



Prof. James C. Ellert on the current economic crisis, its causes and consequences

The world economic situation worsened dramatically over the last couple of months. No one knows how serious this crisis will become. Every day brings new surprises. Some economists are predicting real catastrophe, others think that it can be patched together with modest disruption and a recession, likely worse in Europe than in the U.S. But no one really knows what will happen. In this interview Prof. Ellert explains causes and consequences of the current economic crisis. The interview conducted Tanja Zabukovnik, IEDC.

Prof. Ellert, what exactly happened over the last months? Can you explain the broader, long-term factors that led to the current financial crisis, beyond the immediate problems with sub-prime mortgages and the fallout from that? We can start with what went wrong on the U.S. financial market.

The roots of the current global financial crisis have been building over four decades. We have experienced three global financial crises during this time period: Latin American Debt in 1980's; the Asian and Russian debt crises in the late 1990's; sub-prime loans in the new millennium; and the collapse of U.S. savings and loan associations in the 1960's. In all of these crises, U.S. financial institutions took on additional risk to improve profitability but did not price appropriately for these risks. Risk-adjusted financial institution margins were not high enough during each of these crises. In each crisis, U.S. financial institutions had to be bailed out. Predictable bail-outs increase the risk appetite of financial institutions. "Let's go for the up-side. If we fail, governments will need to bail us out," becomes the operational mantra.

About James C. Ellert

James C. Ellert is Emeritus Professor and former Dean of Faculty at IMD, Switzerland and Visiting Professor at IEDC. He has more than 40 years of experience in consulting and executive education for a wide range of companies and public institutions in more than 40 countries within North and South America, Western and Eastern Europe, the Middle East, India, South Africa, the Far East, and Australia. He has also served on the boards of several not-for-profit organizations in Europe and North America. His viewpoints and activities have been profiled in Fortune Magazine, the Wall Street Journal, Financial Times of London, Handelsblatt, International Business, Le Monde, L'Expansion, New China Post, the Straights Times, and other managerially oriented publications. His current areas of research interest are financial management, valuation of companies, implementing value-based management strategies, financial restructuring, and mergers and acquisitions. He is the author of several books, articles, presentations, and cases on these subjects.

Professor Ellert graduated in political science and economics from the University of Toronto, and gained his M.A. in economics at the University of Western Ontario and the Ph.D. in finance and economics from the University of Chicago.

What contributed most to the sub-prime mortgage problem?

The current sub-prime crisis is related to debt management and a speculative real estate market in the United States. U.S. housing prices rose, on average by 8% a year between 1998 and 2006 in a relatively low inflationary environment. For contrast, U.S. housing prices rose on average by 0.7% a year only between 1930-1998. America has become a nation of debtors, importing and consuming more goods than it can export. To close the deficit between imports and exports, the U.S. sells monetary assets (debt instruments) to other countries. Between 2000 and

2007, foreign ownership of debt instruments issued by the U.S. government increased from 40% to 60%. Today, China and Russia are the largest investors in U.S. government debt.

Domestically, Americans were encouraged by the low interest rate environment of the last decade to take on more personal debt to finance home ownership and consumption preferences. Government financed large budgetary deficits by issuing debt. As a consequence, U.S. total debt to GDP rose from around 200% in 2000 to more than 300% in 2007. Today, the average U.S. household spends 16% of personal income for interest payments on home mortgages, auto loans, and credit cards compared to 10% in 2000.

With escalating home prices, more Americans wanted to become home owners. Between 1994-2004, the percentage of U.S. families owning a house increased from 64% - 69%. The old rule of thumb that home price should not exceed annual family income by more than 2 to 3 times was replaced with home prices being upward to 5 to 6 times annual family income. Many of the new entrants into the home mortgage market were classified as sub-prime (high risk) borrowers. The percentage of sub-prime mortgage loans in the U.S. rose from 5% to 20% between 2002 to 2006.

How did U.S. banks respond to these developments?

Domestic U.S. banks, of course, set higher interest rates for sub-prime loans. Unwilling to take these risks on their own balance sheets, many originating banks began to "securitize" these risky loans, selling them off in packages to other financial institutions who were attracted by the relatively high interest rates. Investment banks like Lehmann Brothers acted as trading intermediaries, buying packages of securitized sub-prime mortgage loans and then re-selling these packages, for a fee, to domestic and foreign financial institutions and pension funds.

