Going fiscal

If "sub-prime" and "crisis" were the most Googled words in 2008, then "bailout" and "fiscal stimulus" are expected to be the frontrunners in 2009. The credit crisis spawned a major upheaval in 2008, resulting in huge bank and institutional failures, as financial markets crashed globally and developed economies hurtled towards a recession. In what can be described as the worst financial crisis since the Great Depression of the 1930s, the governments around the world have been forced to step in to rescue their respective economies from plunging deeper into the abyss.

In a typical recessionary scenario, over the last 25 years, the role of the central bank and its monetary policy was key to economic recovery. However, these are unusual times, and they demand unusual measures. As the central bank runs out of options today, the government's role is two-fold—aggressively allocating taxpayers' money to bail out failing banks and institutions and, at the same time, implementing a fiscal stimulus package to increase jobs and spur consumption in an effort to arrest the economic contraction. Before we cover both these issues in detail, let us briefly touch upon the origins of the current financial crisis and how it came to such a pass.

Origins of the financial crisis

The origins of the current global financial crisis can be traced back to the bursting of the US housing bubble and the subsequent fallout of sub-prime lending in 2007. An undervaluation of real risk in the sub-prime market and the use of complex financial derivative instruments by financial institutions worldwide rippled through and eventually impacted the world economy adversely, resulting in contracting liquidity in credit markets.

The crisis started after the US housing bubble burst when interest rates rose, resulting in high default rates on "sub-prime" and adjustable or floating rate mortgages (ARM). The sub-prime crisis can be traced back to loan incentives and rising housing prices which encouraged borrowers to assume difficult mortgages on the belief that they would be able to quickly refinance these at more favorable terms.

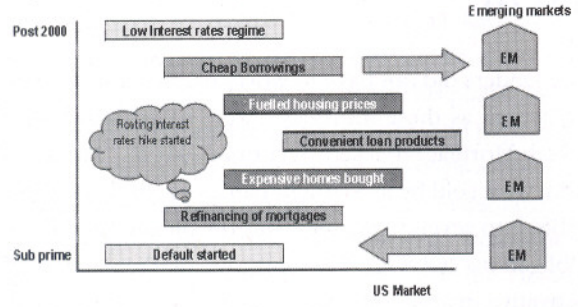
The lenders did not have to worry much about the risk of default as these mortgages were rolled into bonds called Mortgage-Backed Securities (MBS). These, in turn, were sold by investment bankers who sliced these MBS' into several 'tranches' called Collateralized Debt Obligations (CDOs). The objective of these financial derivative instruments was to create some higher risk assets and some much safer ones by slicing up the MBS into equity (high risk), mezzanine (middle risk), and the much sought-after investment grade bonds (low risk).

Investors in MBS and CDOs could insure against credit risk by buying credit defaults swaps (CDS). Everything seemed hunky-dory initially, but as defaults on mortgages increased, the entire system went for a toss. As mortgage defaults rose, the likelihood that the issuers of CDS would have to pay their counterparties increased. This created uncertainty across the system, as investors wondered if CDS issuers would honor their commitments.

The parties involved in these transactions were, typically, well-established investment banks, financial institutions, hedge funds, investors, and insurers. All these parties were sucked into the turmoil as the US housing bubble got pricked. As the sub-prime crisis began to unfold, it became increasingly evident that banks' balance sheets may be filled with "toxic" sub-prime assets which found no takers and was difficult to value. As a result, these institutions were forced to declare huge mark-to-market losses, shaking the very foundations of their existence.

As losses began to mount, investment banks and hedge funds started selling their more liquid investments in the emerging markets to meet their financial commitments. The result—a global stock market meltdown that later spilled over into the real estate and commodity markets. Moreover, with banks holding on to their cash dearly in the face of mounting losses, there was a severe global credit squeeze as liquidity dried up from all the corners of the global economy.

Figure 1: The sub-prime adventure



US financial crisis: Bailouts unlimited

Truer words were never spoken when someone once said, "When the US sneezes, the rest of the world catches a cold." Those who believed in the "decoupling theory"—that emerging markets are less dependent on the US—were made to eat humble pie as the financial upheaval, which emanated in the US housing market, spread to each and every contour of the globe. The sheer scale of the crisis forced the US government to step in at a very early stage, and bailouts became a common refrain in the financial sector for top banks and financial institutions. Clearly, if the government had not stepped in, the possible institutional failures would have reverberated through the global financial system.

