



# High vantage point nails the crux of the crash

## FINANCE

**THE GREAT CRASH OF 2008.** By Ross Garnaut with David Llewellyn-Smith. Melbourne University Press. 256pp. \$24.99.

Reviewer: **PAUL MALONE**

If you don't have a lot of time but want to get the crux of the great crash of 2008 you won't find a better short account than in this wide-ranging book. Ross Garnaut, with media consultant David Llewellyn-Smith, is able to view the global imbalances and greed that led to the boom and bubble from a high enough vantage point to provide the overall picture, while at the same time giving enough detail and anecdotes to support his arguments and maintain interest.

Garnaut is uniquely placed to analyse and assess the events. An economist by training, he was principal economic adviser to prime minister Bob Hawke in the 1980s and later appointed ambassador to China. He is a Distinguished Professor at the Australian National University and Professorial Fellow at the University of Melbourne. A company director and member of various research organisation boards, he was most recently the author of the *Garnaut Climate Change Review*. Perhaps because he is in Australia and far from the centre of events, Garnaut is able to see the world in perspective. He observes the growth of China, the global imbalances, the world property market boom, the stockmarket bubble, the deregulation fever, the greed and the bailout. Finally he explores what the world must do to prevent a repeat of the disaster.

This is not simply a story of United States housing financiers Fannie Mae and Freddy Mac fuelling a boom and then going bankrupt. But the housing bubble did play a big part. He notes that from 1995 to 2006-07 median house prices grew by 139 per cent in the US, 261 per cent in Britain and 169 per cent in Australia. Housing speculation was given a boost when the governments in all three countries altered their tax laws to favour capital gains, rather than income from other sources. Credit standards declined in both the US and Britain.

But other great movements were taking place too. In the first few years of the 21st century a flood of surplus savings found its way from East Asia and resource-exporting countries to the Anglosphere countries (a term Garnaut uses for the English-speaking US, Britain, Australia, New Zealand and Ireland, but also including Spain).

This lending enabled these countries to increase expenditure on private housing, consumption and government activities, and to reduce taxes beyond what was prudent. In Australia many private economists maintained that the imbalances of high current account deficits and foreign debt levels did not matter as they were generated in the private sector, and Australia had a floating exchange rate. Now they don't look so smart.

The US also ran up current account deficits and, after 2000, increased government spending on defence and cut tax, producing huge budget deficits. These imbalances were inflamed by the innovative "derivatives" that the financial sector invented. As Garnaut puts it, "Entire nations were freed to live beyond their means." Much of the world was transformed by the "shadow banking" system, made up of hedge and money market funds and investment banks. In the US the line between a proper bank and a shadow bank became blurred.

Traditionally, the proper banks – for example, the Commonwealth, National, Westpac and ANZ – were governed by laws that sought to ensure that they had sufficient capital and liquidity to cover their lending.

In the 1980s, under then-treasurer Paul Keating, bank regulations were eased and, Garnaut says, there followed a sharp reduction in lending standards as foreign and domestic banks battled for market share and income. In the recession of the early 1990s four major Australian banks suffered near-death experiences.

Australian regulators were left with a high sensitivity to banking risk. This shock may have helped keep Australia out of the worst excesses of risk-taking that followed elsewhere around the world.

Australian banks did not get into the securitisation, or the purchases of the packages of debts, in the way that the US and other overseas banks did. Garnaut says

only the National Australia Bank ventured deeply into the exotic securities market. Nevertheless, he says Australian banks were heading down the shadow banking track and may have been saved only by the arrival of the crash.

The US could well have a W-shaped growth curve – a slight recovery followed by another downturn

In many countries, including the US, extreme versions of libertarian economic thought facilitated the bubble. Former US Federal Reserve head Alan Greenspan had an unquestioning faith in self-regulation and self-correcting financial markets in the 20 years he headed the Reserve from 1987. Greenspan's appointment was the first in a series of top Washington economic posts given to Wall Street figures with a similar outlook. To his credit, since the crash, Greenspan has acknowledged flaws in his thinking on the workings of the free-market system.

