



# **The Global Financial Crisis and its Impact on the International Stock Markets**

John Arnold  
President Director, PT APCO Worldwide

IPRA International Conference, Jakarta  
February 3, 2010

**APCO**  
worldwide®

We have all been coexisting with the global economic crisis for approaching 18 months, and most major economies now appear to have bottomed out and returned to growth. Nevertheless, the crisis has been widely characterized as the worst since the stock market crash of 1929 and the subsequent Great Depression of the 1930s. 2008 was the first year since the Great Depression that the global economy as a whole experienced negative growth. Fears that this recession would develop into a depression have substantially receded, although there are still widespread concerns about the possible shallowness of the recovery. Many economists and other commentators including the IMF continue to caution governments not to relax stimulus packages that have been launched to rescue those economies in recession. Events have moved so quickly that it is sometimes difficult to recall that as recently as mid- 2008, the greatest global economic threats appeared to be the ballooning prices of crude oil and staple food commodities.

From the perspective of those of us engaged in the field of public relations, it is certainly important to know something of how stock markets are performing. They reflect the health and value of companies and their need for and ability to retain the services of the public relations industry. The market capitalization of companies also reflects their power and thereby their ability to raise further capital for expansion.

### **What Caused the Crisis?**

The markets did go through a challenging period in the early years of the decade following the bursting of the dot-com bubble and then the Enron and WorldCom failures. However, the markets recovered, and for the remainder of the decade, global growth continued unabated, underpinned by the fast-growing Chinese and Indian economies. The ability of those economies to reduce the prices of goods and services consumed by “developed” economies led some to believe that the inflationary cycle problem had at last been solved. A pattern of steady growth could now be expected to continue well into the future excepting possible external shocks. Effectively almost an entire generation of workers, consumers and voters in developed economies had yet to experience a major recession. At the top end, these people were in their forties and included emerging leaders of the corporate world, bankers and government officials. Even many of those more senior seemed to suffer from impaired memories.

Uninterrupted growth became a habit that was not easy to break. Politicians who failed to consistently deliver growth and high employment could not expect re-election. The unacknowledged problem was that those countries that were buying the cheap goods and services from China and India were only able to do so with the support of a debt mountain that was increasingly unsustainable. Much of the liquidity that financed the debt had itself been created by myriad so-called private equity deals. The explosion of these deals released old value but created very little that was new. Other liquidity had been derived from the explosion of commodity markets, not least oil. A large part of the debt was channeled into real estate based on an assumption that house prices would inexorably increase in value. If the history of real estate markets tells us anything, it is that property values do not increase over time on a linear basis. If that was not a sufficiently naïve assumption, the perfect storm was created once all the rules on prudential lending were disposed of and mortgages were extended in the United States to so called sub-prime borrowers.

That the U.S. subprime mortgage market was allowed to develop in the first place was a culpable error both on the part of the lenders and regulators. That somehow the inherent risk attached to such loans could be eliminated, by securitizing and trading the debt, almost defies belief. Through the trading of such poor debt, risk was not mitigated, but actually increased. Initially, the process would certainly have been attractive to the prime lenders and the first buyers of the securities. As the market for the securities increased, the secondary buyers had no idea how to evaluate the risk they had acquired. This debt mountain was then happily traded by most of the world's largest and formerly strongest financial institutions. It was palpably stupid, but as everyone else was doing it and making money, then why not?

But it wasn't only the sub-prime housing market that was creating non-performing loans. Many private equity deals had been based on superficial valuations that banks too casually accepted. Why? Because again ingenious new instruments were created to repackage and securitize the debt to enable the original lenders to pass it on and spread the risk; risk that had not been properly evaluated in the first place. The only excuse that one can afford to the banking community is that they were victims of their own self-confidence and a mistaken belief that ingenious financial instruments could somehow rewrite the fundamental rules of sound lending and investing.

The regulators were at best either asleep on the job or still fighting the battles of Enron or earlier crises. In part, my own sense is that a new generation, through a savvy use of jargon, duped themselves and others into believing that globalization and digitalization have fundamentally transformed the way financial and investment markets function. Thus all the old rules and certainties no longer apply. A new promised land had been discovered. Many of the promoters of the dot-com companies labored under a similar illusion. History may not repeat itself, but those who ignore it do so at their peril.

The speed of change in our globalised world is such that memories become ever shorter. Were many decision-makers infected by a collective myopia such that they were unable to see anything that conflicted with their immediate goals and perceived opportunities? Despite idealistic theories about rationalism and perfect markets, human behavior is often irrational and not guided by knowledge and experience. Human behavior patterns are guided as much by a herd mentality as by logical intellectual responses to widely available data or information. The majority of humans inherently tend to avoid the risk of being out of step with their peers as much as or more than they fear committing errors. I suggest this ultimately applies to groups commonly regarded as elite as much as it might to, say, an unruly crowd at a soccer match. It's the idea that "I may have got it wrong, but so did everyone else." There is safety in numbers even if the numbers are wrong! To step aside from the pack can mean moving into a very uncomfortable environment. I surmise that many of those occupying high places in the financial world knew that a disaster was waiting to happen, but were unable to step out of their individual comfort zones and inform their stakeholders that the good times were over.

