

Financial crisis 2008: Wall Street ninjas and the downturn

“The market can stay irrational longer than you can stay solvent”

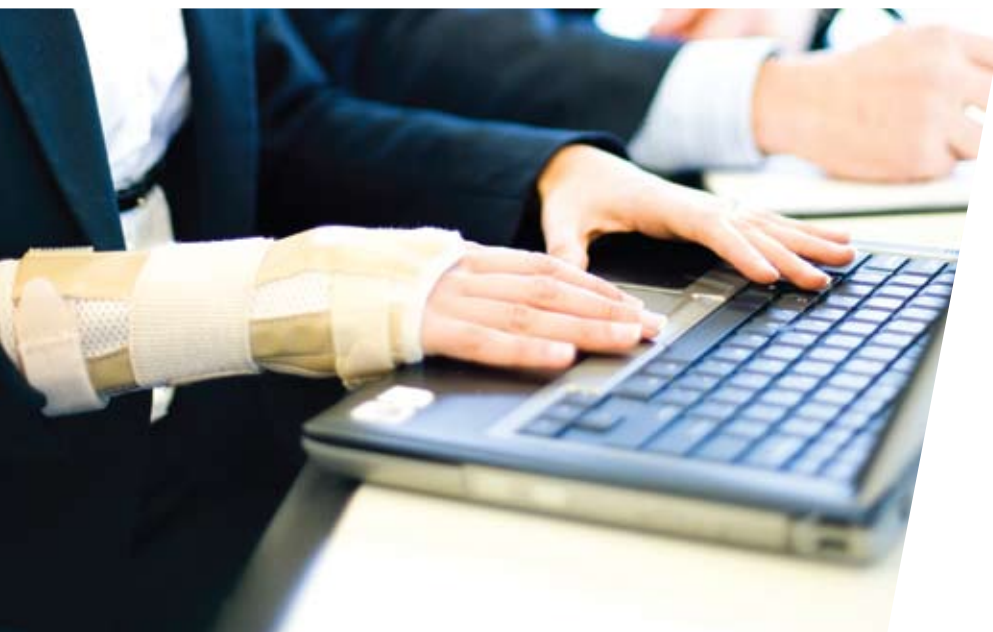
John Maynard Keynes,
British economist

There is no doubt: the economic and financial turmoil that began in the United States last year has turned into a global economic crisis of an as yet unknown magnitude. Scenarios range from a foreseeable economic crisis to a global recession that has only the Great Depression as a peer in history. However, the crisis's symptoms, for lack of a better word, are very different across industries around the world, and despite the economic damage that has already been caused and the pessimistic prospects for markets all over the globe, it seems that there are also opportunities arising and some optimists left to exploit them. In the following analysis, some aspects of recent events will be examined and some views presented that aim to show how the financial crisis is being perceived in different regions around the

world. In order to provide both diverse and profound views, we invited scholars from Germany, China, India, Romania and Japan to contribute to this article and share their view on what is perhaps the biggest financial crisis for over 70 years.

Providing an in-depth analysis considering all questions that come to light in connection with current events would be far beyond the scope of this article, especially given the complexity and interrelatedness of markets, economies and financial products involved. However, the crisis is real and the impact on the real economy has already been felt on a global scale. Companies in a wide variety of industries will experience fierce competition driven by slumps in demand as well as funding drying up.

It does not take a lot to realize that the world economy is experiencing a downturn. Several countries have either already entered a recession or are teetering on the brink. According to several sources, the United States is currently in a recession. Similarly, several economies in the Eurozone are experiencing comparable troubles. Among other countries, Italy, France, Germany and the United Kingdom are on the verge of entering a recession. But it's not only developed Western economies that are stumbling - growth prospects for Japan, Singapore and South Korea have been modified. The same holds true for most of the emerging markets not mentioned so far - most economies fared worse than anticipated and growth prospects for 2009 have had to be corrected considerably (IMF 2008). Finally, the case of Iceland deserves



special attention. Iceland is one of the wealthiest nations in the world, ranking number one in the United Nation's Human Development Index and among the nations with the highest GDP per capita. However, as of October 2008, Iceland was in acute danger of bankruptcy due to the failure of the nation's three major banks. The country's GDP is expected to drop by at least 10% in 2008 alone and, by October, the Icelandic krona had already lost 70% of its value against the euro (Ibison 2008).

