Ten Years After the Early Signs of the Financial Crisis: the State of the Economy and Economists

Mahmoud Mohieldin

November 21st, 2017

‘"Why did nobody notice it?" the Queen asked, surveying the size of the toxic debt that has led to the collapse of banks around the world. "If these things were so large, how come everyone missed them? It's awful.“’ – *from express.co.uk in November 2008*

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BRITISH ACADEMY

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22 July 2009

MADAM,

When Your Majesty visited the London School of Economics last November, you quite rightly asked: why had nobody noticed that the credit crunch was on its way? The British Academy convened a forum on 17 June 2009 to debate your question, with contributions from a range of experts from business, the City, its regulators, academia, and government. This letter summarises the views of the participants and the factors that they cited in our discussion, and we hope that it offers an answer to your question.

Many people did foresee the crisis. However, the exact form that it would take and the timing of its onset and ferocity were foreseen by nobody. What matters in such circumstances is not just to predict the nature of the problem but also its timing. And there is also finding the will to act and being sure that authorities have as part of their powers the right instruments to bring to bear on the problem.

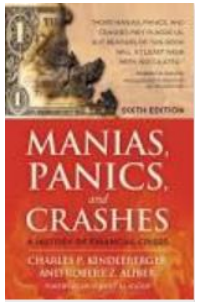
There were many warnings about imbalances in financial markets and in the global economy. For example, the Bank of International Settlements expressed repeated concerns that risks did not seem to be properly reflected in financial markets. Our own Bank of England issued many warnings about this in their bi-annual Financial Stability Reports. Risk management was considered an important part of financial markets. One of our major banks, now mainly in public ownership, reputedly had 4000 risk managers. But the difficulty was seeing the risk to the system as a whole rather than to any specific financial instrument or loan. Risk calculations were most often confined to slices of financial activity, using some of the best mathematical minds in our country and abroad. But they frequently lost sight of the bigger picture.

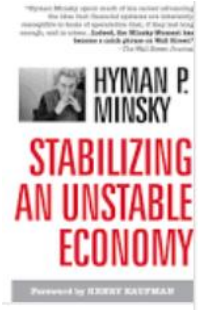
Many were also concerned about imbalances in the global economy. We had enjoyed a period of unprecedented global expansion which had seen many people in poor countries, particularly China and India, improving their living standards. But this prosperity had led to what is now known as the 'global savings glut'. This led to very low returns on safer long-term investments which, in turn, led many investors to seek higher returns at the expense of greater risk. Countries like the UK and the USA benefited from the rise of China which lowered the cost of many goods that we buy, and through ready access to capital in the financial system it was easy

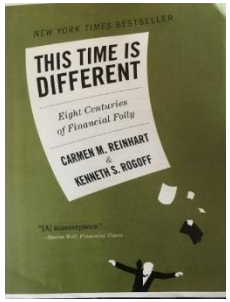
Letter from British Academy to Her Majesty The Queen – July 2009

"There were many warnings about imbalances in financial markets and in the global economy… but the difficulty was seeing the risk to the system as a whole rather than to any specific financial instrument or loan. Risk calculations were most often confined to slices of financial activity, using some of the best mathematical minds in our country and abroad. But they frequently lost sight of the bigger picture"

History of Financial Crises







1720: South Sea Bubble

1792: Panic of 1792

1825: Latin American Crisis

1837: Cotton Crisis

1857: Railroad Crisis

1873: Long Depression

1907: Knickerbocker Crisis

1929: Wall Street Crash

1973-4: Oil Crisis

1982: Latin American debt crisis

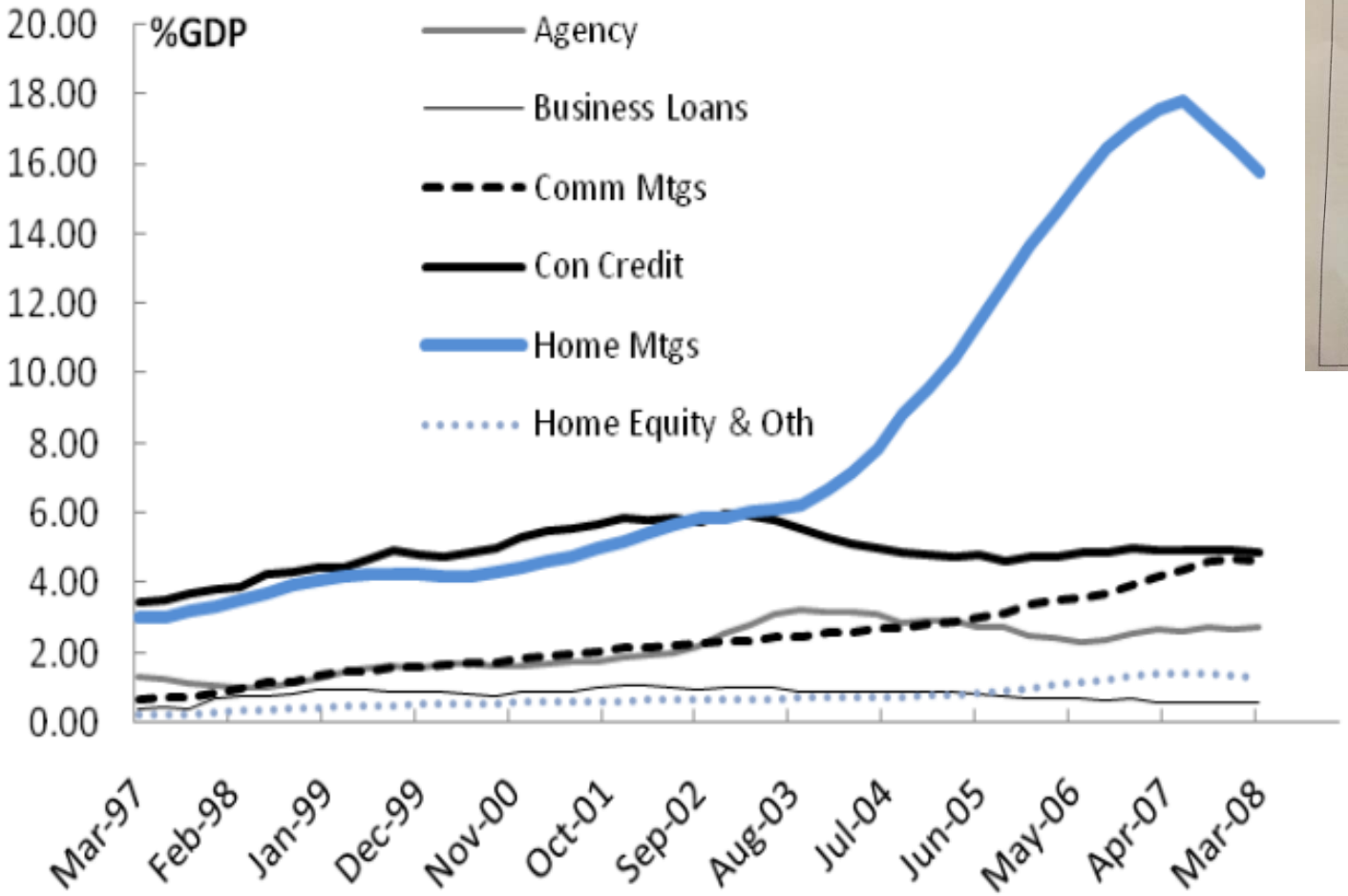
1987: Black Monday

1997: Asian Crisis

2001: Dotcom Crash

2008: Subprime Crisis

The origins of 2008 financial crisis: US financial assets as a proportion of GDP



Minsky's moment

Source: Carlos Braga, 2017

Central Banks have a key role to play in mitigating crises

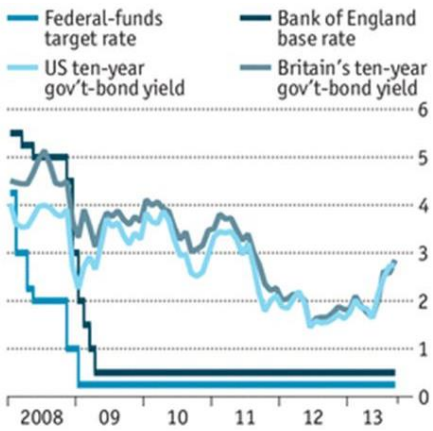
"During the Great Depression, the Federal Reserve not only failed to keep the money supply steady but also, by not acting as lender of last resort, allowed otherwise viable commercial banks to collapse, turning a financial storm into an economic catastrophe."
-Anna Schwartz, co-author of A Monetary History of the United States (1963), together with Milton Friedman

"You're right, we did it. We're very sorry, but thanks to you, we won't do it again."
-Ben Bernanke, 2002.

