GLOBAL FINANCIAL CRISIS - LESSONS FOR THE FUTURE

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1. Introduction

New York has often been hailed as the global centre for financial activities. From high rise buildings to fast cars, the wealth of the U.S. and the entire world is concentrated on the floors of Wall Street and all those glistering bank buildings in Corporate America. 'When the U.S. twitches the rest of the world convulses' is no understatement. All contractual transactions related to trade is predominantly executed in the U.S. currency. Other nations need to maintain USD currency stocks and with that, the parity of their own currency, is subjected to volatility of the economic health of the U.S. A rude shock was the financial crisis, which was announced by the Bush administration in late 2008 and the subsequent confession by Greenspan at a Congressional hearing, for overlooking the dire warnings. Subsequently, it was bequeathed on Barack Obama to redress these issues and put the economy back on track not only to save America but the stability of the financial systems of the world at large.

The Financial Crisis of 2007-2009 has been called the most serious financial crisis since the Great Depression, by leading economists. The crisis which was brewing for a while really started to show its effects in the middle of 2007 and into 2008. The extent of the problem has been so severe that around the world stock markets have fallen, large financial institutions have collapsed or been bought out, and governments in even the wealthiest nations have had to come up with rescue packages to bail out their financial systems. Some governments have moved to make it harder to manipulate the markets, while other governments have moved to try and reassure investors and savers that their money is safe. In a number of European countries, for example, governments have stepped in to guarantee depositors' savings. In other cases, banks have been nationalized. Various causes have been cited with varying combinations of factors including risk weights assigned. These causes include macro-economic policies, deficiencies in financial sector supervision and regulation, financial engineering, and the global activities of large private financial institutions.

The first part of this paper, whilst providing an overview of the crisis seeks to ascertain the reasons in length that led to the crisis.

The after effects of the crisis are significant. Even now the full dimension and consequences are not known, but almost certainly the crisis will prove to be the most severe in the context of severity of its global impact and depth since World War II. On the one hand many are concerned that those responsible for the financial problems are the ones being bailed out, while on the other hand, a global financial meltdown will affect the livelyhood of almost everyone in an increasingly inter-connected world.

The second part of the paper reviews the lessons that can be learned from this crisis based on the International Monetary Fund (IMF)'s assessment with regard to financial sector regulations and supervision.

2. Background to the Crisis

The immediate cause or trigger of the crisis was the bursting of the United States housing bubble which peaked in approximately 2005–2006. High default rates on "subprime" lending and adjustable rate mortgages (ARM), began to increase quickly thereafter

In the years leading up to the start of the crisis in 2007, significant amounts of foreign money flowed into the U.S. from fast-growing economies in Asia and oil-producing countries. This inflow of funds combined with low U.S. interest rates from 2002-2004 contributed to easy credit conditions, which fueled both housing and credit bubbles. Loans of various types (e.g., mortgage, credit card, and auto) were easy to obtain and consumers assumed an unprecedented debt load. As part of the housing and credit booms, the amount of financial agreements called mortgage-backed securities (MBS), which derive their value from mortgage payments and housing prices, greatly increased. Such financial innovation enabled institutions and investors around the world to invest in the U.S. housing market. As housing prices declined, major global financial institutions that had borrowed and invested heavily in subprime MBS reported significant losses.

2.1 Growth of the Housing Bubble

Between 1997 and 2006, the price of the typical American house increased by 124%. During the two decades ending in 2001, the national median home price ranged from 2.9 to 3.1 times median household income. This ratio rose to 4.0 in 2004 and 4.6 in 2006. As a result of this housing bubble, quite a few homeowners refinanced their homes at lower interest rates, or financing consumer spending by taking out second mortgages secured by the price appreciation.

U.S. home mortgage debt relative to GDP increased from an average of 46% during the 1990s to 73% during 2008, reaching $10.5 trillion. In 1981, US private debt was 123% of GDP, by 3Q2008 it was 290%.

By September 2008, average U.S. housing prices had declined by over 20% from their mid-2006 peak. Easy credit, and a belief that house prices would continue to appreciate, had encouraged many subprime borrowers to obtain adjustable-rate mortgages. These mortgages enticed borrowers with a below market interest rate for some predetermined period, followed by market interest rates for the remainder of the mortgage's term. Borrowers who could not make the higher payments once the initial grace period ended would try to refinance their mortgages. Refinancing became more difficult, once house prices began to decline in many parts of the USA. Borrowers who found themselves unable to escape higher monthly payments by refinancing began to default. During 2007, lenders had begun foreclosure proceedings on nearly 1.3 million properties, a 79% increase over 2006. This increased to 2.3 million in 2008, an 81% increase vs. 2007. As of August 2008, 9.2% of all mortgages outstanding were either delinquent or in foreclosure.

