

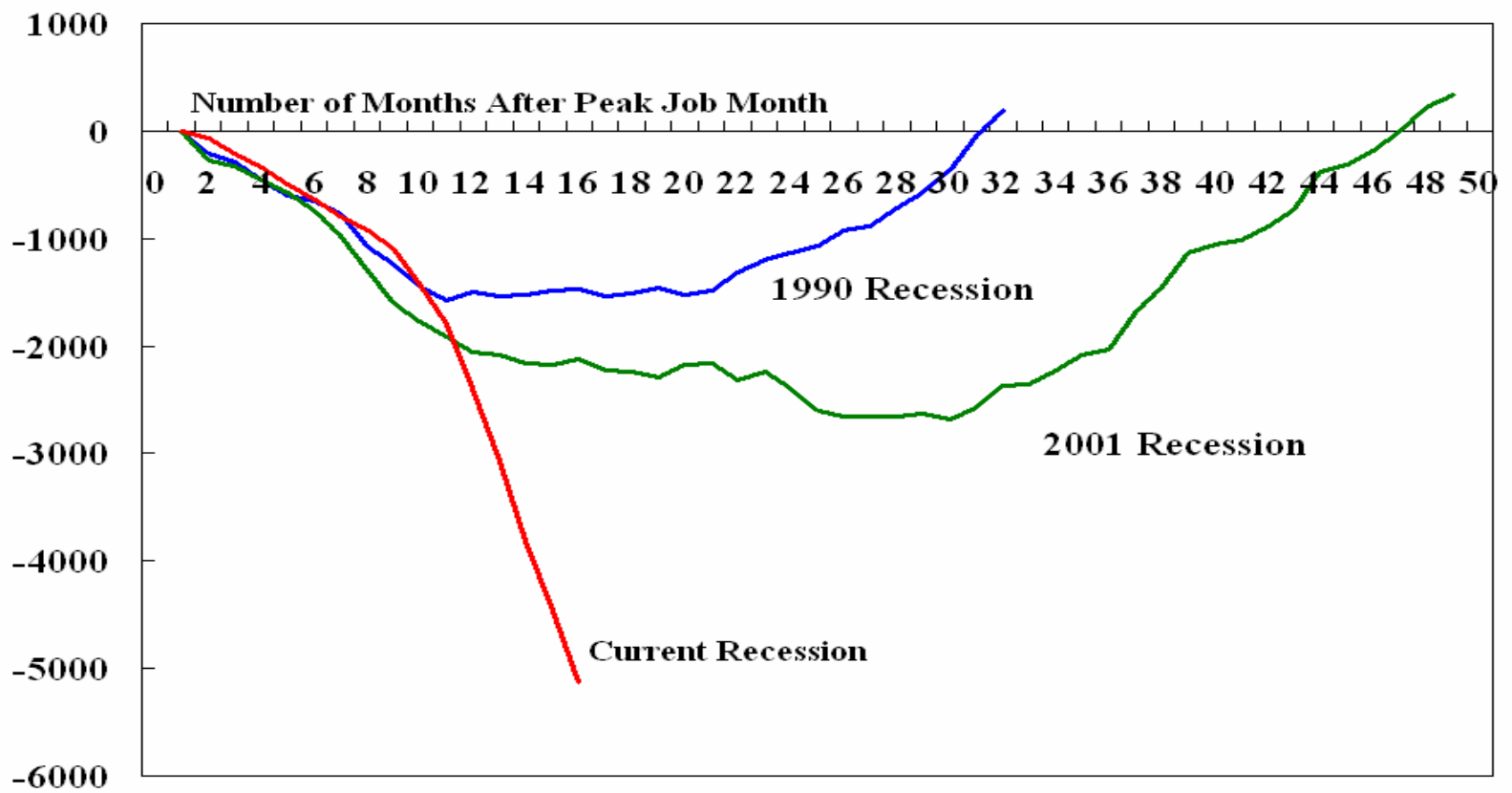


# The Financial Meltdown

A Spiritual Diagnosis

# Job Losses in Recent Recessions

(Total non-farm jobs relative to peak, 000s)



Source: Bureau of Labor Statistics.

# Overview

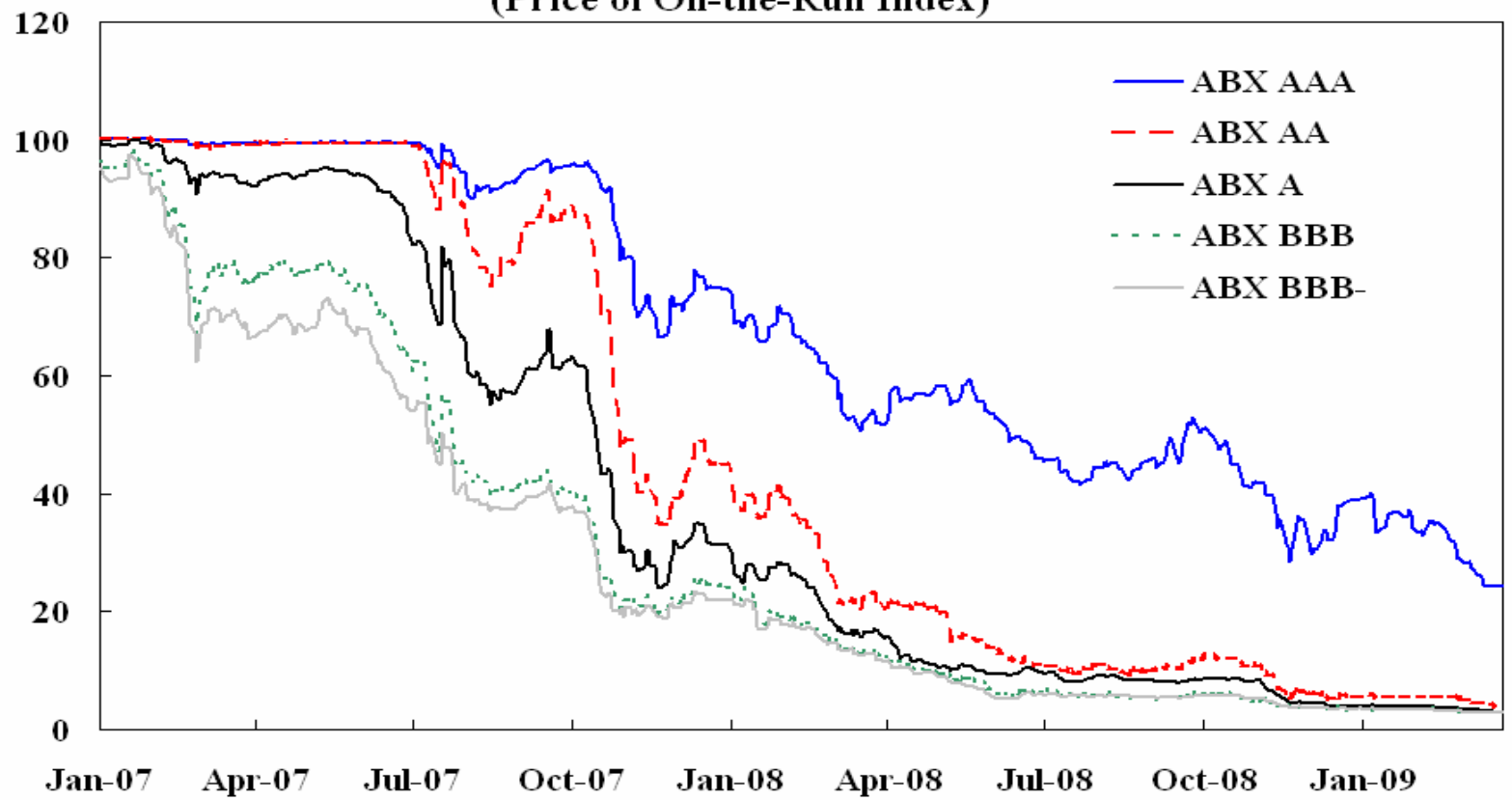
- The Causes and culprits;
- The Consequences;
- Underlying root cause;
- What this reveals about the spiritual state of high income countries (esp. US/UK);
- What the Bible teaches about finance, in contrast to conventional thinking;
- Implications for public policy; the church; and Christians.

# The Causes and Culprits

- Foreign central banks recycling surplus dollars
- Fed – LTCM, dotcom bubble, loose monetary policy (2002-05)
- Fed – inadequate mortgage regulation
- Investment banks and credit rating agencies – from risk modelers to CEOs
- Bank regulators – off-balance sheet leverage; liquidity; risk-adjusted assets; credit default swaps; systemic risk
- Congress – mortgage subsidies; GSEs; regulatory inertia
- House purchase industry – brokers, realtors, appraisers, buyers

# Subprime waterfall

ABX Index by Rating  
(Price of On-the-Run Index)



Source: JPMorgan Chase & Co.

