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Article

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CESifo Forum

Provided in Cooperation with:

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Suggested Citation: Dabrowski, Marek (2008) : The Global Financial Crisis: Causes, Anti-Crisis Policies and First Lessons, CESifo Forum, ISSN 2190-717X, ifo Institut für Wirtschaftsforschung an der Universität München, München, Vol. 09, Iss. 4, pp. 28-32

This Version is available at:

<https://hdl.handle.net/10419/166337>

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THE GLOBAL FINANCIAL CRISIS: CAUSES, ANTI-CRISIS POLICIES AND FIRST LESSONS

MAREK DABROWSKI*

When the US subprime mortgage crisis erupted in summer 2007 few people expected that it could hit the entire world economy so hard. One year later nobody had already doubts that we faced a financial system crisis on the global scale with dramatic macroeconomic and social consequences for many regions and countries. Few local analysts and politicians would dare claiming that their country is shielded from the financial crisis effects as the storm unfolds worldwide. Left to the unknown is its scale, sequencing, distribution effects between regions and countries and the consequences for the future architecture of the financial system. As critical as the quality of the day-to-day management of the crisis is the understanding of what has happened and what may happen, whence the need for an interim diagnosis, even one incomplete and involving a certain margin of misperceptions and wrong interpretations.

This short commentary tries to analyze the extent to which monetary policy and financial market regulation failures bear responsibility for the eruption of this crisis and its further spread, the zigzags of anti-crisis management, crisis impact on emerging markets and, finally, to present some tentative lessons for policymakers.

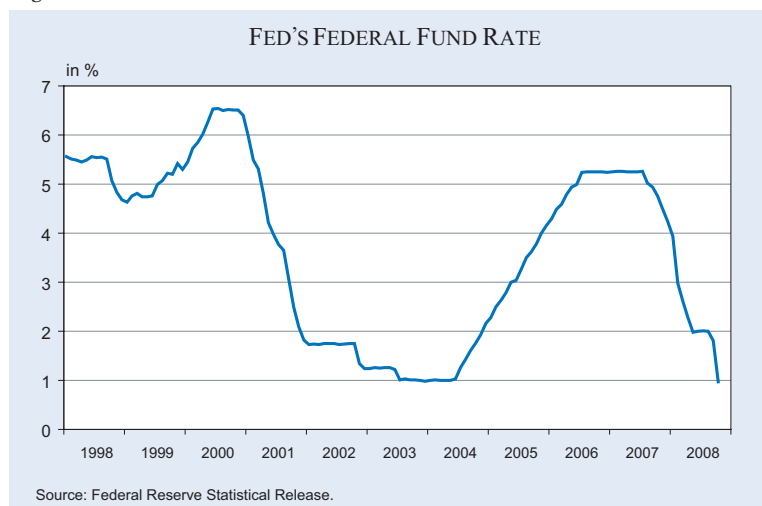
Monetary roots of the current crisis

The primary causes of the current financial crisis are imput-

able to lax monetary policies conducted by the US Federal Reserve Board and other major central banks (e.g. the Bank of Japan) from the mid-1990s. Enjoying record-low inflation and low inflationary expectations, central banks reverted to more intensive fine-tuning in order to avoid the smallest risk of recession. As a result, the Fed aggressively reduced its interest rate three times over the last ten years (see Figure 1), starting with the series of crises in emerging markets (Mexico, South-East Asia, Russia, the pre-crisis situation in Brazil) and the Long-Term Capital Management troubles in the United States at the end of 1998. This was followed by the 2001-2002 post-9/11 drastic interest rate cuts, down to 1 percent, and the bursting of the dot.com bubble. On both occasions, the Fed provided relief to troubled financial institutions, helping to circumvent (1998) and reduce (2001) the danger of a US recession while fueling global economic growth. The third intervention occurred in the wake of the current crisis (end of 2007 and beginning of 2008): the federal funds rate was reduced from 5.25 percent to 2 percent within a few months and then to a low of 1 percent in November 2008.