From 2004-07, the top five U.S. investment banks each significantly increased their financial leverage which increased their vulnerability to a financial shock. These five institutions reported over $4.1 trillion in debt for fiscal year 2007, about 30% of U.S. nominal GDP for 2007. Lehman Brothers was liquidated, Bear Stearns and Merrill Lynch were sold at fire-sale prices, and Goldman Sachs and Morgan Stanley became commercial banks, subjecting themselves to more stringent regulation. With the exception of Lehman, these companies required or received government support. Fannie Mae and Freddie Mac, two U.S. Government sponsored enterprises, owned or guaranteed nearly $5 trillion in mortgage obligations at the time they were placed into conservatorship by the U.S. government in September 2008.

These seven entities were highly leveraged and had $9 trillion in debt or guarantee obligations, an enormous concentration of risk, yet were not subject to the same regulation as depository banks.

2.2 Easy Credit Conditions

From 2000 to 2003, the Federal Reserve lowered the federal funds rate target from 6.5% to 1.0%. This was done to soften the effects of the collapse of the dot-com bubble and of the September 2001 terrorist attacks, and to combat the perceived risk of deflation. The Fed then raised the Fed funds rate significantly between July 2004 and July 2006. This contributed to an increase in 1-year and 5-year adjustable-rate mortgage (ARM) rates, making ARM interest rate resets more expensive for homeowners.

In 2005, Dr Ben Bernanke, before being appointed as Chairman of Federal Reserve, addressed the implications of the U.S.'s high and rising current account (trade) deficit, resulting from U.S. imports exceeding its exports. Between 1996 and 2004, the U.S. current account deficit increased by $650 billion, from 1.5% to 5.8% of GDP. Financing these deficits required the USA to borrow large sums from abroad, much of it from countries running trade surpluses, mainly the emerging economies in Asia and oil-exporting nations.

Hence large and growing amounts of foreign funds (capital) flowed into the U.S. to finance its imports. This created demand for various types of financial assets, raising the prices of those assets while lowering interest rates. Foreign investors had these funds to lend, either because they had very high personal savings rates (as high as 40% in China), or because of high oil prices. Bernanke referred to this as a "saving glut "A "flood" of funds (capital or liquidity) reached the U.S. financial markets. Foreign governments supplied funds by purchasing U.S. Treasury bonds and thus avoided much of the direct impact of the crisis. U.S. households, on the other hand, used funds borrowed from foreigners to finance consumption or to bid up the prices of housing and financial assets. Financial institutions invested foreign funds in mortgage-backed securities. Needless to say, U.S. housing and financial assets dramatically declined in value after the housing bubble burst.

2.3 Sub-prime Lending and Securitization

In addition to easy credit conditions, there is evidence that both government and competitive pressures contributed to an increase in the amount of subprime lending during the years preceding the crisis. Major U.S. investment banks and government sponsored enterprises like Fannie Mae played an important role in the expansion of higher-risk lending.

The term subprime refers to the credit quality of particular borrowers, who have weakened credit histories and a greater risk of loan default than prime borrowers. The value of U.S. subprime mortgages was estimated at $1.3 trillion as of March 2007, with over 7.5 million first-lien subprime mortgages outstanding.

The subprime crisis came about largely because of financial instruments such as securitization where banks would pool their various loans into sellable assets, thus off-loading risky loans onto others. (For banks, millions can be made in money-earning loans, but they are tied up for decades. So they were turned into securities. The security buyer gets regular payments from all those mortgages; the banker off loads the risk. Securitization was seen as perhaps the greatest financial innovation in the 20th century.)

Starting in Wall Street, others followed quickly. With soaring profits, all wanted in, even if it went beyond their area of expertise. For example,

- Banks borrowed even more money to lend out so they could create more securitization. Some banks didn't need to rely on savers as much then, as long as they could borrow from other banks and sell those loans on as securities; bad loans would be the problem of whoever bought the securities.
- Some investment banks like Lehman Brothers got into mortgages, buying them in order to securitize them and then sell them on.
- Some banks loaned even more to have an excuse to securitize those loans.
- Running out of who to loan to, banks turned to the poor; the subprime, the riskier loans. Rising house prices led lenders to think it wasn't too risky; bad loans meant repossessing high-valued property. Subprime and "self-certified" loans (sometimes dubbed "liar's loans") became popular, especially in the U.S.
- Some banks evens started to *buy* securities from others.
- Collateralized Debt Obligations, or CDOs, (even more complex forms of securitization) spread the risk but were very complicated and often hid the bad loans. While things were good, no-one wanted bad news.

High street banks got into a form of investment banking, buying, selling and trading risk. Investment banks, not content with buying, selling and trading risk, got into home loans, mortgages, etc without the right controls and risk management.

Many banks were taking on huge risks increasing their exposure to problems. Perhaps it was ironic that a financial instrument to reduce risk and help to lend more had backfired so much.

2.4 Creating More Risk by Trying to Manage Risk

Securitization was an attempt at managing risk. There have been a number of attempts to mitigate risk, or insure against problems. While these are legitimate things to do, the instruments that allowed this to happen helped cause the current problems, too.

