

"Israel and the Global Financial Crisis"

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In the past month, the US Government has taken over some of America's biggest financial institutions and committed \$700 billion of public money to prevent a financial disaster. America's five large investment banks have either gone bankrupt or been converted into commercial banks. Within three weeks, the US Government has expanded its gross liabilities by more than \$1 trillion (almost twice as much as the cost –so far- of the Iraq war). Five European banks were nationalized or bailed out with public funds in the last week of September.

This is not the world's first financial crisis and it won't be its last. Remember the Asian financial crisis 10 years ago? Except that the world looks very different today. At the time, cash-trapped Asian countries turned to the IMF and to the US Treasury to rescue their collapsing economies. Today, those same Asian countries are comfortably sitting on piles of foreign exchange reserves, while the US Treasury and the Fed are trying to prevent the implosion of the American financial system. Ten years ago, the Treasury and the Fed were dictating tough terms to Asian governments. Today, they're begging Congress for public money to repair the damages of the excesses of Wall Street.

Still, we are experiencing the most serious financial crisis since the 1930s. British Prime Minister Gordon Brown recently claimed that "The global financial market has ceased to function." Banks are going

bankrupt or are unable to raise money, which means that companies are short of funding, and which in turn is affecting their production and value. Hence the decline of their shares and of the stock market.

What happened? One popular, if not populist, answer is to put the blame on speculators, Wall Street executives and free-market ideology. In other words, to blame today's financial system. But this system has also boosted economic activity and created wealth.

Is there something fundamentally wrong with today's international financial system? Finance has changed a lot in the past three decades. It used to be that regulated commercial banks would lend money to trusted clients and hold the debts on their books. Today, capital flows faster but also through more complicated and sophisticated financial products. Financial markets, especially in the rich world, have become increasingly integrated. The stock of foreign assets and liabilities held by rich countries has risen fivefold relative to GDP in the past 30 years and doubled in the past decade.

This is due to deregulation, to technical innovation, and to the international mobility of capital. The rationale behind financial deregulation was that freer markets produce superior outcomes. Capital would flow to its most productive use, boosting economic growth. But you can also look at it the other way round and say that, because financial markets are inherently unstable, periods of stability always lead to excess and eventually to crisis, and therefore that freer capital markets only cause greater damage.

Would more government regulation make the financial market safer and more stable? Not necessarily. After all, an entire government agency was devoted to overseeing the housing-finance giants, Fannie Mae and Freddie Mac, but that did not stop them from behaving recklessly. And hedge funds, the least regulated actors of the new financial system, have so far proved more stable than the supervised and regulated banks.

Central banks and financial regulators have been accused of falling asleep at the wheel while the risks created by modern finance were piling up. They've also been accused of being partly responsible for the credit bubble for keeping money too cheap for too long.

For the current crisis started with the American housing and credit bubble. America's house prices have got down 20%, and many analysts expect another 10% drop across the country. That would bring the cumulative decline in nominal house prices close to the one of the Great Depression. The housing market has also declined in Spain and in Ireland, and Europeans are wrong to blame America for their own troubles.

The credit losses on the mortgages that financed these houses are accumulating. The IMF estimates that those losses could reach \$1.4 trillion. So far, some \$760 billion have been written down by banks, insurance companies, and hedge funds. Credit is shrinking, which will affect growth. In fact, recession is already there in developed economies, both because of the credit crunch and because of the surge in oil prices earlier this year. Output has already started to fall in Britain, in France, in Germany and in Japan.

Like in the past, this financial crisis can be partly solved with public money. This generally worked in the past, and it may work today. Governments can minimize damages by recapitalizing banks and taking on bad debts. But they have to act swiftly to minimize the price paid by the taxpayer, as well as the damage caused to the economy. Sweden took over its failed banks after a property burst in the early 1990s, and it recovered pretty fast. By contrast, it took Japan over a decade to recover from its own financial burst, which happened around the same time.

No one can tell whether the relief plans in America and in Europe will work. For a start, no one knows exactly how much capital will be needed to restore the solvency of American and European banks. The US Treasury plans to buy huge amounts of bad debts. The fact that the Treasury is prepared to act decisively offers a good reason for optimism. So does the fact that China's economy will likely grow by 6% in 2009, despite the financial turmoil. The continued growth of China and of other emerging markets might save the global economy from recession.

