



## Bubbles, busts, and bailouts: Lessons from the global financial meltdown

What first appeared as sub-prime mortgage cracks in the United States housing market during the summer of 2007, began widening during 2008 into deeper fissures across the global financial landscape, and ended with the collapse of major banking institutions, precipitous falls on stock markets across the world and a credit freeze. These financial shockwaves have now triggered a fully-fledged economic crisis, with most advanced countries already in recession and the outlook for emerging and other developing economies deteriorating rapidly, even for those with a recent history of strong economic performance.

The cost of the government response in the United States (in the form of liquidity injections, credit warranties, bail-outs and stimulus measures) has risen steadily over the past year to more than \$7 trillion by November 2008, and together with the combined measures of European countries and elsewhere the count may well be in the order of \$11 trillion (more than 20 per cent of world gross product).<sup>1</sup> Emerging markets are also beginning to respond, notably the recent major fiscal stimulus packages announced by China and the Republic of Korea. Along with mergers and acquisitions (including by the public sector itself) such moves have radically altered the financial landscape and buried the myth of efficient and self-regulating financial markets. Even so, rebuilding confidence and stopping the downside spiral is proving difficult as jobs are lost, exports contract and consumer and investor confidence continue to head south.

This policy brief looks at how this happened and what needs to be done to regain stability and jumpstart a sustainable global recovery.

### A once in a century event?

After presiding over one of the largest bubble economies in modern economic history, former Federal Reserve Chair Alan

<sup>1</sup> The estimates refer to committed funds either in the form of guarantees on loans and deposits, direct government investments in financial institutions, low interest-rate loans made by governments as part of bailouts and fiscal stimulus. Such committed funds by the United States government amassed \$7 trillion to November 2008 and of which about \$1.4 trillion had been effectively spent by that time. Alongside, the EU and the United Kingdom had set aside some \$3 trillion in financial bailout resources and fiscal stimulus, and an estimated \$1 trillion by China and other countries.

Greenspan has recently described the current crisis as a once in a century event. Even if this is correct, as now seems likely, in terms of its severity, it is highly misleading as a description of the underlying pattern of events. Manias, panics and crashes have been recurrent throughout the history of the modern financial system, sometimes threatening near systemic failure, such as the developing country debt crisis of the 1980s and the Asian financial crisis in the late 1990s. Each boom-bust cycle has its own idiosyncratic features, but they all exhibit certain common characteristics. They are triggered by new high-yielding financial investment opportunities which are supported by increasing credit. Asset price bubbles emerge, fomented by euphoric speculation and widening leverage ratios. As more and more purchases are made on margin or by instalments, the resilience of borrowers to downside risks is weakened, giving rise to financial distress and a rush for liquidity as soon as prices begin to fall and expectations go in to reverse. The frequency of these cycles and the damage they cause tend, moreover, to be greater following a period of rapid market deregulation and liberalization. Just such a trend began in advanced countries in the late 1970s, accelerating from the early 1980s and spreading, thereafter, to many developing countries.

### From sub-prime borrowers to submerging economies: who is to blame?

A good deal of analysis has focused on stresses in the housing market, particularly in the United States, where so-called “sub-prime” mortgages and home equity loans helped feed a \$15 trillion home mortgage debt mountain. The collapse of the real estate market has led to defaults and foreclosures and a good deal of personal hardship. However, this is rather a symptom than a cause of the problem. The 15-20 per cent drop in (average) US house prices since their peak in 2006 could not, by itself, have triggered a global financial meltdown. That is, rather, the direct result of an incessant drive to deregulate markets—dismantling firewalls within and across the financial sector—and the promise that efficiency gains and higher profits would be accompanied by a more secure investment climate thanks to product innovations and the self-discipline of market participants. In the United States and elsewhere, this has led to the eclipse of traditional deposit and insurance institutions, which accounted for over two thirds of financial sector assets in the United States in 1976 but only 30 per cent