So what happened exactly? Was it really the burst of the housing bubble in the US that started the problems that may lead to a global recession? According to numerous sources, the answer is a clear yes (e.g., Elliott 2008). In order to understand exactly what caused the collapse of the US housing market and its subsequent ripples around the world, it is worth going back in time several years. At the beginning of the decade, the US economy recovered from the burst of the dotcom bubble and a recession in 2001. In response to the economic downturn and the 9/11 terrorist attacks, the Fed lowered interest rates in order to stimulate growth and stabilize the economy. Finally, in 2002, interest rates in the US reached a low of 1% - a historic low which remained unchanged for over a year (Aversa 2008). Consequently, there was a lot of liquidity in the market and economic activity picked up momentum. For the housing market, the increased access to cheap credit meant that demand went up accordingly, which eventually led to rising housing prices. Due to the fact that interest rates were so low, mortgages were more affordable at that time - especially because houses seemed to be an attractive

investment that appreciated rapidly and could be financed with mortgages that were both cheap and tax deductible. Up to this point there was nothing wrong with that. Or maybe there was: there were certainly mechanisms in place that imply that there was a conflict of interests in the mortgage industry. Namely, many distributors of mortgages were mainly interested in the volume of the mortgages they distributed and not so much in quality because the risk was born by parties other than those who distributed the mortgages. Distributors of mortgages tried to gain access to a bigger market share and therefore came up with ways to target the economically weakest demographics - people without savings, jobs, regular income or with poor credit histories - so-called subprime borrowers. For example, one of the most obscure mortgage products that came to be rather infamous were so-called ninja loans - loans for borrowers with no income, no job and no assets with fixed teaser rates, which were usually very attractive, that would reset to an adjustable rate (usually the return of an index like LIBOR plus a premium) after a pre-determined period of time (Conway 2008). These and similar products enabled many households to qualify for mortgages and purchase property that they could not have afforded otherwise. In an environment of rising prices, many subprime buyers were incentivized by the prospect of future wealth suggested by the prospects of property appreciation and the possibility of reselling or refinancing property before interest rates were reset. Apart from the process of buying new homes, there were at least two more

factors that contributed to the current situation. Firstly, the rising number of speculators in the housing market, betting on increasing prices, contributed to the building up of the bubble. Secondly, the rising value of houses and the favorable conditions caused many households to take on new mortgages on the houses they already owned, to repay old mortgages and to have funds available for consumption - estimates are as high as USD9 trillion for the time between 1997 and 2006 or 8% of total personal consumption in this time span (Feldstein 2007; Federal Reserve 2008).

However, when prices for houses stopped their rapid upsurge and started to fall, many households had mortgages worth more than the houses purchased. In addition, many households faced problems when their mortgage rates got reset to much higher levels. This was partly because adjustable rates that appeared attractive when the contract was signed happened to be much higher when the rates were reset and also because they were adjusted to rates that had risen by that time. As a consequence, delinquency rates rose, which made many lenders tighten their lending standards, which in turn put additional pressure on the housing market and started a downward spiral of housing prices. In short, by mid 2006, housing prices peaked and started to drop from there on. Intuitively, this already suggests potential problems on a relatively large scale: if American households are not as wealthy as they used to be, they would reduce their consumption. One estimate is that US households have a marginal propensity to consume of USD 0.0375 for

every dollar of change in wealth (Mishkin 2007). Secondly, the construction industry is hit severely by the oversupply of houses. Those two factors alone could have seriously harmed economic growth in the US as well as elsewhere given the high dependence of many economies on the US as an export market (Feldstein 2007).

