ACG
AMERICAN COUNCIL ON GERMANY

The LEVIN Institute

"The Global Credit Crisis: How Bad Will It Get?"

Michael Klein
Chairman and Co-Chief Executive Officer
Citi Markets & Banking

Dr. Adam Posen
Deputy Director
Peterson Institute for International Economics

Dr. Nouriel Roubini
Professor of Economics,
Stern School of Business, NYU
Chairman, RGE Monitor

Nikolaus Piper
New York Correspondent
Süddeutsche Zeitung

The American Council on Germany and the LEVIN Institute at SUNY brought together four distinguished panelists on April 14, 2008, to analyze the severity of the current credit crunch and to forecast the repercussions in the near term. The program interwove the views of a banker, a policy analyst, an academic, and a financial journalist.

In his introduction, LEVIN Institute President and ACG Chairman Garrick Utley said we are being tested and influenced at a changing time. He noted that Spanish philosopher José Ortega y Gasset recognized the imperative of modernity and stated that "I am what I am plus my circumstances." In turn, the panelists took a closer look at these circumstances – and how we are affected by them – before entering a dialogue with one another, moderated by Mr. Utley, and with the wider audience.

At a bank with offices in more than 100 countries, Michael Klein of Citi said he has found himself at the epicenter of the credit crunch. He shared some daunting numerics since the onset of the crisis. He said we are in the 10th month of financial market turbulence and the 28th month of housing decline, and that these forces are accelerating rather than decelerating. He said about $4 trillion in capital has been taken out of the system, plus another $1 trillion lost in the "alphabet soup" of credit products that have entered the vernacular, including collateralized debt obligations (CDOs). In addition, the $11 trillion market for mortgages has been deeply affected, with a decline in housing values that is "almost unfathomable."

Ultimately, roughly 50 percent of GDP has been removed from the system – although about half of this has been replaced by sources including sovereign wealth funds. But the risks have tripled during this time, and universal banks have seen a 60 percent decline in values at a time when the costs of doing business have been on the rise. Mr. Klein likened the subprime issue to a pin pricking a bubble, unleashing the forces of unregulated – and decidedly opaque – pools of capital. The aftershocks reverberated from the subprime market to the municipal bond market and eventually directly to banks. He said we are at the beginning of the third act now, but we do not yet know if this is a three- or four-act play.

Despite some grim numbers, Mr. Klein sees reason for optimism. He said some sophisticated players are making moves. Citi was able to raise $35 million in capital in two months; JPMorgan Chase acquired Bear Stearns despite the huge risks involved; papers that are now selling used to be unsaleable; and the IPO of Visa was highly successful. In his view, those who see value are taking risks, and the regulation side has been constructive.

Adam Posen of the Peterson Institute noted that a crisis tends to seem more severe when one is in the midst of it. He said that when he hears talk of the depth of the current crisis, he issues a challenge: "Show me why it's different this time." So far, he saw the arguments as weak. For example, he said that "housing bubbles come and go," and their impact depends on whether policymakers respond. He said the Fed has done a lot to address the current crisis. He also noted that the United States is less important in the global financial system than in the past. He drew parallels to Japan, which he said "shut down for 10 years" – but the crisis "didn't matter much, except to the Japanese." Projections by the Peterson Institute see another year of export growth – and no reason to think that the global economy will not grow. He said policy is more effective than people think – even if the Federal Reserve Bank was not as aggressive early on in the United States as the European Central Bank was in Europe. He saw the Fed's tax credits for small businesses and tax rebates to individuals as positive moves. He urged the U.S. government to hold off on restricting foreign capital; he said we must allow the market to work.

NYU Professor Nouriel Roubini presented a much starker outlook. He said today there is no longer a question of whether we will have a hard or soft landing but rather how hard the landing will be. He said the recessions of 1991 and 2001 lasted only eight months. He suggested that the current recession may last as long as 12 to 18 months. He felt that the housing decline will grow even more grim. He said that new-home sales have decreased by 60 percent and home prices are down by 10 percent. In his view, home prices will fall by 30 percent by 2010. This scenario would mean that 21 million out of 51 million households would be affected, and up to 40 percent of houses could be "underwater." He said the number of voluntary defaults on

mortgages has basically wiped out three-quarters of banking capital. In contrast, the boom and bust of technology stocks in 2001 involved 10 percent of GDP. The repercussions are wider than the housing industry. Consumers increasingly cannot borrow against their home at a time of rising gas prices and an uncertain stock market. Private employment has declined, and consumption has gone down as well, resulting in a significant recession. The housing market also has an effect on commercial real estate. Simply put, he felt that we are facing the worst housing recession in 50 years, and this has a strong impact on consumerism.