U.S. policy response to the 2008 crisis

Fiscal stimulus; expansionary monetary policy; regulatory reform

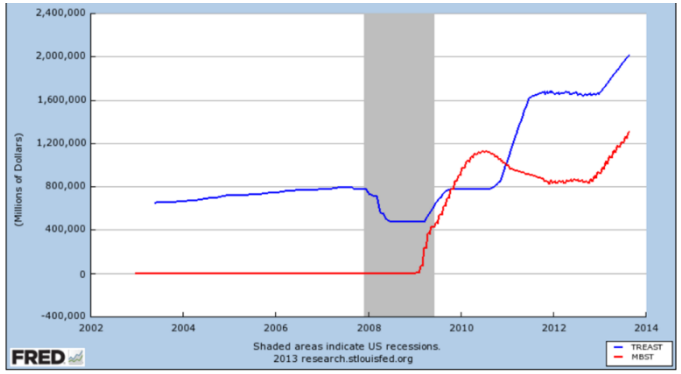
U.S Interest Rates, %



Source: Economist, 2017

U.S. Federal Reserve: Treasury and Mortgage-Backed Securities Held

U.S. Treasury Securities held by the Fed: All maturities (TREAST)
Mortgage-backed securities held by the Fed: All Maturities (MBST)



Source: St. Louis Fed, 2013

Support Packages:

- Economic Stimulus Act of 2008
- Housing and Economic Recovery Act of 2008
- Emergency Economic Stabilization Act/Troubled Asset Relief Program (TARP)
- Dodd–Frank Wall Street Reform and Consumer Protection Act

The Federal Reserve Bank:

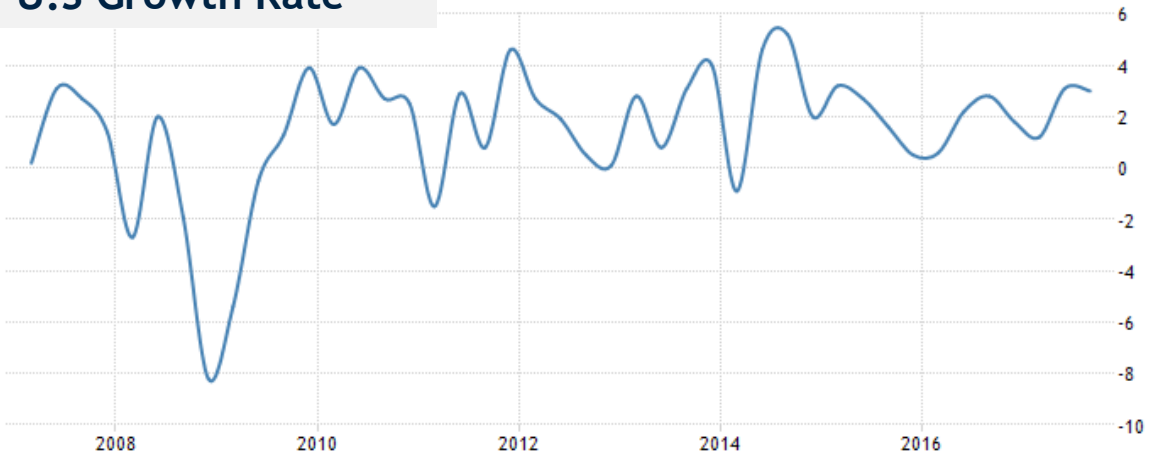
- Lowered the target for the Federal funds rate from 5.25% to 2%, and the discount rate from 5.75% to 2.25%. In Dec. 08, the Fed further lowered the fed funds rate target to a range of 0–0.25%.
- Undertook open market operations to ensure member banks remain liquid.
- Created a variety of lending facilities to enable the Fed to lend directly to banks and non-bank institutions, against specific types of collateral of varying credit quality.
- In Nov. 08, it announced a $600 billion program to purchase the MBS of the GSE to help lower mortgage rates.
- In Mar. 09, the Federal Open Market Committee (FOMC) increased the size of the Federal Reserve's balance sheet by purchasing up to an additional $750 billion of government-sponsored enterprise MBS, and to increase its purchases of agency debt that year by up to $100 billion to a total of up to $200 billion. Moreover, to help improve conditions in private credit markets, the FOMC decided to purchase up to $300 billion of longer-term Treasury securities during 2009.