Bear Stearns was the first major investment bank to be bailed out by JPMorganChase in March 2008. While it appeared like the worst may have been over then, things came to a head in September 2008, when Merrill Lynch was bailed out by Bank of America (BOA), American International Group (AIG), the US insurance giant, was bailed out by the US government, and Washington Mutual (WaMu), one of the country's biggest banks, was bailed out by JPMorganChase. Other significant bailouts included the government's seizure of mortgage behemoths, Freddie Mac and Fannie Mae, in early September, and the partial bailouts of the Detroit "Big-Three" automakers. Lehman Brothers, however, couldn't find any takers and became the first major casualty, filing for bankruptcy. Clearly, the government had its hands full trying to prevent the country from hurtling into its worst financial crisis since the Great Depression of the 1930s. The result—the US 3Q GDP growth came in at -0.5% and the advance GDP estimate for the fourth quarter is -3.8%.

The financial crisis first spilled over into Europe, almost immediately after it erupted. For instance, the UK was forced to prop up Royal Bank of Scotland. Germany bailed out real estate giant Hypo, and the Netherlands and France bailed out Fortis. Many countries in Europe, particularly Eastern Europe, were adversely affected by the crisis as their respective currencies witnessed massive value erosion. The result—consumption was badly hit as developed nations simultaneously entered into a recession, sparking global recessionary fears. In such a scenario, bailouts, guarantee programs, reduction in interest rates and fiscal stimulus packages have come to be the order of the day around the world.

Prevailing global economic scenario

Euro-zone: With most of the Euro-zone economies falling prey to the crisis, the entire economy of the European Union grew by -0.2% in the second and third quarter. With Germany, the largest economy of the region, entering into a recession, the zone as a whole has been caught in a pall of gloom. Italy, too, is in recession and countries like Ireland and Spain are in trouble.

UK: The immediate impact of the US sub-prime crisis was seen in the UK housing markets, which fell more than expectations, dragging the economy down further. The HBOS 3-Month House Price Index dropped 16.2% Y/Y in 2008 while unemployment surged to 6.10% from 5.20% in 2007. For all practical purposes, the UK is technically in a recession, having recently grown negatively for two successive quarters.

Germany: It is the largest economy in the Euro-zone that has technically entered into a recession. Germany has seen two successive negative GDP numbers of -0.5% and -0.4% in Q3 and Q2, respectively. Its exports were severely hit, resulting in an overall slump in industrial activity. Germany's industrial output was down 6.4% Y/Y in November, while consumer confidence has been at its five-year low.

Iceland: As the crisis hit Europe, the Icelandic krona shed almost 40% of its value against the euro, with inflation running at 14%. With large banks dependent on foreign debt, the depreciation of the currency squeezed resources, putting further pressure on banks. Iceland is potentially bankrupt and economists expect its GDP to shrink at least 10%.

Japan: As the Japanese economy is export-oriented, the global economic slowdown has hit the nation hard. The recessionary scenario in developed countries, such as the US and Euro-zone, which constitute the major buyers of Japanese products, resulted in shrinkage in the nation's trade. Exports to the US and EU fell 15.4% and 11.2%, respectively. In addition, major Japanese banks were listed in the creditors' list of Lehman Brothers, a huge blow to the banking sector. Aozora Bank was listed in Lehman's filing as the largest bank lender to Lehman Brothers Japan, with $463 million in loans. Shinsei Bank had $363 million, and Mizuho Bank had $289 million. On November 17, 2008, the Japanese Economy Minister announced that the nation was officially in a recession.

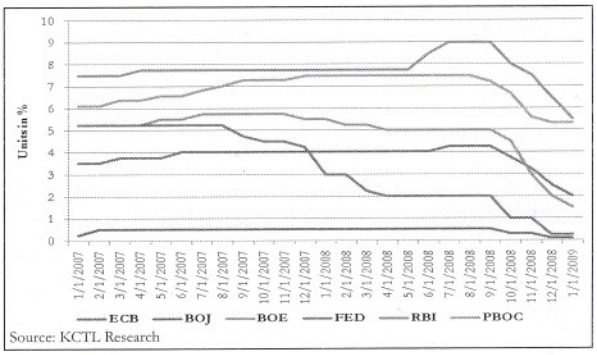
Asia: While Asian economies have had limited exposure to US sub-prime, these markets witnessed heavy sell-offs as foreign institutional investors (FIIs) pulled out their money to meet financial commitments and redemption pressures, and avert further risk. It must be remembered that FIIs had played a key role in the worldwide asset boom in the early part of the decade, triggered by aggressive Fed interest rate cuts, which saw huge liquidity flowing into emerging markets like India and China.