Fearing recession and deflation (in the early 2000s), the subsequent tightening of monetary policy always came too late. Such an excessively lax Fed attitude contributed to a systematic building up of excess liq-

Figure 1



* The CASE – Center for Social and Economic Research, Warsaw. This is a revised and updated version of Dabrowski (2008).

uidity both in the United States and the world. Distracted by the supply shock flowing from economic reforms and market opening in China, India and in other developing and transition countries, many policymakers and analysts were misled by the temporary lack of visible inflationary consequences. The Uruguay Round, especially the Agreement on Cotton and Textiles, and the ensuing liberalization of world trade further exerted downward pressure on prices in the manufacturing market.

However, the excess liquidity had not vanished and brought on three asset bubbles: one in the real estate market (primarily in the United States but also in several European countries such as the United Kingdom, Ireland, Spain, and Iceland, the Baltic countries and Greece), a second in the stock market and a third in the global commodity markets. These bubbles had to burst sooner or later.

Serious macroeconomic concerns had also started to surface, namely an increasing current account deficit in the United States, and recently, mounting global inflationary pressures triggered by rising commodity prices (seen as an external price shock by national monetary authorities in individual countries), rapidly growing official international reserves in many emerging market economies and a depreciating US dollar.

Regulatory failures

Monetary policy is not the sole culprit. A large share of responsibility weighs upon regulations and regulatory institutions that lagged well behind rapid financial market developments. Two major inconsistencies are particularly apparent when looking at institutional issues:

- the global character of financial markets and the transnational character of major financial institutions as opposed to the national nature of financial supervisory institutions (even inside the EU);
- the increasing role of financial conglomerates operating in various sectors of the finance industry and the innovative, cross-sectoral financial instruments versus the sectoral segmentation of financial supervision; only a few countries can boast of consolidated financial supervision. The United States presents additional institutional peculiarities with two levels of responsibilities (federal and state) for financial supervision.

The blame should also be borne by rating agencies and supervisory authorities that failed to understand the nature of innovative financial instruments and that provided excessively short-sighted risk assessment by not taking sufficiently into account the actual risk distribution in the long intermediation chain between the final borrower and creditor, thus underestimating the actual risk. The same rating agencies which granted excessively positive grades to financial institutions and individual financial instruments in times of boom hastily started to downgrade their ratings at the time of distress, adding to market panics.

Precautionary regulations, usually meant to enhance the safety and credibility of financial institutions, such as capital-adequacy ratios (especially when assets are risk-weighted and mark-to-market priced) or tight accounting standards related to reserve provisions against expected losses, also unveiled their perverse effect as they led to sudden credit stops and massive fire selling of assets. They proved to be strongly pro-cyclical, especially as the crisis had already erupted.

Zigzags of crisis management

The crisis management proved chaotic and centered on calming nervous financial markets in the short-term rather than addressing fundamental challenges like the massive insolvency of financial institutions. The lack of international institutions able to manage macroeconomic and regulatory policy coordination very often led to hasty national actions as exemplified by the Irish government's unilateral decision to provide full deposit guarantees, prompting other EU governments to follow suit or by the Iceland-UK conflict over cross-border deposit guarantees.

The drastic cuts in Fed rates at the end of 2007 and at the beginning of 2008 are another instance of a short-sighted unilateral policy. The cuts added to inflationary pressure and the commodity markets bubble worldwide. And when combined with the appreciation of the euro and the yen, it exported the risk of recession to Europe and Japan while failing to restore domestic US financial market confidence, as demonstrated by increasing spreads and periodic liquidity crunches. The initial diagnosis pointing to liquidity rather than solvency as the crisis' *raison d'être* now appears to have been erroneous. Indeed, US authorities wasted time and

potential ammunition needed at the moment and in forthcoming months on suboptimal monetary and fiscal interventions (interest rate cuts and broad-based tax rebates) in order to stimulate the economy and provide more liquidity rather than concentrating their resources on fixing the insolvency of financial institutions.