in 2006, by a new breed of financial enterprises (and speculators), including hedge funds, mutual funds, and security brokers and dealers. These players have introduced a plethora of new financial instruments (mortgage backed securities, collateralized debt obligations, credit derivatives and swaps, etc) for leveraging credit and managing risk, and which encouraged mounting levels of debt in the household, corporate and public sectors. In some countries, both developed and developing, domestic financial debt as a share of GDP has risen four or five fold since the early 1980s. Much of this growth was allowed to happen outside of the reach of regulators and regulatory frameworks. As the boom continued the talk was about how everyone was winning while the risks were conveniently ignored, despite the warning signs that mounting household, public sector and financial sector indebtedness in the United States and elsewhere could not be sustainable over time.

The logic of unregulated finance has, moreover, taken charge of the globalization process which, in the absence of international checks and balances, has introduced a further source of fragility as financial institutions have expanded their cross-border operations in search of the next boom cycle. The hypertrophy of the Icelandic financial sector to many times the size of its national GDP is a particularly exaggerated example of this broader trend.

## What makes this a systemic crisis?

This crisis is systemic because its origins lie within the workings of financial markets themselves; and it has affected all financial institutions simultaneously, freezing the supply of credit with a devastating effect on the real economy. Credit is an essential part of any economy where decisions take time to come to fruition and managing credit risk is a necessary part of a healthy economy. However, the greater the distance between those that first arrange a loan and those holding the risk, the greater the number and diversity of creditors to any individual borrower, and the greater the capacity to actively trade credit risk, the greater the danger that risks will go undetected or be under-priced. Alarm bells should have sounded, when the value of the securities involved in financial transactions reached several times global income, and as these transactions were 'sustained' through leverage ratios (the proportion of debt acquired on the back of each institutions own assets) of 30 or higher, as compared with the ceiling of 10 normally imposed on banks. Furthermore, the increasing complexity of credit derivatives led to excessive reliance on rating agencies who proved inadequate to the task at hand, in part because of conflicts of interest over their own sources of earnings which are proportional to the trade volume of the instruments they rate.

The spread of financial networks across the world, and the vested belief that securitization could effectively conquer

risks, has made practically all financial transactions hinge on the 'confidence' that each counter-party in isolation is capable of backing-up its operations. This seems an elusive assumption when asset prices are rising across the board. Indeed, as prices start to fall and insolvencies emerge, such confidence is weakened, and may quickly vanish generating a credit freeze which spreads to the business sector, and which in turn makes them increasingly vulnerable. Because the underlying assets have been valued and their risk assessed by the originating financial institution, a turnaround can very quickly drain trust from the entire system.

## Whatever happened to the "goldilocks economy"?

The advocates of efficient financial markets promised lasting prosperity and stability so long as political interference was kept to a minimum and macroeconomic policies stuck to keeping a tight reign on inflationary pressures. Such phrases as the "goldilocks economy", the "great stability" and the "great moderation" rolled around policy making circles and the financial press as the boom began to take hold giving the impression that a new era of macroeconomic tranquillity and unbounded prosperity had arrived. In reality, with asset prices conveniently left out of inflation-targeting models, macro policy was overseeing a debt-driven boom in which asset prices rather than income flows determined spending decisions and attitudes to risk, and where investment became identified with rearranging existing assets through leveraged buyouts, stock buybacks and mergers and acquisitions. By overlooking more traditional concerns -- such as the level and composition of aggregate demand, labour market performance, etc -- the policy choices and institutional reforms deemed necessary to bolster market fundamentals have ended up weakening long-term growth and stability. Sluggish employment growth, stagnant wages and anaemic investment in productive capacity, in both the private and public sectors, were among the clearest signs that this policy stance was failing to deliver in many countries, both developed and developing, even as "boom" conditions prevailed.