However, apart from the immediate damage suffered by households and the housing industry in the US, the turmoil on the US housing market caused severe problems in capital markets around the world. Traditionally, a mortgage used to be a simple relationship between a bank and a homeowner. The bank provided the funds, collected the rates and bore the risk of delinquencies. However, nowadays, originators securitize loans to tap international markets for funding and liquidity by recycling the proceeds into further lending. Mortgage-related securities have existed for over 30 years - what has changed drastically is their volume as well as the complexity of the products involved. In 1996, the volume of mortgage-related securities issued was as high as USD492.6 billion; by 2007 it had risen by over 400% to a total of USD2,050.1 billion (SIFMA 2008). Just to compare - this is almost 15% of the US GDP for that year. In addition, innovations in the securitization process made it possible to pool subprime mortgages and use them as collateral for securities that were partly rated better than the

collateral. For example, pooled subprime mortgages (e.g., ninja loans) were used as collateral for securities that were rated just like government bonds and, as it turned out, the rating was in many cases overly optimistic. In short, the securities ended up in the portfolios of banks, hedge funds and other institutional investors (many of these institutional investors were only allowed to hold AAA-rated assets) around the globe that were attracted by the above average returns.

Despite the fact that subprime-related securities make up only a rather small part of the overall securities market, the rising defaults on these securities set in motion a process that affected the prices of all risky assets and ultimately led to severe problems for many financial institutions. Until 2007, credit spreads were at historic lows but had skyrocketed by mid 2007 as a reaction to the rising spreads in the subprime segment that caused investors (who experienced first losses at that time) to demand assets that were perceived as less risky (Feldstein 2007). As a result, prices for all risky assets went down and caused further losses on investments that were not even directly exposed to subprime mortgages. Banks that had securitized mortgages and other structured securities in their books had far-reaching write-downs and were forced to sell off assets in order to fight liquidity pressures. Given that many banks experienced similar problems, banks became more cautious about lending

money to each other, which worsened the situation for numerous institutions further as they faced problems financing their operations and repaying their short-term debt (IMF 2008). As a result, numerous banks either went bankrupt or were bailed out by their governments. At this point, the subprime crisis had infested the financial industry around the world and contributed to plummeting stock prices in virtually every stock exchange around the globe.

The implications for companies in nations around the world are manifold: first of all, it must be realized that overall conditions are likely to become more problematic. Not only is demand likely to drop in most industries but the conditions to raise capital have also worsened. Many companies will have no choice but to save costs and slow down their metabolisms - be it for the sake of plummeting demand or due to problems in funding. Companies and markets that for the longest time had not anticipated being affected by the financial crisis - like, for instance, many emerging countries - are likely to experience some of the aftermath of the financial crisis. In the end, it must be said that it is hard to differentiate between causes and effects of the current crisis. However, the bottom line is that entrepreneurs and businesses will have to cope with the conditions they face in order to make it through the storm as safely as possible.

Author
Lars Geissel is a Consultant in the Advisory Practice,
Ernst & Young, Germany.



Financial crisis: from Wall Street to main street

From subprime crisis to financial crisis - this was yesterday. Today, the headline is: from financial crisis to recession. In other words: from Wall Street to Main Street.

How do the financial markets affect the real economy? More than 20% of the subprime credit takers will lose their homes. Furthermore, new issues will arise such as a potential credit card bubble and the threat of the automotive banks being gridlocked.

Which countries will be hit by the financial crisis? Basically, it is a worldwide predicament. Countries such as the US, Great Britain, Germany, Spain and Japan are directly hit by the financial crisis. An indirect influence can be seen in countries such as Russia, China and India.

What are the fundamental factors influencing today's stock market? There are the Price/earnings (P/E) ratio, the interest rates, the inflation and the GDP growth. Currently, P/E ratios are low.