With the global economy slowing down considerably, commodity prices plummeted to multi-year lows in the latter half of 2008, after witnessing a spectacular rally in the first half of 2008. The global demand concerns and increased attraction of the US dollar as a safe-haven asset resulted in a worldwide commodity meltdown. Countries that were largely export oriented were badly hit, as the US, Europe and Japan simultaneously entered into a recession. World trade began to shrink with economies posting a steep decline in the GDP, while banks' reluctance to lend money curbed consumption. The overnight financing rate spiked and investor confidence plummeted. Industry suffered as profits declined amid lower sales and demand, resulting in huge layoffs across the globe.

Monetary policy: Little impact

Central banks implemented aggressive monetary policy with a string of interest rate cuts to pump liquidity into the financial system, restore confidence and revive economic growth. Central banks worldwide took a proactive stance and reduced interest rates aggressively. For instance, the US Federal Reserve reduced its target lending rate to the 0-0.25% range, the European Central Bank (ECB) reduced it to 2%, down from 4% in January 2008, the Bank of England cut its bank rate by 400 bps to 1.5%, China reduced its interest rates by 216 points, among others. However, despite being aggressive, central banks' moves failed to improve the credit crisis as banks preferred to hoard the money released into the financial system than lend it out. In a nutshell, monetary policy, which has been quite a success in the last 25 years, was just not good enough in these turbulent times.

Figure 2: Chart showing trends in interest rates of Euro, Japan, UK, US, India and China



Source: KCTL Research

Given the scale of the crisis, it became increasingly evident that monetary policy could do little on its own and the government had to step in. The government responded by announcing a mammoth $700-billion bailout package, aimed at buying the troubled mortgage assets of banks or buying a stake in these banks or a combination of the two. By the end of November, the US government had committed $8.5 trillion, or more than half the value of everything produced in the country in 2007, to save the financial system. The EU earmarked more than $3 trillion to guarantee bank loans and provide capital to lenders. Meanwhile, China unveiled a $586-billion fiscal stimulus plan and its biggest interest-rate cut in 11 years.

Nevertheless, the trillion-dollar bailouts, record-low interest rates, and open market operations have been

Table 1: Government relief/bailout programs

Country	Authorized program size (BLNs)	Initial date of eligibility	Final date of eligibility	Term of guarantee
Australia	No limit	11/28/2008	Not disclosed	5 years
Austria	€100	10/20/2008	12/31/2009	5 years
France	€320	10/16/2008	12/31/2009	5 years
Germany	€400	10/17/2008	12/31/2009	3 years
Hong Kong	HK$10	12/15/2008	6/15/2009	6/30/2012
Ireland	€485	9/30/2008	9/29/2010	9/20/2010
New Zealand	No limit	11/1/2008	Not disclosed	5 years
South Korea	US$100	10/20/2008	6/30/2009	6/30/2012
Spain	€100	10/31/2008	12/31/2009	3 years
Sweden	SEK1,500	10/29/2008	4/30/2009	5 years
UK	£250	10/31/2008	12/31/2009	3 years
US - TARP	US$700	10/14/2008	Not disclosed	Not disclosed
US - TALF	US$200	11/25/2008	12/31/2011	3 years

Source: Bloomberg.

Table 2: Losses and job cuts

Particulars	Loss (US$ billion)	Job cuts
Region-wise		
Worldwide	799.7	2,56,312
Americas	494	1,68,273
Europe	275.6	83,619
Asia	30.1	4,420
Company-wise		
Wachovia Corporation	97.9	8,393
Citigroup	85.4	38,900
Merrill Lynch	55.9	6,120
UBS	48.6	9,000
Washington Mutual	45.6	9,200
Bank of America	40.2	46,150
HSBC Holdings	33.1	4,598
JPMorganChase	29.5	7,100
National City Corp.	26.2	4,900
Morgan Stanley	21.5	10,993
Wells Fargo	17.3	500
Lehman Brothers Holdings	16.2	13,390
Royal Bank of Scotland	14.4	11,020
Credit Suisse Group	13.7	7,420
Bayerische Landesbank	13.5	5,950

Source: Bloomberg.

unable to deter the global recessionary fears. All leading economic indicators point towards further slowing down of economic activity worldwide, evident from the latest forecast made by the International Monetary Fund (IMF). The IMF now sees global growth slowing down from the projected 3.7% in 2008 to 2.2% in 2009. Both advanced and emerging nations are expected to witness a significant downturn in economic activity.

