

Danish student foresaw the crisis

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An entire year before the financial crisis initiated in the US, a Masters Thesis landed on the table of University of Copenhagen. The conclusions in the 120 page thesis only pointed in one direction: A financial crisis is on its way.

When Jens Kjaer Sorensen handed in his MSc in Economics thesis in March 2006 mild and optimistic winds were blowing. Only very few would think that the attitude would be able to turn 180 degrees only one year later– and only very few economists talked about it.

But in Jens Kjaer Sorensen's thesis there is no doubt. Will the current development continue – looked at with 2006-glasses– will the economy with great probability derail? Maybe even end in a recession?

New and previously unseen crisis

Jens Kjaer Sorensen, who is an equity trader from a greater Nordic bank, has analyzed the background for 23 house price bubbles, which have busted throughout history. And in March 2006 the conclusion was that a new and previously unseen real estate and financial crisis is potentially under way because of financial liberalization.

Clearly there is a strong connection between the development in real estate and the financial markets. The two follow each other, since the financial markets have become deeply dependant on the square meter prices.

"The stock market and housing market often synchronize, and when this happens, the risk for bank crisis are high, which will have severe costs for the economy. This time the bubble is synchronized internationally, which makes the world economy fragile. Due to the size of the bubble the consequences of a downturn can be greater than ever before," the analysis concluded in the thesis.

This prediction leans closely to the exact reality today, where we are "celebrating" the birthday of the financial crisis, after the bad subprime loans initiated in the US turned the world upside down last summer.

In his thesis Jens Kjaer Sorensen points out that the return on real estate investments lately have been abnormally high in comparison to a historic average, which initiated the discussion about a bubble scenario.

The housing market demands equilibrium

The framework for the thesis is that real house prices in the long run are constant in comparison to fundamental economic parameters. And when the housing market is above its fundamental value, then house prices will follow the trend and adjust downwards.

"The most likely way the market will find its equilibrium is that a credit restriction will be implemented. If banks or regulators encourage a credit stop, then it will highly likely put downward pressure on house prices," the thesis points out.

The Financial crisis has brought national economies to their knees worldwide, and that prediction is also found in Jens Kjaer Sorensen's thesis, which circles around the world's largest economy, USA. He points out that even though the American market doesn't look as much like a bubble as other countries, then several American cities are experiencing very high prices.

"At the current stage most commentators argue, that there is no national residential bubble, but there are clear signs of local bubbles, which are difficult to handle on a national level."

Economic world history

This analysis turned out to be reality one year later, when many US families already struggling economically had to leave their house and home, since they no longer could afford their monthly payments on the subprime-loans, which many banks had offered— well knowing that home buyers were risky with low credit scores.

As we all know, the consequences by the bad loans spread with great force globally.

"This time the bubble is not isolated to a single economy. For the first time in the history of the world the situation is now, that the real estate market is crucial for the world economy," Jens Kjaer Sorensen concluded in 2006.

The thesis points out, that many house prices in many countries are overvalued, and especially in the Netherlands and Great Britain there are signs of housing bubbles, which will have a remarkable downward impact on house prices or a long period with decreases in order for equilibrium to be re-established.

Long walk through the desert ahead

The prediction of the downturn in Great Britain is flashing in neon. The English housing market– and thereby the economy of the country - has suffered more than any other country in Europe, and the pound has decreased substantially.

The thesis concludes that in line with the natural laws of economics, that an economic upturn is followed by an economic downturn, and that the length of the coming downturn often follows the length of the upturn proportionally. This statement points out that a long downturn could be on its way, since the Danish economy has been in an upturn since the middle of the 1990es.

"The latest, long upturn indicate, that the coming downturn easily can be around 5-10 years depending on policy responses. The outlook for a long period of adjustment and the dependency of real estate in the economy increases the risk for low growth or maybe even a recession," the thesis by Jens Kjaer Sorensen concluded.

Recession-clouds are threatening with rain.

The horror scenario in the thesis is clear. The MSc of Economics points out that the economic development up to March 2006 could lead to a recession. And he has been right. Denmark is the first European country in recession, which counts two quarters in a row with negative growth.

"The timing of such an adjustment is only depending on a change in attitude. Previous bubbles have shown and will show again that it will have great impact on the world economy, and can end in a global recession."

A recession can "very well be the result of a laissez faire attitude" towards credit growth, which according to Jens Kjaer Sorensen is untameable during an upturn, if restrictions are not implemented.

"It is therefore crucial that credit restrictions are loosened during a downturn and tightened during an upturn to help stabilizing the economy, so that it doesn't get out of control."