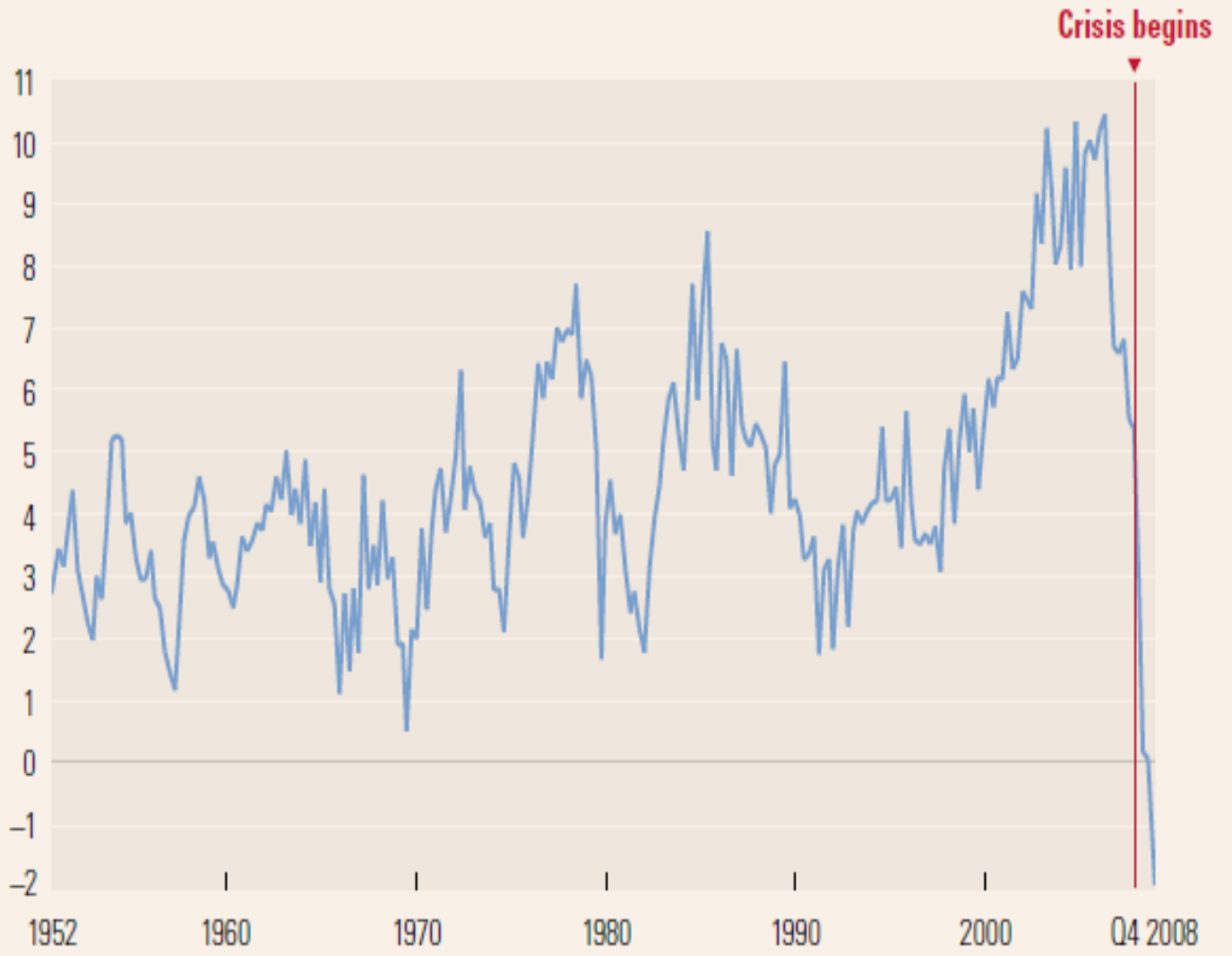
# Dominoes fall...

- Subprime losses  $\Rightarrow$  capital needed and liquidity strains. Off-balance sheet assets taken onto balance sheet
- Banks and hedge funds tighten standards and sell assets
- Interbank lending stressed
- Bond insurers downgraded
- Liquidity runs (Bear Stearns; Lehmans)
- Failure of firms (IndyMac; Merrill Lynch; GSEs; WaMu; Wachovia etc)
- Delayed impact on equity prices and world economy
- Systemic guarantees, bailouts (AIG, Citi, BoA), and equity and asset purchase schemes
- Fed moves to “printing money”

# Consequences

- Sharp rise in delinquencies and unemployment
- Disappearance of broker-dealers
- Financial regulatory transformation (banks, insurance?, GSEs, Fed as systemic risk regulator?)
- Tightening of credit standards and stock price fall → borrowing falls and dramatic impact on wealth and consumption → sharp rise in saving
- Substantial fiscal risks (Fed, Treasury, GSEs, FDIC, FHLBs, etc) – threat to US AAA-rating?

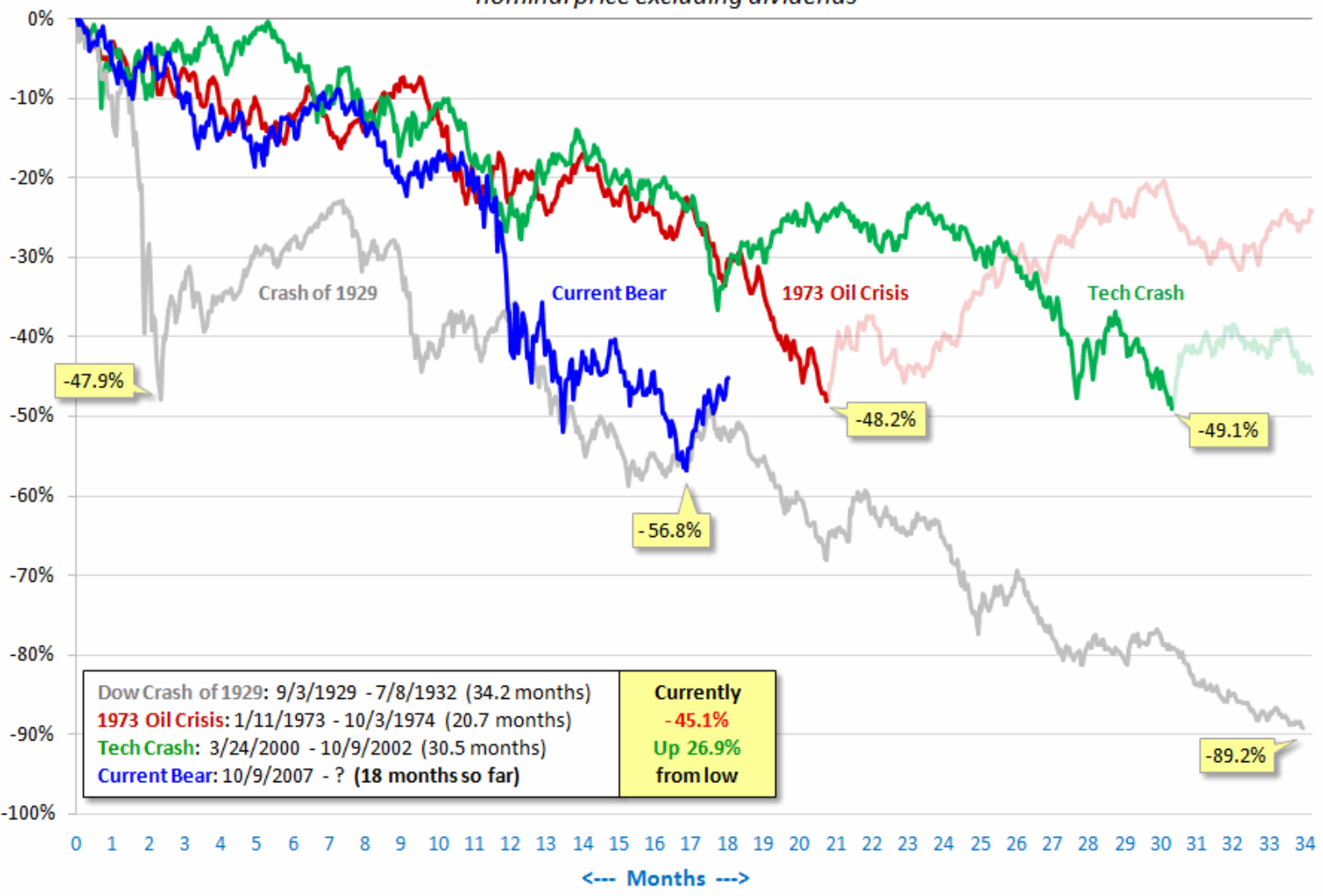
Net new borrowing by US households,<sup>1</sup> % of GDP