So what about greed? Greed was certainly a factor, but the banking community should probably not be singled out for the opprobrium of the rest of humanity. Banks are themselves pressured by shareholders, many of them institutions, to produce consistently stellar performances. Underperforming banks quickly become takeover targets. To maintain their own growth and profitability, banks had to think up ever new and more creative products and stratagems. It was as dangerous to be in step as it was out. To resist such pressure was not a test of intellect, but rather a test of character. The U.S. and UK economies in particular had become addicted to full

employment and steady growth. But these twin goals were unsustainable when key enablers were out of balance. While Asia invested and produced, Europe and North America borrowed and spent. The Bush administration had been funding two wars and bequeathed its successors the largest deficit in U.S. history. Something had to give and it did. My own belief is that the crisis was fundamentally the result of a collective failure of political leadership and poor regulatory control. The economies of North America and Europe had become like an express train, racing out of control with no one brave enough to pull the emergency break. The only way to get off was to wait for the inevitable crash and hope that you would be amongst the survivors.

### **The Stock Market – Collapse and Recovery**

As a result of the collective failures of bankers and regulators, global stock markets experienced precipitous declines. The recent high for global stock markets had occurred in 2007 and the leading indexes first declined sharply in Q4 2007. There was a partial rebound in the first half of 2008, but a global slowdown was already being anticipated. Yet in September 2008, all leading markets fell off a cliff face. The collapse of Lehman Brothers on September 15, 2008, with losses of US\$140 billion, was the catalyst for the meltdown. The bankruptcy resulted in a one-day fall in the Dow Jones index of 500 points, an all-time record. In fact the signs of a pending catastrophe can be observed much earlier. The numbers just got bigger and in the case of Lehman, no one came to the rescue.

In fact the signs of pending disaster were already apparent in 2007. The UK then experienced a run on Northern Rock Bank and the bank was subsequently nationalized, an unprecedented event in the UK. In March 2008, Bear Stearns in the United States collapsed. Fannie Mae and Freddie Mac, the United States' two largest mortgage lenders, were effectively nationalized in early September. Merrill Lynch only survived after being taken over by Bank of America a day before the collapse of Lehman Brothers. After the fall of Lehman, Morgan Stanley lost its status as an investment bank.

The contagion quickly spread across the financial services sector once it was understood how the fortunes of many of these institutions were bound together through inter-connected transactions. On September 16, 2008, the AIG insurance group was granted US\$85 billion liquidity support by the U.S. Federal Reserve Bank. Citibank, once the world's largest financial institution, incurred massive losses from the mortgage market and its future is still questioned. Bank of America came under enormous pressure after the acquisition of Merrill Lynch.

Beyond the United States, the UK's RBS Bank was nationalized. Lloyds TSB Bank acquired a failing HBOS Bank, but soon itself also needed substantial government support. European banks rapidly followed. Fortis Bank was rescued by the Belgium government. ING, UBS and Deutsche Bank all incurred massive losses. Iceland as a nation was effectively bankrupted by the bailout of its banks. The resulting contraction of bank credit then hit the real sector, most starkly exemplified by the U.S. auto industry.

For the remainder of 2008 through the first quarter of 2009, the bear market continued unabated. Perhaps more than any other factor, it was the global loss of confidence that was undermining stock markets. There was no consensus on the full extent of the crisis or on a solution. As governments underwrote bailouts of financial institutions and discussed stimulus packages, investors trembled.

The Financial Times World Index recorded a loss for 2008 of 42.6 percent measured in U.S. dollars. Most of that loss occurred in the fourth quarter. The FT World Index lost a further 11.6 percent in the first quarter of 2009 (i.e., almost 50 percent down from January 2008). In Q1 2009, the performance of Asia Pacific stabilized while other major markets continued to fall. Decoupling was after all a reality.

During Q2 2009, there was a marked change. Globally markets rose by 20.8 percent with Asia Pacific performing the strongest with a 31.2 percent increase. The market now believed that the worst was known and that the bear run had overshot. The overall result for the year was a gain of 30.5 per cent. Asia Pacific, excluding Japan, showed a remarkable advance of 70.0 percent. Nevertheless the pace of recovery slowed considerably in Q4 to an overall 4 percent, suggesting that the market has corrected to where it believes is the true state of the global economy and its prospects in the immediate future.