Fiscal policy: The right option in the current scenario?

Given these unusual times, economists are grappling with a barrage of questions? Has monetary policy lost its importance in the current scenario? Should monetary policy be used in conjunction with fiscal policy? Should greater importance be given to fiscal policy and government spending? Can the government afford to be wasteful? Why has monetary policy failed on its own when it had done so well in the last 25 years? Where do we draw the line when we go on an aggressive interest-rate cutting measure? Are the policymakers aware of the epidemic that is aimed to be cured? Which is the more accurate diagnosis for the problem? As economists debate over these questions, it has pitched the two schools of thought—the Chicago school of monetarists (monetary policy) versus the Keynesian school (fiscal policy)—against each other.

With the slowdown deepening and monetary measures doing little to rejuvenate economies, the governments around the world are now gearing up for massive fiscal stimulus plans. Keynesian (named after the legendary British economist, John Maynard Keynes) economists favor economic growth through tax measures and increased public or government spending. Government spending in infrastructural projects would result in job creation and, used in conjunction with the tax reduction, would increase disposable incomes, consumption and growth.

Typically, the scope for implementing an effective fiscal policy is greater for countries with lower existing fiscal deficits, but given that we are moving towards a deflationary environment, these textbook rules do not really apply today. Moreover, countries like China have a young, growing population, huge forex reserves, and a current account and budget surplus, resulting in greater leeway for a huge stimulus boost. The scope of a short-term stimulus is also applicable to the US, although the country runs the world's biggest current account deficit. This is due to the fact that US dollars and treasuries are considered as a safe haven during uncertain times.

In these tumultuous times, economists believe that government spending should not be perceived negatively, and you are better off implementing a fiscal stimulus plan, rather than not implementing one at all, citing the damage caused to Japan due to its prolonged slump in the 1990s. Moreover, it is recommended that short-term increases in the budget deficit caused by a stimulus package be offset by deficit-reduction measures gradually over time. The scale and mix of a fiscal stimulus will differ by country. For instance, in the US, federal aid to the states makes a lot of sense while Europe and China should look for value-added tax cuts and increased social spending, respectively.

Table 3: Global debt map

Region	Amount (US$)
North America	7 trillion
South America	346 billion
Central America	475 billion
Western Europe	12 trillion
Pacific Rim	3 trillion
Eastern Europe	140 billion
Central Asia	139 billion
Africa/Middle East	218 billion

Source: Bloomberg.

Table 4: Fiscal packages announced

Country	Amount
European Union	€200 billion
Germany	€81 billion
UK	$29.91 billion
Hungary	$6.9 billion
Spain	€38 billion
Sweden	$1 billion
France	€26 billion
Japan	> $550 billion
China	$586 billion
India	$4 billion

Source: Bloomberg.

The world economy is weakening at a brisk pace today, and across the globe, falling asset prices, tighter credit, and declining confidence have left firms and consumers unable or unwilling to spend and invest. Clearly, voices favoring a fiscal boost to solve the deepening recession have reached stratospheric levels. A summary of fiscal relief programs by a few countries is shown in Table 4. As we go to press, the US is on the verge of getting approval for its $819-billion fiscal stimulus plan while Japan is also evaluating a stimulus injection worth $55.2 billion.

Highlights of a successful fiscal stimulus plan

To be efficient, a fiscal package should maximize the amount of near-term stimulus per dollar of increased federal expenditure or lost revenue. To be effective, a stimulus package should be implemented quickly and structured so that its effects on aggregate spending are felt as much as possible within the next twelve months. The fiscal measures that involve long lead times or result in additional economic activity only over a protracted period, whatever their intrinsic merits might be, will not provide the desired stimulus when it is most needed.

Tax cuts provide cash to consumers, but people may choose to save the money or spend it on imports. According to Lawrence Summers, a US economist, stimulus measures must meet three basic tests to be effective, namely, timely, targeted, and temporary. Timely measures are those that stimulate new spending quickly so that businesses do not have to cut back on production or lay off workers due to weak demand. Targeted measures are those aimed at individuals and entities that will spend quickly the bulk of any new resources they receive while temporary measures are those that expire once the economy improves.