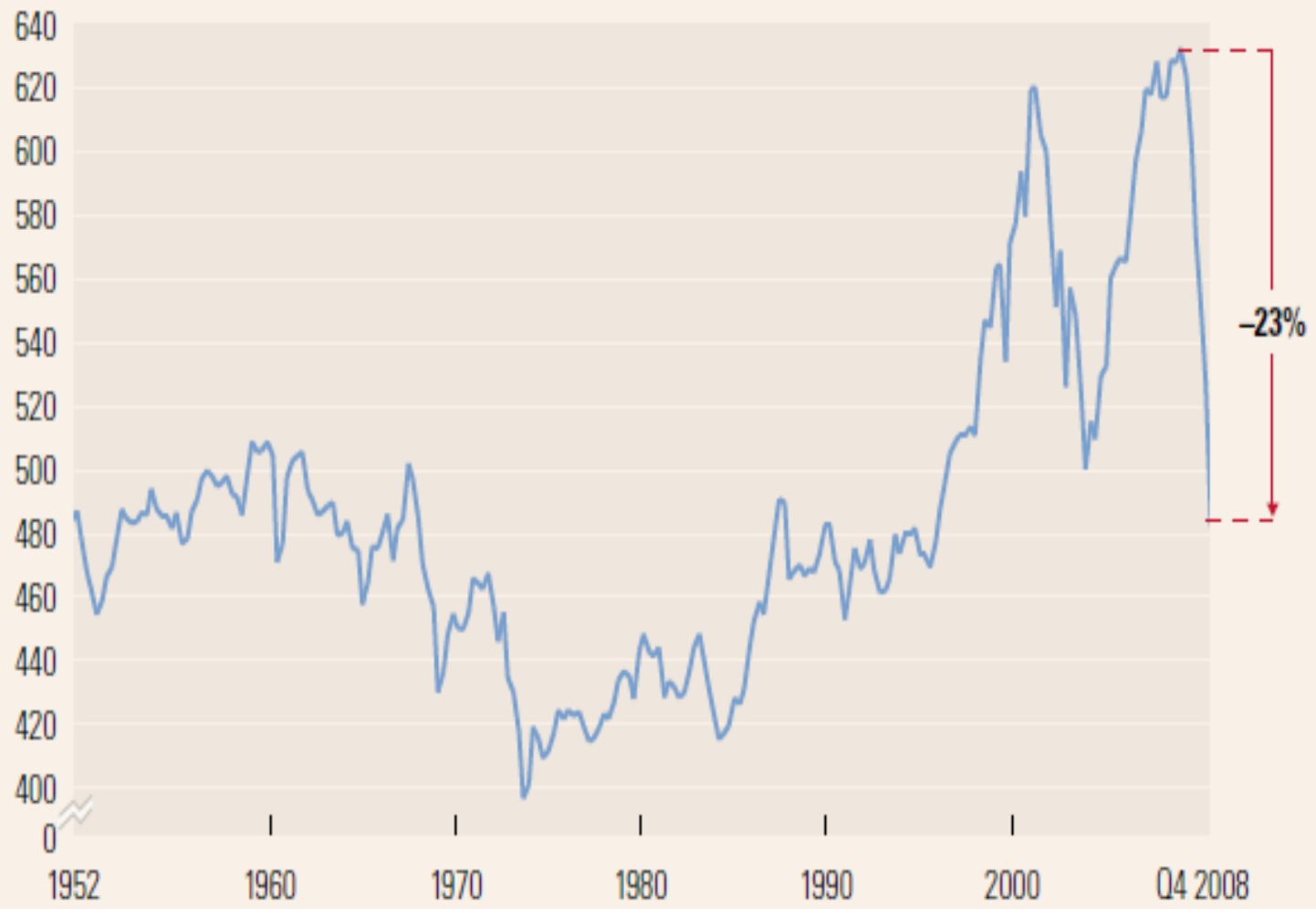
# Four Bad Bear Markets

Dow in 1929-1932; S&P 500 in 1973-74, 2000-02, 2007-09

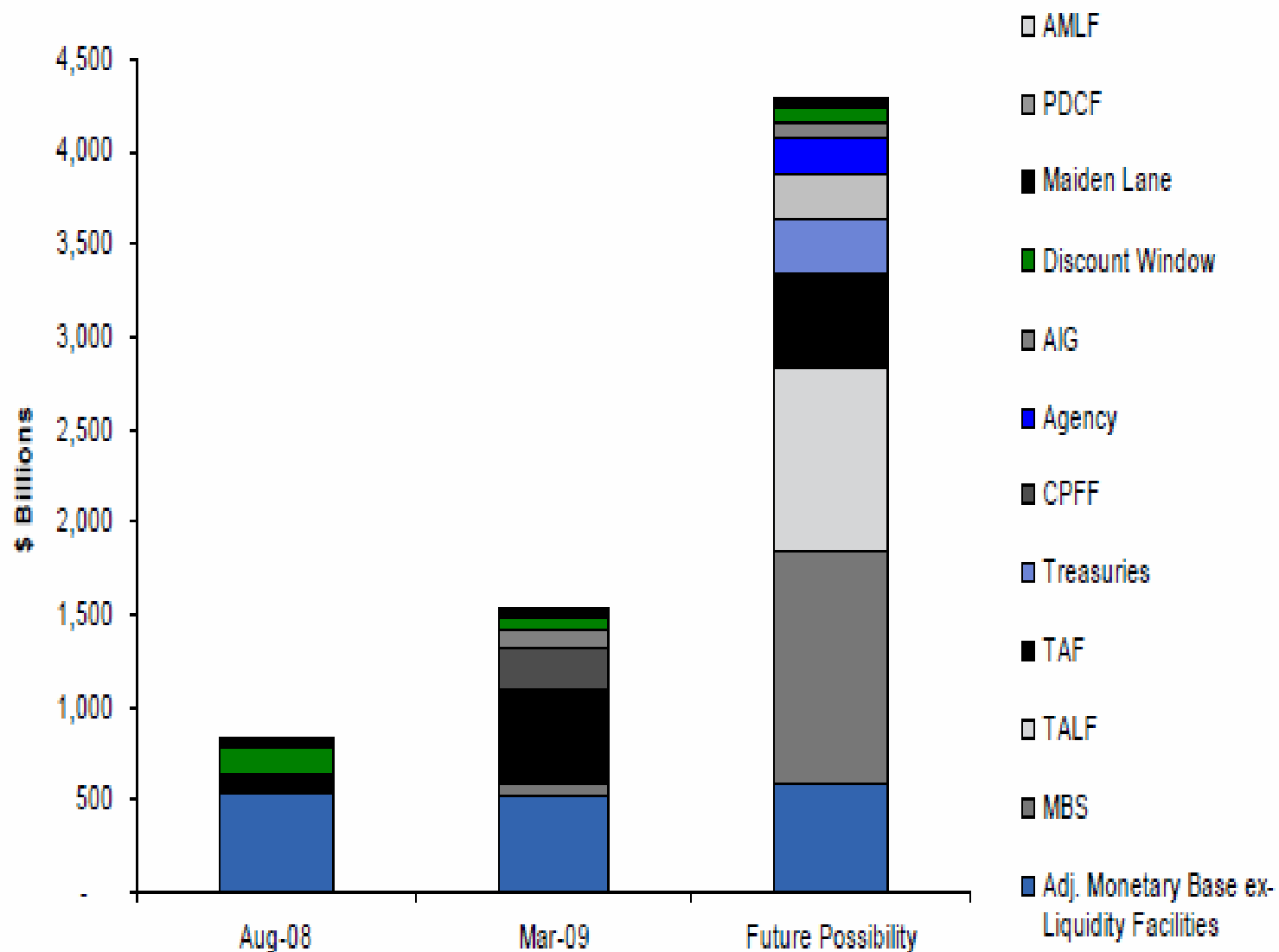
nominal price excluding dividends



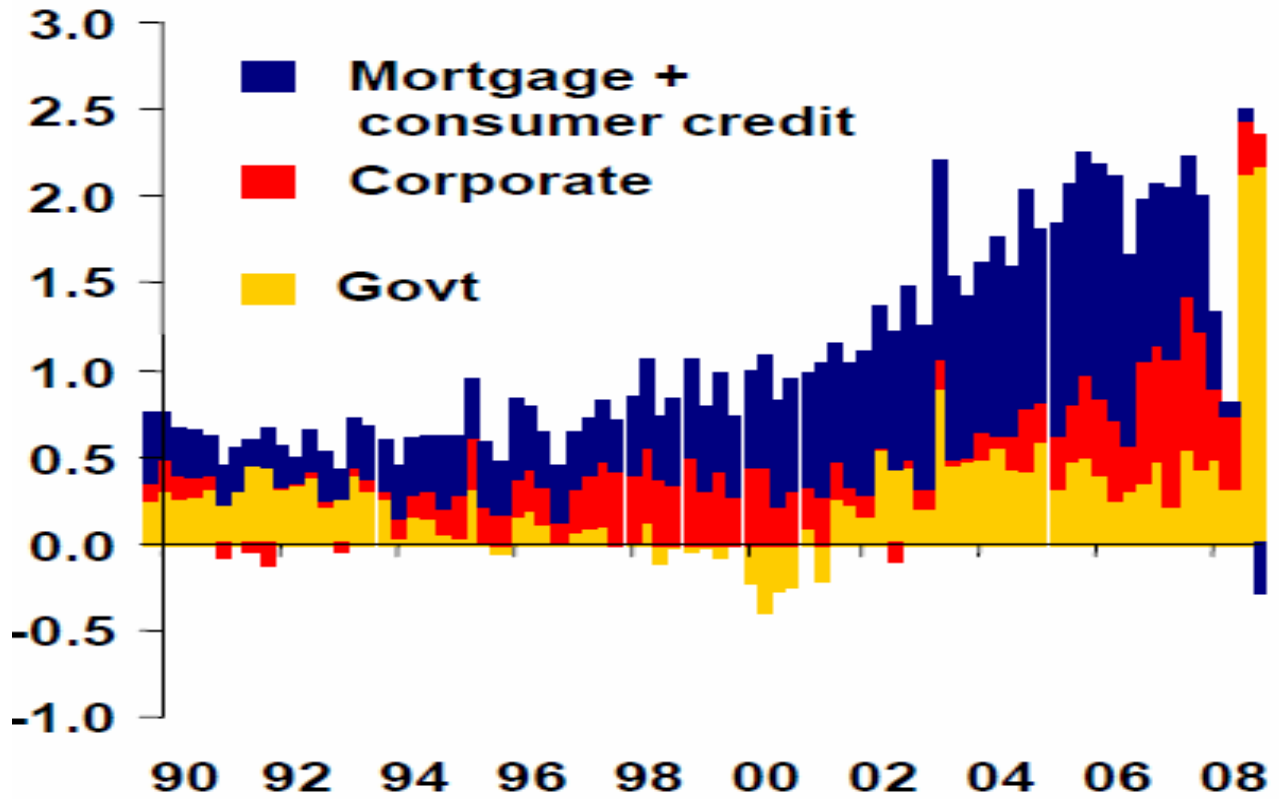
US household net worth relative to disposable income, %



