GLOBAL ECONOMIC TSUNAMI
Causes, Effect and Lessons

Wold Zemedkun, Ph.D.
Norfolk State University
wzemedkun@nsu.edu

PROBLEM REVIEW:

A tsunami is normally a result of underwater earthquake that travels at a great speed and under open water usually unnoticed. The best you would see is mere ripples or swells moving across the sea. But, as the tsunamis reach shallow water of shores, they pile up into crests that can be as much as 200ft high with an astonishing speed approaching 400 miles an hour. Economic tsunamis do happen. In late 1980's and early 1990, an economic tsunami was feared for the Japanese economy and for South Korea peninsula was in 1997. The countries nearby like Thailand and even deep in south Indonesia were also impacted with the wave from the Japanese economy. All the other surrounding countries' financial markets lost over 50% of their values in short order.

In the current global financial sectors, the sub-prime mortgage deception and corruption noticed at least a couple of years earlier was seen and ignored as mere ripples over the global high sea of finance. Evidences, now, clearly points to an economic tsunami forming from the sub-prime mortgage meltdown starting from early 2007 and gaining significant speed later that year. It is a glaring example of how a seemingly negligible financial sector (mortgage finance) issues can fast grow to an uncontrollable global destruction of economies. Later, 2007, some shore lines, high mortgage payment default for some, for others, high debt ratios, and for still others home foreclosures, began to erode consumer confidence. The global economies were still high flying and those issues were just more 'ripples' on the sea surface. The officials of the Federal Reserve, the FDIC, the Treasury, the SEC and others like the Federal National Mortgage Association, and the Federal Government Mortgage Association were sleeping at the wheels. As a result, an ever increasing number of overpriced homes were set for default. Debt burdened citizens who happened to own homes with unrealistic teaser rates, some approved with fraudulent documentations, were completely written –off as insignificant. In a tsunami, the real destruction would occur when the waves approach the shoreline and then the full force of the devastation is evidenced.

EXPERTS AND PUBLIC OFFICIAL AT THE WHEEL:

In 2007 and most of 2008, practically every expert, government agencies, the Central Banks, Wall Street, and financial markets around the globe ignored and quickly dismissed the fast moving under current global economic and financial tsunami. Not only was the self evident fast swelling mortgage bubble neglected, but also, the 2006-07 financial market bubbling around the globe never gotten any attention but rather considered as mere ripples. Examples of blotting 2006-07 markets:

Market	**Increase in Stock Index**
China's Shanghai Stock Index	265%
India's Sensex	122
Russia's RTS	187
Mexico's Bolsa	142
Brazil's Bovespa	108

Source: The Wall Street Journal

Most sailors got caught up in the great wave of this century's killer global financial and economic tsunami. Since the second quarter of 2007 (just 12 months before the tsunami hit the US shores), the Federal Reserve had instituted its broadest expansion of lending programs since the Great Depression and expanded its safety net to more of Wall Street firms. "…since the peak of residential real estate markets around the country (about mid-2005 in hindsight), as the term "sub-prime" gained verbal traction in the mainstream media, their army of prognosticators, pundits and whistlers-past-graveyards has continued to wishfully pronounce any potential economic fallout from the meltdown as "contained", and "unlikely to spill over" to the general economy. (." Hazelton, Keith, 2007). Until late 2008, the third quarter of the year, most believed that a bunch of price inflated houses will not be able to rattle the great economies.

GEAT ECONOMIC TSUNAMI: **Evident:**

The global economic tsunami hit the shores of, first the U.S. financial markets and quickly thereafter, the entire developed world in the form of the twine price rise in energy and commodities. There was high and unexpected waves of high food prices, high prices in health care, tax rates, closing of industries, high government deficit, consumer debt levels, and a continued consumer deficit spending coupled with sub-prime mortgage complete melt down constituted the most destructive global economic tsunami since the Great Depression. The impact of all these was still minimized in the books of all the experts. At the beginning of 2008, most of the concerns were focused on bail out some firms deeply involved in the sub-prime mortgage debacle. Initially, when New Century Financial, at the time, the nation's second largest sub-prime lender collapsed, the market, investors, and the finance authorities believed that things were under control. However, shortly after, some of the largest banks began to admit that their other portfolios are being affected by the mortgage crisis. The tsunami began hitting all shores. Just weeks later, another mortgage company, American Home Mortgage went deeper into Chapter 11. Banks, in general, began to experience credit crunch because their loans were not being sold. Still no one recognized the magnitude of the up coming economic tsunami.

