Norman T L Chan: Excessive leverage – root cause of financial crisis

Speech by Mr Norman T L Chan, Chief Executive of the Hong Kong Monetary Authority, at the Economic Summit 2012 "Roadmap to Hong Kong Success", Hong Kong, 9 December 2011.

*   *   *

1. Following the outbreak of the Global Financial Crisis in 2008, it is now generally recognised that serious imbalances in the global economy have been built up over the past 10–20 years. There are many different theories on how these imbalances came about and on their contributions to the Global Financial Crisis. A commonly held theory in western countries attributes the global imbalances and the financial crisis in the US and Europe to the so-called "savings glut" in the Emerging Market Economies (EMEs), especially China. In other words, the problems and miseries being experienced in the US and Europe arose because the EMEs not only over-exported, over-saved and under-spent, but also have been lending moneys at very low rates to the industrial economies and have financed the consumer booms and fuelled the credit and asset bubbles there. I do not subscribe to this view. However, given the complexity of the global financial system, it is very hard to try to come up with a grand theory that can fully explain what has gone so badly wrong that it has resulted in the worst Global Financial Crisis since the World War II. Having said that, I would still venture to identify the root cause of the Global Financial Crisis. In so doing, it is inevitable that one has to simplify and generalise matters considerably so as to draw some conclusions.

2. In my view, regardless of the causes of the global imbalances, both the Global Financial Crisis in 2008 and the current European sovereign debt crisis have been driven by excessive leverage in private and public sectors alike in the major industrial economies, resulting in dangerously high levels of debts. In 1980, the average debt level of the 18 major industrial economies was at 165% of GDP. In 2010, the ratio rose drastically to 320% of GDP. In the US, the debt-to-GDP ratio remained stable at 150% from mid-1950s to early 1980s, but the ratio rose sharply and steadily to slightly under 300% in 2010.

3. Why did households, companies and governments borrow so much more than before in the past decade or two? Some put the blame on financial innovation, such as securitisation, which made it much easier to obtain finance or gearing. Some suggest that declining real interest rates in the US and other major economies since the 1990s have increased the ease and affordability of debts and leverage. Some others believed that the Great Moderation beginning in the mid-1980s has nurtured a euphoric view that economic prosperity, job security, income growth and continued rise in asset prices could be taken for granted. This has encouraged both individuals and companies to take greater risks to enhance financial returns. Besides, companies have an incentive to rely more on debt than equity because many countries permit the deduction of interest expenses from tax liabilities. These are all causes of the problem of over-leveraging.

4. But there is another cause of this over-leveraging problem that I would like to draw to your attention – it is market failure. By this I mean the market had been sending out wrong signals to the borrowers, be they households, companies or governments, that increased indebtedness was nothing to worry about. A prime example is the experience of Greece. In the 1990s, the Greek Government had to pay on average 1,550 basis points above German bunds for 10-year funding from the capital market. However, after Greece joined the Eurozone, the market supplied funds to Greece at interest rates very close to the triple-A rated Germany. In 2005, 10-year Greek sovereign bonds were traded at only about 20 basis points above German bunds. Because of this extended period of serious market failure, Greek nationals and their government were under the wrong impression that they would be

able to roll over their debts perpetually. Of course, we now know that such an illusion could lead to catastrophic consequences.

5. The ever increasing leverage in the US and Europe eventually came to an end following the burst of the US housing and credit bubbles in 2007, triggering the Global Financial Crisis. In response, the US and other major industrial countries introduced a series of extraordinary measures from late 2008, which successfully stabilised and prevented the collapse of the global financial system. However, these extraordinary measures, including quantitative easing policies, do not seem to be very effective in stimulating economic growth and creating jobs. In the US, for example, the sharp fall in housing prices has significantly damaged household balance sheets. Such kind of balance-sheet driven recession has substantially impaired the responsiveness of the economy to monetary stimulus, as consumption and credit growth will remain sluggish until household balance sheets are repaired. I believe that US households still have some way to go in repairing their balance sheets through de-leveraging, before they regain confidence in consumption and investment. At the same time, the US fiscal conditions have deteriorated since 2008 and this has restricted the headroom for the government to launch further fiscal packages to stimulate growth and create jobs. The situation in Europe is in no better than the US. The sovereign debt problems of the Eurozone have already spread to Spain and Italy, and have even threatened the stability of the debt markets in the core countries of the Eurozone. It now appears that the rescue package announced by the European Union in late October is no longer sufficient, and hence the market is expecting the European Union Summit tonight to introduce stronger and more effective solutions to resolve the European debt problems. The situation remains highly unstable and the market is showing little confidence in the European leaders' resolve and ability to bring an end to the debt crisis. The situation is very worrying.