The belated and costly interventions of some governments to rescue their financial sector look controversial to many. These doubts are at least partly justified. On the one hand, rescue plans represent an additional burden on taxpayers, though part of the current recapitalization costs may be recovered by subsequent privatizations. Those countries, however, with an already high debt to GDP level must particularly be cognizant of the limits of their fiscal interventions as they are prone to illiquidity and insolvency.

Furthermore, the prospect of worldwide economic stagnation/recession adds to potential fiscal stress in many countries. Thus, fiscal policy requires a very careful approach. While rescuing large insolvent financial institutions may be sometimes unavoidable at least in short term (see below), the idea of using a large-scale fiscal stimulus to overcome recession/stagnation must be treated with a large dose of skepticism. The experience of Japan, which tried to fight the post-bubble recession in the 1990s with aggressive monetary easing and large-scale fiscal stimulus, should be studied very seriously. Japan's fiscal activism failed to overcome stagnation, but contributed to building up the large public debt (175 percent of GDP in 2006). In this context, the recent IMF call for global fiscal expansion is controversial (IMF 2008).

Whether government intervention is sufficient to guarantee market confidence, considering governments' failure to avoid the crisis and provide an adequate response right from the onset, is a legitimate question to ponder. In general, private sector and market-oriented solutions, like arranging the takeover of a bank in trouble by a new private investor if available at a given time, will always prove a better solution than its nationalization. The bottom line is that the current crisis cannot serve as the excuse for turning to government interventionism and state (public) ownership of financial institutions as a long-term solution.

On the other hand, as learned from the Great Depression, governments must intervene in large-

scale financial crises to prevent a systemic banking crisis and total collapse of the financial system and a resulting deep recession spiral. This lesson seems to be well understood by contemporary policymakers (others analogies referring to the early 1930s are not always correct). The very nature of financial institutions – a high level of leverage and mismatch between their assets and liabilities (borrowing short in order to lend long) – makes them extremely vulnerable in times of distress and confidence crises. The collapse of one large bank or investment fund may cause a far-going chain reaction as was experienced recently after the bankruptcy of Lehman Brothers. Hence, a government rescue of troubled financial institutions cannot be compared to the bailing out of loss-making non-financial corporations. Regarding moral hazard, it is difficult to expect government bail-outs to reward irresponsible bank managers and owners because they are already running out of business.

How is the crisis spreading to emerging markets?

Amidst shattering hopes of ducking the side-effects of the current financial crisis, emerging market economies are nonetheless feeling its blow. From 2006 onwards, these economies have experienced rising inflationary pressure resulting in numerous economic and social problems. This pressure is unlikely to subside quickly, even if the price of some commodities has started to decrease and the US dollar has recovered in recent weeks. Moreover, a slower world economy means a weaker demand for many commodities, as well as investment and construction-related products. Plus, the global credit crunch and liquidity problems of many transnational corporations have already led to net capital outflows from emerging markets, halting new investment projects. Finally, banks in many emerging market economies are vulnerable to a global liquidity crunch due to short-term international financing exposure and risky lending practices. Put otherwise, new waves of crises in emerging market economies appear rather unavoidable, much more so in countries that have not built up sufficient international reserves or have not run fiscal surpluses. Ukraine, Hungary, Belarus and Pakistan, for instance, have already filed for IMF emergency support.¹

¹ The same concerns Iceland which does not belong to the group of emerging-market economies.

These new crisis cases are very telling. Hungary's troubles were caused by the combination of banking sector fragility, excessive fiscal deficits and public debt, and a long-lasting lack of political consensus to conduct the necessary fiscal adjustment. In the case of Ukraine, there was a sudden collapse of metal prices (the main export of this country), excessive exposure of the banking sector to international short-term financing and domestic political turmoil. Belarus, the country with a closed economy and financial system, became the victim of its reluctance to introduce market-oriented reforms, which made the country unable to resist a negative terms-of-trade shock. The same factor – a negative terms-of-trade shock caused by higher oil and food prices – combined with a high fiscal deficit and domestic security problems (conflict in the border area with Afghanistan) led to the crisis situation in Pakistan.