Only in late 2008, the realization of the real economic tsunami was evident. Mortgage bailout became the occupation of everyone. Once great companies of American financial markets like Bear Stern simply disappeared overnight, when tax payers' $29 billion was used to buy its debt and the firm was quickly slammed with J.P. Morgan Chase. This was later on followed by icons like Lehman Brothers, Merry Lynch, Wachovia, Countrywide, Washington Mutual and others. Great signs of the deepening of the economic slow down were the every day economic activities in the media and the market. You would observe ads like: "Mortgage Bailout is Greeted with Relief…"; Washington Mutual's New Chief prepares to dive in amid skepticism; (WSJ 9-9-2008); "Lehman Faces Mounting Pressures"; "Retailers Reprogram Workers in Efficiency Push"; Mall Glut to Clog Market for Years"; The Dow Loses…Most of Prior Gain" ; Banks push hard on credit card debt" (WSJ:9-10-2008). Lehman, Merrill Lynch and others attempted to raise capital as soon as it came to their attention that the tsunami is biting up the shores off the global financial sea. But, it was too late. Once the tsunami hit the shores, no one can stand in the way of the great storm of the century. Tight credit hit the market full fledged in 2008. Several Wall Street firms and money center banks are unable to raise equity capital. The ratio of bad debt to equity levels got to historically unacceptable high levels.

	Problems Assets	**Shareholder Equity**	**Ratio**
Lehman Brothers	**71**	**32**	**2.22**
Merrill Lynch	**81**	**42**	**1.93**
Morgan Stanley	**58**	**34**	**1.71**
Goldman Sacks	**54**	**45**	**1.20**

Real Estate Investment Trusts (REITs) and other real estate funds and financial investments continued in a downward spiral. Morgan Stanley, the Wall Street firm marked down the value of the Crescent properties by $150 million in its fiscal second quarter ended May 31, 2008 deepening losses for its asset management business. Lehman Brothers was hammered by its bad timing of investments in California land and New York City apartments (Real Estate Alert, 10/13/2008). On another front, the nation's large banks began squeezing consumers on credit card debt further deteriorating consumer confidence. Banks began pushing harder on credit card rising delinquencies with both carrots and stick approaches. Banks began calling delinquent customers early on. Borrowers who realize early their facing of payment problem and call-in early may be able to negotiate a payment plan, get a break on interest payment and/or interest rates, fees or both. Customers carrying big balances may get incentives to pay off debt early, all in line of banks attempting to make quick collection of their accounts receivables. However, such move came at the time when consumers are in a rising unemployment environment, even lower consumer confidence about their financial future, and these bank moves in the direction of credit crunch did only force more consumers to default on their credit card payments. According to the American Bankers Association, report in second quarter clearly shows substantial increase in delinquent accounts. For instance, delinquency of bank credit card account in 2008 is as follows:

1st Quarter	**2nd Quarter**	**3rd Quarter**	**Y-207**	**Card Balances**
4.51	**5.1**	**6.4**	**4.41%**	**4.80 (up: 3.5 prv. mo.)**

As credit card delinquencies rose substantially, credit card issuers (banks) are using various approaches to collect.

Bank	Collection Techniques (approaches) on Past Dues
American Express	Customized pmt: fees, terms (plan length), interest, flexibility.
Bank of America	Hired more collectors, offer better terms, interest, wave fees
Capital One Financial	Aggressive collection efforts, finding tailored solutions
Citigroup	Aggressive calls, targeted settlement programs where required
Discover Financial	Hired more collectors, use of web for card holders Services
J.P. Morgan Chase	Contacting and settling up hardship programs.
Washington Mutual	Will work with customers, temporarily lowering payments, and for delinquent card holders, set up web-help where they can set up payments plans.

The Different financial institutions all tried creative approaches to collection, main focus; but, the lending arms seem to have long been severed and credit crunch getting worse daily. The tax paying public is now engaged in a major rescue operations of Freddie Mac and Fannie Mae for over $200 billion despite recent past repeated expression by members of Congress how great this assets are and thereby denying existence of any apparent problems within these real estate marketing firms. In Fall of 2008, the fear of the unknown has roiled the global economies and the financial markets in general. The tsunami is at its climax destructive stage off-shores. The big Wall Street firms began to feverishly looking for buyers to market themselves or place on market for sale, at least some of their important assets. Early September, 2008 Lehman Brothers said that it would listen to all offers to buy the New York Investment Bank. Unfortunately, the potential suitors were all sick with unhealthy balance sheets.