The other good news is that commodity prices, especially oil, have recently dropped. Oil prices had almost doubled in the first two quarters of 2008, and food prices went up 55%. This pushed up consumer prices, and as a result inflation reached an average 4% in rich countries and an average 9% in emerging economies. The combination of high prices and weak credit created a dilemma for central banks: they could either raise interest rates to prevent higher inflation, or lower interest rates to boost credit. With the recent and sharp fall in commodity prices, this dilemma is less of an issue.

So it is still too early to predict how much damage the current financial crisis will cause, and how long it will take to overcome it. But it is reasonable to predict that globalization as we've known it for the past two decades is heading toward a new direction. The collapse of communism and the Internet revolution generated an unprecedented integration of the world economy, with Anglo-Saxon capitalism as a model and America as a leader. In a way, the global integration of the past two decades was the triumph of markets over governments. This trend is likely to change, for three reasons.

First, financial markets are going to be more regulated. The new level of control will largely depend on the depth of the crisis, but the \$55 trillion market of credit derivatives is definitely going to be brought into the regulatory orbit. Britain, who privatized most of its economy twenty years ago, just nationalized most of its banking industry.

Second, because of concern about food security, governments in emerging markets are extending their reach, increasing subsidies, fixing prices, and banning exports of key commodities. Don't forget that the food-price spike in late 2007 and early 2008 caused riots in over 30 countries. Global trade liberalization is also being affected: The Doha round of trade negotiations collapsed this past summer partly because of Chinese and Indian concerns over food security.

Third, America is no longer the unchallenged leader of an unchallenged model. Global trade and global finance are increasingly being shaped by emerging economies, first and foremost by China. China is piling up foreign-exchange reserves so fast that if it were to put them into American shares instead of bonds, it would be owning more US stocks

than all other foreign investors put together. Plus, America is no longer in a position to lecture on the "Washington consensus." As China's deputy Prime Minister sarcastically commented lately: "It looks like the teacher got into trouble."

So the balance between markets and governments is shifting and America's global power has been affected. But it would be wrong to get into an anti-market and anti-American mood. Yes, there have been speculative excesses and, yes, some regulation is needed in the financial market. But governments also bear some responsibility for the current mess, as they've been distorting the market with misguided subsidies, from biofuels to mortgage interests. Putting all the blame for today's crisis on speculators and greed is simplistic. The bubble and the burst were also caused by cheap money, government distortions, and poor supervision.

The financial innovations and capital mobility of the past three decades have brought both wealth and mess. What is needed is the type of financial regulation that prevents gambling and irresponsible risks, and that requires banks to accumulate more reserves during good times.

But getting into an anti-market and over-regulatory mood is not a solution. Governments need to clear the mess without hampering wealth. This means introducing regulation into the financial system without dragging the free movement of non-financial goods and services into the argument. Capitalism has always generated crisis and it always will. But no one has been able to come up with a better system to create wealth and pull people out of poverty.

And what about Israel in all this? Our Finance Minister, Roni Bar-On, said a few platitudes. His only noteworthy comment was that it is still too early to tell how the crisis will affect us. He sounds like Mao Zedong who once said that it was still too early to evaluate the consequences of the French Revolution. *Ha'aretz* recently reported that a senior Government official said that the world financial crisis is not really affecting Israel, and that there are many disagreements within the Government about what to do.

In truth, Israel is in pretty good shape. Our banks are not collapsing and our industry is not suffering from a credit crunch. Israeli banks have raised interest rates claiming that they need to cover themselves from a riskier world market. But they may just be taking advantage of the situation –something they can afford doing since Israel's banking system is in effect a competition-free and well-coordinated cartel. In a way, having a backward banking system, as we do, has its advantages. Israeli banks don't borrow from each other (they borrow from the central bank) and they didn't get into the subprime business.

The sector that may suffer the most is our high tech industry, since it's going to be harder for VC funds to raise money. But we've been there before. Our VC funds couldn't raise a penny in 2001-2002, and then they bounced back.

The real risk for Israel is for its politicians to use the current election period to get into an anti-market rhetoric. Ehud Barak has already started. He's been denouncing capitalism out loud. If he was living modestly like Ben-Gurion or Menachem Begin, he could at least be taken seriously. But coming from someone who became rich thanks to

capitalism and who is trying to sell his luxurious apartment for \$11 million, it sounds a bid fake. Anti-capitalist populism sells very well in Israel. Unfortunately, most of our politicians have used the world financial crisis to reap electoral benefits through cheap and empty slogans instead of telling us what they think should be done about the crisis.

The upcoming elections in Israel are a good opportunity for our politicians to say something intelligent about our economy. Good luck on that. But the fact that we are doing pretty well despite our leaders is in itself a good reason for optimism.