BETWEEN A ROCK AND A HARD PLACE

GAVIN KEETON TAKES AN ECONOMIST'S TOUR OF THE CURRENT CRISIS: HOW DID IT HAPPEN AND WHAT DOES IT MEAN?

An economist inspecting current economic data without any knowledge of recent events could be forgiven for concluding that the world is either in the midst of a major global war or is suffering the consequences of an extraordinary global natural disaster. Industrial production in a wide range of countries is down by 10 to 25% compared to a year ago. Volumes of trade between countries have plunged, and global economic growth in 2009 is likely to be the worst since the end of World War 2.

That same economist would further discover that the economic crisis was, in fact, self-inflicted; even more extraordinarily, that it originated in the astonishingly risky actions of the banking sector, a sector for so long considered to be the epitome of caution and sound business practices.

The banking sector is the oil that keeps the engines of modern economies running. In addition to processing our daily payments, banks provide us – and, importantly, businesses – with the credit on which modern economies operate. Businesses borrow money to buy stock, which they then sell to build new factories and production facilities. Households borrow via credit cards to buy houses and cars as well as everyday items. Remove that credit and large parts of the economy grind to a halt.

In recognition of their importance, banks are treated differently from other sectors of the economy. Special banking rules and regulators are supposed to prevent precisely the events we have witnessed. But these regulations have now been exposed as inadequate for an increasingly sophisticated and global financial system.

The trigger of the current crisis was the sub-prime debacle in the United States. Sub-prime is lending to people not normally considered creditworthy. How was it possible that more than $1-trillion could have been lent to people who could not pay it back?

The popular media is quick to point fingers at greedy bankers as the cause. From some of the commentary, one would think that innocent poor people were forced to borrow money they did not want. But, of course, the truth is rather more complicated.

The first cause of the explosion in sub-prime lending was well-intentioned government legislation which attempted to force banks to lend more to the poor. This coincided with rising prices and a (foolish) belief by many in the banking sector that house prices would never fall. It followed that mortgage lending to borrowers with poor credit rating was no longer risky as the houses of defaulters could always be repossessed and the bank's money recovered. Packages of US mortgages – now deemed low-risk – were then on-sold to banks and pension funds around the world. Thus it was that when the sub-prime crisis burst, its earliest manifestations were in such unlikely places as Australian pension funds and German regional banks rather than the US.

Sub-prime loans were granted at historically very low interest rates in the US following the bursting of the dotcom stock market bubble and the 9/11. As interest rates rose back to more normal levels so an increasing proportion of subprime borrowers defaulted on their loans. House prices began to fall and banks discovered what their predecessors already knew – that when there are no buyers a repossessed house actually has no value. As a result an increasing number of banks around the world found themselves in financial trouble. Central banks quickly came to their rescue, pumping billions of dollars into national banks to prevent them from collapsing. In extreme cases banks were nationalised to prevent them from closing. But even rescued banks no longer had the means or desire to lend to households or firms and the credit stream, which had supported almost a decade of rapid global economic expansion, was switched off almost overnight. The global economy was suddenly in the worst recession since the Great Depression of 1929.

In South Africa it was initially believed that high commodity prices would sustain domestic economic growth and export levels. In addition, the fact that domestic banks – thanks to prudent banking regulation, tight lending conditions imposed by the National Credit Act and exchange controls – had almost entirely escaped the sub-prime woes was expected to shield the domestic economy from global woes. Finally, the massive public-sector infrastructure rollout was expected to underpin domestic investment. Subsequent events have shown that this view was unrealistically optimistic. South Africa's GDP contracted by 6.4% on a seasonally-adjusted annualised basis in the first quarter of this year, confirming that the economy is now officially in recession.

Moreover, the pace of the decline is much more dramatic than could ever have been previously imagined. Manufacturing production plunged -22% annualised in the first quarter and mining output declined a staggering -33%, confirming the extent to which the slowdown is driven by the collapse in demand for exports. But consumer spending is also very weak as a consequence of previously high interest rates and rapidly falling employment levels.

Fortunately there is light at the end of the tunnel. There are signs that the huge amounts of liquidity injected by the global central banks is starting to flow through into renewed lending. Governments also sought to underpin domestic spending through increased spending themselves and by tax cuts. While economic activity remains very weak in most countries there are signs that if economic activity has not yet started to improve it has at least stopped contracting. In South Africa, economic activity has been underpinned by a larger government deficit, infrastructural spending and significant cuts in interest rates. But consumer spending remains very weak as heavily indebted households continue to feel the impact of previous interest rate hikes and job losses.

The extent of the policy response globally (support for banks and fiscal stimuli) has been such that a repeat of the Great Depression seems unlikely. Most commentators see a pickup in the global economy in the second half of this year or the first half of 2010. Such a recovery will be important to South Africa as exports will recover only when the global economy strengthens.

Importantly, however, the global policy response has been financed by incurring huge increases in government debt. These will need to be repaid if future generations are not to be burdened with paying for the folly of the current generation and this repayment will be a damper on economic activity for years to come. In South Africa, the budget deficit has already risen sharply, mainly as a result of weakening tax revenue, even before any of the spending promises of the new ANC government could be implemented. The room for manoeuvre on the fiscal front has therefore already been significantly reduced.

September 2008

16 September
The US Federal Reserve announces an $85bn rescue package for AIG, the country's biggest insurance company, to save it from bankruptcy. AIG gets the loan in return for an 80% stake in the firm.

17 September
Lloyds TSB announces it is to take over Britain's biggest mortgage lender HBOS in a £12bn deal creating a banking giant holding close to one-third of the UK's savings and mortgage market. The deal follows a run on HBOS shares.

25 September
In the largest bank failure yet in the United States, Washington Mutual, the giant mortgage lender, which had assets valued at $307bn, is closed down by regulators and sold to JPMorgan Chase.

28 September
The credit crunch hits Europe's banking sector as the European banking and insurance giant Fortis is partly nationalised to ensure its survival. In the US, lawmakers announce they have reached a bipartisan agreement on a rescue plan for the American financial system. The package, to be approved by Congress, allows the Treasury to spend up to $700bn buying bad debts from ailing banks. It will be the biggest intervention in the markets since the Great Depression of the 1930s.

29 September
In Britain, the mortgage lender Bradford & Bingley is nationalised. The British government takes control of the bank's £50bn mortgages and loans, while its savings operations and branches are sold to Spain's Santander. The Icelandic government takes control of the country's third-largest bank, Glitnir, after the company faces short-term funding problems. The US House of Representatives rejects a $700bn rescue plan for the US financial system – sending shockwaves around the world. It opens up new uncertainties about how banks will deal with their exposure to toxic loans and how credit markets can begin to operate more normally. Wall Street shares plunge, with the Dow Jones index slumping 7% or 770 points, a record one-day point fall.