# Breakdown of Adjusted Monetary Base + Liquidity Facilities

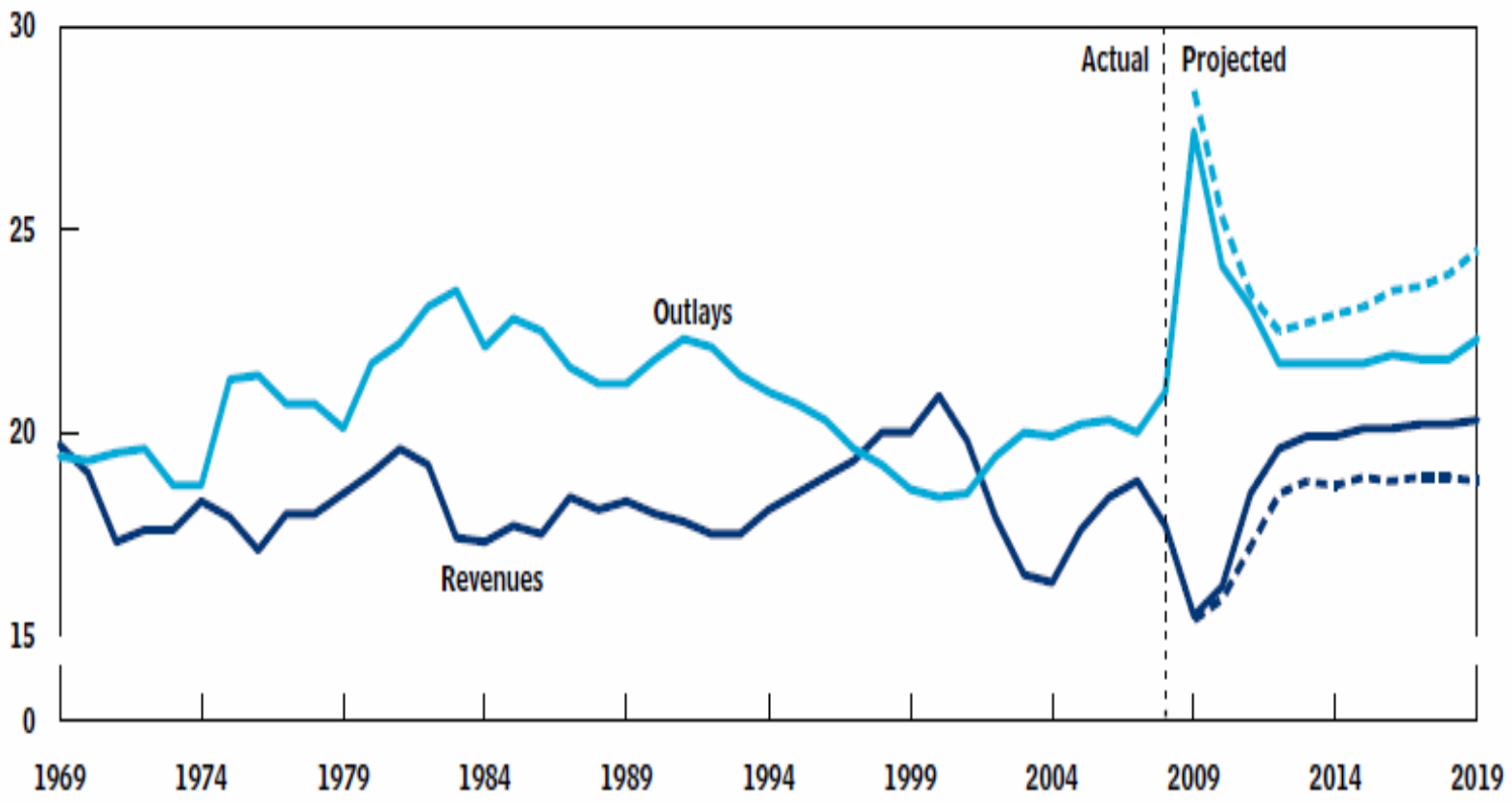


# US Borrowing by Sector (*\$ Tr, Quarterly Annualised*)



# Total Revenues and Outlays as a Percentage of Gross Domestic Product in CBO's Baseline and the President's Budget

(Percent)



Source: Congressional Budget Office.

Note: Dashed lines represent CBO's estimate of revenues and outlays as a share of gross domestic product in the President's budget.

# Initial cause of contagion: illiquidity

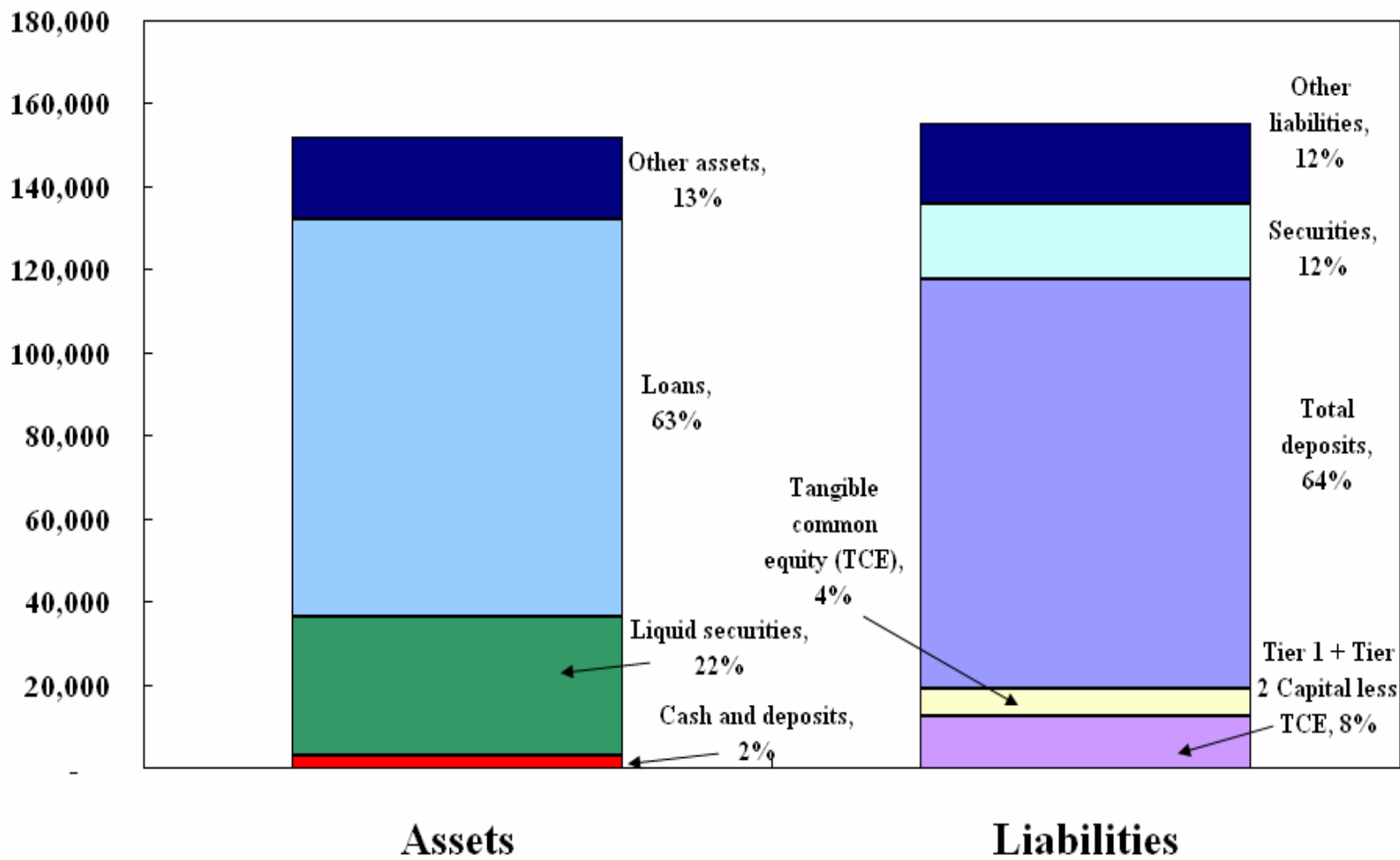
- Banks transform liquid liabilities into illiquid assets
- Ability to do so is meant to be limited by regulation.

But:

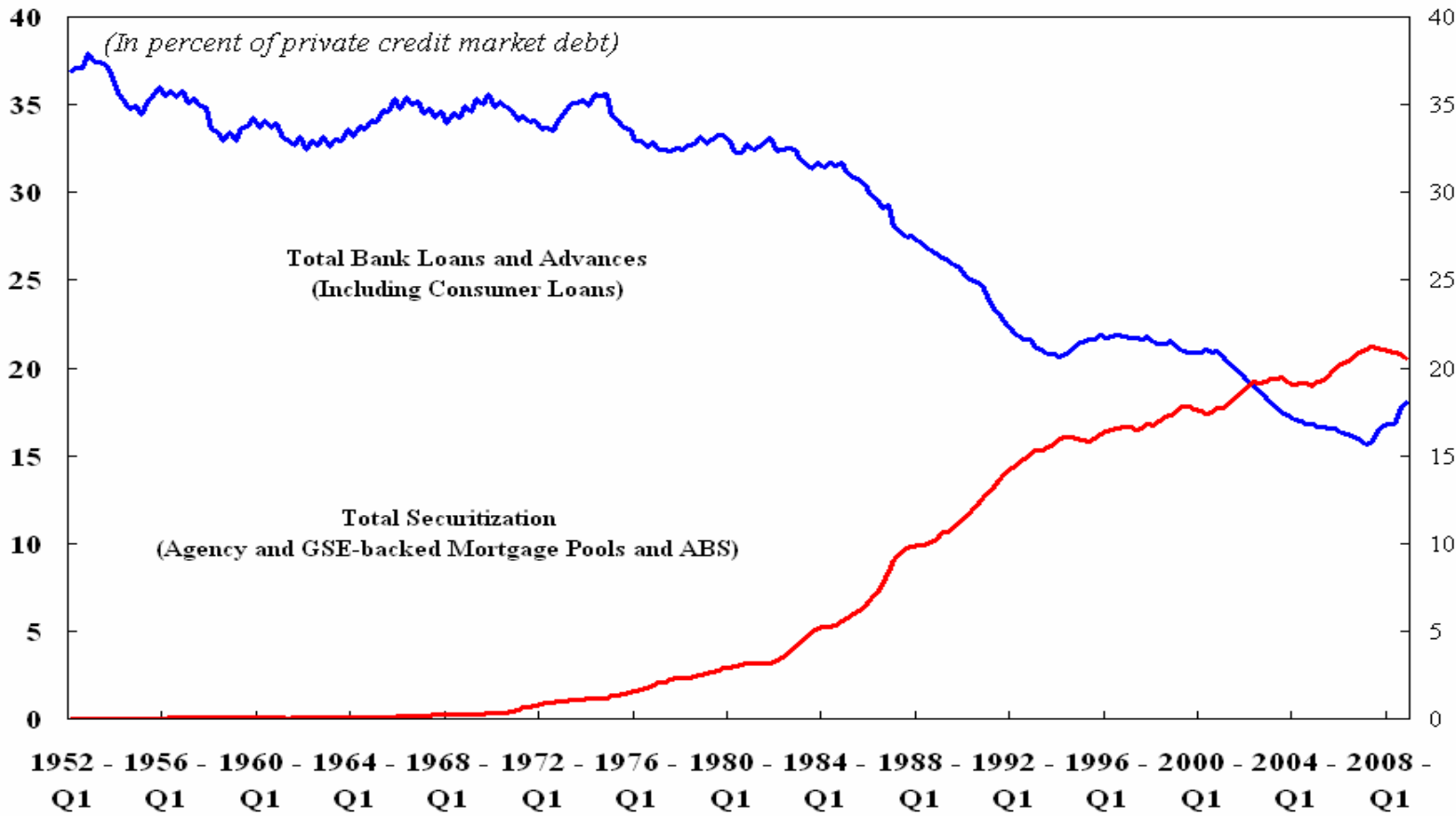
- maturity mismatch, and
- reliance on wholesale sources of finance, grew strongly from 2003 on.