U.S Economic Indicators, 2007-present

U.S Inflation Rate

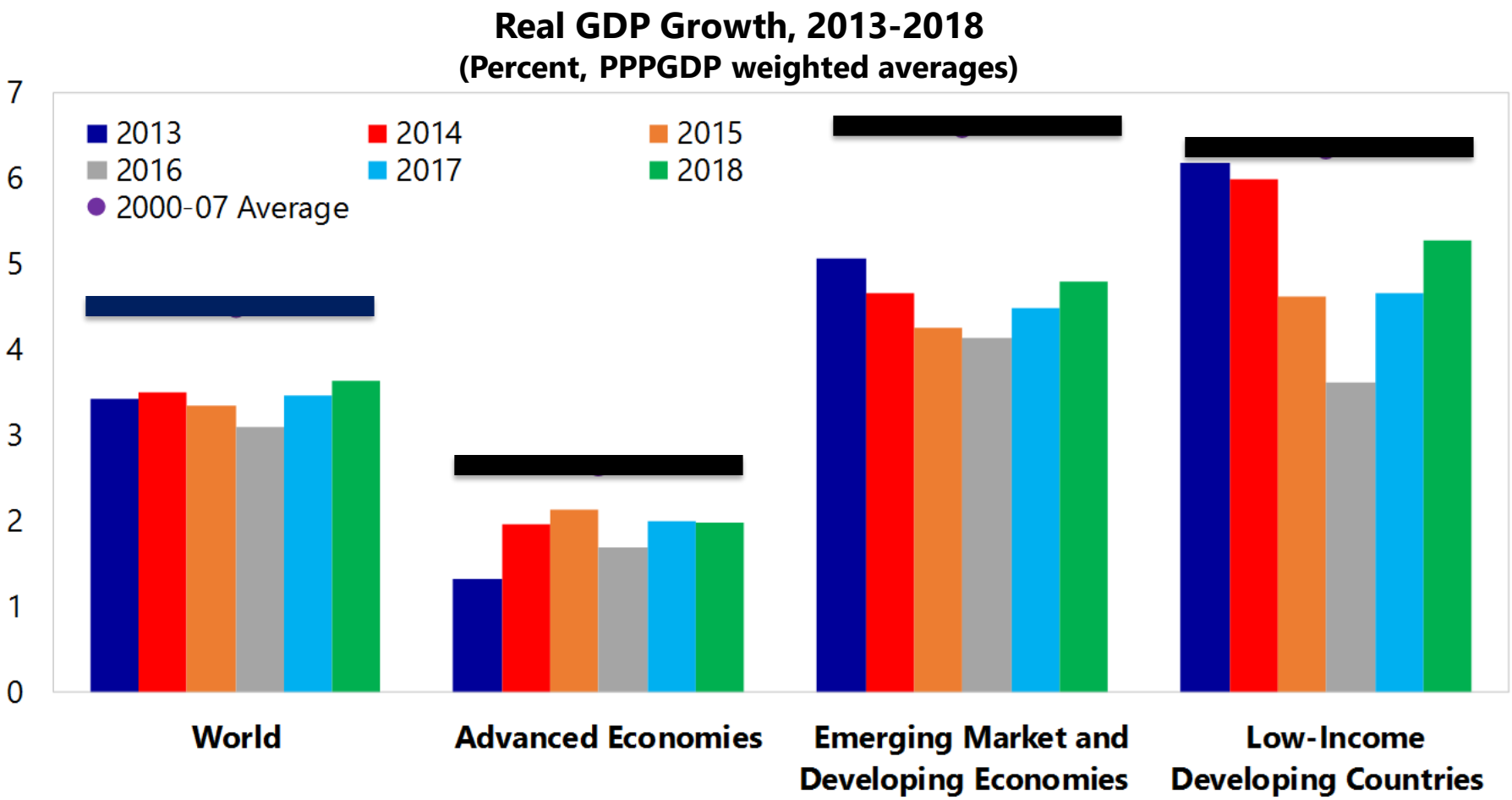
U.S Unemployment Rate

U.S Growth Rate



Shifts and changes in the global economy

Growth is picking up but is still lower than the pre-crisis average

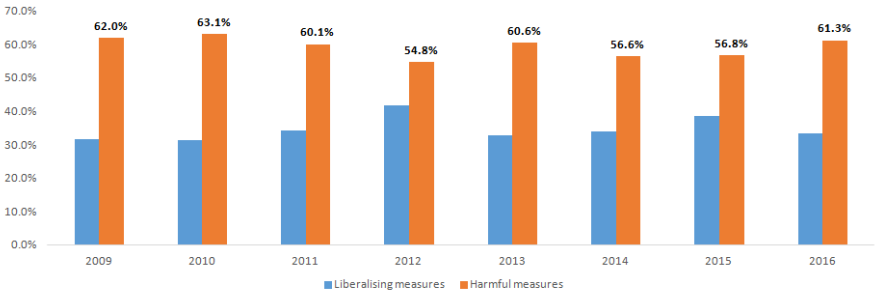


Source: World Economic Outlook and Sean Nolan, 2017

Shifts and changes in the global economy

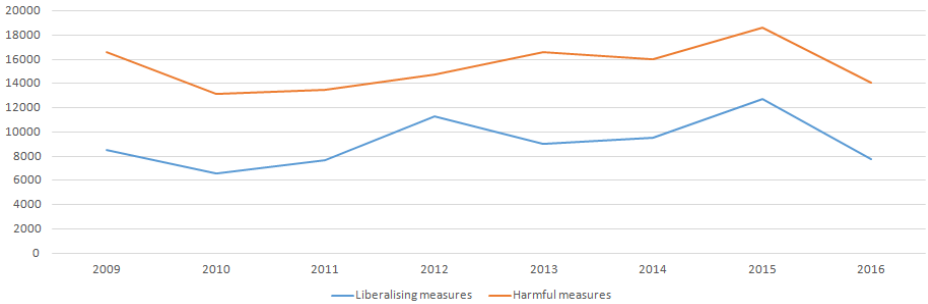
The rise of protectionist measures

Liberalizing and harmful measures as % of all trade measures, globally

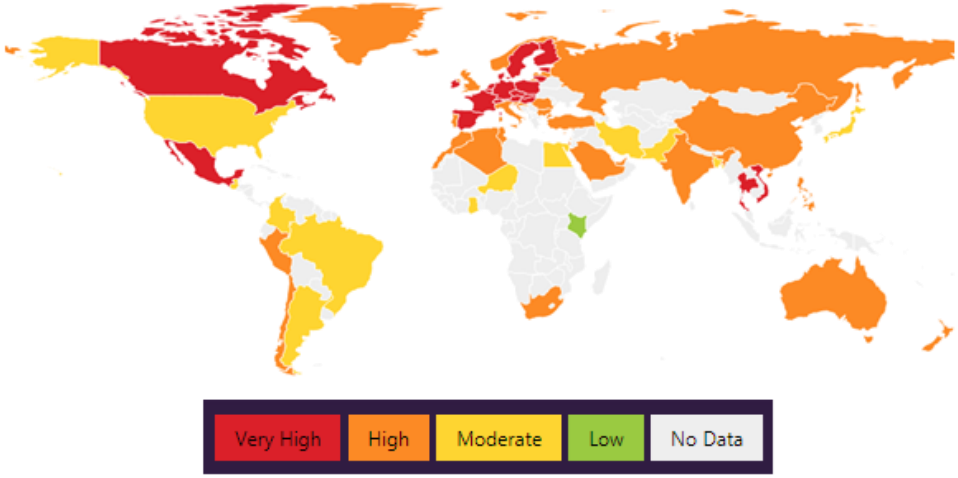


Number of trade measures implemented each year