Nikolaus Piper, a correspondent with the *Süddeutsche Zeitung* whose time in New York began at the start of the crisis, said that current conditions do indeed feed anti-Americanism in Europe. He said they fuel views on "greed and Wall Street" and American recklessness. He said that UBS had even called for a stop to the "Americanization" of the European economy. He said it would be easier to counter anti-Americanism if Americans were to "fix some things at home." Those things would include offering risky mortgages with no down payment and on tenuous terms. He said that the crisis in America has had a big impact on German Landesbanken, for example, but the crisis may not have as strong an impact on wider Europe. Earlier in the day, the Minister-President of the Free State of Saxony, Georg Milbradt, had resigned, in part due to the collapse of the Saxon Landesbank, coupled with questionable personal loans. While the state guarantees for Landesbanken have already been phased out, Mr. Piper called for further reform. He said the Bavarian Landesbank is not in such bad shape as the Landesbank in Saxony but that it is close. He said the IMF is "surprisingly pessimistic" but that the institution still does not predict a recession in Europe. "We never had a bubble, so we don't have a bust," Mr. Piper said. Inflation is a greater concern.

In an interchange with Mr. Utley, Mr. Klein said that a measure of hyperbole comes into play in the current situation. There has been a sense (at least in the United States) that money does not cost a lot. People borrowed money who did not need to, and now are getting caught up in the crisis. He said that there is a lag between the United States and Europe and that the problems began in the United States long enough ago that they should have hit Europe by now if they were going to.

Dr. Roubini said that the crisis stems not so much from a housing bubble as from a credit bubble, and suggested we will be feeling the impact for some time to come: "There are many bubbles, and the boom-and-bust cycle is getting bigger." When asked whether there was enough regulatory oversight, he said that greater capital reserve requirements are likely and that there will be a higher degree of self-regulation by the banks. Dr. Roubini suggested that banks will strive for a better analysis of risks but not more regulation: "they will want principles, not rules." Dr. Posen agreed that the regulatory oversight was lacking. He said that Alan Greenspan loosened regulation on banks, instead of having the Fed increase it. He does not think self-regulation is the answer.

Mr. Piper contemplated whether or not this is a "watershed moment." He noted a sea change at the IMF-World Bank meeting which immediately preceded the panel discussion. At earlier meetings, he described the American delegates as relaxed and open as they promoted a free market and free trade and the Europeans as more cautious and careful. At the most recent meeting, the Americans came across as frightened and pessimistic, while the Europeans were more relaxed. The Americans called for greater state intervention. Dr. Posen took something different from the weekend's meeting: He noted how little Schadenfreude the Europeans and Asians seemed to have for the American situation. He maintained that the response to the current challenges has been positive and constructive. He is confident that the United States "will be okay." The enormous growth in liquidity and assets (as outlined by Mr. Klein) is out of sync with the real economy. Many international barriers have been removed, so money, resources, and jobs are moving with fewer and fewer restrictions. Dr. Posen indicated that this is a natural adjustment of the markets. Mr. Klein agreed that we are digesting these market changes. He called it an "unintended consequence of globalization."

Michael Klein *is Chairman and Co-Chief Executive Officer of Citi Markets & Banking (CMB), with primary responsibilities for corporate client coverage and Global Transaction Services across Citi.*

Nikolaus Piper *is the New York Correspondent for the* Süddeutsche Zeitung. *From 1999 to 2007, he was Business Editor and headed the Economics Section of his newspaper.*

Dr. Adam Posen *is Deputy Director of the Peterson Institute for International Economics in Washington, D.C., where he has been a Senior Fellow since 1997. His research covers macroeconomic and financial policies, European and Japanese political economy, and central banking.*

Dr. Nouriel Roubini *is a Professor of Economics at New York University's Stern School of Business and is also the Co-founder and Chairman of RGE Monitor (www.rgemonitor.com), an economic and financial information service named one of the best economics websites by* BusinessWeek, Forbes, The Wall Street Journal, *and* The Economist.