However, this is not only based on low share price performance but also based on ambitious earnings estimates. These estimates will decrease and we might find ourselves near the 14.5 P/E average of the S&P 500 again. Interest rates are low. However, the scope for further decline may be limited, especially in the US. Monetary policy, one important tool in the Keynesian world, is no longer to be found in Obama's toolbox. Mr. Bernanke might find a sword. However, after the election it appeared to be a floret. The remaining tool is fiscal policy. Therefore, we probably will see more rescue packages wrapped up by the government and paid for by the taxpayers. At least inflation seems to be in line. Due to decreasing commodity prices the stagflation ghost is not in the house yet. In terms of the real economy we are currently on the dark side of expected worldwide GDP growth.

Is there light at the end of the tunnel? Could this light also be that of an oncoming train? We don't know the answer. One thing we know for sure: there will not be an oncoming train on our track. The usage

of the Keynesian toolbox calls for Keynes' rescue methods. History teaches us that we are currently suffering from a bursting bubble. This bubble is a bubble in a set of bubbles. Mid 2003 to mid 2004 we saw interest rates of 1% in the US. This was the cause of the last bubble which ended at the beginning of this year. Soon, the Keynes-oriented Fed will lower the current interest rate yet further to an all-time low. The next all-time high will be the result. Whoever dislikes this permanent up and down should think about turning away from Keynes' philosophy. However, this New Year's resolution might easily be forgotten when we are too busy buying call options on the eve of an all-time high.

Author

Joachim Häcker is a Professor of corporate finance at Heilbronn University (Germany) and at the University of Louisville (US). Furthermore, he is a member of the advisory board of PHTS (Personal HealthCare Telemedicine Services GmbH) as well as Director of the German Institute of Corporate Finance (DICF). He has been a vice president of Rothschild in London and Frankfurt carrying out numerous corporate finance transactions.

Romanian marketing in the global financial crisis

Our world is undergoing arguably the worst financial crisis in the last 70 years. Thanks to the interconnectivity of globalization, the imprudent behavior of the US housing market is affecting everyone. Less than 20 years after celebrating the triumph of free-market capitalism, the world is taking a second look at the benefits of government intervention. In these turbulent times, we must ask ourselves, how does the current financial crisis affect firms marketing in Romania?

Expensive capital

Capital is the lifeblood of every business. Given the current "credit crunch" any initiative a firm might undertake will cost more and have a higher break-even price. In the current transitional condition of the Romanian economy, capital investment is still required for the development of certain regions and industries, but it's not likely that private investment will be expended on venturesome projects or infrastructure needs. The source of that much needed capital will be the public rather than the private sector.

Slowdown in Foreign direct investment (FDI) and innovation

Naturally, given the drop in their market capitalization and the scarcity of capital in general, some multinationals will be less likely to expand into new markets. Romania will not only miss the FDI, but more so the technology and know-

how transfer that accompanies it. The companies already in Romania will be forced to be more efficient and innovative.

Stagnant or fallen realestate prices

Although the Romanian realestate market does not resemble the US or the UK, the general worldwide negative perception regarding realestate has permeated Romania, driving down the overall values. This will especially affect those individuals without a balanced portfolio, who hold their entire assets in real-estate. With falling prices, they will feel less wealthy, which will result in a more prudent purchasing behavior.

Slowdown in the sales of luxury items

Multinationals in Romania tend to target the top 10% of the population in terms of income for their goods and services. This segment derives its income either from speculative activity (typically realestate) or from working outside Romania. Earnings outside Romania are already negatively affected by the global economic downturn and realestate speculators have less liquidity to spend. As a result, firms marketing high-end, luxury items such as cars, exotic vacation or designer-label clothes might experience a slowdown in sales.

Products and services that promise safety and security

Luxury items will be replaced by products and services that emphasize safety and security. Most brands will have to offer solid guarantees and highlight stability as

the Romanian consumers, individuals and businesses alike, are stability conscious.