# Balance Sheet: BB&T

(As of December 31, 2008; in millions of U.S. dollars)

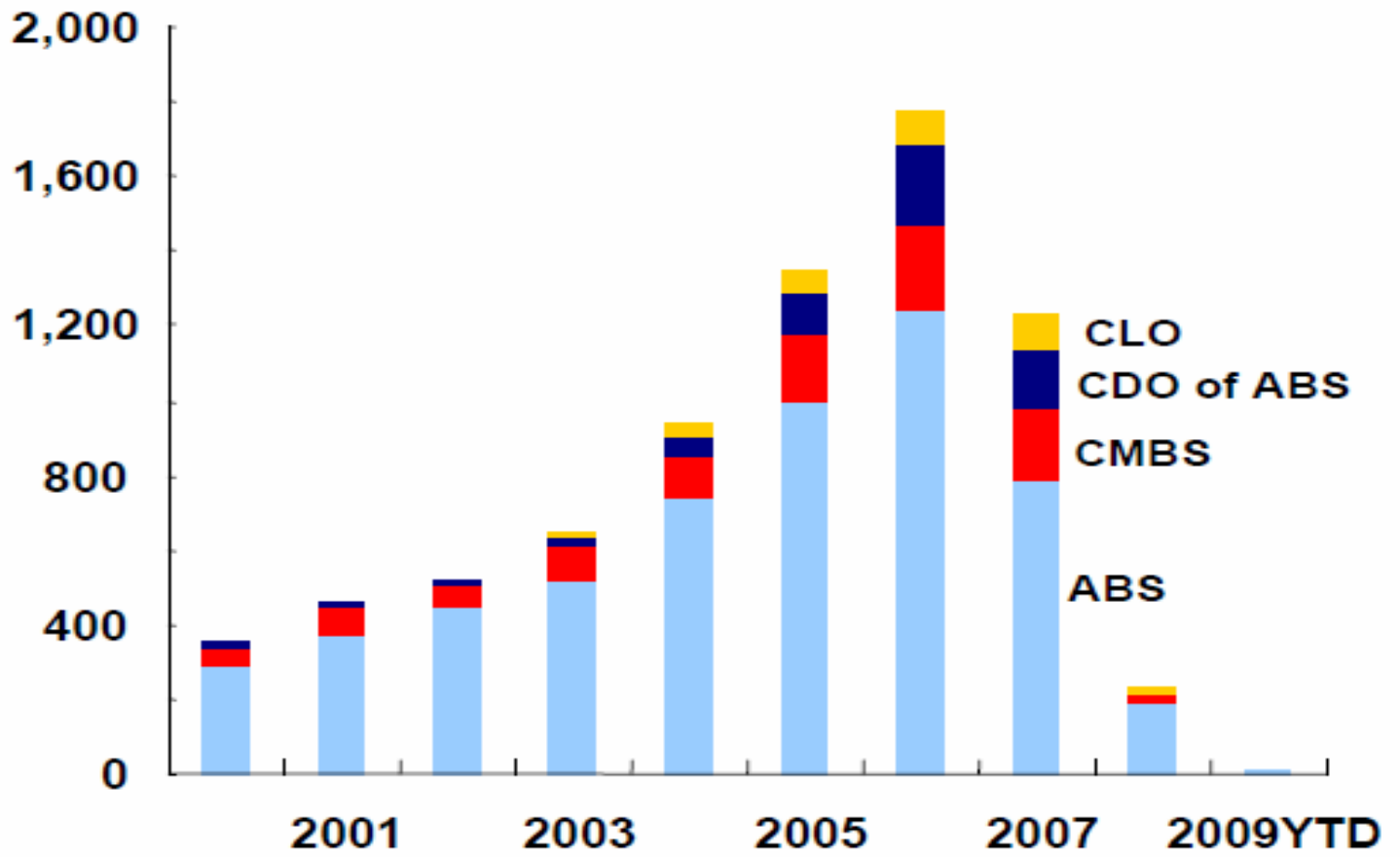


# Bank loans vs securitization



Source: Flow of Funds.

# Non-agency securitization (\$bn)



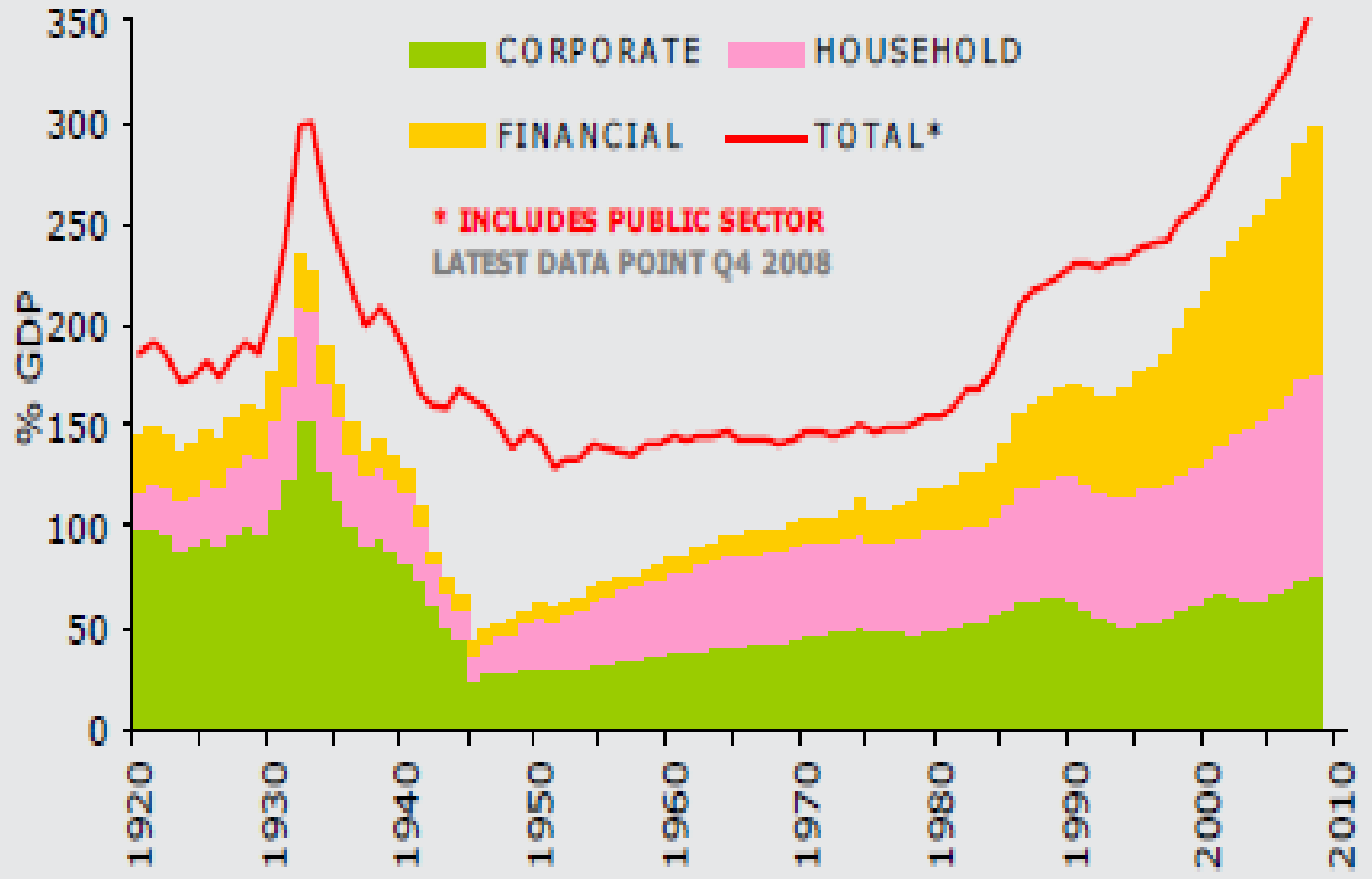
# Ultimate Cause of Contagion - Leverage

Drastically over-leveraged and over-extended private sector:

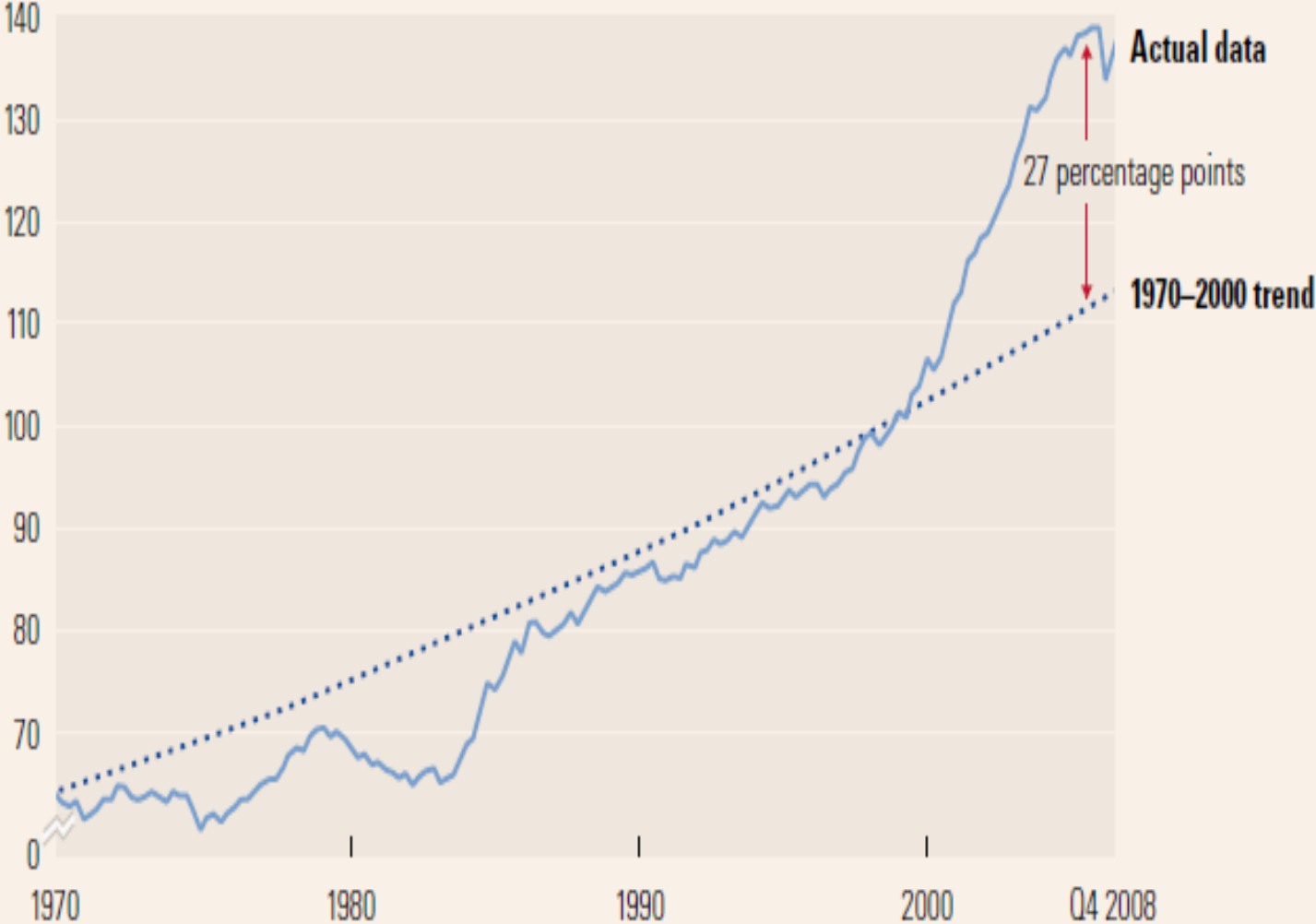
- **Households:** rising debt, largely secured against overvalued property
- **Companies:** borrowing to buy-back equity
- **Financial institutions:** leverage hidden in the 'shadow banking system' (GSEs, hedge funds, private equity, off-balance sheet vehicles, securitized credit and derivatives)

# The Debt Mountain

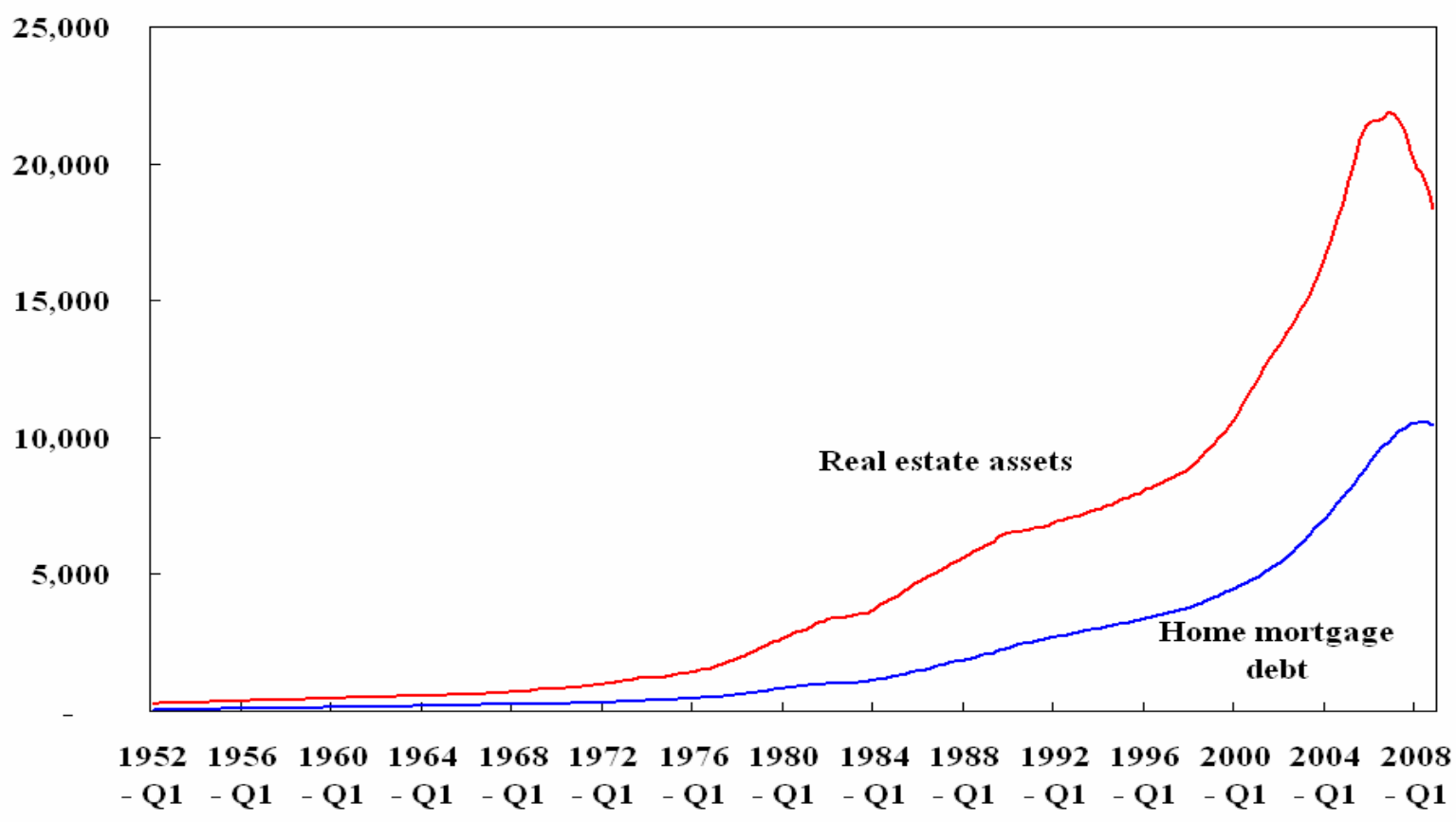
US DEBT TO GDP, BY SECTOR



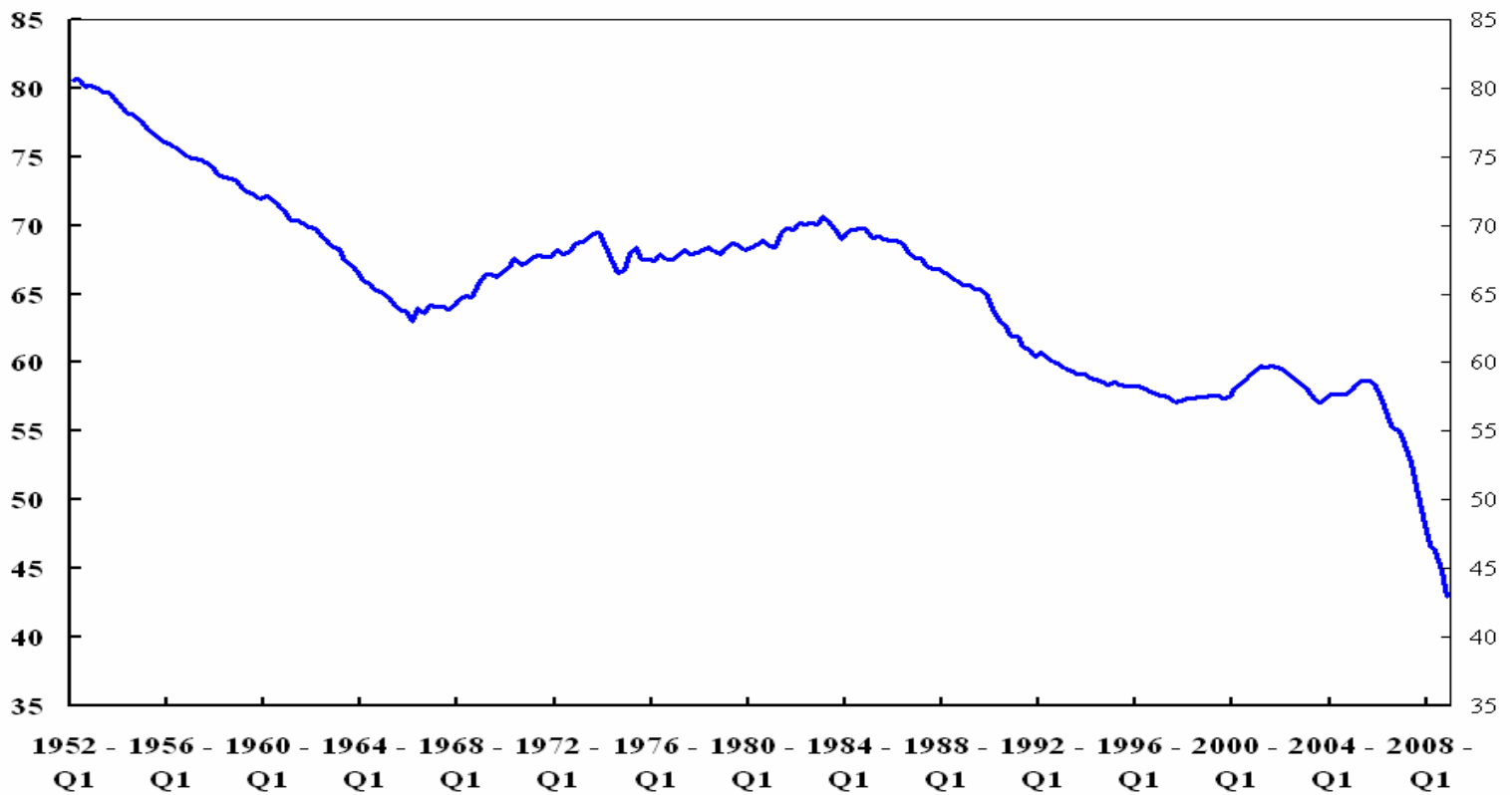
Household liabilities as share of disposable income, %