Liberalizing and harmful measures



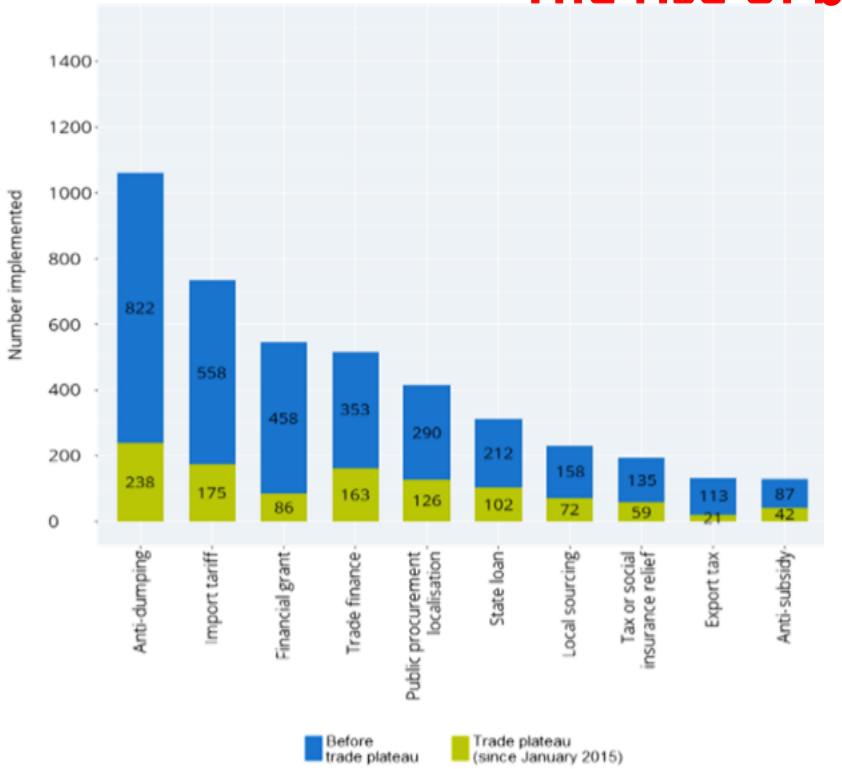
Heat map of world protectionism

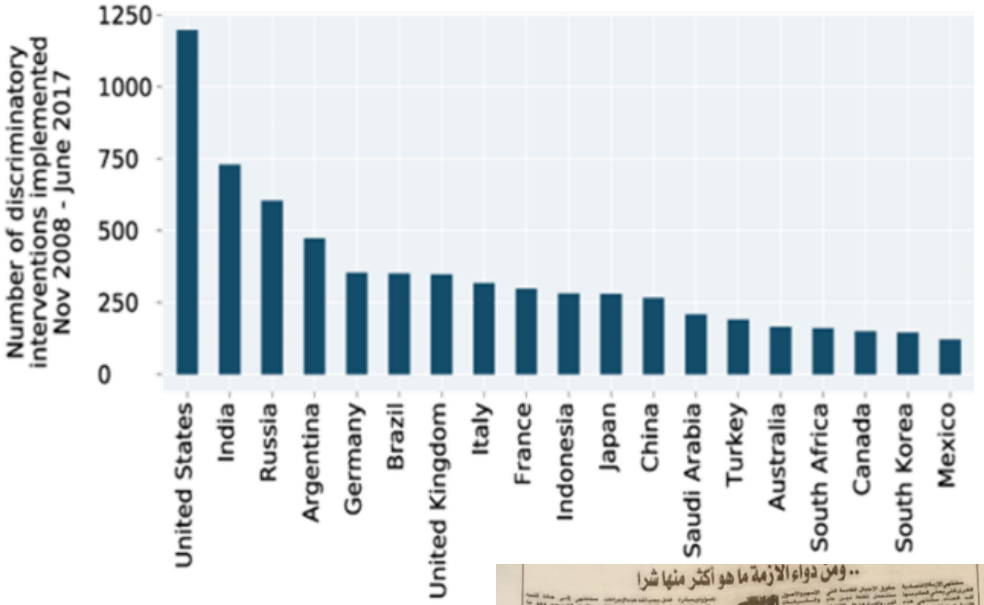


Source: Reuters, 2017

Shifts and changes in the global economy

The rise of protectionist measures

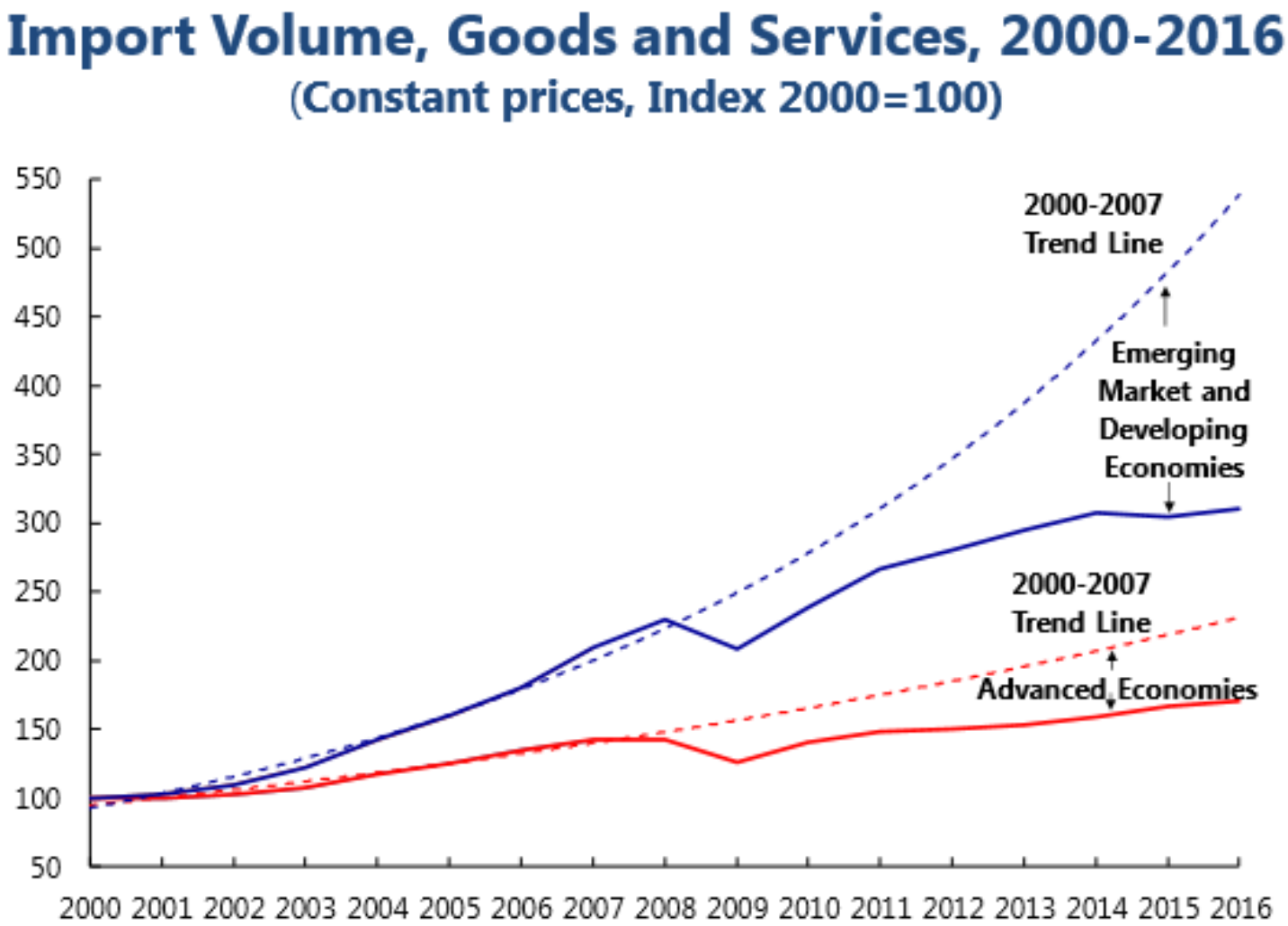




Source: Carlos Braga, 2017

Shifts and changes in the global economy

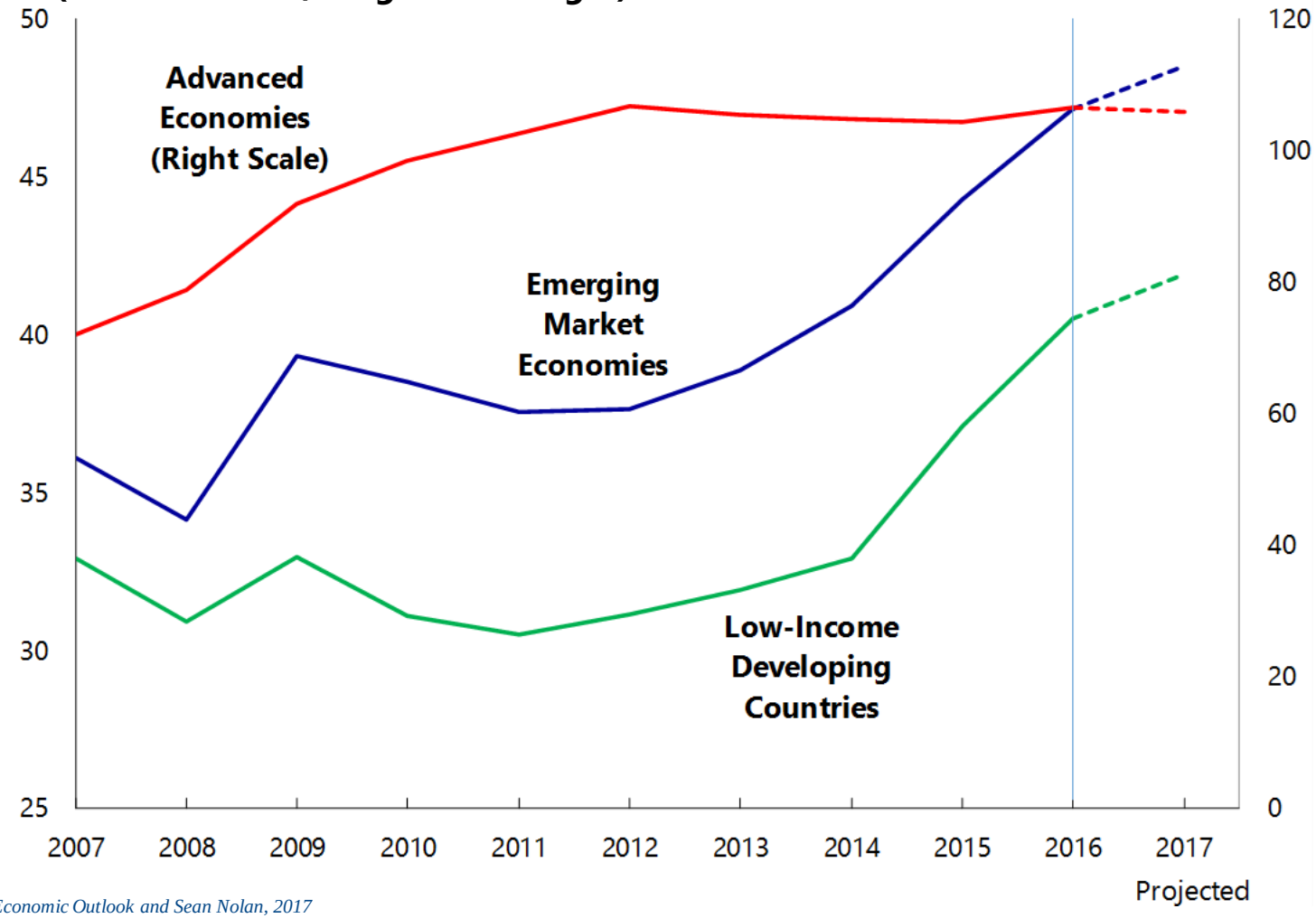
Growth of international trade is slowing



Shifts and changes in the global economy

Public debt burdens are rising

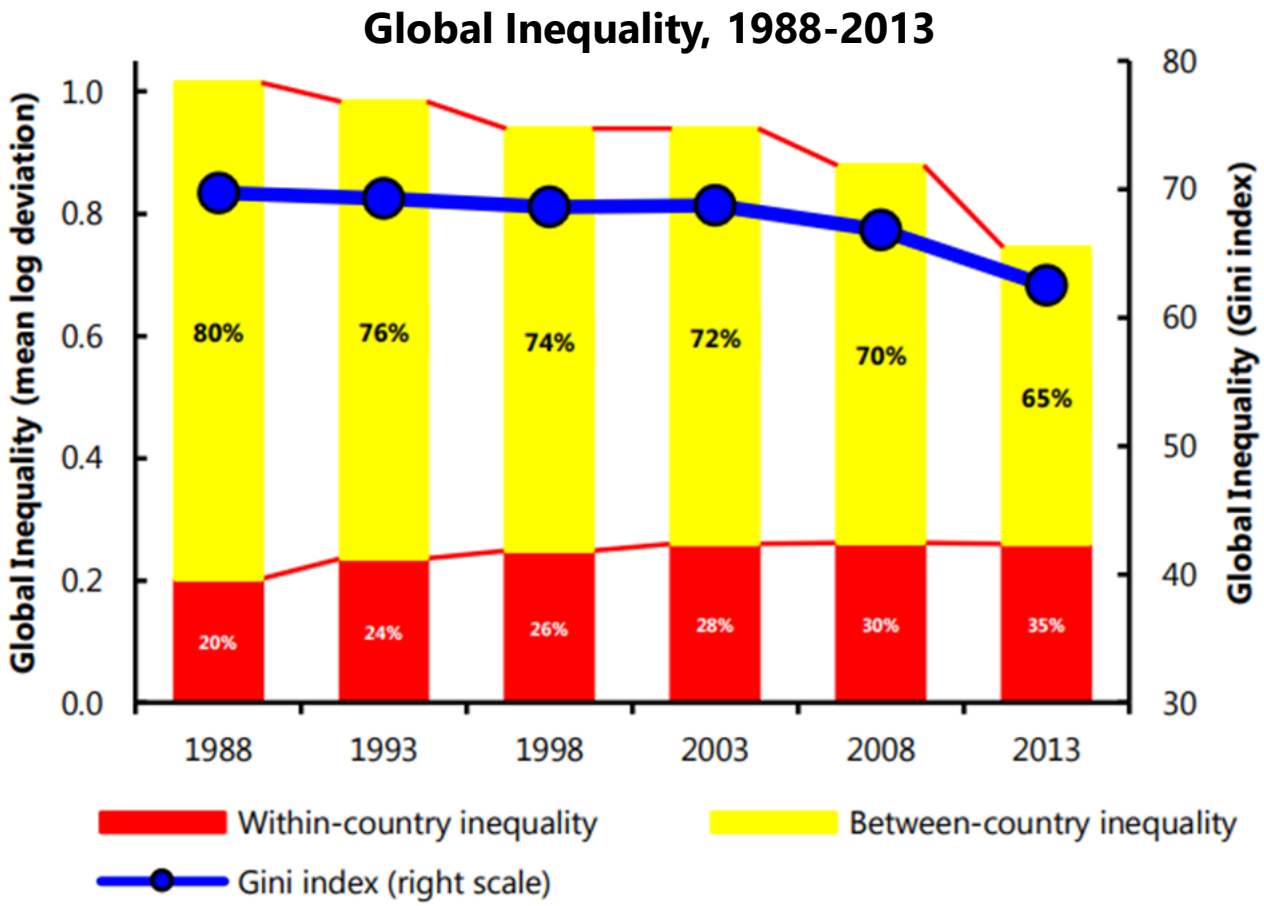
Public Debt burdens are rising, 2007-2017
(Percent of GDP, weighted averages)