Even though stock markets have now strongly rebounded from cyclical lows with one of the strongest ever bull runs, they have yet to recover fully to their pre-crisis highs. Major stock markets are not only down compared with mid-2007. At the end of 2009 they were below the levels of a decade earlier, thus making the decade one of the three worst in history. Nevertheless, fears of another Great Depression have all but disappeared. No matter the extent of the failures that may have contributed to the recession, there is a belief that governments and regulators are far better resourced now to find solutions compared with their predecessors of 80 years ago. We must hope that this belief is not misplaced.

### **How Other Markets Performed**

The stock market, however, is not the only market of importance. In mid-2008, it was crude oil that was grabbing most of the headlines when in July its price hit a high of US\$137 per barrel. The high price of oil was then being blamed for the already slowing global economy. I have yet to read a convincing analysis as to the causes of the explosion that saw prices increase by 270 percent from 18 months previously. Six months later they had declined to less than US\$35 or by almost 75 percent. Today prices have recovered to around US\$80 or by almost 130 percent. The price today is still 60 percent higher than just two years ago and higher than the all-time previous high prior to the 2008 high. The latter statistic is a possibly more accurate reflection of where global consumption really is headed and in particular the sustained recovery of the Chinese and Indian economies.

If we look at industrial metals, we see similar signs of recovery. Nickel's price had fallen from pre-crisis highs of above US\$24 an imperial pound in early 2007 to less than US\$4.50 or 81 percent by the end of 2008. 2009 has seen a 100 percent rebound. Copper prices fell from highs of above US\$4 in Q3 2008 to less than US\$1.50 a pound and have now rebounded astonishingly to prices nearing US\$3.50 a pound, a surge of 130 percent in the last 12 months. Tin prices fell from a 2008 high of above US\$14.50 to less than US\$5 in Q1 2009. Prices today are around US\$8, a rebound of 67 percent. Each of these markets can identify supply-side constraints that elevated prices before the crash, but I would surmise that huge fortunes have been lost and made as a result of such price volatility. The fortunes of all these metals are linked to the motor industry, but new applications driven by technology developments are creating new demand.

It is interesting to contrast the fortunes of industrial metals with the market for gold. There has been much talk of gold being a safe haven investment particularly when the U.S. dollar is in decline and general economic uncertainty prevails. In 2001 the price of gold had fallen to US\$256 per oz. The gold price increased without interruption by almost 400 percent by Q4 2008. It then proceeded to fall off a high of US\$1,000 to US\$712 per oz or by a relatively modest 29 percent. In December 2009 the price hit US\$1,217 per oz but has now fallen back below US\$1,100 per oz. The rebound of gold at the most recent high was 71 percent, but now is closer to 55 percent. During the crisis, gold has performed well but less well than industrial minerals. Even silver, which unlike gold has industrial applications, has outperformed gold. I am not in the business of economic forecasting but these price movements suggest to me that the real economy is recovering. They also cast doubt on forecasts of gold prices reaching US\$2,000 per oz within the present long-term gold cycle.

The very high food prices of mid-2008 were leading to talk of a global food crisis. U.S. wheat reached an export price of US\$480 in March 2008, but the price then declined steadily to less than US\$ 230 by September. Prices have since recovered but are not close to the 2008 high. Many other food commodities hit all-time highs in 2008 and then rapidly declined. Rice prices remain relatively high linked no doubt to improving living standards and consumption in China and India. Rice prices also remain high in part due to exporting countries restricting deliveries to the international market. Harvests in the first half of 2009 were generally good. Other food commodity markets show similar trends with extreme peaks in 2008, including oils, sugar and milk. Generally the extreme food price increases in 2008 seem to be predominantly due to short-term supply problems and speculation rather than long-term fundamental shifts in demand.

### **Lessons Learnt from a Brief Lifetime**

The speed and severity of the recession were a shock to us all. The scale of the present crisis has been unprecedented since before World War II. However, for those of us born in the 1950s or earlier, crises seem normal. They have just had a tendency to get bigger as the world has shrunk and speed of information exchange has accelerated exponentially.

My own formative years were spent largely in the Britain of the 1960s and 70s. The UK economy was then habitually in crisis. Governments were chronically unable to manage the balance of payments, which resulted in frequent economic disruption and sterling being formally devalued in 1967. Interest rates were constantly high, as was inflation, and foreign exchange was very tightly controlled. Price freezes and wage freezes were normal. Labor union led strikes were endemic. The excesses of industrial action culminated in 1973 with the “three-day” week as there was no longer sufficient fuel to meet total energy needs. It was in that year also that then British Prime Minister Edward Heath coined the phrase “the unacceptable face of capitalism.” It is a phrase that has been often recalled during the present crisis.