In essence, what had happened was that banks, hedge funds and others had become over-confident as they all thought they had figured out how to take on risk and make money more effectively. As they initially made more money taking more risks, they reinforced their own view that they had it figured out. They thought they had spread all their risks effectively and yet when it really went wrong, it all went wrong.

The finance industry flourished as more people started looking into how to insure against the downsides when investing in something. To find out how to price this insurance, economists came up with options, a derivative that gives you the right to buy something in the future at a price agreed now. Mathematical and economic geniuses believed they had come up with a formula of how to price an option, the Black-Scholes model.

This was a hit; once options could be priced, it became easier to trade. A whole new market in risk was born. Combined with the growth of telecoms and computing, the derivatives market exploded making buying and selling of risk on the open market possible in ways never seen before.

As people became successful quickly, they used derivatives not to reduce their risk, but to take on *more* risk to make more money. Greed started to kick in. Businesses started to go into areas that were not necessarily part of their underlying business.

In effect, people were making more bets, speculating or gambling.

The market for credit default swaps (a derivative on insurance on when a business defaults), for example, was enormous, exceeding the entire world economic output of $50 trillion by summer 2008. It was also poorly regulated. The world's largest insurance and financial services company, AIG alone had credit default swaps of around $400 billion at that time which was a significant exposure, lacking regulation. Furthermore, many of AIGs credit default swaps were on mortgages, which of course went downhill, and so did AIG.

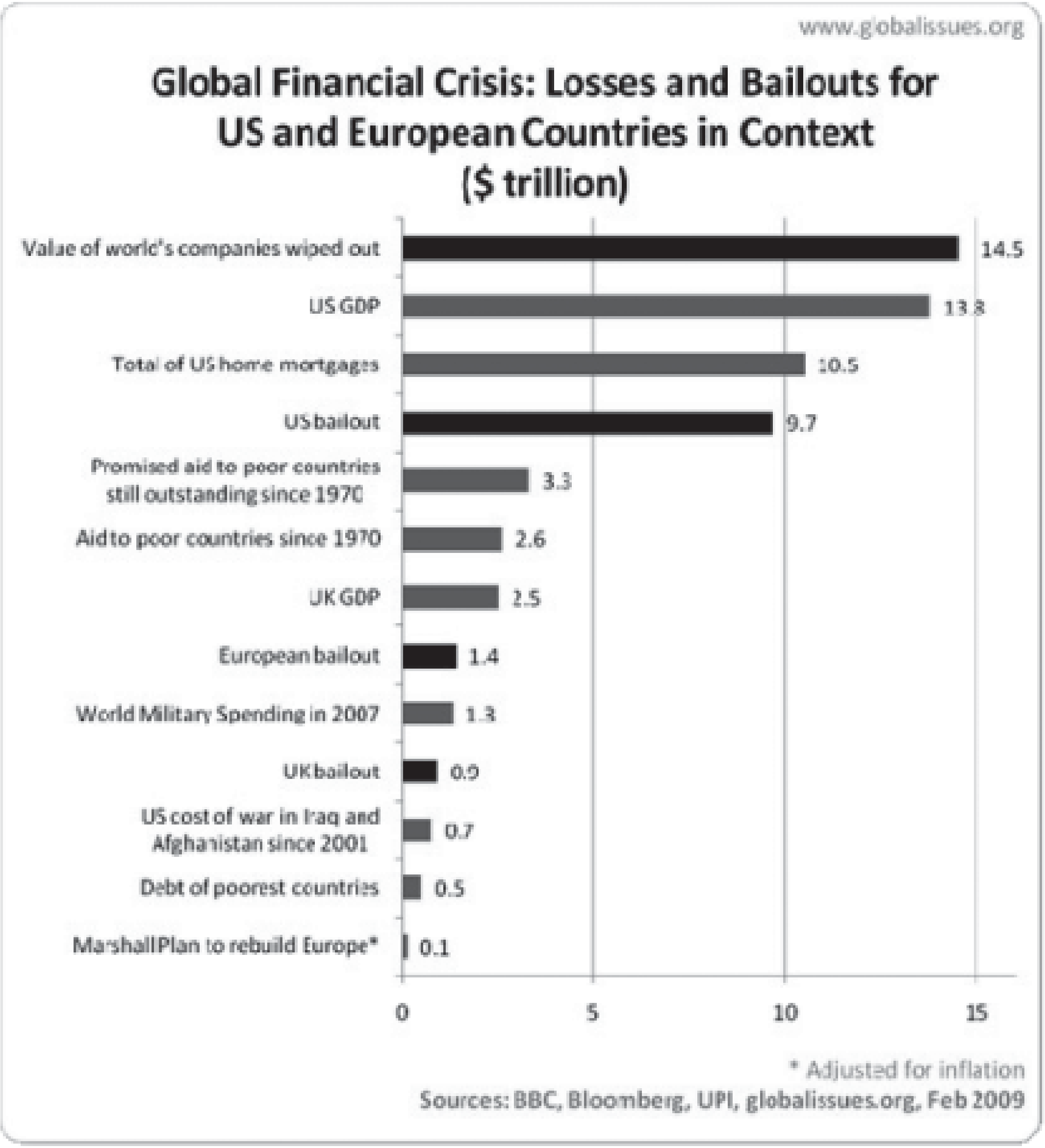
Of course, derivatives didn't cause this financial meltdown, but they did accelerate it once the subprime mortgages collapsed, because of the interlinked investments. Derivatives revolutionized the financial markets and will likely be here to stay because there is such a demand for insurance and mitigating risk and the challenge now is to reign in the wilder excesses of derivatives to avoid those incredibly expensive disasters.