Source: World Economic Outlook and Sean Nolan, 2017

Shifts and changes in the global economy

Inequality within countries is rising

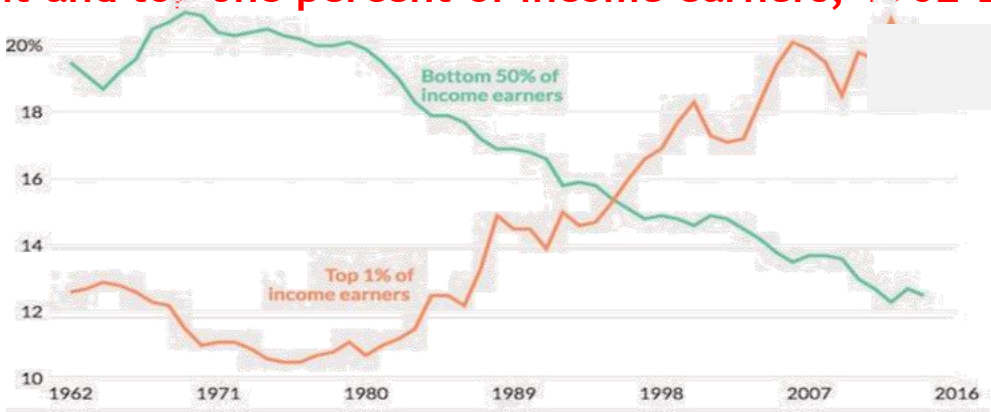


Source: Sean Nolan, 2017 and World Bank, 2017

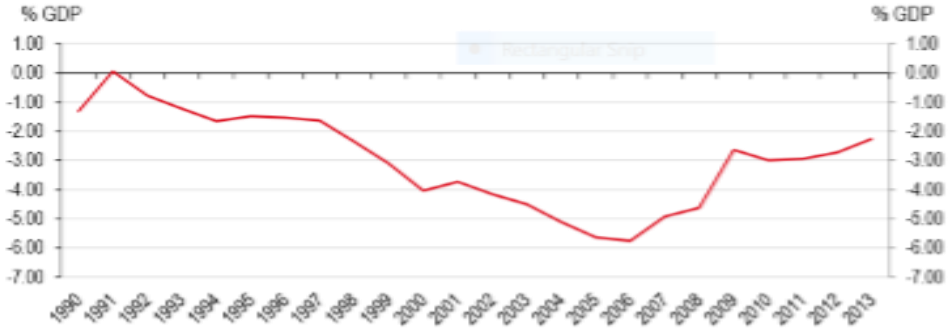
Shifts and changes in the global economy

Inequality within countries is rising

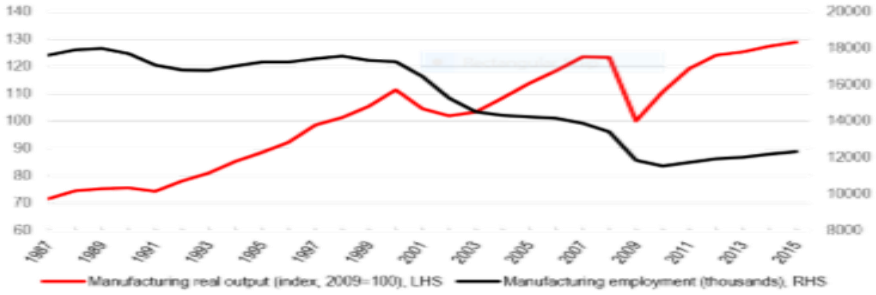
The share of US pre-tax income accruing to the bottom 50 percent and top one percent of income earners, 1962-2014



USA – current account



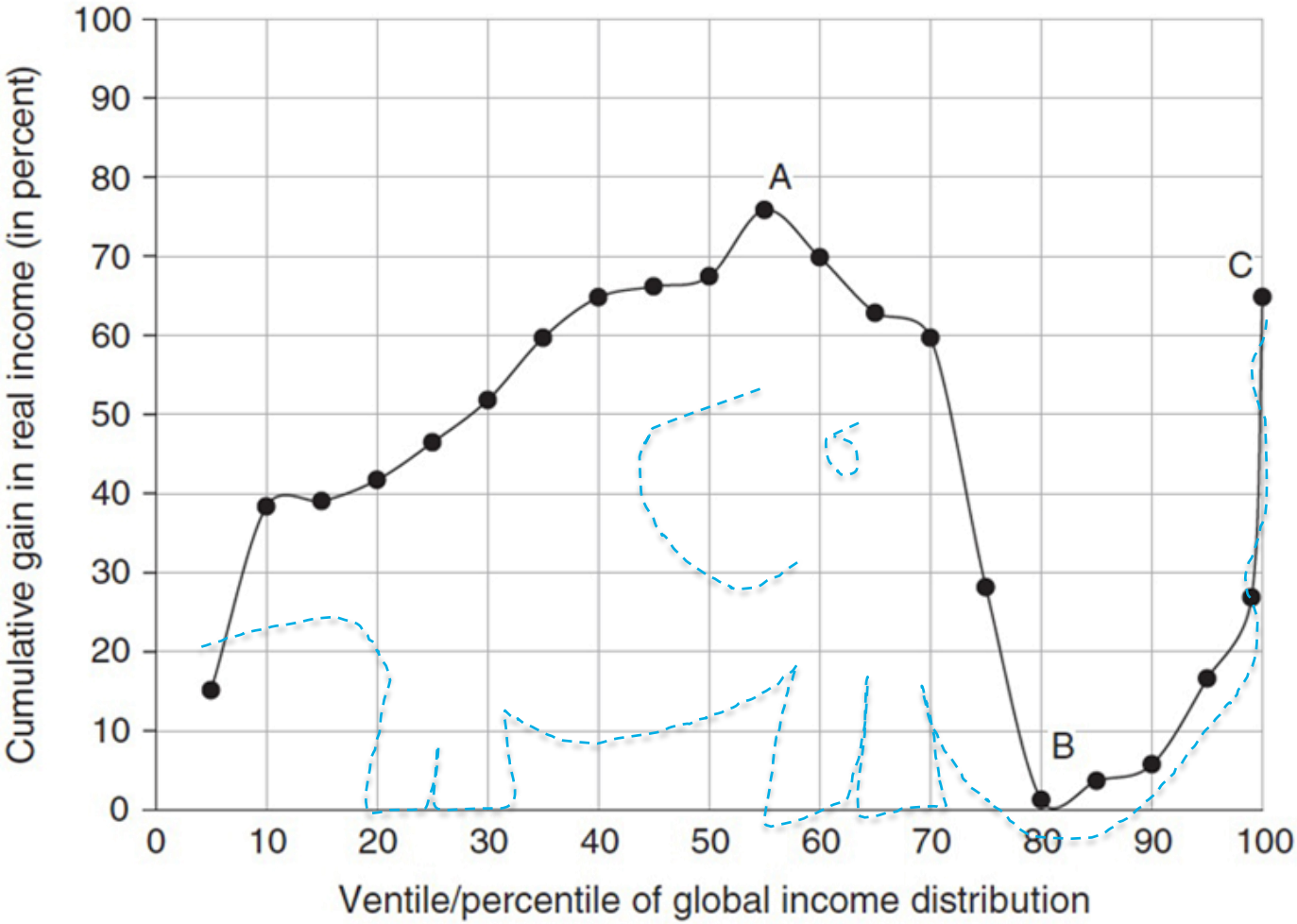
USA – Employment in manufacturing – the role of technology



Source: Braga, 2017

Although inequality is rising within countries, it is declining across the global population

Relative gain in real per capita income by global income level, 1988-2008



The largest negative effect is on the lower and middle classes in developed economies