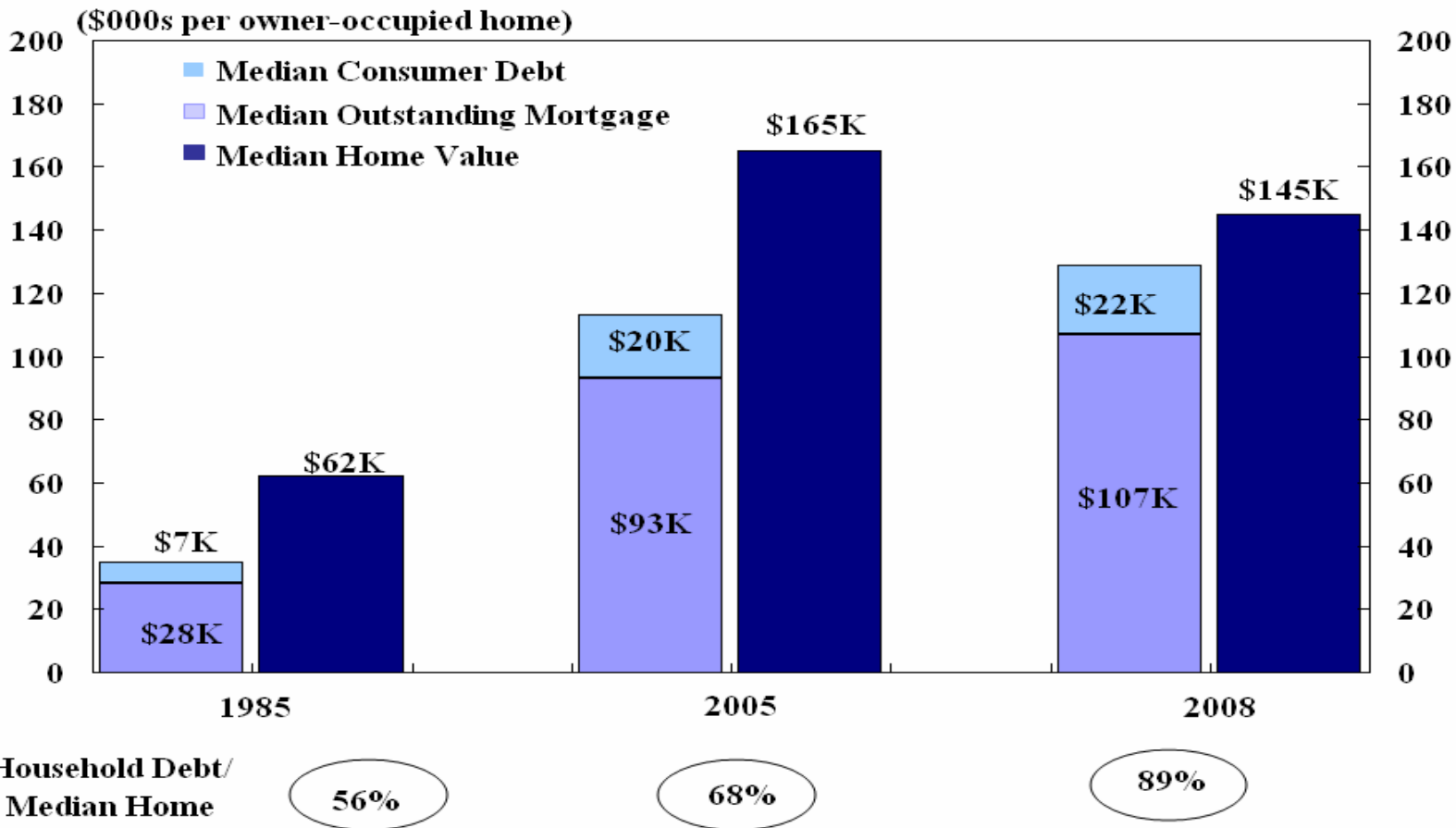
# Real Estate Assets and Mortgage Debt (\$tr)