6. Once a country gets into the habit of spending beyond its means, relying on debts to finance its expenses and rolling over old debts with new ones, it is a matter of time that the country would run into trouble. The only way out is to reduce debt and endure the excruciating pain of de-leveraging. While leveraging or borrowing normally produces intoxicating feel-good effects, such as job and income growth, buoyant consumption and investment, strong credit demand, asset value appreciation and business boom, de-leveraging has exactly the opposite effect, creating very unpleasant and painful consequences. The injection of ample liquidity into the banking system by central banks to suppress interest rates is certainly helpful in alleviating the pain of those debtors who can refinance their loans with lower interest rates and thus reduce their interest and repayment burden. However, many households in the US are denied access to cheaper and falling mortgage rates because they are in negative equity and cannot afford to refinance. Lower interest rates are thus of little help to them. Moreover, pushing interest rates to close to zero also deprives prudent savers of the interest income that they can earn from their savings. Many savers, including pensioners, have to cut back spending because of the sharp fall in their recurrent interest income. This will offset the impetus to consumption and investment provided by the near-zero interest rates.

7. Some academics believe that the effectiveness of the quantitative easing policy in the US is also undermined by the fact that the US property market has not yet bottomed out and US households need to continue to de-leverage. Many policy measures introduced in the US recently aim to reduce the pain of households in a falling property market and slow down the process of foreclosures. Even though property prices have already fallen significantly, more than 50% in some places according to anecdotal reports, potential buyers still prefer to wait as they fear that prices may fall further once the huge stock of foreclosed properties are put back to the market or when interest rates return to more normal levels. In other words, while measures to slow the downward adjustment of the property market are well-intentioned and have their political merits, they could prolong the time needed for the market to reach a new equilibrium or find the so-called clearing price. In my view, this may delay a true recovery of the property market and create a negative drag on the repair of US

households' balance sheets, making the recovery of consumer confidence farther and farther away.

8. Finally I would like to share with you a few policy lessons learnt from the latest crisis:

(a) Households, companies and governments alike must avoid excessive leverage or borrowing. This may be easier said than done as leveraging can bring transient prosperity and euphoria to everyone. To avoid committing such mistakes and the pains of de-leveraging in the future, we must stay alert and discipline ourselves not to over-spend;

(b) Beware of wrong signals resulting from market failures, which may induce borrowers to wrongly believe that access to low-cost funds will never be cut off and prosperity and affluence funded by borrowing is legitimate and sustainable;

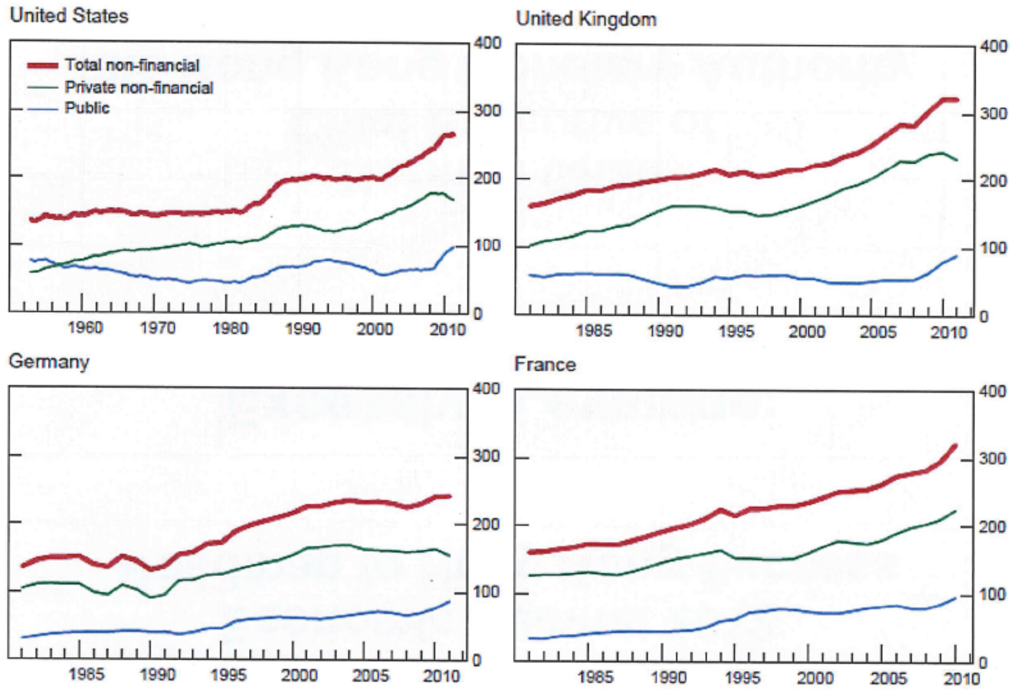
(c) Strengthen market regulation to reduce the risk of market failures. Major reforms to be introduced include enhancing the policy functions for maintaining financial stability; implementing appropriate counter-cyclical regulatory measures when necessary; strengthening bank capital and liquidity requirements (Basel III); and increasing the regulation of credit rating agencies. Most of these reforms are still at various stages of implementation and may not be ready remedies for the current debt crisis in the US and Europe;