3. The Scale of the Crisis: Trillions in Taxpayer Bailouts

The extent of the problems has been so severe that some of the world's largest financial institutions have collapsed. Others have been bought out by their competition at low prices and in other cases, the governments of the wealthiest nations in the world have resorted to extensive bail-out and rescue packages for the remaining large banks and financial institutions.

The total amounts that governments have spent on bailouts have skyrocketed. From a world credit loss of $2.8 trillion in October 2009, US taxpayers alone will spend some $9.7 trillion in bailout packages and plans, according to *Bloomberg*. $14.5 trillion, or 33%, of the value of the world's companies has been wiped out by this crisis. The UK and other European countries have also spent some $2 trillion on rescues and bailout packages. More is expected.

Some of the bail-outs have also been accompanied with charges of hypocrisy due to the appearance of "socializing the costs while privatizing the profits." The bail-outs appear to help the financial institutions that got into trouble (many of whom pushed for the kind of lax policies that allowed this to happen in the first place).


www.globalissues.org
Global Financial Crisis: Losses and Bailouts for US and European Countries in Context ($ trillion)
Value of world's companies wiped out
14.5
US GDP
13.8
Total of US home mortgages
10.5
US bailout
9.7
Promised aid to poor countries still outstanding since 1970
3.3
Aid to poor countries since 1970
2.6
UK GDP
2.5
European bailout
1.4
World Military Spending in 2007
1.3
UK bailout
0.9
US cost of war in Iraq and Afghanistan since 2001
0.7
Debt of poorest countries
0.5
Marshall Plan to rebuild Europe*
0.1
0
5
10
15
* Adjusted for inflation
Sources: BBC, Bloomberg, UPI, globalissues.org, Feb 2009

Some governments have moved to make it harder to manipulate the markets by short selling during the financial crisis, blaming them for worsening an already bad situation.

Other governments have moved to try and reassure investors and savers that their money is safe. In a number of European countries, for example, governments have tried to increase or fully guarantee depositors' savings. In other cases, banks have been nationalized (socializing profits as well as costs, potentially.)

3.1 A Crisis so Severe, the Rest Suffer Too

There is the argument that when the larger banks show signs of crisis, it is not just the wealthy that will suffer, but potentially everyone. With an increasingly inter-connected world, things like a credit crunch can ripple through the entire economy.

For example, banks with shaken confidence in lending may lend at higher interest rates or tougher conditions. People may find their mortgages harder to pay, or remortgaging could become expensive. For any recent home buyers, the value of their homes are likely to fall in value leaving them in negative equity. In the wider economy, many sectors may find the credit crunch and higher costs of borrowing will lead to job cuts. As people will cut back on consumption to try and weather this economic storm, yet other businesses will struggle to survive leading to further fears of job losses.

The crisis became so severe that after the failure and buyouts of major institutions, the Bush Administration offered a $700 billion bailout plan for the U.S. financial system. This bailout package was controversial because it was unpopular with the public, seen as a bailout for the culprits while the ordinary person would be left to pay for their folly. The U.S. House of Representatives initially rejected the package as a result, sending shock waves around the world. It took a second attempt to pass the plan, but with add-ons to the bill to get the Congress to accept the plan.

In Europe, starting with Britain, a number of nations decided to nationalize, or part-nationalize, some failing banks to try and restore confidence. The U.S. resisted this approach at first, as it goes against the rigid free market view the U.S. has taken for a few decades now.

Eventually, the U.S. capitulated and the Bush Administration announced that the US government would buy shares in troubled banks. Despite the large $700 billion US plan, banks have still been reluctant to lend. This led to the US Fed announcing another $800 billion stimulus package at the end of November. About $600bn was marked to buy up mortgage-backed securities while $200bn will be aimed at unfreezing the consumer credit market. This also reflects how the crisis has spread from the financial markets to the "real economy" and consumer spending.

By February 2009, according to *Bloomberg*, the total US bailout is $9.7 trillion. Enough to pay off more than 90 percent of America's home mortgages (although this bailout barely helps homeowners).