## What has the financial crisis to do with 'global imbalances'?

The present crisis comes on top of a prolonged period of growing financial and macroeconomic imbalances which originated in the early 1990s as the United States became the global consumer of last resort. Domestic savings all but evaporated and ever widening trade and current account deficits were chalked up. The deficits were financed by capital inflows from surplus economies whose own performance depended, in no small part, on selling goods to (increasingly indebted) consumers in the United States. For this to continue, indebted

countries depended on rising asset (and currency) values to attract foreign investors, while creditor countries' were expected to maintain low costs of production by postponing wage increases and higher social expenditures to ensure overseas demand for their exports. This nexus provided the basis for massive international leveraging by financial institutions. The years between the Asian financial crisis in 1997 and the bursting of the 'dot-com' bubble in 2000, set the stage for a further twist in the interconnected tale of macro imbalances and deregulated finance, as emerging markets accumulated massive reserves to insure themselves against future shocks by increasing production, curtailing domestic spending and exporting, and the United States (and a few other advanced countries) specialized in creating attractive asset markets by (successfully) building the expectation of ever-rising values (initially in stock markets). The loosening of monetary policy in the United States in response to the dot.com bust was the catalyst for an even bigger explosion in lending by financial institutions, frantically, searching for higher and higher returns at home and abroad.

## Have we hit bottom?

As long as confidence is not restored, the financial system will continue to malfunction; financial investors will focus on repairing their balance sheets by liquidating assets, inducing further price falls; and productive investors will retreat in the face of reluctant consumers at home and abroad, further choking demand. An important step in restoring confidence comes with the perception that policy makers will do 'whatever it takes' to turn the crisis around. Some big steps have been taken to repair the financial system and bolster demand but doubts and ambiguities remain over the value of the 'toxic' assets being acquired, whether or not recapitalizing the financial institutions will activate the flow of credit and help the resumption of economic activity and whether or not tax payers will have to carry most of the costs of the bail outs. As time passes, the real economy weakens further, triggering a new round of threats to financial stability and raising doubts about the speed of any recovery.

Given the systemic nature of the crisis, the domestic measures which can help restore balance sheets, rekindle animal spirits and strengthen consumer confidence must not only be commensurate with the scale of the problem but must also be co-ordinated worldwide. This has not happened yet. If confidence is not quickly restored, the United Nations projects in the latest World Economic Situation and Prospects 2009 (<http://www.un.org/esa/policy/wess/wesp.html>) that the world economy would continue to slip deeper in to recession, reaching a global growth rate of only 1 per cent per annum in 2009 with no strong recovery likely to follow any time soon.

## What will be the impact on developing countries?

Beginning with the debt crisis of the early 1980s, developing countries have been on the fault line of the new financial architecture, enduring a series of recurring financial crises through the end of the 1990s. However, a period of widely shared and strong growth from 2001 raised hopes that the developing world had become much less vulnerable to external shocks and had accumulated sufficient reserves to manage any downside risks. Moreover, there was a growing belief that this growth would provide a way to correct global imbalances and even provide a safe haven from financial turmoil elsewhere. This so-called "decoupling" thesis ignored the fact that global imbalances were organically linked to the unprecedented debt explosion in deficit countries and that favourable global demand was dependent on the pace and volume of imports from advanced countries.

In reality, developing countries are already being hurt by the crisis through international trade and finance channels. Commodity prices have dropped significantly since their peaks in the summer hurting primary exporters in particular, but lower developed country demand will affect export growth throughout the developing world. Some emerging market economies, such as Brazil, are already facing severe curtailments in access to trade credits and the threat of reversals in private capital flows.

A rapid reversal of capital flows together with the rising cost of borrowing and asset price deflation has already hit some emerging markets, particularly those which still hold large stocks of external debt, driving some back to borrowing from the international financial institutions. But even the vast amounts of foreign reserves accumulated by developing countries in recent years may quickly evaporate in the ensuing global crisis.

There is also the risk that aid commitments to the poorest countries will be drastically curtailed as fiscal priorities change in the wake of bank bail outs and rising deficits in the donor countries. Moreover, the flow of worker remittances, an increasingly important source of foreign exchange for some countries, is certain to slow sharply as employment prospects falter in more advanced economies.