(d) Understand and accept that there is no clever or easy way out of the trap of excessive leverage. While innovative financial derivatives may facilitate borrowing and leverage, or even conceal them, no financial engineering can reduce debt and achieve de-leveraging without the required reduction in public spending and the economic and social pains that the de-leveraging process generates.

(e) While the government should step in to help if the financial system or the whole economy gets into trouble, this is feasible only if the government has the fiscal headroom to foot the bill. If the government itself is already heavily indebted or has incurred a huge amount of debts after bailing out the private sector or introducing measures to stimulate the economy, the market may start to doubt the sustainability of its fiscal position. A case in point is Ireland, where the government incurred a huge amount of liabilities by bailing out the banking system, calling into question the government's fiscal sustainability and triggering the sovereign debt crisis.

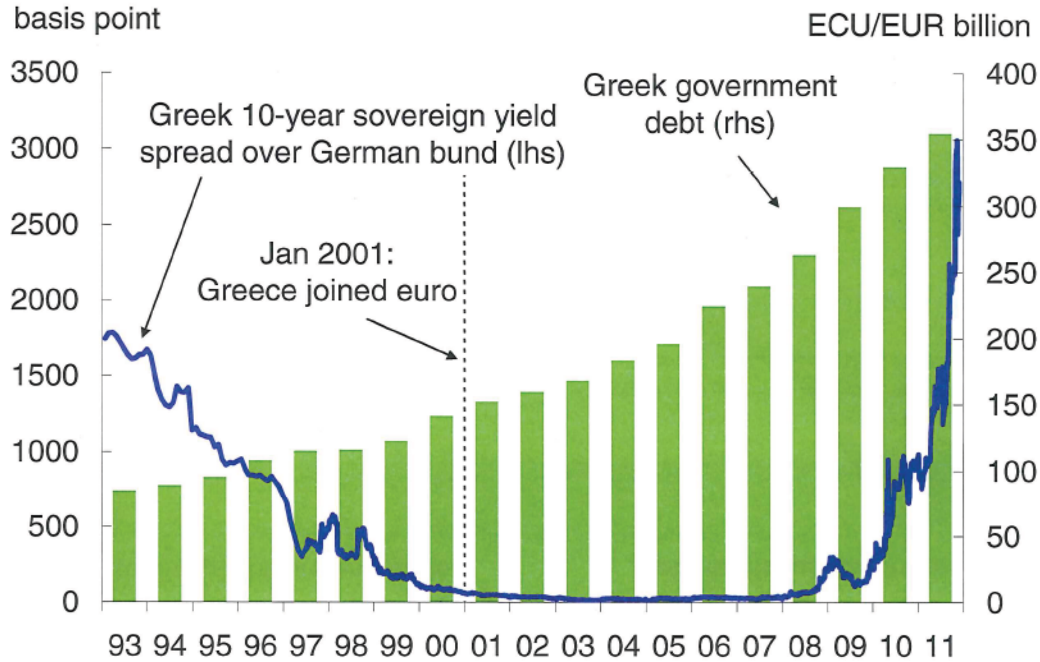
(f) The crises unfolding in the US and Europe are not new to Asia. This region had its share of suffering during the Asian Financial Crisis of 1997/1998. In Hong Kong we went through almost seven years of painful economic adjustment after the burst of the property bubble in late 1997. Our economy shrank by 8.7% in five quarters. Unemployment increased fourfold from 2.1% to 8.5%. Property prices dropped by 70% in six years while the general price level fell by 15% in five years. The hard lesson we learned from our experience is to face the reality, take the pain in stride and do whatever it takes to restructure the economy, to increase productivity and improve competitiveness. If this can be done, it should be possible to return to the track of sustainable economic growth.