3.2 Global Contagion

The crisis rapidly developed and spread into a global economic shock, resulting in a number of European bank failures, declines in various stock indexes, and large reductions in the market value of equities and commodities. Moreover, the de-leveraging of financial institutions, as assets were sold to pay back obligations that could not be refinanced in frozen credit markets, further accelerated the liquidity crisis and caused a decrease in international trade.

A commodity price bubble was created following the collapse in the housing bubble. The price of oil nearly tripled from $50 to $140 from early 2007 to 2008, before plunging as the financial crisis began to take hold in late 2008. Experts debate the causes, which include the flow of money from housing and other investments into commodities to speculation and monetary policy. An increase in oil prices tends to divert a larger share of consumer spending into gasoline, which created downward pressure on economic growth in oil importing countries, as wealth flows to oil-producing states.

World political leaders, national ministers of finance and central bank directors coordinated their efforts to reduce fears, but the crisis continued. At the end of October 2008 a currency crisis developed, with investors transferring vast capital resources into stronger currencies such as the yen, the dollar and the Swiss franc, leading many emergent economies to seek aid from the International Monetary Fund.

In Europe, a number of major financial institutions failed. Others needed rescuing.

In Iceland, where the economy was very dependent on the financial sector, economic problems have hit them hard. The banking system virtually collapsed and the government had to borrow from the IMF and other neighbors to try and rescue the economy. In the end, public dissatisfaction at the way the government was handling the crisis led to the subsequent fall of the Iceland government

A number of European countries have attempted different measures (as they seemed to have failed to come up with a united response).

For example, some nations have stepped in to nationalize or in some way attempt to provide assurance for people. This may include guaranteeing 100% of people's savings or helping broker deals between large banks to ensure there isn't a failure.

The EU is also considering spending increases and tax cuts said to be worth •200bn over two years. The plan is supposed to help restore consumer and business confidence, shore up employment, getting the banks lending again, and promoting green technologies.

Russia'a economy is contracting sharply with fears of increased poverty. One of Russia's key exports, oil, was a reason for a recent boom, but falling prices have had a big impact and investors are withdrawing from the country.

The Brookings Institution reported in June 2009 that U.S. consumption accounted for more than a third of the growth in global consumption between 2000 and 2007. “The US economy has been spending too much and borrowing too much for years and the rest of the world depended on the U.S. consumer as a source of global demand.” With a recession in the U.S. and the increased savings rate of U.S. consumers, declines in growth elsewhere have been dramatic. For the first quarter of 2009, the annualized rate of decline in GDP was 14.4% in Germany, 15.2% in Japan, 7.4% in the UK, 9.9% in the Euro and 21.5% for Mexico.

By March 2009, the Arab world had lost $3 trillion due to the crisis. In April 2009, unemployment in the Arab world is said to be a ‘time bomb’. In May 2009, the United Nations reported a drop in foreign investment in Middle-Eastern economies due to a slower rise in demand for oil. In June 2009, the World Bank predicted a tough year for Arab states.

For the developing world, the rise in food prices coupled with knock-on effects from the financial instability and uncertainty in industrialized nations are having a compounding effect. High fuel costs, soaring commodity prices together with fears of global recession are worrying many developing country analysts.

3.3 Asia and The Financial Crisis- A Faster Recovery ?

Countries in Asia are increasingly worried about what is happening in the West. A number of nations urged the US to provide meaningful assurances and bailout packages for the US economy, as that would have a knock-on effect of reassuring foreign investors and helping ease concerns in other parts of the world.

Many believed Asia was sufficiently decoupled from the Western financial systems. Asia has not had a subprime mortgage crisis like many nations in the West have, for example. Many Asian nations have witnessed rapid growth and wealth creation in recent years. This led to enormous investments in the western countries. In addition, there was increased foreign investment in Asia, mostly from the West.

However, this crisis has shown that in an increasingly inter-connected world, there are always knock-on effects and as a result, Asia has had more exposure to problems stemming from the West. Many Asian countries have seen their stock markets suffer and currency values going on a downward trend. Asian products and services are also global, and a slowdown in wealthy countries means increased chances of a slowdown in Asia and the risk of job losses and associated problems such as social unrest. For example, Sri Lanka’s Garment industry had its worst period after the expiry of the Multi-fiber agreement with significant job losses.

India and China are the among the world’s fastest growing nations and after Japan, are the largest economies in Asia. From 2007 to 2008 India’s economy grew by a whopping 9%. Much of it is fueled by its domestic market. However, even that has not been enough to shield it from the effect of the global financial crisis, and the growth rate dropped to 7% in 1Q 2009.

China, similarly has also experienced a sharp slowdown and its growth is expected to slow down to 8%. However, China also has a growing crisis of unrest over job losses. Both have poured billions into recovery packages.