The number of emerging-market applicants for IMF emergency assistance may be expected to increase in coming weeks and months when the effects of the global economic slowdown and a bursting commodity bubble will spread to the developing world. Looking ahead, once the crisis is over, “easy” money can hardly be expected to return to emerging markets regardless of the quality of their macroeconomic policies, business climate and political risk. To regain credibility and attract investors, the recently receding demand for economic and institutional reforms may well be back on the agenda.

The first lessons

Although it is too early for final conclusions from the ongoing crisis episode, some lessons can already be drawn. Though not a new notion, the first lesson is that monetary policy cannot be excessively proactive and too much engaged in anti-cyclical fine-tuning. Its involvement must be symmetric, i.e. monetary policy must not only stimulate an economy during difficult periods but it must also be able to tighten early enough when the danger of overheating looms on the horizon. Risky ideas such as “the risk management approach” advertized by Alan Greenspan in the early 2000s (Greenspan 2004) and going well beyond the classical central bank mandate must be abandoned.

A short-term focus on inflation targeting limited to the consumer price index is of no avail without mon-

etary authorities tracking more carefully the monetary aggregates and asset markets. This means that conceptual and methodological approaches to this innovative and increasingly popular monetary policy strategy require rethinking.

There are two other, more fundamental dilemmas facing monetary authorities, which should be discussed again in the context of the current crisis experience. First, in an era of globalization, no national monetary policy can be entirely sovereign; even the biggest central banks (the Federal Reserve Board, the European Central Bank and the Bank of Japan) must take into account the external macroeconomic environment and the potential consequences of their decisions on others. Thus the question whether coordination of monetary policy among major central banks, which would go beyond spectacular joint rate cuts (as that of 8 October 2008) or the joint emergency liquidity interventions, is possible and desirable must be discussed again. The closer coordination could perhaps minimize the frequency of global financial shocks, such as sharp changes in exchange rates between major currencies, and secure a stable global liquidity management.

While nothing close to a Bretton Woods system or a new monetary order is likely to emerge in the near future, an institutional framework ensuring effective international cooperation in the sphere of monetary policy is urgently called for. The IMF, which could have well served this purpose as it did under the Bretton Woods system, was downsized and weakened recently (obviously prematurely) to the extent of undermining its policy coordination mission in monetary and fiscal affairs.

The limited sovereignty of national monetary policy is even more obvious in case of small open economies where central banks' ability to “lean against wind” is even more restricted. The choice of the optimal monetary/exchange rate regime (either one of the “corner solutions” or the hybrid one), so hotly discussed at the end of the 1990s and early 2000s and then forgotten for a while during an extraordinary calm on financial markets, will be placed on the policy agenda again.

The second fundamental question concerns the degree of central banks' responsibility for the stability of the financial market and banking system. The current crisis tends to corroborate that shifting too much responsibility to central banks, as happened in

the United States and the United Kingdom, compromises their anti-inflationary mission. In contrast, a clearer and more straightforward anti-inflationary mandate of the ECB, backed by its strong legal independence, has limited its involvement in rescue operations of the troubled financial institutions and forced governments of Eurozone countries to take the lead in fixing financial sector problems.

More thought need to be given to financial regulation, financial supervision and rating agencies. How should they respond effectively to financial innovations, financial conglomerates, and cross-border transactions? How should they assess the various kinds of risks on a long-term rather than a short-term basis? How should they mitigate the credit boom in times of prosperity and the credit crunch in times of distress?

The question of effective international coordination of financial regulation and financial supervision is even more pressing than monetary policy coordination because of the global character of the financial industry. Again, the IMF can play an important role here but this requires a strengthening of its institutional mandate and operational capacity.

On a European level, the crisis revealed a similar paradox. In spite of a Single European Market (including its financial sector component) and a single currency, there is no European financial supervision *per se* and no fiscal scope for joint rescue operations. Resistance to future financial storms in Europe will depend on how these shortcomings are addressed.

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