Rising indebtedness of major industrial economies



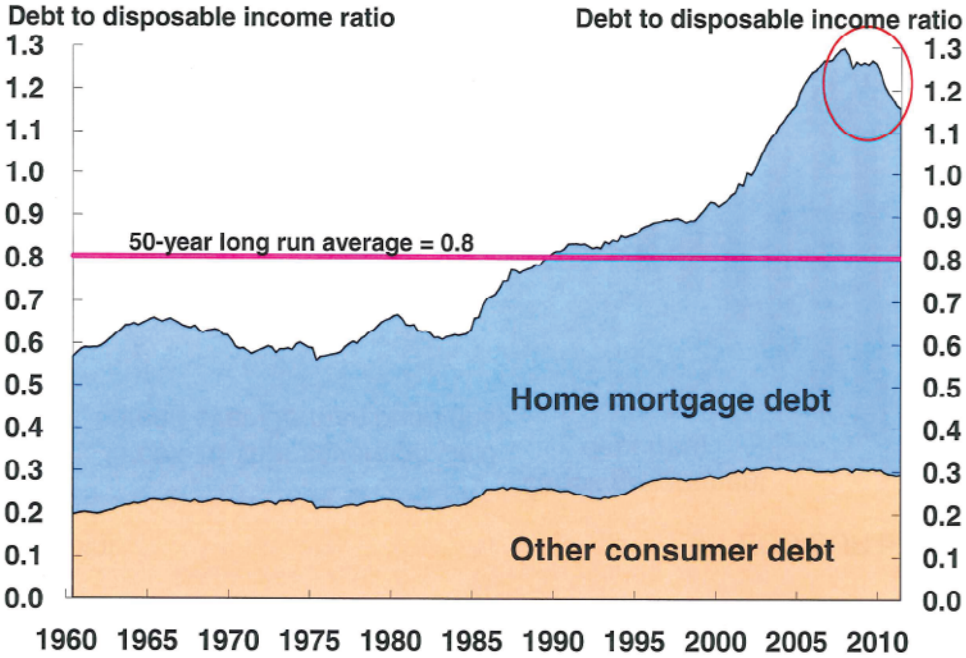
Source: Bank for International Settlements

Market failure: the Greek example



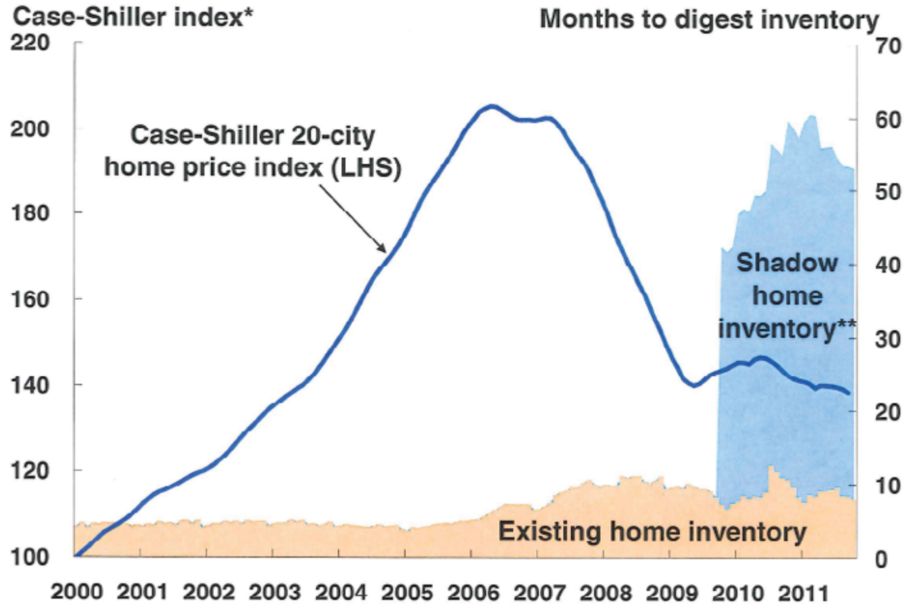
Sources: EcoWin and AMECO

US balance sheet recession: household deleveraging still ongoing



Source: CEIC

US balance sheet recession: huge quantity of housing inventory to be cleared



* Case-Shiller 20-city home price index is set at 100 for January 2000

** Shadow home inventory is estimated by Standard and Poor's which includes the total number of homes with mortgage loans more than 90 days delinquent, currently or recently in foreclosure and those that are real estate owned (REO).

Sources: CEIC, Standard and Poor's