Japan, which has suffered its own crisis in the 1990s also faces trouble now. While their banks seem more secure compared to their Western counterparts, it is very dependent on exports. Japan is so exposed that in January alone, Japan's industrial production fell by 10%, the biggest monthly drop since their records began. Japan's output for the first 3 months of 2009 plunged at its quickest pace since records began in 1955, mostly due to falling exports.

However, latest statistics indicates that Asia's emerging economies are recovering much faster than the economies in other parts of the world. In the second quarter of 2009, Asia's emerging economies probably grew at an average annualized rate of over 10%, while America's GDP fell by 1%. In 2009 as a whole, recent forecasts suggest that emerging Asia could grow by at least 5%, while the G7 economies contract by 3.5%. The growth gap between the two has never been wider.

Emerging Asia as a whole might enjoy annual growth of 7 - 8% over the next five years according to "The Economist". The sharp downturn in Asia in 2008 painfully proved that the region was not immune to America and EU's downfall, but the speed and strength of its rebound, if sustained, would show that it is not chained to the U.S. either. If anything, the Global crisis has reinforced the shift of economic power from the West to the East.

4. Lessons for the Future

Almost two years after the beginning of the financial crisis that has overwhelmed the world economy, it may be time to draw some conclusions and outline the main lessons for the future. Is it really a turning point for market economies, a systemic crisis that will radically change the division of tasks between state and market? Or will everything be back to normal once a number of important technical problems concerning financial regulation are solved? Although the crisis originated in financial market failings, policymakers are much to blame. Regulatory failure amplified private sector errors, and poorly planned policy responses exacerbated the troubles.

4.1 Market failure

There is no doubt that the crisis has revealed a serious failure in one of the most sophisticated markets in the world – modern finance. One of the crucial tasks of financial markets is to allocate and manage risks. They have failed stunningly. Risk has been underestimated, and many intermediaries took excessive risks. The reasons for this failure and the implications for economic policy, however, are less clear.

One possible explanation is that it was just due to poor judgment. Financial innovation has been so fast that even sophisticated operators were not always able to fully understand the degree of risk of the financial instruments that were constructed. The systemic implications of those instruments were even less clear. As a consequence, many investors overestimated global financial markets' capacities, overlooking the systemic risk and the illiquidity risk that proved crucial in this crisis. This mistake can partly be explained by the difficulty of correctly evaluating the probability of rare or infrequent events. This crisis will not be forgotten, and it will certainly leave a mark on risk management practices and organisation models of financial intermediaries.

There is also a less benevolent explanation for the failure of financial markets, however, that highlights a systematic distortion of individual incentives rather than a mistake. First of all, the "originate and distribute" model, which separates the concession of the loan from the financial investment decision, entails obvious moral hazard problems. Secondly, rating agencies, paid by those issuing the very assets being rated, experienced an obvious conflict of interest. Third, managers' remuneration schemes encourage myopic behavior and excessive risk taking – if the bonus depends on short-term performance indicators, each individual manager is induced to take risks that are large but rare. If this is true, it means that we cannot trust the ability of markets to learn. Distorted incentives must also be redressed, through new, stricter regulation, even at the cost of significantly slowing down financial innovation or giving up some of its beneficial effects.

4.2 Regulatory failure

Mistakes in risk management cannot be only attributed to private operators. Supervisors have made major mistakes as well, allowing banks to accumulate off-balance-sheet liabilities and tolerating an excessive growth of leverage (i.e. the ratio of total assets to shareholders' equity) and indebtedness. This could be due to capture of supervisors by banks, arbitrage and international competition among supervising agencies, or implementation deficiencies. But more importantly, there has been a fundamental conceptual mistake –monitoring each financial institution solely on an individual basis, considering as the value at risk of the individual intermediary without taking systemic risk into any consideration. This is the same mistake that the individual intermediaries made.

A crisis of these proportions cannot have stemmed exclusively from mistakes in risk management. The reason is that high-risk investments were relatively small compared to the overall dimension of global financial markets. Many observers expected that the American real estate bubble would burst. But few imagined that it would overwhelm financial markets all over the world. Now that it has happened, it must be that the shocks hit important amplifying mechanisms. This amplification can largely be attributed to financial regulation. In other words, even more than a market failure, the crisis was triggered by a failure of regulation.

There are two aspects of regulation that have amplified the effects of the initial shock:

(i) the procyclicality of leverage, induced by constraints on banks' equity, and
(ii) The accounting principles that require assets to be evaluated according to their market value.

In case of a loss on investments, which erodes the capital of financial intermediaries, capital adequacy constraints under the Basel accord require reduced leverage and thus force banks to sell assets to obtain liquidity. The problem is thus exacerbated: forced sales reduce the market price of assets, worsening the balance sheets of other investors and inducing further forced sales of assets, in a vicious circle. Exactly the opposite happens during a boom: capital gains on portfolio assets allow intermediaries to expand leverage, which means taking on more debt in order to acquire new assets, in such a way that the price of assets is pushed up and other intermediaries become indebted chasing increasingly high prices. In sum, banking regulation has created a mechanism that amplifies the effects of shocks and accentuates cyclic fluctuations in the indebtedness of financial intermediaries.