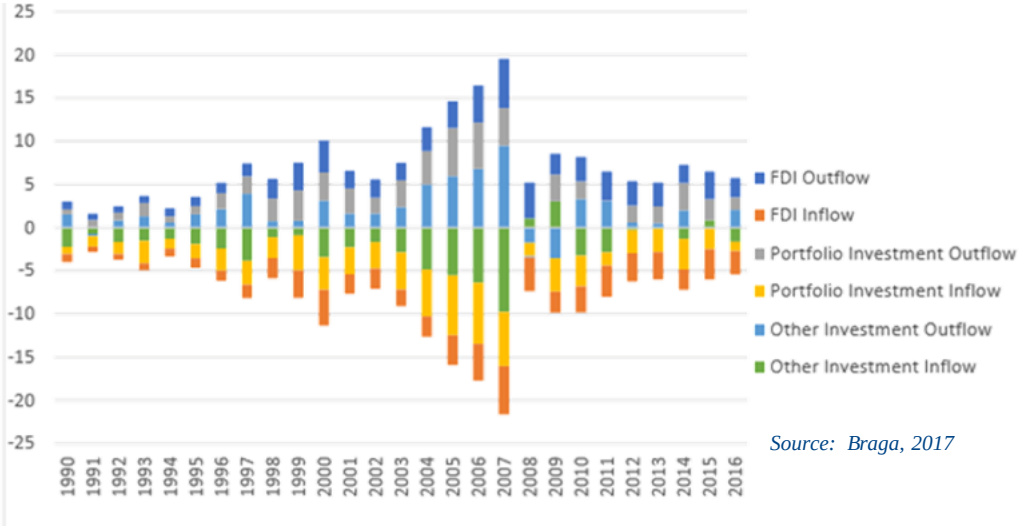
Source: Adapted from Branko Milanovic and Christoph Lakner, 2013

“Globalization and technology, both of which favor the most highly skilled individuals are not the only reasons for the top 1 percent’s increasing wealth; some people have pointed the figures at earning in the finance industry especially in the US and UK.”

Jean Tirole, 2017
Economics for Common Good

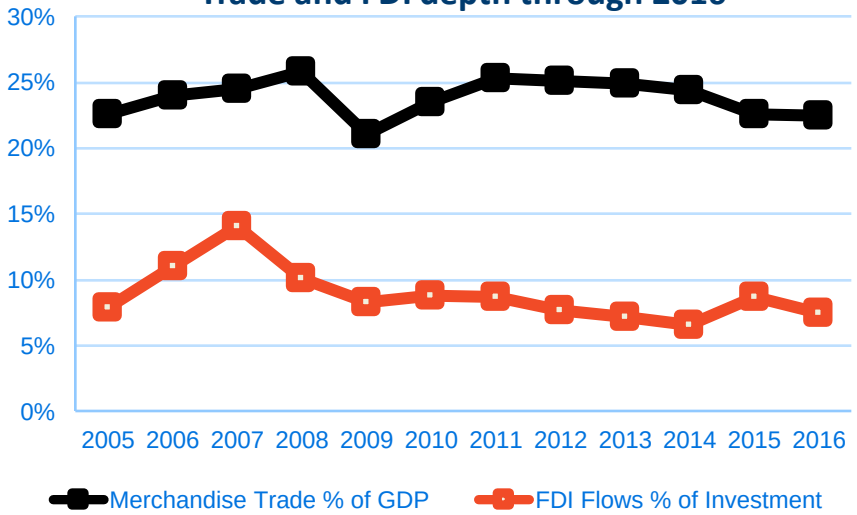
Is globalization retrenching?

Global Gross Financial Flows, 1990-2016 (percent of world GDP)



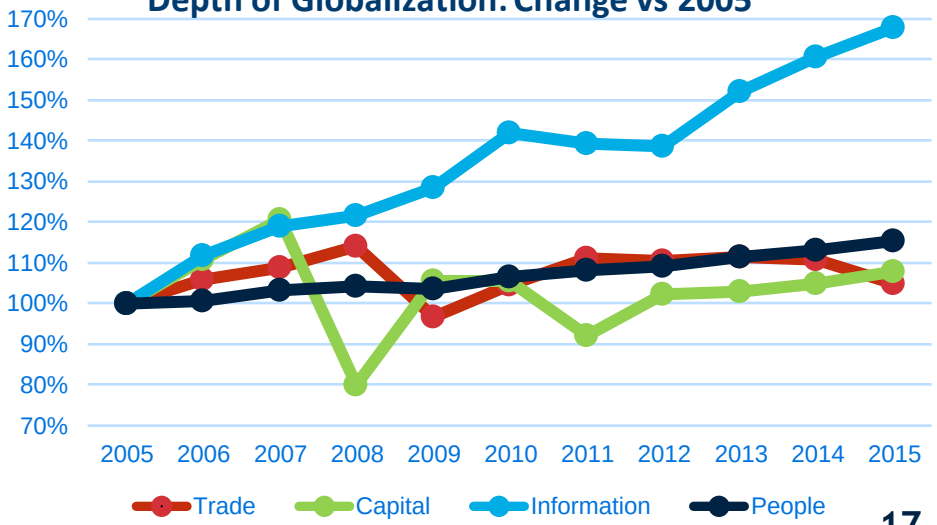
Source: Braga, 2017

Trade and FDI depth through 2016



Source: Ghemawat, 2017

Depth of Globalization: Change vs 2005

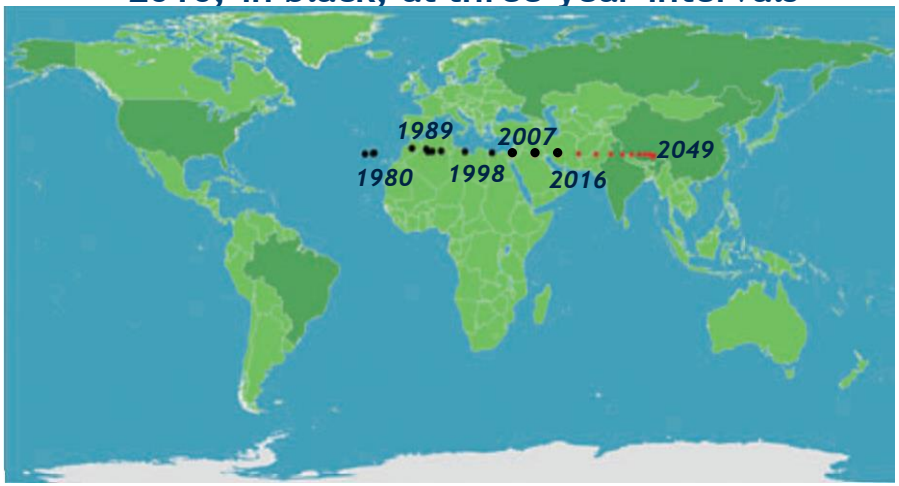


Source: Ghemawat, 2017

Shifts and changes in the global economy

Multipolarity

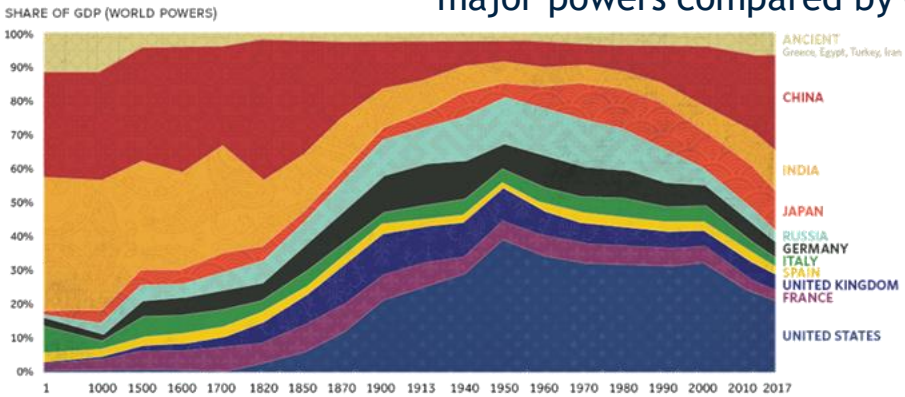
The world's economic center of gravity, 1980-2016, in black, at three-year intervals

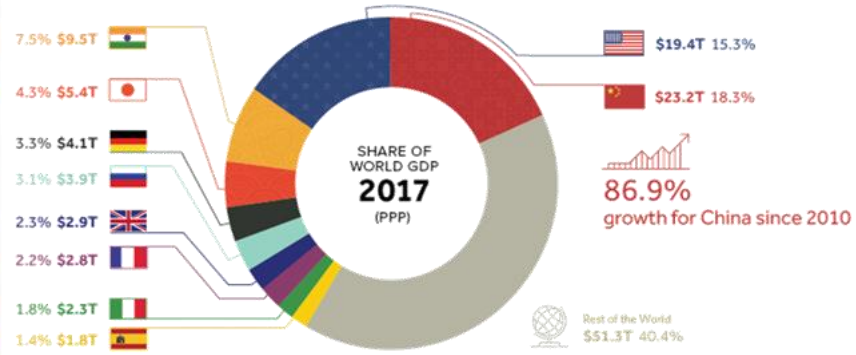


Source: Danny Quah, 2011

Evolution of the earth's economic center of gravity: 1 CE to 2025

2,000 Years of Economic History in One Chart: All major powers compared by GDP from the year 1 AD