Before there was Bernie Madoff, who now personifies the worst example of investor management fraud, the 1970s had the colorful Bernie Cornfeld, creator of Investor Overseas Services. IOS was subsequently taken over by the even more notorious Robert Vesco. That period also suffered the two Middle East wars of 1967 and 1973 when we learnt a salutary lesson about the political power of oil. For graduates entering the job market like myself in the early 1970s, opportunities were limited.

The world's two most successful economies were the losers of World War II; West Germany and Japan. Having seen their economies destroyed in the 1940s, they were able to rebuild anew embracing the latest technology and by implementing work place practices that resulted in satisfactory industrial relations. The public investment in infrastructure was also massive. They offered the models that others sought to emulate.

Japan was able to produce better, cheaper, more technologically advanced products than any other country. But Japan fell victim to believing its own hype. It had not discovered a secret formula. Weak regulation allowed a runaway property bubble. Basic market rules had been suspended. They didn't matter because Japan was 'different.' The market crash of 1987 destroyed Japan's property market and almost brought down the banking system. Japan has not been able to return to that period of industrial and economic supremacy. Germany also faltered due to the cost of reunification and structural rigidities, especially a bloated welfare state and inflexible labor practices.

Those major nations that were struggling economically in the 1960s and 70s did change but ultimately it was not by emulating Germany and Japan. The beginnings of change were signaled in the UK in 1979 when Margaret Thatcher first became prime minister. Her philosophy was to attack the rigidities that were undermining the market economy's ability to deliver sustained growth. Despite painful adjustments, the doctrine of Thatcherism took hold, and the UK economy was transformed. The U.S. followed suit and adopted its own version of the doctrine known as Reaganomics. In 1989 the Cold War ended. At approximately the same moment, China and India both independently realized that they were following failed socialistic economic models. The power groups that governed them had either to change or risk being swept aside. The EU was enlarged after the fall of the Berlin Wall and subsequently adopted a single currency for many member states.

For the next 20 years, the world experienced one of its longest periods of largely uninterrupted low inflationary growth. But from time to time there were still crises and lessons to be learnt. In 1992, the UK government was forced to leave the European Exchange Rate Mechanism, the precursor to the Euro. In 1997, Asia Pacific was hit by a regional financial crisis resulting from lax banking supervision and poor corporate governance. In Indonesia it also resulted in democratic government supplanting the previous dictatorship.

In 1998, the Long Term Capital Management hedge fund collapsed requiring a bailout of \$4.7 billion to obviate the risk of a contagion in global markets. The LTGM debacle was the more remarkable because among its promoters and managers were two Nobel Economics laureates. Investor stupidity hit new heights with the dot-com bubble. All normal rules for the evaluation of stocks were suspended as lemming-like madness gripped the world. Like Japan, dot-com companies were different. They certainly were, and in 2000 the bubble burst with billions of dollars wiped off share valuations across all markets.

In case we hadn't learnt very much from the dot-com and LTCM fiascos, the Enron and World Com sagas were soon to offer new titillation. Shareholder losses from each bankruptcy in late 2001 and 2002 were approximately \$11 billion. Each in turn represented the largest corporate bankruptcies so far seen. When corporate results are too good to be true, they usually are. By the time the regulators reacted, the battle had already been lost. The regulations that followed, most famously the Sarbanes-Oxley bill, may have appropriately addressed some issues but can be

accused of having created a smokescreen of action that has principally made many accountants rich without greatly enhancing investor protection.

### **A Realignment of Power**

The global economy is now showing increasingly positive signs of the beginnings of recovery. How long full recovery will take remains uncertain, but however quick recovery may be, the crash has resulted in a massive redistribution of the concentration of economic power both between corporations and nations. The shake-out may not yet be complete or fully understood. A glance now at the world's largest-traded companies based on market capitalization compared with before the crash shows many changes. Some of the largest financial institutions are now Chinese as is the largest oil company. Previous household names have disappeared. As the relativities among corporations have changed so too have those between nations. The fortunes and misfortunes of nations have been heavily linked to the importance of their banking and financial services sectors. Of the major nations, the relative size of the UK's financial services sector has resulted in it being anticipated to remain longest in recession. The impact on the UK, however, has been far less dramatic on than small countries such as Iceland and Ireland.

The crisis has been nothing if not a period of intense and painful change. For some, though, it has also marked a period of unprecedented opportunity. From the perspective of public relations practitioners, there will be a need to learn who the new power companies are and to understand their needs. Those who do this well will be winners in the market.

Whatever the future may hold, I will only predict that it will be just a matter of time before the world experiences another global crisis. New regulations will close off the opportunities that led to the current crisis, but as the pace of change remorselessly quickens new imbalances will inevitably emerge. Human beings are by nature fallible and mistakes will continue. The nature of globalization and integration of economies also means that the repercussions may once again be potentially very disruptive.

*John Arnold can be reached at [jarnold@apcoworldwide.com](mailto:jarnold@apcoworldwide.com).*