A relatively new financial derivatives market (credit swaps) developed during this period that allowed banks and traders to buy insurance or to speculate on movements in bond ratings and credit risk associated with publicly traded debt instruments. This market, in contract value, grew from \$1 trillion in June 2001 to \$57.8 trillions in December 2007 (\$57.8 trillions is a very large number: \$57,000,000,000,000).

So what went wrong?

Compensation packages for senior executives of the large global banks are most commonly paid through common stock price options. Stock options provide senior managers with high upside potential if risky strategies result in rising stock prices. At the same time, these executives do not share the potential loss in shareholder value if their risky investment strategies result in decreased stock market prices. Options are the only financial instrument whose values increase with an increase in risk.

So, we have created a classic agency problem dilemma. Senior bank executives have an incentive to take on more risk than what would normally be desired by their equity shareholders. They can gain from the up-side potential of risky investment strategies but are protected personally from sharing in the downside shareholder losses from these risky strategies if their strategies fail. Re-enforcing this risk-taking behaviour is the historical record of governments to bail-out financial institutions that take on too much risk, make bad bets, and then pose a threat to the collapse of the domestic or global financial system.

In the current crisis, the bond rating agencies also contributed to the problem by not assessing properly the risks associated with sub-prime securitized packages of U.S. consumer mortgage loans.

The bank originators of sub-prime mortgage loans also deserve some of the blame. Knowing that they would not take these risks on to their own balance sheets, they had little short-term incentive to engage in costly due

diligence of the risks and proper pricing for these loans.

How have the various players fare out to date?

As examples, consider U.S. homeowners, large global commercial and investment banks, common equity owners, the bond rating agencies, and the general public.

During 2007 to 2008, the speculative market in the U.S. home prices burst with average house prices falling already about 30% from 2006 peaks. Because U.S. mortgage loans are asset-based loans with limited liability, many U.S. homeowners have defaulted on these loans rather than continue to meet their mortgage interest payments.

The banks then take ownership of home assets whose current market value is often less than the book value of the loans that are on the bank balance sheet. With mark-to-market accounting rules, the banks must re-state the value of these loans on their balance sheets at the lower of initial book and market value. Bank liabilities are relatively unaffected, so the book value of bank equity is reduced, leaving the banks deficient in the amount of risk-adjusted capital required by bank regulators.

The size of the required bailouts is unprecedented. The U.S. government has already injected \$45 billions to shore up Citigroup's equity position while committing to guarantee \$275 billions of toxic Citigroup assets. In addition to equity fund infusions from Singapore and the Middle East, the Swiss central bank has injected \$60b of new funds into UBS. Lehman Brothers, under the weight of \$70b of inventory of sub-prime loans, was allowed to go bankrupt.

On a global basis, the value of common equity shares has fallen by more than 40% during 2008. For the U.S. S&P index of shareholder returns from common stock price investments in industrial companies, 2008 returns to date are the second worst ever since 1825 – competing with 1931 for first place.

The U.S. bond rating agencies have lost global credibility for the high credit ratings given by them to credit swap instruments and securitized mortgage loan packages.

Many economists believe that unemployment rates will surge to 8-10% in the U.S. and some European countries during the current recession. The days of liberal access to cheap credit is over for many American consumers.



Clearly there's much more capital flowing around financial markets than there has been ever in the past. Can we talk a little bit about this dynamic and the challenges it poses?

The global economy is much more interconnected today than at any time since the end of the Second World War. Central to this development has been the large increase in trade and capital flows that has supported healthy worldwide GNP growth as well as redistribution of capital and investments and differential growth rates between countries.

Interdependence means that financial crises in one part of the world spread easily into regional or global crises. The Asian crisis of 1997, sparked by Thailand's devaluation of the baht, had profound regional impacts and significant spill over effects on global industries with high export volumes to the region. The current crisis has already spread to Europe's real economy sector as well as to the financial sectors in Asia and the Middle East.

The first challenge is how to secure co-ordinated global actions from many

central banks and governments and to avoid succumbing to anticipated populist pleas for protectionist policies that would reel back the gains made over the last few decades to establish a truly global village for finance and trade.

The second challenge will be to restore global confidence in the free enterprise model that currently needs fixing but remains our best hope for future prosperity and upward social mobility.

The third challenge is more geo-political. China and Russia have replaced Japan as bankers for the U.S. society of debtors. Unlike Japan, China and Russia are likely to press for more political influence in the global economy as a pre-condition for their continued support. Is America willing to share more power gracefully with these countries in institutions like the United Nations, the World Bank, and the International Monetary Fund?

