A Joke on the streets of Moscow these days: “Everything the Communists told us about communism was a complete and utter lie. Unfortunately, everything the Communists told us about Capitalism turned out to be true.”  
– John Nellis, World Bank
The disclosure that highly leveraged financial institutions in the United States (and abroad) were holding toxic securitised subprime mortgages shocked market participants. Banks, fearful of their own solvency, all but stopped lending. Issuance of corporate bonds, commercial paper, and a wide variety of other financial products largely ceased. Credit-financed economic activity was brought to a virtual standstill.

Alan Greenspan strongly believes (and I concur) that the use of government credit must be temporary. Eventually, the most credible source of equity will be a partial restoration of the $30 trillion of global stock market value wiped out in 2008, which would enable banks to raise needed private capital over time. Markets are being suppressed by a degree of fear not experienced since the early 20th century (in the United States).

Another critical factor for the return of global financial stability is that of American homes (underlying many mortgage backed securities). As these prices stabilize we will be able to clarify the market value of financial institutions assets and therefore more closely compare book value with market pricing. This knowledge will help remove both risk and fear over time, and help stabilize stock prices.

Temporary public capital infusions into banks would facilitate this process and arguably provide more benefit per dollar than conventional fiscal stimulus. Early on in this process, we will need to start unwinding the massive sovereign credit and guarantees put in place during the crisis, now estimated at $7 trillion.

The bad bank intervention system calls for buying the very worst assets at their market value. Coupling this with an insurance system to insure to the market that the healthy assets are protected against catastrophe will allow the good banks to make a clean start and raise and lend capital. Each bank would be examined on its merits and cleaned out partially insuring against risks, re-capitalizing it with government capital as necessary. In some situations this will leave the government as the single largest shareholder (Royal Bank of Scotland), or the sole owner (Northern Rock). In such cases, nationalization is not an end unto itself, but a consequence of policy that will most rapidly return the banking system to health.

As such, a component of each of these intervention systems is likely to be the most effective overall. It will also be tempting to bind lending in a thicket of regulation. Some tighter regulation is in order, especially greater transparency, however, too tight a regulatory environment will strangle enterprise, which is certainly not the goal of logical reform of these institutions.
In the face of the current economic crisis it is easy to overlook some long-term factors that will surely affect the major economies around the world over the coming decades. Many of the world’s largest economies have aging populations, commonly due to the rapid increase in births after World War II (the baby boom).

As this large group retires from the work force, which will be a steadily increasing number over the coming 20 to 25 or so years, the work force of these countries will significantly decrease, impacting GDP in these nations in all likelihood. This will also be coupled with an increase in the cost of social services, magnifying the downward affect of a smaller workforce.

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2008 Median Age:
- Japan, Germany, & Italy = 45
- France, the United Kingdom, & Spain = 42
- Russia = 40

2005 % Population aged 60 & over:
- Japan = 26.4
- Spain = 21.7
- Italy = 25.3
- United Kingdom = 21.2
- Germany = 25.1
- France = 20.8
- Austria = 21.9
Second: The aftermath of banking crises is associated with profound declines in output and employment. The unemployment rate raises an average of 7 percentage points over the down phase of the cycle, which lasts on average over 4.8 years. Output falls (from peak to trough) an average of over 9 percent in GDP, although the duration of the downturn, averaging 1.9 years, is considerably shorter than for unemployment.

Third: The real value of government debt tends to explode, rising an average of 86.6 percent in the major post–World War II episodes. The main cause of debt explosions is not the widely cited costs of bailing out and recapitalizing the banking system. Bailout costs are difficult to measure, and there is considerable divergence among estimates from competing studies. But even upper-bound estimates pale next to actual measured rises in public debt. The big drivers of debt increases are the inevitable collapse in tax revenues that governments suffer in the wake of deep and prolonged output contractions, as well as often ambitious counter-cyclical fiscal policies aimed at mitigating the downturn.
Equity price declines (stocks, bonds and related instruments) that accompany banking crises are far steeper than housing price declines, if somewhat shorter lived. The shorter duration of the downturn when compared with real estate prices is consistent with the observation that equity prices are far less inertial. The average historical decline in equity prices is 55.9 percent, with the downturn phase of the cycle lasting 3.4 years. The above chart shows equity declines for the United States to be above 40% in the first year of the down cycle.

The data tends to suggest that the downturn in the equity markets actually began in mid to late 2007. As such, this data tends to suggest that we are a little more than a hear (18 months possibly) into this down cycle.
On average based on historical crisis precedent, unemployment rises for almost 4.8 years, with an increase in the unemployment rate of about 7 percentage points.

Unemployment in the United States was 8.5% March 2009, with an average of 5.8% across 2008. Based on this data it appears that unemployment began to rise slowly in early to mid 2007 and began to pick up steam late in 2008. As such, this factor has been worsening for approximately 18 months. If there is a 7% increase in unemployment in the United States to the peak, then this figure is likely to increase to approximately 11.5% before it’s decline back to a long term stabilized rate.
Figure 4 looks at the cycles in real per capita GDP around banking crises. The average magnitude of the decline is surprisingly large at 9.3 percent.

An interesting data comparison showed a 79% increase in home sale prices over the 1997 to 2008 period. GDP over the same period increased by 72% (not adjusted for inflation) showing a similar relationship between the average cost of housing and national production.

Adjusting for inflation, GDP increased by 33.5% over the 1997 to 2008 period, compared to the average CPI increase of 25% over the 1997 to 2007 period. Median income levels grew 5% more than CPI over the same period.

These relationships suggest that the cost of true housing (relative to income performance) to the consumer in the United States has stayed relatively stable over this period.
Figure 5 shows the rise in real government debt in the three years following a banking crisis. The deterioration in government finances is larger than most would imagine, with an average debt rise of over 86.6 percent.

The characteristic huge buildups in government debt are driven mainly by sharp falloffs in tax revenue and, in many cases, big surges in government spending to fight the recession. The much ballyhooed bank bailout costs are, in several cases, only a relatively minor contributor to post-financial crisis debt burdens.
The intervention system most likely to create the most benefit for the economy is a combination of insurance and good / bad bank methods. This will also certainly create some nationalized institutions, as the government will in some cases become the majority stakeholder. The rescue intervention should shock the market in its scale, which will have the effect of bleeding off some of the persistent psychological fear/paralysis (sooner than it would otherwise), which is worsening an already bad financial crisis.

An examination of the aftermath of severe financial crises shows deep and lasting effects on asset prices, output and employment. Unemployment rises and housing price declines extend out for five and six years, respectively. On the encouraging side, output declines (GDP) last only two years on average. Even recessions sparked by financial crises do eventually end. However, they are almost invariably accompanied by massive increases in government debt.