In conclusion, regardless of the governmental initiatives and the attempts to regulate the economy, the private free-market sector will still generate the most innovations in product and services. Firms who are engaged in this process must have a good grasp of their new environment and an excellent grip on their capital management.

Author

Dr. Sebastian Vaduva is the Dean of the Griffiths School of Management at Emanuel University of Oradea where he specializes in International Business and Entrepreneurship. He also taught at the University of Akron and was a US Fulbright Scholar.

Innovating for future: considering the crisis as a strategic opportunity

Sustained progress in globalization may provide excellent opportunities for innovation as the financial crisis spreads unexpectedly. Judged by the share of the world economy affected, this may be the most significant financial crisis since the 1930s. Let us get a feel for the potential impact of

the crisis on regions and industries to explore innovation opportunities.

The opportunity may enhance balance among industries that were disturbed due to excesses in the US, the prime mover of the crisis. The excesses were visible on several fronts: both in the macro and industrial structure. Excessive focus on service industries created several imbalances and divides. The pole position that the financial services industry reached

in terms of revenues and profits (see Table 1) was partly due to the excesses and is not sustainable. Apart from the highest profits and profitability, the segments collectively had high revenue share and percentage change over the last year. While the industry did attract brains keen on lucrative salaries, it can become a driving force in eroding the trust of the masses in financial services and even business.

Table 1: Overview of the imbalances in industries

| Industry | Total revenue 2006 USD million | No. of firms | Profits 2006 USD million | Profit/revenues | Change in revenues |
|--------------------------------------|--------------------------------|--------------|--------------------------|-----------------|-----------------------------|
| | | | | | Percentage change from 2005 |
| Petroleum refining | 2,971,018 | 39 | 247,223 | 8.3 | 16.9 |
| Banks: commercial and savings | 2,875,797 | 60 | 327,775 | 11.4 | 19.8 |
| Motor vehicles and parts | 1,918,757 | 33 | 35,946 | 1.9 | 7.7 |
| Insurance: life, health (stock) | 1,037,946 | 20 | 53,053 | 5.1 | 7.5 |
| Food and drug stores | 918,513 | 22 | 22,679 | 2.5 | 5.6 |
| Telecommunications | 884,328 | 21 | 65,144 | 7.4 | 7.7 |
| Electronics, electrical equip. | 855,934 | 18 | 35,156 | 4.1 | 7.8 |
| Insurance: P&C (stock) | 713,192 | 15 | 66,373 | 9.3 | 3 |
| Utilities | 658,668 | 21 | 42,660 | 6.5 | 14.9 |
| General merchandisers | 599,495 | 9 | 21,021 | 3.5 | 11.2 |
| Computers, office equipment | 445,940 | 11 | 28,313 | 6.3 | 4.6 |
| Metals | 400,251 | 14 | 27,737 | 6.9 | 11.4 |
| Pharmaceuticals | 382,734 | 12 | 79,430 | 20.8 | 6.4 |
| Securities | 297,411 | 6 | 32,072 | 10.8 | 45.1 |
| Wholesalers: healthcare | 290,006 | 5 | 3,349 | 1.2 | 9.1 |
| Diversified financials | 280,514 | 5 | 30,567 | 10.9 | 19.2 |

Source: Based on data from Global 500 (Fortune)



Progressive firms in India have an opportunity to innovate for the future, if they can scale-up competitiveness process capabilities and performance. Several firms from India focused excessively on low-hanging fruits in service industries based on wage arbitrage for too long. Now it is time to think of higher levels of capabilities and innovate. Many firms talk about service innovations (or even so-called business model innovation), but that may not take them to the next level of competitiveness. Strategic differentiation may demand product, technology or much greater architectural innovations to enable really capable firms to achieve rapid growth.

Less disruptive transition from crisis to prosperity demands cooperative strategies.