How long will it take to develop capital markets, to fix the current crisis?

The reality is that the financial markets in both mature and emerging economies are moving in tandem during this crisis. Lost in this development is the power of diversification of risks that prompted many investors to internationalize the composition of their portfolios of both financial and real assets. Risks that cannot be diversified away are increasing and the conventional textbook wisdom that equity markets, for example, only price for non-diversifiable (systematic) risk, is being challenged. What is happening this year is similar to what we observed in the meltdown of global equity prices in October of 1987 when total risk, in addition to systematic risk, was being priced in the equity markets.

In the long-run, in a more stable environment, I am convinced that equity markets will revert to pricing systematic (non-diversifiable) risk rather than total risk. More difficult to predict is how long the short-term pricing of total risk will persist.

Central bank efforts to orchestrate artificial low interest rates will not be

sufficient to calm financial markets or to stimulate rapid economic recovery. In this regard, consider Japan's "lost decade of the 1990's" following a collapse of speculative Japanese real estate and equity prices. The central bank brought interest rates down to close to zero percent with little positive effect.

Regulators will strengthen capital requirements for beleaguered commercial and investment banks, potentially requiring even larger bail-outs to allow commercial banks to comply with the new requirements.

I am less confident that the regulators will effectively reform bank risk assessment, risk pricing, and internal risk control systems which have contributed now to a disturbing series of major financial crises over the last four decades.

When do you think the investors will come back? Could we assume that the stock market will anticipate sooner?

The U.S. equity market has been characterized by long market cycles. We are coming off a bull market period that has extended from 1983-2007 (with some correction in 2000). The last U.S. bear market lasted 16 years from 1966-1982.

Long stock market price cycles have been observed in other mature national stock markets. We do not have long time series of data for most emerging country stock market indices. I think we will see lower than normal equity market returns over the next decade. Equity markets typically respond with upward stock price increases before we exit from a recessionary period. For the short cycle, we should expect this to happen again.

Do you think the situation will worsen over the following months? How long will the crisis last?

Fear is driving the equity markets today and we do not have theory to guide us here. I expect continued high volatility in intra-day stock price movements in the

short-term. Data now available confirms that the U.S. economy has been in recession for nearly a year with Europe largely in recession for the last 6 months. The Asean economies, particularly China, show reduced growth rates but not recession.

The U.S. economy is driven by consumer spending with 72% of U.S. GDP, in 2007, originating from consumers rather than coming from business and government spending. As American consumers continue to cut back on discretionary spending, the economic situation there will worsen during 2009. While the U.S. government may accelerate spending on social infrastructure projects to reduce unemployment (e.g. highway and bridge repairs), these investments will have mainly long-term rather than short-term demand stimulus effect.



Similar signs of collapse of consumer confidence are evident in Europe.

I see three possible scenarios for the length of the current crisis. The first and most likely scenario would see the end of the recession in very late 2009 or early to mid 2010, with unemployment levels

peaking at between 8-10% in the mature Western economies.

The second, but still feasible scenario would be a period of more than five years characterized by negative and then very low growth, similar to Japan's "lost decade" of the 1990's.

The third and most unlikely scenario would be a global depression similar to what we experienced between 1929 and 1933. I think we have learned enough from history to avoid this scenario.

Which industry sectors and consumer groups will be the most affected?

The commercial banking sector is likely to see consolidation through mergers and acquisitions rather than significant bankruptcies. Higher capital requirements in this industry and new restrictions on product class development (e.g. financial derivative products) are likely to reduce levels of bank profitability and executive compensation in this sector.

Hardest hit will be industries characterized by high levels of financial leverage and heavy balance sheet requirements for net working capital and net fixed assets. The automobile sector, both suppliers and manufacturers, is most vulnerable by these criteria. The most affected countries will be the U.S., Germany, and Japan where the automobile sector constitutes a very significant proportion of manufacturing jobs. We can expect global consolidation in this industry with the U.S. companies in the weakest position to survive unless they are also bailed out by the U.S. government in what would be viewed globally as a decidedly national protectionist declaration.

Industries that rely on discretionary consumer expenditures will have a difficult time as consumers make difficult choices on where to cut back on expenditures. Typical industry examples would be automobiles, clothing, personal care, restaurants, luxury goods, personal computer up-grades, and home furnishings. We should expect numerous bankruptcies in these sectors.

Service businesses with light balance sheets that are mainly people dependent (e.g. consulting companies, accounting companies, advertising agencies) will need to restructure and downsize, but have higher chances of surviving even if demand falls for their services.

