

Year of the financial crisis

The year 2008 was the year when banking giants fell into their own trap. Only two of the world's five largest investment banks were left standing at the end of the year.

Text: Åsmund Fanuelsen

Bear Stearns threw in the towel in the first quarter, followed by Lehman Brothers and Merrill Lynch in the third quarter, while Goldman Sachs and Morgan Stanley have changed their status to commercial banks. The world's two largest mortgage companies, Fannie Mae and Freddie Mac, were taken over by the US authorities in September. The insurance giant AIG is surviving now thanks to loans from the authorities. Financial institutions in countries such as the UK, Germany, Iceland, Belgium and Denmark have also shared the same fate. We can safely say that the year 2008 was anything but a "normal year".

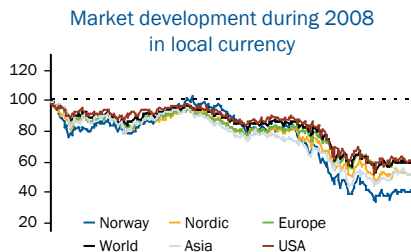
Historical willingness to assume risk

The financial crisis developed due to the fact that far too many people were given loans they never should have received – this gradually became evident when the housing prices in the US started to fall. The banks that experienced distress were all characterised by the fact that they assumed too much risk in their lending portfolios. Their equity capital ratios were low and their financing was often short-term. Fannie Mae and Freddie Mac only had equity capital ratios of 2 per cent to cover their overall liabilities. Thus even small losses could have brought down the banks.

When the losses surfaced a new problem arose. Since the loans had been "packaged" and resold to many different banks and financial institutions throughout the world, it was difficult (or impossible) to know who held bad securities and how poor the securities actually were. This created a widespread lack of confidence in the global financial markets. It became difficult to perform ordinary banking activities, and the cost of funding rose because of a sharp increase in the "risk mark-up". The banks became far more restrictive in their lending in the wake of this. The impact on the real economy came fast and furious.

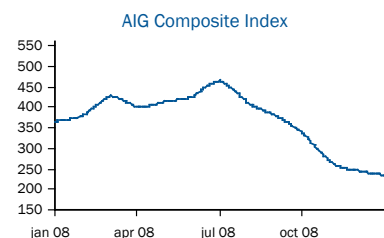
Shares plummeted

A lack of confidence breeds uncertainty and this is something that does not make the investors happy. In October the equity markets throughout the world fell by over 30 per cent. It was the greatest monthly decline ever measured on a global basis. The fear of bankruptcy increased in line with the falling share prices, and investors who lent money to companies with a low credit rating demanded record high interest rate compensation.



Source: Reuters EcoWin

The foreign currency and commodity markets also felt the unrest. The exchange rates between the world's major currencies have never fluctuated more than they did at the end of last year. World commodity prices fell sharply at the same time. The figure below shows the broad-based commodity index Dow Jones-AIG, which also includes oil prices.



Source: Reuters EcoWin

Debt-driven crisis

The financial crisis in 2008 was the first worldwide banking crisis in modern times. The banks have been forced to incur large losses, and their equity capital has not been adequate. At the same time there has never been more debt in the world in relation to the goods and services that are produced. Too much of the growth in recent years has been created by means of credit – and this is the process that is being reversed now.

From unrest to recession

When the financial system needs to "go to the garage for repairs" it generates ripple effects in the real economy. The uncertainty that arose in the wake of the financial crisis and the situation in the credit markets resulted in a lack of credit. Tighter credit had at the same time an impact on the capacity of businesses to service debt. Housing prices plummeted in several countries, and growth in employment came to a halt or fell. Consumers became unsure and tightened their belts.

The trend at the end of 2008 indicates a sharp fall in private consumption, retail sales, housing prices, company investments and industrial production. The economic recession is primarily consumer driven, and the demand for products and services has declined sharply. Gross domestic prod-

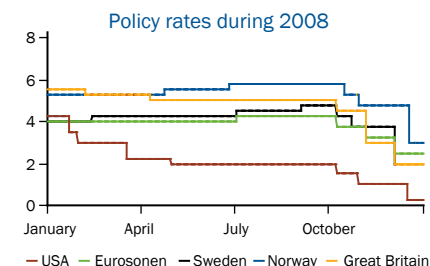
uct, i.e. the sum total of all the goods and services that are produced in a country, showed a falling trend in 2008 for the first time in many years.

Two consecutive quarters with negative GDP growth are often defined as a recession. Large economies such as the US, Germany and Japan are already in this phase. Growth has also slowed substantially in Norway. While GDP growth in mainland Norway was 6.1 per cent in 2007, the annual growth in the third quarter was only 0.6 per cent.

The financial markets and real economy are related, but they can nevertheless be separated. Several observers predict that the unrest in the financial markets will bottom out soon. The effects on the real economy will undoubtedly last longer. The International Monetary Fund (IMF) estimates that GDP growth in the industrialised countries will be negative in 2009. A moderate increase is not expected until the end of the year.

Interest rate cuts and aid packages

The world's central banks cut their key rates sharply last autumn. The interest rate cuts are supposed to stimulate increased investments in the business sector and make existing debt easier to bear. The same will apply to private individuals, since the interest charges for mortgage loans will be reduced and their purchasing power will increase.



Source: Reuters EcoWin

The authorities have established a number of aid packages in addition to the interest rate cuts by the central banks. The scope of the packages is broad, ranging from direct emergency relief for the banking sector to extraordinary loan facilities, acquisition of shares in banks and guarantee schemes for the industrial sectors, as well as direct real economic measures over the state budgets.

The scope of the measures and their coordination clearly shows that the authorities throughout the world means business. If the measures already announced are not enough, more money will be made available. We must be prepared for an economic cooling down period, or a "deleveraging period" as the Norwegian Central Bank Governor Svein Gjedrem has described it. With lower interest rates, capital injections in banks, and economic stimulus packages for the rest of the economy, the velocity, depth and length of this period may be shorter than many fear. And the equity markets are at the leading edge of it all...