Potential suitors for Lehman and their handicap:

Firm	Financial Issues

Bank of America	Already struggling with Countrywide acquisitions Barclays Bank The level of capital required for Lehman's balance sheet
BNP Paribas	Big Job cuts and potential culture clashes
HSBC	Capital requirement too high, cultural issues
Santander	Better opportunities in Europe

The bottom line is that credit dried up not only in the U.S. but also around the world. As the tsunami widens and expands around the financial shores, options for battling for credits was getting narrow. "With the share prices of Lehman Brothers Holdings Inc;, Merrill Lynch & Co. and others financial firms on a roller caster, the crisis could be entering a critical stage (WSJ 9/12/08). About the same time, the nation's largest mortgage marketers, Freddie Mac and Fannie Mae were placed under government receivership. Federal officials and market players are struggling with the great economic and financial wave of the century for sure. Lending between banks seizes up. Individual financial shares were all over the map, as investors tried to sort out who will survive the market turmoil. By mid-September, Lehman shares lost 95% value, Merrill Lynch 70% and AIG 80%. Bank of America, only with the government urge, desired to acquire Merrill. The rest, no one would come up with the capital or even willing to negotiate.

In the area of credit SWAPS, (private contracts that let firms trade bets on whether a borrower is going to default and when the default occurs one party pays off the other), the value of the swaps rise and fall as market re-assesses the risk that the company won't be able to meet its obligations. In 2008, there were about $62 Trillion of such bets as opposed to only mere $145 million in 1997. The cost for a firm to protect itself from such risks increases as the risk of default goes up due to market and economic conditions. American International Group (AIG) was in the center of all these. As of end of June 2008 an AIG unit had written credit-default swaps of more than $445 billion in credit assets, complex structured products including mortgage securities and corporate loans. The amount an investor must pay annually for protection against a default on $10 million debt over five years has been hitting them hard. Such cost rose from $152,000 to nearly $195,000.

The tsunami force moved on cleaning everything and everyone on its way with untold destruction. The giant AIG kept scrambling to raise cash. Insurer looks to sell automotive businesses, annuities unit, and seeks billions in fresh capital as down payment to just survive the tsunami that showed at its door without much warning. What is more, on the public side, each Sunday (as the market is closed), emergency deals and government fixes and other scramble for sweet deal rush continued to mitigate the killer wave. At this time, the only thing positive going on fore the populous was that oil prices were in down ward spiral for business is hit globally and all sales are down already. The Dow Jones is on down ward spiral too (negative). Dashing hopes that the damage of this financial and economic tsunamis could be isolated to just few financial institutions that made bad bets on mortgages. The new waves come not so much from the original problem, i.e. troubled sub-prime mortgages; but, from losses on credit default swaps, the insurance contracts sold by AIG˝ Inc. Others came from those seeming insuring businesses seeking risk protection against other companies and individuals defaulting. Mean while, corporate core businesses kept on declining in sales and consumer confidence plummeting rapidly. Just in the month of September 2008 alone consumer spending unexpectedly sagged as follows:

Company	September Sales	Annualized
J.C Penney	**_8.3%**	**--99%**
Gap	**_7.4**	**_88**
Dillards	**_6.1**	**_72**
Nordstrom	**_5.7**	**_68**
Limited Brands	**_4.9**	**_59**
Kohl's	**_4.8**	**_57**
Sacks	**_3.8**	**_47**

The tsunami got worse. The demise of Bear Sterns and Lehman's triggered another wave of crunch around the world. The Tsunami waves hit European banks and one of the first ones to require fresh funds was British HBOS. Germany's Hypos Real Estate Group was in credit trouble and government officials were in rescue talks. Moreover, countries like Germany issued a blanket guarantee of all its consumer bank deposits.

U.K. nationalized mortgage lender Bradford & Bingley and increased deposit guarantee to 50,000 pounds.

