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The Global Financial Crisis: Causes, Channels of Contagion and Potential Lessons

by Marek Dabrowski

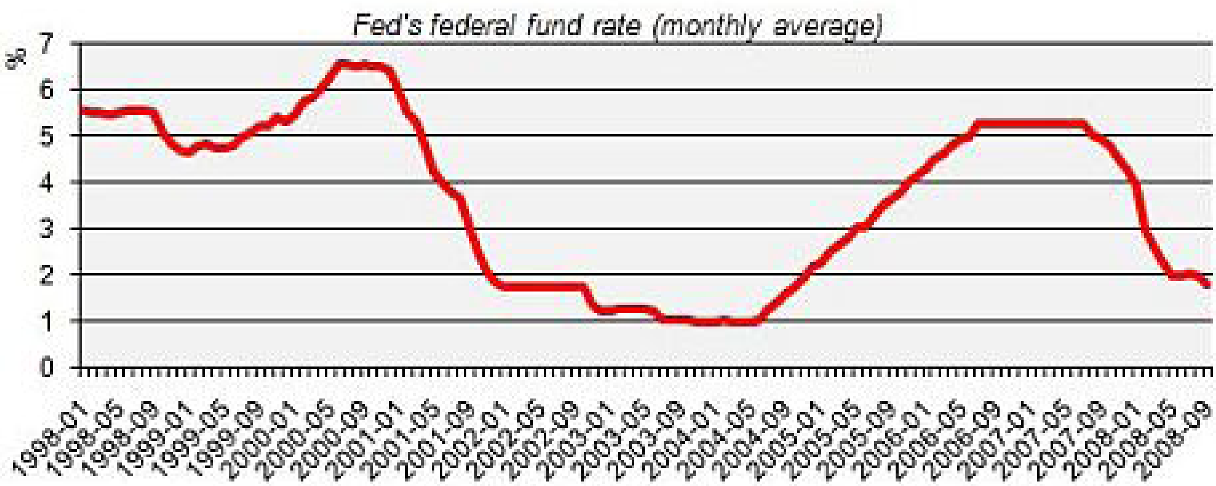
Allusions to a US-limited subprime mortgage crisis have long died out. Few local analysts and politicians would dare claiming that their country is shielded from the financial crisis effects as the storm unfolds worldwide. Left to the unknown is its scale, sequencing, distribution effects between regions 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.

Monetary roots of the current crisis

The primary causes of the current financial crisis are imputable 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 a 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 10 years, starting with the series of crises in emerging markets (Mexico, South-East Asia, Asia, Russia and the pre-crisis situation in Brazil) and the Long Term Capital Management troubles in the US at the end of 1998. This was followed by the 2001-2002 post 9/11 drastic interest rate cuts, reaching down 1%, 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 at the wake of the current crisis (end of 2007 and beginning of 2008): the federal funding rate was reduced from 5.25% to 2% within a few months span to a percentage low of 1.5 in October 2008.

Fearing recession, the subsequent tightening of monetary policy always came too late. Such an excessively lax Fed attitude contributed to a systematic building of excess liquidity in both the US 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 pressured price down 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 US but also in several European countries such as the UK, Ireland, Spain, 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.



Source: The Federal Reserve Board, U.S.A.

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

Regulatory failures

Monetary policy is not the sole scapegoat. A large share of responsibility weighs upon regulations and regulatory institutions that remained 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 financial instruments versus the sectoral segmentation of financial supervision; only a few countries can allege consolidated financial supervision. The US present 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.

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, unveiled their perverse effect as they led to sudden credit stops and massive assets selling.

Zigzags of crisis management

As the crisis surprised, its management revealed 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 deficit of international institutions apt to manage macroeconomic and regulatory policy coordination gave way very often to hasty national decisions as exemplified by the Irish government's unilateral decision to provide full deposit guarantees, prompting other EU governments to follow suit.

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 to the appreciation of the Euro, it exported the risk of recession to Europe's courtyard while failing to restore US financial market confidence internally, as demonstrated by increasing spreads and periodic liquidity crunches. The initial crisis diagnosis pointing to liquidity rather than solvency as the crisis' raison d'être now appears error inducing. Indeed, the US authorities misemployed 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 financial institutions' insolvency.

The late costly interventions of some governments to rescue the financial sector look controversial to many. These doubts are partly justified. On one hand, it is difficult to expect that government bail-outs will reward irresponsible bank management and owners already running out of business. As government support might only compensate a fraction of creditors' losses (*e.g.*, the original version of the US Paulson Plan), it should not create a moral hazard problem. As learned from the Great Depression, governments must intervene in large-scale financial crises to keep away from a total collapse of the financial system and deep recession. This analogy seems to be well understood by contemporary policymakers (others referring to the early 1930s are not always correct).

On the other hand, rescue plans represent an additional burden on taxpayers, though part of the current recapitalization costs may be recovered by subsequent privatization. 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 (*e.g.*, Iceland). Whether government intervention is enough to guarantee market confidence anew considering governments' failure to avoid the crisis and provide an adequate response right from the onset is a legitimate question to ponder on. Generally, private sector and market-oriented solutions, like arranging the takeover of a bank in troubles by a new private investor if available at a given time, will always prove a better solution than its nationalization.

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 a bit in recent weeks. Moreover, a slower world economy means a weaker demand for many commodities, primarily investment and construction-related products. Plus, the global credit crunch and liquidity problems of many transnational corporations have already led to net capital outflow 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 sufficient international reserves or have not run fiscal surpluses. Ukraine and Hungary, for instance, have already filed for IMF emergency support.

Once the crisis is over, it can hardly be expected that "easy" money will return to emerging markets regardless of the quality of their macroeconomic policies, business climate and political risk. To regain credibility and attract investors, it might well be that the receding demand for economic and institutional reforms will be back on the agenda.

The first lessons

Although it is too early to make 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 pro-active 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. Short-term focus on inflation targeting limited to the consumer price index is of not avail without monetary authorities tracking more carefully monetary aggregates and assets markets. 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.

And who should bear the ultimate responsibility for the financial market and banking system stability – a central bank or a government? The current crisis tends to corroborate that shifting the onus on central banks, as it happened in the US and UK for instance, compromises their anti-inflationary mission.

More thoughts need to be given with respect to financial regulations, financial supervision and rating agencies. How should they respond effectively to financial innovations, financial conglomerates, 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?

Another important lesson to reckon with is that spectacular joint actions of central banks, like the synchronized interest rate cuts on 8 October 2008 or the joint liquidity interventions, are not sufficient to solve the conundrum between the global nature of the financial market and the national character of monetary policy in the long-run. 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 both in the sphere of monetary policy and financial supervision is pressingly called for. The IMF, which could have well served this purpose as it did under the Bretton Woods system, was downsized and weakened recently to the extent of undermining its policy coordination mission in monetary and fiscal affairs. An even feebler institutional framework of policy coordination rules the realm of financial supervision.

On a European level, the crisis uncovered 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 say and no fiscal room for joint rescue operations. Resistance to future financial storms in Europe will depend on how these shortcomings are addressed.

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