The consumer group most affected will be those approaching retirement or in early retirement years who have invested heavily in financial assets and now find the value of these assets seriously eroded. I think that this group is least likely to reduce expenditures on health, housing, and heating.

How should companies act in this situation?

There will be short-term cost reductions, down-sizing, consolidation, and re-shaping of some industries. The advantage will go to companies that are currently "cash-rich", have businesses that are "cash cows", and are not dependent on significant infusions of debt or equity to support their business model objectives.

Flexibility to adjust the business plan, speed of decision-making, and new approaches to strategic decision-making will separate winners from losers.

I agree with Hugh Courtney (McKinsey Quarterly Interview, December 2, 2008) that we have moved away from clarity of future outcomes that impact on corporate strategy choices. There is no single view of the future. There is no limited set of possible future outcomes with assurance that one of these outcomes will occur. There is not even a clear range of possible future outcomes. Rather, we face today true uncertainty – not even a predictable range of possible future outcomes.

With such uncertainty, companies must entertain a broader and more radical set of possible future industry outcomes, develop scenarios of the implications of many of these uncertain outcomes, continuously up-date market intelligence from higher and lower levels within the organization, devote more frequent top-

management time to strategy reconsideration, and to act ahead of others based on changing industry developments. This is not the time to be an industry bystander, waiting for things to happen.

Many people could see it coming, but still many governments and economies weren't prepared for it. I would appreciate your view on this.

We did not fully anticipate the magnitude of the sub-prime mortgage problem affecting U.S. and European financial institutions, the severity of the likely recession in the U.S. and Europe, or the size of the global bail-out of financial institutions needed to prevent a repeat of 1929-1933.

The history repeats itself. What have the governments learnt from the past financial crises?

Not enough in my view. They continue to bail-out the financial institutions without containing excessive risk-taking by financial institutions. This is enough to prevent another great depression or complete collapse of the global financial system. But, it is not enough to curb excessive risk-taking or inadequate risk pricing and risk control systems by large global financial institutions who have come to expect that they will be bailed out if they create a significant threat to the functioning of the domestic or global financial markets

What should the business learn out from this current crisis?

- **financial institutions and investors**
- **managers in the "real" sector**

Financial institutions need to improve their risk assessment and risk pricing models as well as their internal risk controls. Unfortunately, a generation of investors is likely to become more risk averse, and sceptical of the long-term advantage of equity investments.

"Real sector" managers will learn again that debt capacity is proven in bad times, not in good times. Cheap equity

prices will spur M&A activity originating from the financially strong players.

In Chinese language the word "crisis" also means "opportunity". Who will be the winners when this crisis is over? How should the business turn this crisis into opportunities?

Crisis does create opportunities. As an example, "it was during the recessionary 1870's that Rockefeller and Carnegie began grabbing dominant positions in the emerging oil and steel industries by taking advantage of new refining and steel production technologies and of the weakness of competitors" (Lowell Bryan and Diana Farrell, McKinsey Quarterly, December 2, 2008).

At some point, equity prices will bottom and the variability of daily stock price movements will begin to stabilize, creating lifetime "bargains" for long-term equity investors.

Some industries will be re-shaped. The winners will be companies with strong balance sheets and flexible approaches to strategic thinking.

With the crisis most acute in the U.S. and Europe, contraction of foreign investments from this geographic sphere will create opportunities for new and local "Rockefellers" to re-shape industry structures in emerging markets like China and India.

Most small and middle-sized American and European companies will focus on survival. Cost-cutting will not be enough for many of these companies to survive.

Globalization already faces some very serious challenges, and it seems like the current crisis has emerged as potential death knell. Prof. Joseph Stiglitz, the Nobel Memorial Prize winner, recently wrote in one of his articles that this crisis marks the end of neoliberalism. Is there a possibility of something really new, a new-better globalization? I would appreciate your comment on this.

I do not see a death knell. Capitalism does produce business cycles but rewards risk-taking over the long-term. There are things to fix here, but this model has produced long-term growth and opportunity over much more than a century.

The biggest risks will come from social discontent (Bangkok and Mumbai most recently as examples) and if national governments revert to protectionism or excessive regulation of economic activity.

Capitalism and the vision of a truly global economy with more equal distribution of wealth and prosperity are not dead or incompatible. There is much to do, however, to create the preconditions, in particular, for more equal distribution of global opportunity and wealth sharing across and within nations.