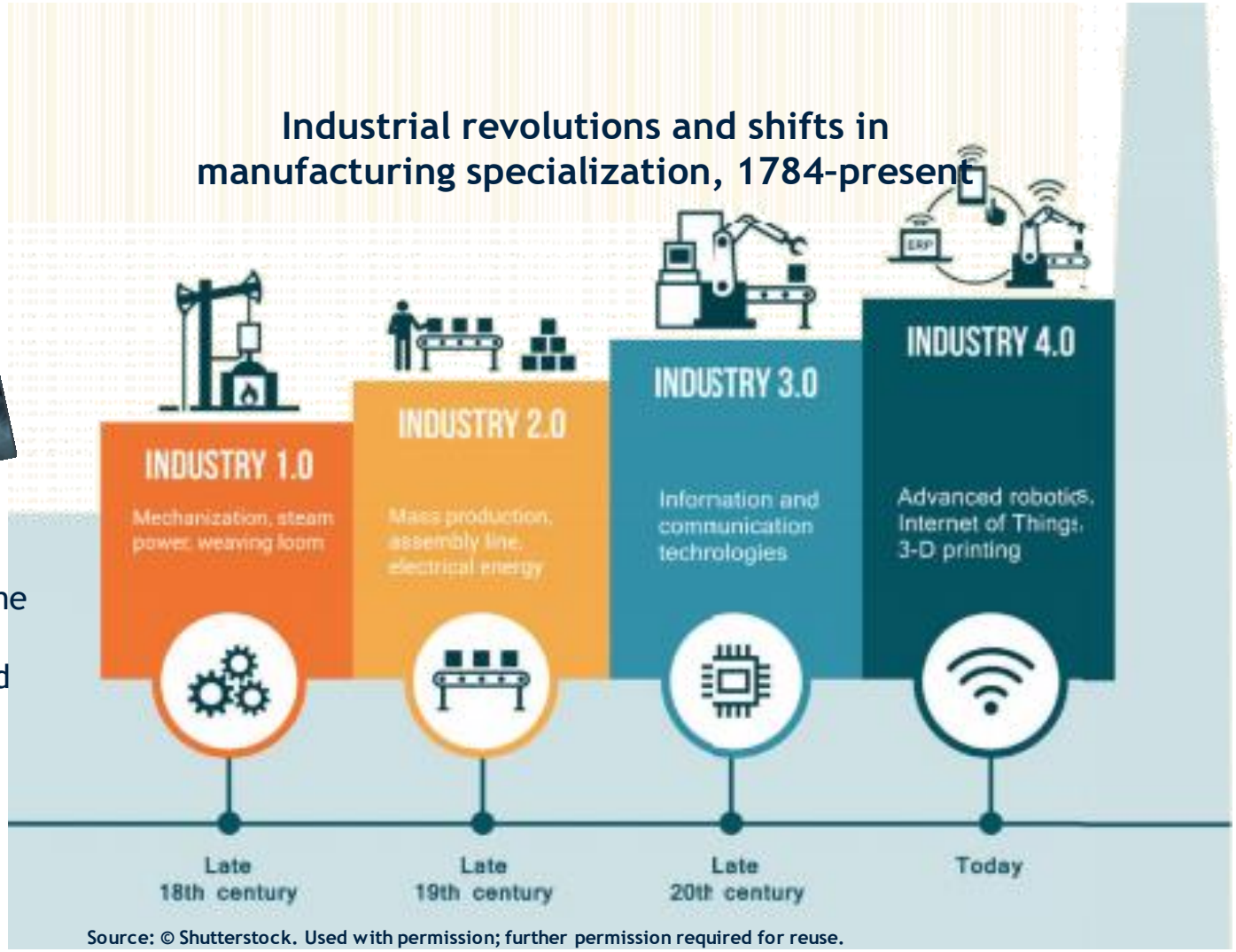


Source: Jeff Desjardins, 2017

Each industrial revolution shifts the manufacturing opportunities and patterns of specialization

Three "C"s determine the feasibility of success in export-led manufacturing:

- Competitiveness
- Capabilities
- Connectedness



Source: © Shutterstock. Used with permission; further permission required for reuse.

Source: Trouble in the Making? The future of manufacturing-led development, World Bank, 2017

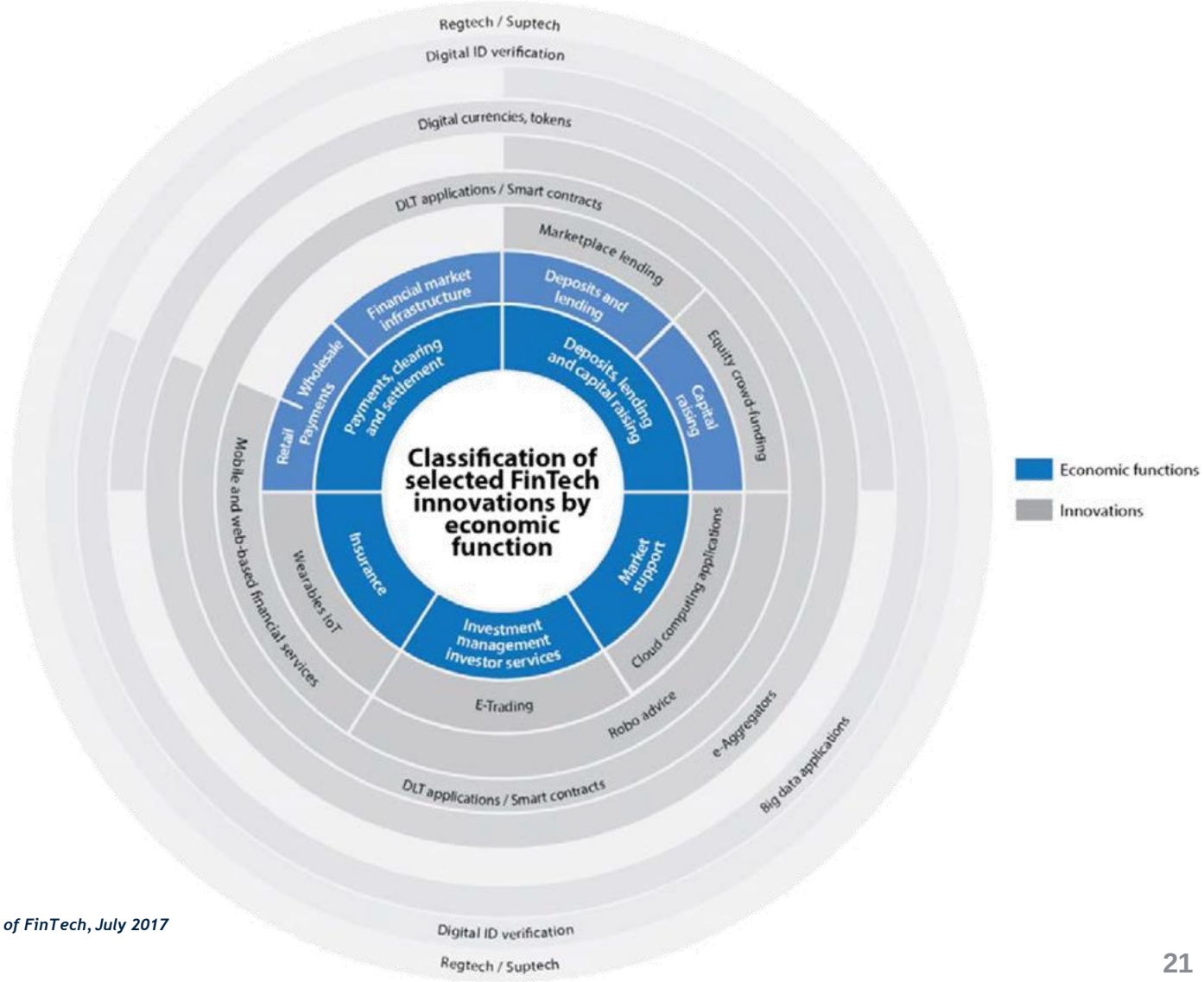
“Digitization” is disrupting every part of financial services