The crisis can facilitate evolving emerging industries of the future. Firms should learn from major experiments such as science businesses e.g., biotech industry. Even after three decades of dynamic capabilities driven by giants and start-ups in Silicon Valley, the industry has been underperforming (Pisano 2006). Considering the limitations of the situation in the US, it is time that many capable firms such as Biocon and others across the world take on the challenges of innovating for great promise of biotech for human health. Similar opportunities

can be created in other emerging industries such as nanotech. Success might also be shaped by business models that balance service with profits.

Rather than turning the wheel back, we shall consider the crisis as a great opportunity to cure the ills of the excesses and innovate for a sustainable future. Emerging industries such as bio/environmental/nano technology can help, if we can bring about some paradigm shifts. It demands a different kind of leadership – one that can learn while on the move. Are real leaders ready to take on the challenges of the next level of innovations together?

Authors

Dr. K Momaya is an Associate Professor of Competitiveness and Strategic/Technology Management in the Department of Management Studies, Indian Institute of Technology, Delhi; currently visiting the Institute of Innovation Research (IIR).

Prof. S Yonekura is the Director of the Institute of Innovation Research, a prolific writer and the editor in Chief in the *Hitotsubashi Business Review*, a leading journal of Japan.



Financial turmoil and China

China is an important part of the global economy. There is no doubt that the financial turmoil has affected China's export trade along with the rising degree of dependence on foreign trade in China. Though export to the US from China has declined by 50%, it has had no significant influence on China's financial industry, since export makes up only a relatively small part of China's economy as a whole and those industries affected are mostly in the manufacturing industry. In contrast, the financial crisis will promote technical innovation and push the restructuring adjustment in these affected industries. Furthermore, the financial market in China is not as big as in the US and has few financial derivatives and an underdeveloped bond market, which is under strict governmental supervision. So, I don't think that the global financial crisis has caused major damage to China's macroeconomy.

Granted, we should learn from the financial crisis. The current status is that China's financial system and services lag far behind the market demand. We should continue to develop the financial industry instead of standing still. We cannot simply claim that financial services, financial innovation and globalization are the culprits of the crisis.

First and foremost, I think China's government should make great efforts to build financial regulations and the financial services system. Due to the underdevelopment of the financial system, investment capability and savings capacity have not matched for a long time. The credit policy is more geared towards state-owned enterprises, and it is very difficult for small and medium-sized enterprises to get financing. Since the capital market was built in the 1990s, it is still not so developed and has a small market capacity. The direct financing system is even less developed than the indirect financing system, which will affect the economic development of entities.

Further, financial innovation should be considered as an important tool in the process of marketization and be strengthened for the localization of research and practice. In addition, the government should continue to establish and improve a variety of laws and regulations. For example, the government should strengthen the quality of accounting information disclosure, demanding the timely and accurate disclosure of information which is useful for investors' decision-making. Only based on the true accounting information will the government be able to implement a new tool for financial monitoring in time and to prevent a financial crisis effectively.

Last but not least, I believe that the financial turmoil brings opportunities for industry restructuring in China. Listed companies, whether small or medium-sized enterprises, can choose different methods such as mergers and acquisitions to exert the function of resource optimizing. It's not the time for us to carry out overseas mergers and acquisitions so eagerly. I suggest that we now have to focus on promoting both inter-industry and intra-industry restructuring. This is the key point for enterprises to raise international competitive power, to promote industrial structure, and to ensure China's sustainable economic growth.

It is also worth noting that - in the same way the 2008 Beijing Olympics have given us the pro-environment, scientific and humanistic spirit - the current global economic conditions have the potential to continue to promote the healthy and stable development of China's economy and enable China to play a positive role in global economic development.

Author
Yongmei Cui is an Associate Professor in the accounting department at the Beijing Jiaotong University. She is Vice Director of the Center for China Mergers and Acquisitions Research; her research area focuses on merger and acquisitions, accounting theory and methodology.