A growing number of developing countries have already witnessed a significant deceleration in economic growth. Even if the contagion were mostly confined to trade flows, developing countries as a whole would see growth rates drop to 4.6 per cent in 2009, compared to 6.7 per cent over the last three years. But considering the wider threats from the financial crisis, growth may drop to well under 3 per cent, with some regions, like North Africa and Central America (including Mexico) falling into outright recession, and others like sub-

Saharan Africa and South America experiencing growth rates under 1 per cent, far below their population growth.

All this, no doubt, is diminishing the prospects of achieving the MDGs.

## What should a global new deal involve?

While this is the first synchronised global slowdown since the 1930s, it is unlikely that this time around a deepening global recession will collapse in to global depression. Rather, it seems more plausible (and certainly more hopeful) that policy makers around the world decide to act, sooner rather than later, in a co-ordinated fashion and with full awareness of the gravity of the crisis in financial markets and its relation to global imbalances, as well as with a sensitivity to wider economic goals and the political ramifications of their actions on each other.

What is required is a new global deal which centres on employment creation as much as it does on reviving the financial system, and includes reform of the international economic system so that it can support a more balanced integration of all countries, but particularly developing countries, into the global economy.

One encouraging feature of the response to the crisis (and very much in the spirit the original new deal) has been the way in which policy makers in rich countries have been willing to experiment with a variety of measures, whether loosening macroeconomic policy, nationalization, subsidies, capital controls, previously excluded from the policy tool kit on ideological grounds.

The first challenge remains to restore confidence and stability in the financial system. However, bailouts and liquidity injections will not be sufficient if there is little prospect of economic recovery. The scope for a further monetary stimulus has become very limited, especially in the United States where interest rates on Treasury Bills are near zero and a liquidity trap is looming. A substantial fiscal stimulus therefore will be needed to give new impetus to faltering economies. Both developed and developing countries are now considering these, but given the scale and the depth of the crisis only massive packages can expect to make sufficient difference. China's package, totalling \$586 billion (or 15 per cent of its GDP) to be spent over the next two years, might be up to the challenge. However, the global economy may only see sufficient benefit if the fiscal stimulus is provided in an internationally coordinated fashion. In a globalized economy, fiscal stimulus in a single country can be undercut by import leakage and other such effects; when internationally coordinated, a reinforcing multiplier effect can take hold.

Such a crisis response could provide a unique opportunity to serve broader global goals by aligning the fiscal stimuli

with much-needed investments in long-term sustainable development. The massive resources required to reactivate the global economy can be applied in part to public investments in infrastructure, food production, education and health and renewable energy sources, helping developing countries to diversify their economies and meet the Millennium Development Goals.

The second challenge is to address the systemic flaws of the international financial architecture in order to prevent the kind of problems the world is facing today from happening again. Detailed reform blueprints can only emerge through full and open discussions which include all interested parties, but some key issues have already surfaced:

- Establishing a credible and effective mechanism for international policy coordination. To guide a more inclusive process this not only requires participation of major developing countries, but also more representative institutions of global governance and hence a fundamental revision of the governance structure and functions of the IMF and the World Bank.
- Fundamental reforms of existing systems of financial regulation and supervision leading to a new internationally coordinated framework that can stem the excesses of the past.
- Reform of the present international reserve system, away from the almost exclusive reliance on the US dollar and towards a multilaterally backed multi-currency system which, perhaps, over time could evolve into single, world currency backed system.
- Reforms of liquidity provisioning and compensatory financing mechanisms, backed, among others, through better multilateral and regional pooling of national foreign exchange reserves and which avoid onerous policy conditionality attached to existing mechanisms.

Such reforms will not easily find consensus among all stakeholders, but the risk of endangering global peace and prosperity by failing to address the systemic problems underlying the present crisis are simply too high and this awareness should give the impetus to finding common solutions. ■

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