"Bang for the buck" is a good way to assess a stimulus proposal—that is, how much immediate spending boost it would deliver for each dollar it costs. During a debate in 2002-2003 over stimulus packages, economist Mark Zandi of Economy.com evaluated various stimulus options in terms of their effect on the economy in the first year after enactment.

While economic conditions have changed since then, Zandi's rankings continue to provide a useful assessment of the relative value of various measures in generating economic stimulus. They indicate that temporarily strengthening unemployment insurance is among the most effective forms of stimulus because most of the additional unemployment benefits would be quickly spent. On the other hand, a dividend or capital gains tax cut would be among the most ineffective measures as much of it would be saved rather than consumed quickly.

Table 5: Bang for the buck

Particulars	Demand generated per $1 of cost
High "Bang for the Buck"	
Extend unemployment benefits	$1.73
Provide state fiscal relief	$1.24
Enact a one-time uniform tax rebate	$1.19
Increase Child Tax Credit	$1.04
Lower "Bang for the Buck"	
Adjust Alternative Minimum Tax exemption levels	$0.67
Reduce marginal tax rates	$0.59
Increase tax breaks for small business investment	$0.24
Cut taxes on dividends and capital gains	$0.09
Reduce estate tax	$0.00

Source: Mark M. Zandi, "Assessing President Bush's Fiscal Policies," Economy.com, July 2004; "The Economic Impact of the Bush and Congressional Democratic Economic Stimulus Plans," Economy.com, February 2003.

What lies ahead for commodities?

The global economic slowdown resulted in a huge commodity meltdown last year, with metals and crude oil prices hitting multi-year lows. The demand from advanced and emerging nations fell drastically as consumers cut spending and banks refrained from lending. Given that monetary policy has shown little impact, the main question before policymakers, economists, and investors today is whether fiscal measures will be enough to rejuvenate demand and restore consumer confidence in markets, in general, and commodity markets, in particular.

According to Mr. Madan Sabnavis, Chief Economist, National Commodity and

Derivatives Exchange Ltd. (NCDEX), "Fiscal policy is the best way to regenerate demand in the markets as lower interest rates cannot deliver adequately." Mr. Sabnavis believes that fiscal stimulus will provide the right direction and, to have a major impact, large packages which are inter-related are essential.

Dr. V. Shunmugam, Chief Economist, Multi Commodity Exchange of India Ltd. (MCX), is of the opinion that a fiscal stimulus in growing and populous economies like India and China (as against Western nations) will be more important for the commodities sector. He feels that demand for commodities would return any time if appropriate measures are taken up by these Asian countries on both the monetary and fiscal front. He adds, "As the economic output of the nations recover and as the confidence of the stakeholders increase, commodity prices could very well take a U-turn."

As far as demand from emerging markets are concerned, especially India and China, these remain a beacon of hope for the developed nations. Economists feel that there are less chances of these nations' growth turning negative, with India being relatively better-off than others. India's economic growth is largely dependent on the domestic sector and a reasonable growth can be expected in the near term. China, on the other hand, is dependent on infrastructure and exports and its economy is likely see a greater downturn in the near future.

Conclusion

Like the Israelites seeking "manna from above", the world markets are yearning for a stimulus to survive the current turmoil. Given the global economic crisis, the all-important question is whether fiscal or monetary policy or a combination of the two would revive global economic growth. According to Mr. Sabnavis, "Both fiscal and monetary policy needs to work in unison. Fiscal policy provides direct impetus, but beyond a point the monetary measures have to take over in terms of providing credit for investment."

Dr. Shunmugam believes that for developed nations fiscal measures have greater chances of reviving the sagging demand than monetary measures. According to him, monetary measures in developed nations would have the least effect as rates are already at rock bottom in real terms. "However, in countries like India, fiscal policy would have to be appropriately followed up by a healthy monetary policy (not-inflation targeted)."

Using monetary policy in isolation has done little to restore confidence in these cataclysmic times. On the other hand, timely implementation of fiscal stimulus packages is likely to boost spending and bring demand back to the markets. However, in our view, this fiscal package should be facilitated by an apt monetary policy, particularly for developing countries like India.

- Bhavana Glory, Vishal Maniyar and Satyan Nair