Regulation rollback in the US saw the repeal of the Glass-Steagall Act which, among other things enforced a rigid separation between commercial and investment banking. Efforts to regulate the new derivative instruments were resisted, and in 2000 the Commodities Futures Modernization Act freed derivatives from regulatory scrutiny altogether. The Basel II accord on international banking allowed the Wall Street investment banks to raise the ratio of their debt to equity from 12 to 1 to 35 to 1.

Garnaut notes that regulatory capture, where government officials come from or adopt the views of the segment of the market they are supposed to be regulating, took hold.

And on top of that there was, of course, greed and corruption, producing among other things the Bernard Madoff Ponzi scheme, the largest fraud the world has ever seen. Senior executives also took huge payments for their achievements in generating short-term "shareholder-



value". After the crash the shareholders might not have been able to find the value but the executives had had their reward and few were willing to give it back.

The US Federal Reserve records the start of the crash as February 7, 2007, but Garnaut notes that nine months earlier US mortgage originator Merit Financial had gone bankrupt. The major financial institutions to find themselves in trouble have been well publicised, and much has been written about the actions of US authorities in deciding to save some and not others. "Too big to fail" was the cry as chairman of the Federal Reserve Ben Bernanke and Secretary of the Treasury Hank Paulson provided public funds to rescue private-sector firms.

The fear was that the whole capitalist financial system could come tumbling down as the realisation struck that poor-quality US mortgage loans had been bundled, packaged, diced, repackaged and sold from one institution to another worldwide. One firm had provided insurance for another. Firms had no accurate idea of the true worth of the securities and derivatives they had been dealing in. One thing was clear – they were not the AAA quality the rating agencies had claimed.

Governments around the world raced to secure their banks and prevent a run. But the banks now feared lending. By the end of 2008 people everywhere were aware they were living through an unprecedented global recession. World trade plunged and from the December quarter of 2008 to mid-2009 global production suffered the sharpest contraction ever recorded.

In China an estimated 70 million people left the cities to return to their rural villages. Everywhere, from the US to the European Union, China and Australia, governments rightly adopted Keynesian economic policies, announcing major stimulatory spending programs and cuts in interest rates.

As the months have gone by, things have started to look up and Australia has avoided a technical recession. But as our Prime Minister Kevin Rudd and US President Barack Obama keep telling us,

we are not out of the woods yet.

**T**he stimulatory packages must be wound back and the government debt has to be repaid. One cannot help but feel sorry for President Obama. The high military spending of his predecessor, George W. Bush, lowered productive capital expenditure in the US and contributed to the huge budget and capital account deficits. With the essential stimulatory expenditure on top of this, the US is left with immense public debt. Garnaut believes that the debt-servicing for both the US and Britain is likely to contribute to a long period of tepid growth for these countries.

He doesn't say so but the fear is that it will be much worse than this. The US could well have a W-shaped growth curve – a slight recovery followed by another downturn. And sadly for Obama, this would not be his fault. With the country deeply in debt to China, among others, will US citizens accept the sale of the farm when the Chinese perhaps decide to convert their debts to equity by purchasing US mines, manufactures and property? We will see how open the US is to the free flow of capital when Chinese nationals seek to buy US telecommunications, high-tech or even defence-related companies, never mind the farm itself.

In Australia the stimulatory package worked, inducing higher employment, income and expenditure, and contributing to government revenue. Some measures have already run their course and others are winding down. The debt may well not be as difficult to pay back as the Opposition would have us believe and, in any case, there was no choice but to have the package.

Garnaut says close international cooperation will be needed to moderate the threat of war, to support development in the poorest countries and to maintain global economic stability. In the midst of this there is also the need to tackle climate change.

