Fallout of the Global Financial Crisis

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April 2008

RSM International
The Worldwide Audit, Tax & Consulting Network

What started as turbulence in segments of the U.S. subprime mortgage market has become a global financial crisis, which some analysts deem the biggest challenge to the international financial system since the Great Depression.

This article summarizes world economic developments since the November 2007 release of RSM Global Business Forecast-Middle Enterprises in the World Economy and examines their repercussions for middle enterprises.

Global Fallout of the U.S. Subprime Crisis

Data released on April 8 by the International Monetary Fund illustrates the magnitude of the present crisis:

- Mark-to-market losses on mortgage-backed securities, collateralized debt obligations, and related assets through March 2008 approximate $945 billion. In absolute terms this represents the largest financial loss in history, exceeding asset losses resulting from Japan's banking crisis in the 1990s ($780 billion) and far surpassing losses emanating from the Asian crisis of 1997-98 ($420 billion) and the U.S. savings and loan crisis of 1986-95 ($380 billion).

- The damage extends across a wide range of investor classes. Commercial banks stand to lose $440-510 billion, insurance companies $105-130 billion, pension funds $90-160 billion, governments $40-140 billion, and other financial institutions $110-160.

- Innovations in mortgage securitization in the early- and mid-2000s enabled loan originators to sell high-risk assets to downstream financial institutions around the world, thereby globalizing the American subprime crisis. Against U.S. bank losses of $144 billion, European financial entities stand to incur $123 billion in mortgage-related losses. Within the latter group, British institutions face $40 billion in asset write offs, nearly matching the combined losses of the Euro area ($45 billion). Financial institutions in Asia and other regions are far less exposed.

- The imprudent lending practices that precipitated the American subprime collapse are not confined to the United States. The IMF estimates that housing prices in Ireland, Netherlands, and United Kingdom are 30 percent higher than justified by economic fundamentals. British housing prices fell by 2.5 percent in March, the sharpest monthly fall in that country since 1992. Australia, Belgium, Denmark, France, Norway, Spain, and Sweden also face sizable housing bubbles.

- Housing prices in OECD countries with more conservative lending practices (Austria, Canada, Finland, and Germany) are more closely aligned with market fundamentals, underscoring wide country variations in mortgage markets.

- A surge in corporate defaults and debt downgrades in the U.S. and Europe indicates spillover of the subprime crisis to non-financial companies, as commercial lenders re-price their risks and de-leverage their portfolios.

- Together with the contraction of household spending resulting from the mortgage crisis, the tightening of corporate credit portends a slowing of economic growth worldwide. The IMF forecasts global economic growth to fall from 4.9 percent in 2007 to 3.7 percent in 2008. The U.S. faces a steep decline from 2.2 to 0.5 percent, with a non-trivial possibility of a prolonged and deep recession. GDP growth in the Euro zone, U.K, Canada, and Japan is expected to fall to the 1.2-1.6 percent range in 2008-2009.

The U.S. Federal Reserve and the Bank of England have slashed interest rates in an attempt to stimulate economic growth. But there are serious doubts about the efficacy of monetary policy in the current downturn, as the contraction of global credit stems less from the high cost of money than from the reluctance of financial institutions (whose battered balance sheets heighten risk aversion) to lend it. Meanwhile, rising inflation has dissuaded the European Central Bank from deploying its interest rate weapon to spur growth.

Growth Opportunities Amid the Downturn

While the deterioration of international financial markets presages slower growth and heightened uncertainty, globally active mid-sized companies enjoy strong commercial prospects in coming years. Indeed, the dislocations arising from the current crisis offer unique opportunities to strategically agile middle enterprises.

- Financially stressed companies face mounting difficulties obtaining credit. However, companies with healthy balance sheets are holding their own in the global downturn. German exporters (led by world-class manufacturers in the Mittelstand) continue their strong performance despite Euro appreciation, posting 9 percent export growth in January 2008. Industrial production in France registered a larger than anticipated increase in February, auguring favorably for that country's ability to weather the downturn.

- The April 1 report of the Institute for Supply Management confirms persistent sluggishness in the U.S. manufacturing sector. But the dollar's fall is proving a boon to American exporters, particularly manufacturers of electrical equipment, machinery, appliances, paper products, primary metals, and transportation goods. Dollar devaluation presents a major untapped opportunity for medium American manufacturers: A recent survey by the National Association of Manufacturers indicates that three-quarters of U.S. small/middle manufacturers generate less than 10 percent of their revenues from exports, while 25 percent do no exporting at all.

- Dollar devaluation also creates opportunities for middle enterprises to launch mergers and acquisitions in the United States. Recent data indicate that foreign investors from Europe and other regions are in fact exploiting currency shifts to expand their U.S. positions.

- The financial crisis has not derailed the large emerging markets from their robust economic growth paths. China's GDP growth is projected to decline from 11.4 in 2007 to 9.3 percent in 2008, India's from 9.2 to 7.9 percent, Russia's from 6.8 to 6.3 percent. Nor has the West's subprime problem endangered the financial systems of those countries. Indeed, sovereign wealth funds based in China and other emerging economies are serving as liquidity buffers by injecting capital into beleaguered Western financial institutions. Middle enterprises active in emerging markets thus have good reasons for optimism about their future growth prospects.

- Profitable growth opportunities abound in global market niches that play to the strengths of technologically nimble middle enterprises. For example, rising hydrocarbon prices and mounting concerns over global warming are stimulating investment in renewable energy. Parallel increases in food prices are spurring R & D in cellulosic processing and related technologies that do not depend on diversion of food crops to biofuels.

More broadly, previous economic downturns have proven excellent opportunities for middle enterprises to undertake counter-cyclical moves that strengthen their competitive position for the inevitable rebound: Lean enterprise campaigns; strategic acquisitions; discounted purchases of advanced equipment on secondary liquidation markets; hiring of talented employees released by downsizing companies. The present financial crisis offers similar possibilities for mid-sized companies taking a long view of their global growth trajectories.

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BIOGRAPHY

David Bartlett

David Bartlett, Economic Consultant, has over ten years' experience of consulting, researching and teaching on international corporate strategy. He specialises in international growth, global manufacturing, foreign sourcing and distribution and corporate risk management.

David's clientele includes multinational corporations and international financial institutions in North America, Europe, Asia-Pacific and the former Soviet Union.

Internationally recognised as an authority on financial sector development in Eastern Europe and the Soviet successor states, David is the author of a prize-winning book on the Hungarian transition and numerous articles on corporate strategy, international trade and investment and global finance.

David is Adjunct Professor of Strategic Management and Organization at the Carlson School of Management, University of Minnesota. He has also held faculty appointments at Vanderbilt University (USA), Yerevan State University (Armenia), and the University of World Economy and Diplomacy (Uzbekistan).

David has received a Fulbright Senior Scholarship, Salzsburg Seminar Fellowship and other scholarly awards. He holds a PhD and BA from the University of California and an MA from the University of Chicago.

David has authored a number of articles on behalf of RSM International and most recently completed the RSM International Global Business Forecast.