Digitization Of:	Money	Cash Transfers	Identity	Origination / Lending	Payments	Capital Markets Infrastructure	Supply Chain/ Invoicing	Savings and Insurance
Drivers	• Ecommerce • Convenience • Govt action (e.g. India) • Transport	• Govt efficiencies • Govt policy programs • Fraud reduction	• KYC, security • SIM reg., govt payments • E-services, elections • Falling costs biometrics • Mobile devices	• Big data (KYC automation) • Need for transparency + efficiency • Convenience • Digital identity	• Global trade • Ecommerce • Business & leisure travel	• Search for global returns • Convenience of personal investments • Democratization of share ownership	• Business need for efficiency, convenience, transparency • Govt push for transparency + tax compliance	• Data analytics & underwriting • Falling interest rates & invest income • Business need for efficiency & risk assessment
Opportunities	Account service providers; cash collection networks; regulatory advice to govts	Govt payment contractors (govts may unintentionally create largest payment banks)	Govt platforms for digital ID followed by innovative private-sector led applications	Digital lenders, marketplaces, originators, Scale SME Lending, Robo advice	Money transfer operators, cross border payment networks, FX operators	Back office operations, main exchanges (stock, currency, bonds, derivatives)	Back office operations, exchanges, value chain securitization	Direct insurance, online brokers & advisors, data and analytics, aggregators
Location	Global - populous countries first	Markets with cash transfer programs	Country specific and global (ID4D is global, regional, country specific)	Global - focus on large demographics	Global - main trade corridors	Financial market capitals (NY, London, Tokyo)	Regional & cross border	Global, regional and country specific
Impact	1.5 Bn wallets in 6 years	Over 300m accounts	1.5 Bn people without ID	$34 Bn in China alone	$3.6Trn value globally p.a.	$20Trn p.a. global flows	>$1Trn p.a. in LAC alone	>5 Trn GWP, >15 Trn AUM
Examples	Paytm, Fawry, M-PESA, bKash	FINO, NET1	AADHAAR	Kreditech, CompareAsia, Kabbage, bankfacil, comparaonline	earthport, VIAMERICAS, Remitly	embonds, LMRKTS	invoiNet, eFactor, FIT	raisin., MICROENSURE, HELLAS DIRECT, Lemonade

Source: World Bank F&M Global practice, October 2017

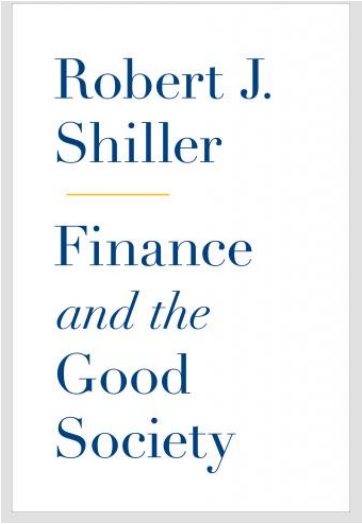
Technology enabled innovation in financial services - FinTech

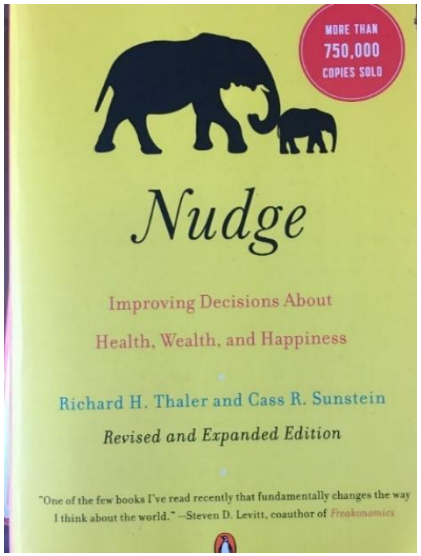
Fintech: Technology enabled innovation in financial services that could result in new business models, processes or products with an associated material effect on the provision of financial services.

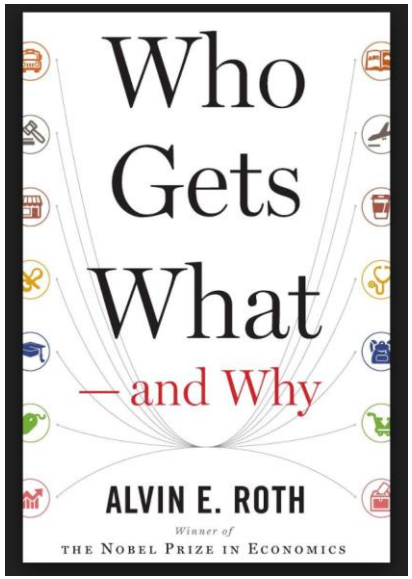


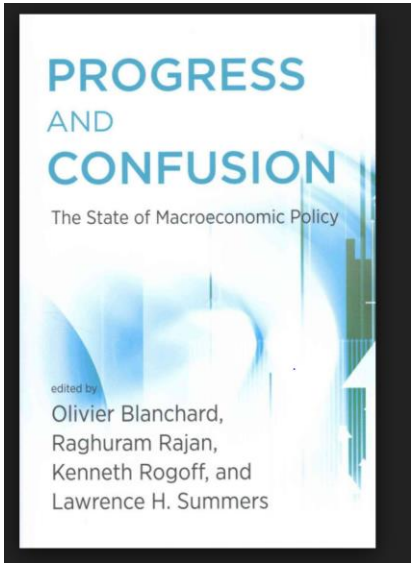
Source: FSB, Financial Stability Implications of FinTech, July 2017

Meanwhile…









Source: Colombia's HLPF presentation

An Opportunity for Transformation

Addressing Global Megatrends and Challenges

Demographic and Growth Transitions

- Economic diversification; 600 million new jobs (SDG#8)
- Sustainable Health & welfare system (SDG#3)

Urbanization

- Urban management (SDG#11)
- Private expertise/funding for infrastructure/urban services (SDG#11; SDG#9; SDG#17)

Climate and Resources

- Shift from fossil fuels to renewables/ efficiency (SDG#7)
- Agriculture adaptation (SDG#2)

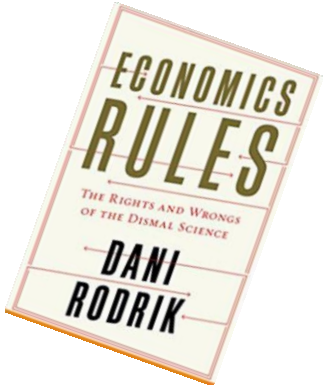
Cycles, Disruptions and Fragility

- Shocks and risks preparedness (SDG#13)
- Protecting vulnerable from fragility & violence (SDG#1; SDG#16)

Shifts in Global Economy

- New sources of growth and trade, especially for commodity exporters (SDG#9)

Rodrik's twenty commandments for economists and non-economists:



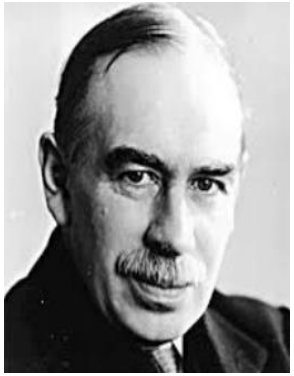
1. Economics is a collection of models; cherish their diversity.
2. It's a model, not *the* model.
3. Make your model simple enough to isolate specific causes & how they work, but not simple that it leaves out key interactions among cause.
4. Unrealistic assumptions are OK; unrealistic *critical* assumptions are not OK.
5. The world is (almost) always second best.
6. To map a model to the real world you need explicit empirical diagnostics, which is more craft then science.
7. Do not confuse agreement among economists for certainty about how the world works.
8. It's OK to say "I don't know" when asked about the economy or policy.
9. Efficiency is not everything.
10. Substituting your values for the public's is an abuse of your expertise.

Rodrik's twenty commandments for economists & non-economists (cont'd)

1. Economics is a collection of models with no predetermined conclusions; reject any arguments otherwise.
2. Do not criticize an economist's model because of its assumptions; ask how the results would change if certain problematic assumptions were more realistic.
3. Analysis requires simplicity; beware of incoherence that passes itself off as complexity.
4. Do not let math scare you; economists use math not because they are smart, but because they are not smart enough.
5. When an economist makes a recommendation, ask what makes him/her sure the underlying model applies to the case at hand.
6. When an economist uses the term 'economic welfare', ask what he/she means.
7. Beware that an economist may speak differently in public than in the seminar room.
8. Economists don't (all) worship markets, but they know better how they work than you do.
9. If you think all economists think alike, attend one of their seminars.
10. If you think economists are especially rude to non-economists, attend one of their seminars.

1944

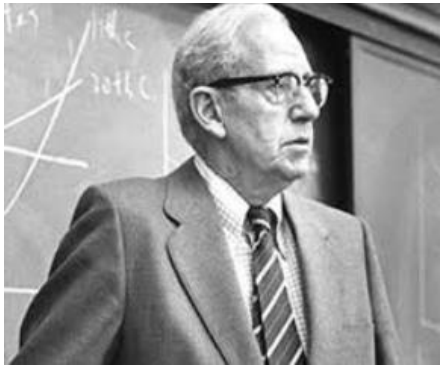
H.D. White and J.M. Keynes



Bretton Woods and establishment of the World Bank and IMF

1952

W. Vickry (Columbia University)



Congestion pricing for the new New York subway

1997

S. Levy

Conditional Cash Transfers (Progessa/ Oppotunidades)

Source: Rodrik, 2016

I.S. Abduallah

S. Al-Naggar

M. Z. Shafee

I. H. Abdelrahman

M. Abdelfadeel

The ideas of economists and political philosophers, both when they are right and when they are wrong, are more powerful than is commonly understood. Indeed the world is ruled by little else. Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist.

(John Maynard Keynes)

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