New worldwide rules will have to be put in place to try to avoid a repeat of the crash. Garnaut says the challenge is to build more

effective regulation of finance without opening the door to economically damaging intervention in other markets. The interests that benefit from the weaknesses in the financial system continue to influence political decisions to perpetuate the flaws, and the acceptance of the close integration between traditional and investment banking remains.

Garnaut wants competition in financial services, rigorous regulation of the institutions taking deposits and a high capital adequacy provision. He proposes that credit ratings should be funded by public national or international institutions. But given the size of some of the institutions being assessed and their potential to put pressure on a national assessment agency, it is hard to see how anything less than a high-level international agency could ensure independence.

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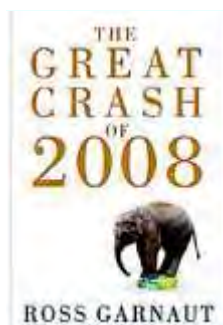
Garnaut rejects the Thatcher view of the world. The idea that an individual could achieve financial or any other goals independently of society always was an illusion. A market economy requires an elaborate set of shared ideas and values to restrain individual behaviour. The new balance will recognise the importance of equity and the environment.

It remains to be seen whether such a new regime can be created or whether in 30 years time punters in a boom will again be saying that "things are different this time" as money yet again pours into another bubble.

**Paul Malone is a former Canberra Times journalist.**



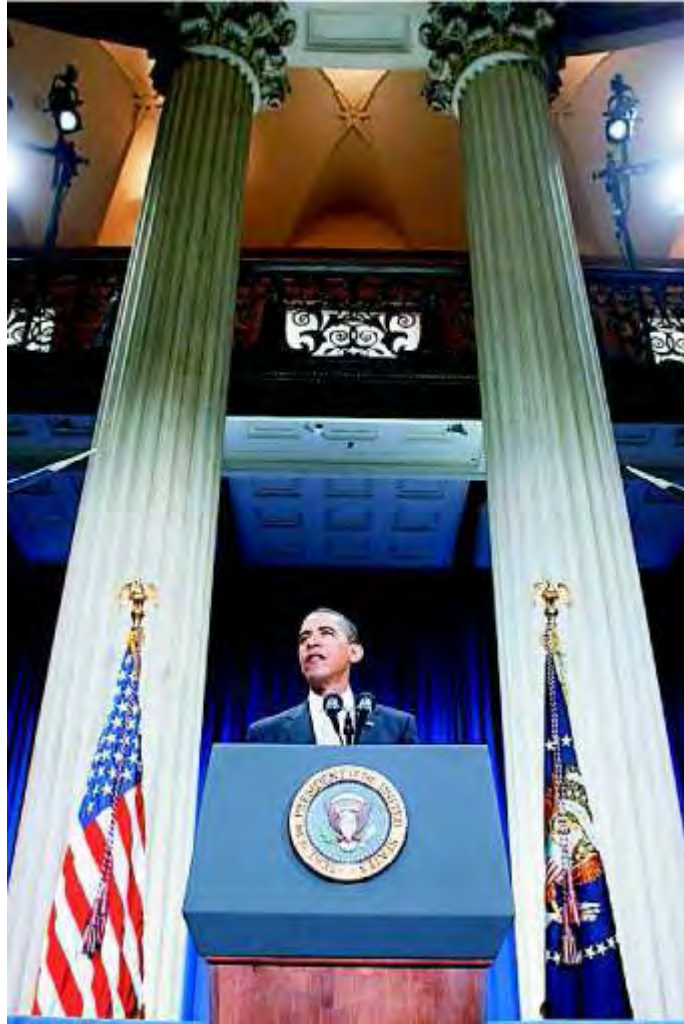
Ross Garnaut: rigorous regulation





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President Obama at the historic Federal Hall in the heart of Wall Street on September 14, 2009, the anniversary of Lehman Brothers collapse, urges regulatory reform.  
Photo: Reuters