# Owners' Equity as Percentage of Household Real Estate (%)

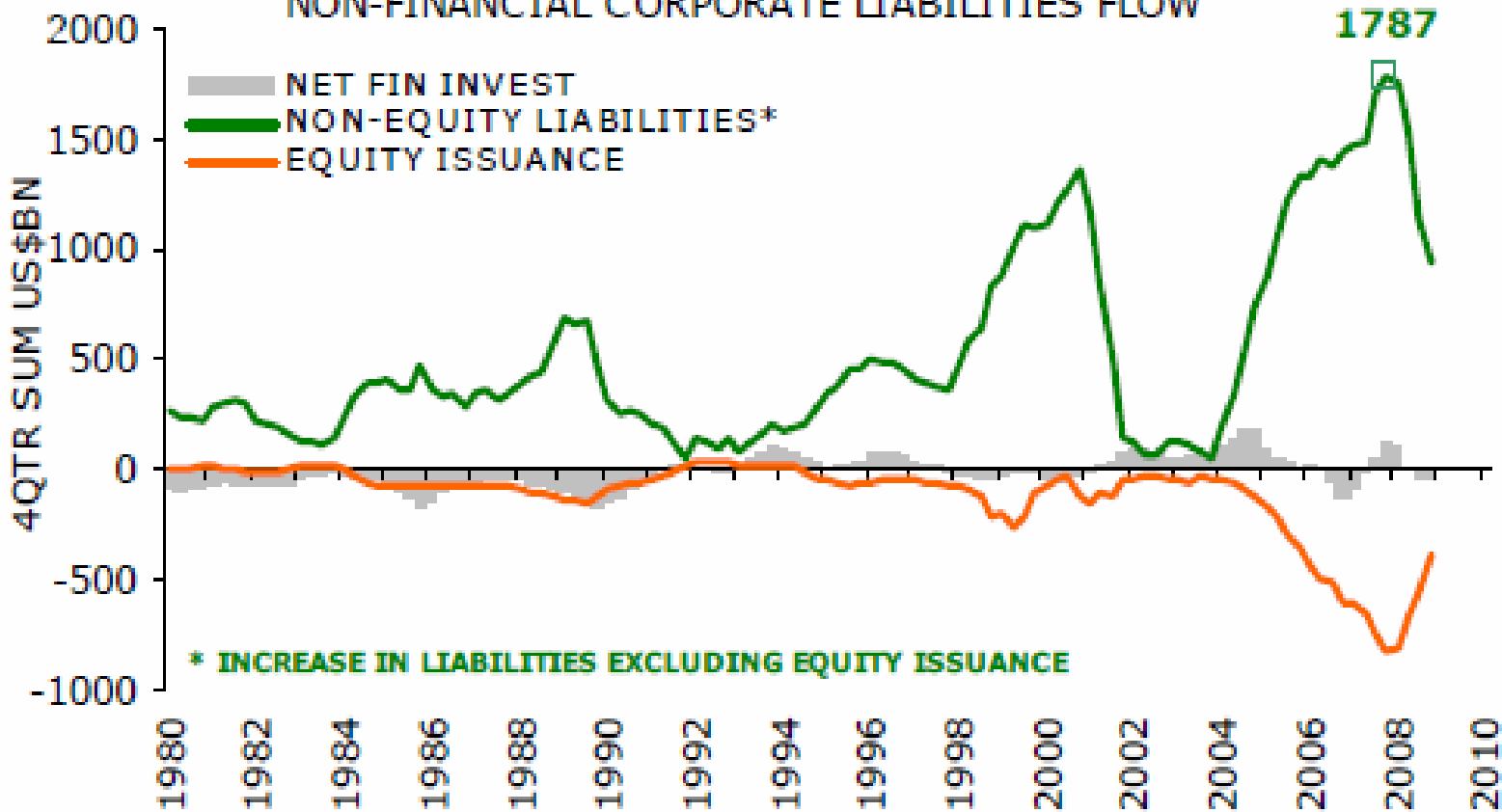


# Household debt to median home value



# Companies borrowed to buy-back equity

NON-FINANCIAL CORPORATE LIABILITIES FLOW





# Understanding bank leverage

Leverage -

Total assets: tangible common equity; or

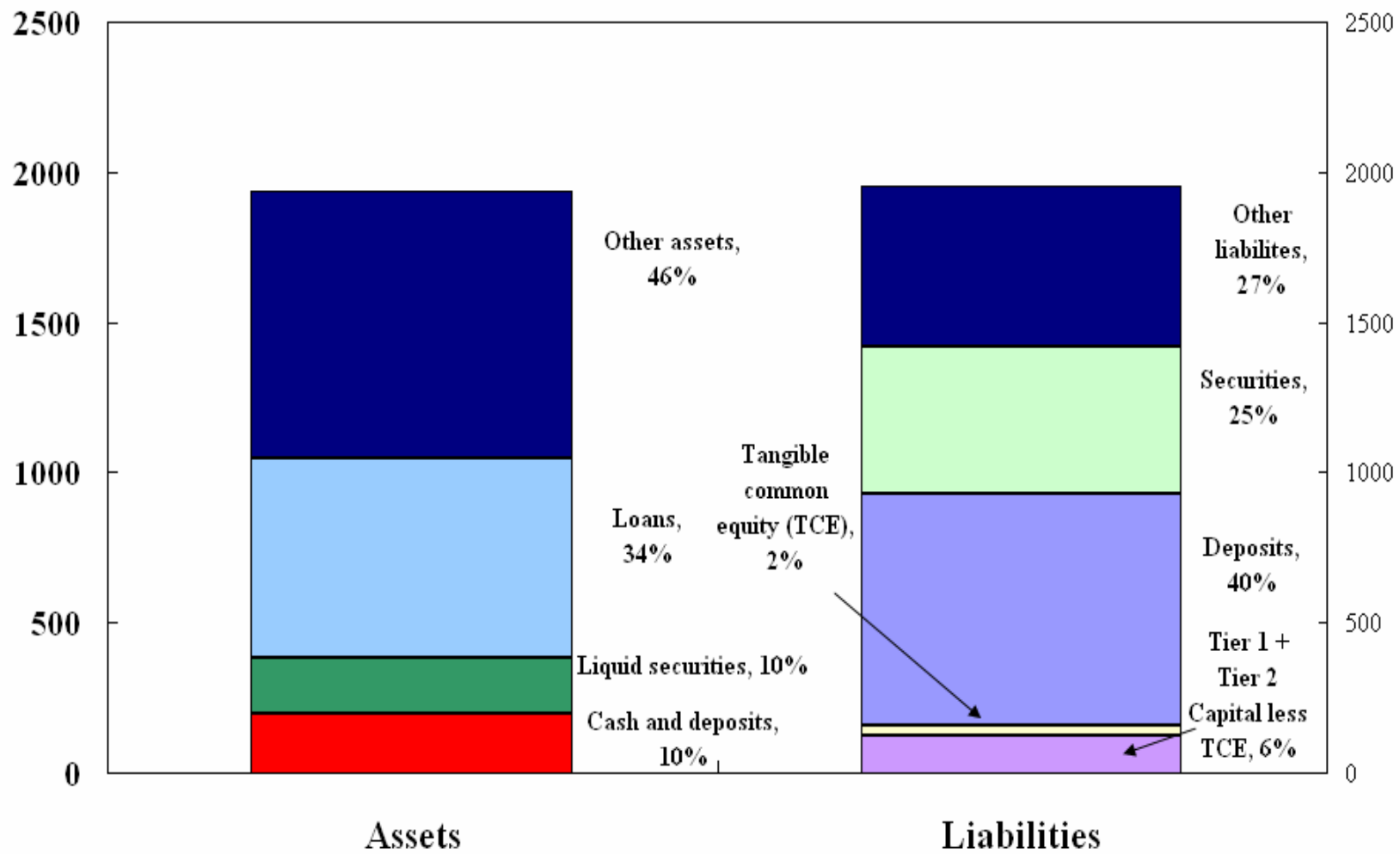
Risk-adjusted assets: Tier I capital

U.S. commercial banks – 12-18 times

U.S. investment banks – 30-35 times

European banks – 35-40 times

*Balance Sheet: Citigroup*  
*(As of December 31, 2008; in billions of U.S. dollars)*

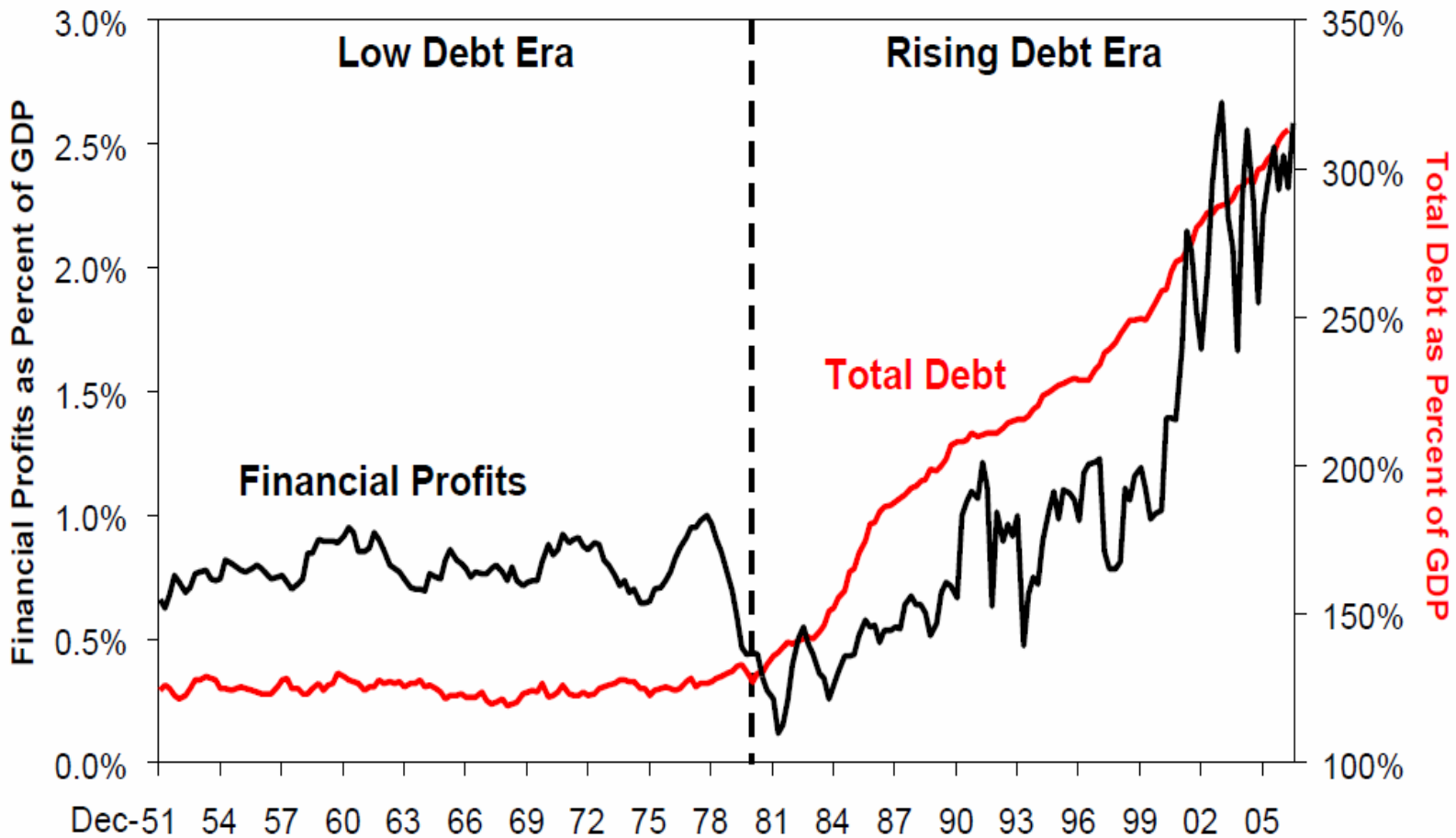


PEOPLE USED TO THINK I'M  
A NUTTER - NOW THEY THINK  
I'M WITH THE IMF

THE  
END  
IS  
NIGH




# Total debt, financial profits: GDP



# What's wrong with a debt-based financial system? (Fisher, Minsky)

- A **volatile economy** – balance sheet leveraging and deleveraging exaggerates investment cycle
- **Speculative booms and busts** in financial assets and property
- An inherently **unstable banking system** that survives only with government backing
- **Misallocation of finance** to those with collateral rather than good projects
- **Poor lending decisions** when loans are securitized, breaking relationships
- **Endemic inflation** when debts become money and borrowers need to have real burdens relieved
- **Entrenchment of differentials** between rich and poor (eg. low income country debt).



*'An economic system that includes the positive feedback of compound interest can only endure if it also includes a counteracting force such as inflation, bank failures, confiscatory taxes, robbery, bankruptcy, revolutions or repudiations of debts. Conventional wisdom considers these events are pathological. Understandable they may be: but at least one such force must be included ... if the system is to endure.'*

*(G. Hardin and C. Bajema, *Biology: Its Principles and Implications*, 1978).*

# A spiritual diagnosis

- Theft and fraud
- Greed
- Fecklessness/myopia
- Pride
- Idolatry

# Biblical model for finance (I)

- The imperative to **love God and neighbour, not money** (Mt.6:24; 22:37-40);
- **Use money to build relationships** that will last into eternity (Lk.16:9);
- **Interest-free lending** is commended (Ps.37:26;112:5) and commanded to aid those in need (Ex.22:25; Lev.25:35; Dt.15:7-11);
- The **moral imperative to repay debt** (Ps.37:21; Rom.13:8); hence collateral could be taken (Ex.22:26,27; Dt.24:10-13);

# Biblical model for finance (II)

## ■ Intended freedom from debt:

- Seven-year cancellation of debts and slaves (Dt.15:1-3,12-15; Neh.10:31);
- Kinsman-redeemer (e.g. Lev.25:25,48);

## ■ Presumption of a **debt-free money** (e.g. Dt.22:19,29);

## ■ **The prohibition of interest** (e.g. Dt.23:19–20; Neh.5:1-13; Lk. 6:34,35; 19:22,23);

## ■ **Alternatives to debt contracts** (Ex.22:14–15; Lev.25:14-16,29-31).

# Likely outcomes/intentions

- Debt incurred interest-free only in need; central part of welfare system;
- No long-term indebtedness; periodic freedom from debt;
- Non-pecuniary lending motives;
- Commodity money with stable price level;
- Finance channeled through non-debt forms of finance (rental, rent-share, leasehold, equity partnerships);
- Close ties between users and suppliers of finance. “Risk and responsibility theory of capital.”

# Applications

- **Public policy:** market system vs free market finance; stop tax subsidizing indebtedness; make banks smaller and easier to close - 'too-big-to-fail' is 'too big to exist'.
- **Church:** rediscover Biblical teaching on finance and debt and seek to apply within the context of healthy relationships (interest-free loans; debt counseling).
- **Christians:** minimize indebtedness; use money to build relationships – we are accountable to God for its stewardship.