Ireland guaranteed all liabilities of six top banks

Belglum/Luxxemboug arranged sales of Fortis banking and insurance units to BNP Paribas

Italy UniCredit's board called a meeting to shore up credits

By October, U.S. and Britain up ante in fight to stop the devastating economic tsunami that more and more, by day, is engulfing the entire global financial systems.

Soon after, massive lay-off began. Hewlett-Packard lay off 24,600, For Lehman employees, at least for 9,000 to 10,000 of them, it was over. End of March 2009, nealy 6 million people in U.S.A. alone are unemployed. AIG and the big Wall Street firms shock the world and the global financial systems. By the time the government woke up to the situation, over one and half years into the sub-prime mortgage default games, it was too late avoid recession. Government bailout programs, perhaps, did avoid deep and protracted recession. However, the jury is still out as far as the success of the bailout funds. It is creating temporary jobs. But, its success would depend

on how much of the long term businesses are stimulated to take over the growth in employment and of the economy. The news paper titles run like these:
."U.K. plans to buy into Big Banks"; back in the U.S. "Home Loans 'Under Water", Grow, Pressure the Economy"; "Alcoa Digs, soft demand"; "Shipping Lines Sail Uncertain Seas"; "Dow's Damage: 13% in Five Days";

LESSONS FROM OTHERS:

In the **1982 Chile's Financial Crisis**, the Chilean plan helped the banks recapitalize and protected depositors. It also minimized and kept the government's role from expanding. Private ownership was preserved and it protected the market system which later sustained the power to bounce back and sustaining it for the last 25 years. Chile was in depression in 1983, not just a recession. Chile continued securing bank loans throughout the crisis. At times, government intervened directly in (the case of two large banks) where the shareholders were cleaned out via nationalization and removing the old management. After the crisis was long over, those banks were re-privatized in a deal that gave tax breaks to the Chileans participating in the deal. The Chilean government guaranteed the other banks loans case by case against bank assets. But, government was only subordinated creditor so that new private capital takes the primary creditor position.

Lesson From the 1990s Japan:

In quiet recent past, Japan was hit by its famous (the lost decade) financial crisis. The U.S. constantly encouraged Japan to take decisive actions. But Japan hesitated taking immediate actions in fear of capital flight, greater economic risk, and even much greater social cost (unempl0yment). The banking sector denied the problem and was not cooperating with the government to take actions. Japan's stock market bubble began to deflate in 1990 shortly followed by bust in the property bubble and create perfect conditions for a prolonged lackluster economic growth down to sustained decline in wealth levels and evaporated corporate profits. Another lesson from Japan is the hesitation and refusal by its banks to recognize what is upon them was devastating its economy and the banks were allowed to do so for a long time period. One major characteristic that Japan of the 1990s and U.S. of 2008 share is that they both permitted an un-stainable lending activity levels. Both financial sectors to balloon to a size much larger than they should. Here in the U.S., the financial institutions have realized the severity of our conditions much earlier than Japan did, thanks to the devastating and painful waves of losses by the mortgage sector of the economy that the taxpayers have to bare. The government and the central bank have taken decisive actions without much more delaying. Moreover, several financial institutions in the U.S. rapidly began to seize up their financial problems and seize down as fast as they could do it. We also need to remember that Japans hesitation to take a decisive move was in fear of run on credit (bank) endangering their economy in terms of the necessary sources of credit that would be so badly needed. Japan also looked at the social cost of such credit related economic crisis.

Conclusion:

There's still a tremendous mistrust by creditors in extending loans simply because (1) increasing unemployment (now job; but tomorrow none economic conditions yet) (2) falling assets values in housing especially in commercial real estate (a looming tsunami wave soon to show up at the shores of our financial seas). (3) consumer confidence has not yet recovered (consumers are still not buying and thus business will take time to recover; not before at least the Christmas season. The best we can look forward to is a milder recession through the summer of 2009 bottoming up at the end of the year. GDP growth may be in the cards in 2010 and inflation is also in the cards as well by then. The asset side of Fed's balance sheet has grown disproportionately. If the Fed has been printing money to relief economic pain, it is going to show up in rising prices almost immediately. That would be another tidal wave, if not a tsunami to contend with in an after mass of current deep recession.

Bibliography:

." Hazelton, Keith, American Chronicle, May 23, 2007, p.1.

Wall Street Journal September 12, 2008

Wall Street Journal, October 13, 2008