to 3.25 per cent by February 2009.

Some argue with hindsight that the RBA should not have raised rates in March 2008.

The problem was that, although there was a risk of a shock from the US, the actual data in Australia on inflation supported rising interest rates.

I was a strong advocate and supporter of the policy. The question of whether it was better to act on what you know (an increasing risk of inflation and a housing asset bubble in Australia) rather than what you fear, is a difficult dilemma for policymakers.

The RBA was among the first central banks outside the US to act when the crash came and was able to undertake a large monetary injection. This, together with the exchange rate depreciation, fiscal stimulus and some help from a fiscal stimulus in China, meant Australia avoided the recession that crashed into most advanced economies.

If Australian interest rates had been lower and left close to US interest rates in the lead-up to the crisis, the bubbles in the pricing of Australian assets and rising inflation fears would have made the shock a much bigger internal and external one, which would have more likely tipped Australia into a recession.

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