One of the main lessons to be drawn from this crisis is that we need to deeply reconsider financial regulation and ask ourselves what its ultimate objective is – correcting distorted incentives of agents, creating buffers that reduce procyclicality of leverage, or reducing risks, and, if so, which risks? A sound regulatory system should address two concerns:

1. Correct distorted incentives of individual intermediaries or financial operators;
2. Reduce negative externalities and systemic risk, bearing in mind that evaluating risk management practices within individual intermediaries is not sufficient.

   Finally, inevitably, this will have to translate into rules that reduce the size of leverage in absolute terms and its procyclicality.

4.3 Mistakes in Managing the Crisis

It is widely held that the current situation is mostly the result of economic policy mistakes (in regulation, in supervision and, according to some, monetary policy) made before the outbreak of the crisis. The corollary of this thesis is that it is sufficient to correct these mistakes in order to avoid the next crisis. However, many serious mistakes have been made during the management of the crisis and have significantly contributed to worsening the situation.

The unclear causes of the crisis have resulted in its management being improvised from the beginning without a clear path in mind. Bear Stearns was saved, Lehman Brothers was allowed to fail, AIG was saved. Each decision was improvised, guided by neither pre-established criteria nor a sound and consistent strategy. The result is that, rather than boosting confidence, economic policy interventions have contributed to increasing confusion, panic, and fear.

Loss of confidence is always at the heart of any financial crisis. Expectations concerning the behaviour of authorities and other operators play a fundamental role in determining whether there will be contagion or whether the shock will be absorbed. But in order to influence expectations and restore confidence, policymakers must act according to procedures and criteria that are agreed upon and well understood, identifying the ultimate objectives and the policy tools to reach them. There has never been such clarity in this crisis, and that is an important lesson. To avoid repeating similar mistakes, it will be necessary to elaborate new and detailed procedures for managing complex phenomena such as the bankruptcy of large banks and more general policies aimed at preventing the worsening of systemic crises.

Given that large banks with systemic implications are typically multinational, these procedures will need to be coordinated at the international level.

Although difficult, this problem is not new. Financial crises in developing countries, which occurred almost yearly in the 1990s, have now become less frequent and less devastating thanks to the procedures of crisis management elaborated by the International Monetary Fund. It is now time to learn from those experiences, adapting them to the specific problems of large multinational banks.

5. IMF's recommendations on handling Systemic Risk Management

The IMF published the first detailed study of the crisis in April 2009 and recommends a worldwide rethink of how to handle systemic risk management.

The IMF's analysis points to failures at three different levels:

- Financial regulators were not equipped to see the risk concentrations and flawed incentives behind the financial innovation boom. Neither market discipline nor regulation were able to contain the risks resulting from rapid innovation and increased leverage, which had been building for years.
- Policymakers failed to sufficiently take into account growing macroeconomic imbalances that contributed to the buildup of systemic risks in the financial system and in housing markets. Central banks focused mainly on inflation, not on risks associated with high asset prices and increased leverage. And financial supervisors were preoccupied with the formal banking sector, not with the risks building in the shadow financial system.
- International financial institutions were not successful in achieving forceful cooperation at the international level. This compounded the inability to spot growing vulnerabilities and cross-border links.

5.1 Light-touch Regulation Failed to Spot Risk

The IMF study on financial regulation notes how, over the past decade, the financial system expanded massively and created new instruments that appeared to offer higher rewards at lower risk. This was encouraged by a general belief in light-touch regulation based on the assumption that financial market discipline would root out reckless behavior and that financial innovation was spreading risk, not concentrating it.

Both these assumptions proved wrong, and the result was a massive asset price bubble, especially in housing, and an enormous buildup of risk both inside and outside the formal banking system. *"What is clear from the crisis is that the perimeter of regulation must be expanded to encompass systemic institutions and markets that were operating below the radar of regulators and supervisors,"* Jaime Caruana, head of the IMF's Monetary and Capital Markets Department, said. *"We are suggesting a two-tiered approach to expand regulation: extending disclosure to provide enough information for supervisors to determine which institutions are big or interconnected enough to create systemic risk, and intensified functional regulation and oversight."*

The study identifies five key weaknesses that need to be fixed:

- ***First, the regulatory perimeter, or scope of regulation, needs to be expanded*** to encompass all activities that pose economy-wide risks. Regulation should also remain flexible to keep up with innovation in financial markets, and it should focus on activities, not institutions. Risk concentrations should not be allowed to develop beyond the regulatory perimeter. Clarifying the mandate for oversight of systemic stability would be an important first step.
- ***Second, market discipline needs to be strengthened.*** The failures of credit rating agencies to adequately assess risk have been criticized by many, and initiatives to reduce their conflicts of interest and improve investor due diligence are underway. Other steps could include less reliance on ratings to meet prudential rules, and a differentiated scale introduced for structured products. Also, the resolution of systemic banks should include early triggers for intervention and more predictable arrangements for loss-sharing.
- ***Third, procyclicality in regulation and accounting should be minimized.*** Increasing the amount of capital required of banks during upswings would create a buffer on which banks can draw during a downturn. An international framework for provisioning is needed to reflect expected losses through-the-cycle rather than in the preceding period. Supervisors should also routinely assess executive compensation schemes to ensure they do not create incentives for excessive risk-taking. In addition, there is a strong case for improving accounting rules by acknowledging potential for mispricing in both good and bad times.
- ***Fourth, information gaps should be filled.*** Greater transparency in the valuation of complex financial instruments is needed. Improved information on off-market transactions and off-balance sheet exposure would allow regulators to aggregate and assess risks to the system as a whole. Such measures would also strengthen market discipline.
- ***Fifth, central banks should strengthen their frameworks for systemic liquidity provision.*** The infrastructure underlying key money markets should also be improved.

While monetary and fiscal policies did not play a major role in the run up to the crisis, the crisis still holds a number of lessons for policymakers on the macroeconomic level.

- ***First, monetary policy should respond to the buildup of systemic risk.*** The IMF said policymakers should focus on macro-financial stability and pay greater attention to the buildup of systemic risk. Of course, how to identify and then to react to an inflating bubble is difficult. Typically, monetary policy will be too blunt an instrument to deal with asset price and credit booms: the response has to be found mainly in prudential regulation. But that first line of defense has failed in the past, and did so again recently. So there is a case for expanding the mandate of monetary policy to explicitly include macro-financial stability, not just price stability.

- ***Second, fiscal policy should be put on a stronger footing in good times .***Fiscal policy did not play a major role in the run up to the crisis, but many countries failed to pay down public debt and reduce deficits during good times. As a result, these countries now find themselves limited in their ability to stimulate their way out of the crisis. Tax policy also encouraged debt financing in recent years. Such tax rules could usefully be changed. The IMF says it has developed detailed analysis of available fiscal space in key countries, how to design effective stimulus packages, and how to ensure fiscal solvency over the medium term, in light of the increase of debt and contingent liabilities.
- ***Third, while international capital flows are on the whole beneficial, global imbalances have to be addressed.*** Policymakers should use macroeconomic and structural policies to rebalance savings and investment in their own economies. They should also use regulation to help reduce systemic risk stemming from capital flows, for example by imposing constraints on the foreign exchange exposure of domestic financial institutions and other borrowers.

5.2 Failures of International Cooperation

Despite the growing threat, the IMF and other institutions failed to send a strong wakeup call to policymakers and achieve a collaborative policy response. To be fair, some warnings were issued, the Fund says. For example, the IMF and others warned about risk concentrations in the financial sector and the prospects of disorderly adjustment from global imbalances. But the warnings fell on deaf ears, partly reflecting their lack of urgency and specificity.

There was also a lack of commitment on the part of policymakers for coordinated policy action in response to global threats. For instance, as the crisis unfolded, the initial policy response was a rush to protect local banks, at the risk of causing runs elsewhere.

The bottom-line is that the crisis has underlined the need for clearer policy messages and for more, not less, international cooperation across a range of economic and financial issues. According to the IMF's analysis, action is needed in four areas.

- ***Policy warnings should be more focused and specific***. The IMF is working with the Financial Stability Forum (FSF) on a new early warning exercise that will bring together scattered macro-financial expertise and drill down on key threats. More generally, the IMF's challenge will be to piece together macroeconomic and financial sector developments into a big picture scenario that also takes into account cross-country spillover effects.
- ***Leadership is needed in responding to systemic global risks.*** A range of organizations can claim a leadership role, including the IMF, the G-7 and G-20, the FSF, and the

OECD, but none has been effective. The IMF has the mandate, near universal membership, and a blend of macroeconomic and financial expertise that makes it particularly well-suited to assume leadership on global risks, but its bureaucratic ways and rigid power structures has shifted the policy debate towards smaller, more flexible groups, including to the G-20 and the FSF. Yet these smaller groups have their own problems of legitimacy and capacity for follow-up. A satisfactory global solution would bring together expertise, legitimacy, and effectiveness, and provide a forum for engagement among high-level policy makers. The IMF can be this solution, but this will require a further rebalancing of voice and representation among its members, to make its decision-making more accurately reflect today's global economic landscape.

- ***Rules for cross-border financial sector resolution are needed*** to encourage collaboration rather than solutions that minimize the burden on the local taxpayer with potential beggar-thy-neighbor effects.
- ***A credible global liquidity framework is needed***. Access to large-scale financing or insurance remains an issue for most emerging market countries. The IMF is reviewing its lending framework to make sure it is well-suited to members' needs. If the Fund cannot provide the needed insurance, countries may in future seek to rely on self-insurance through surpluses and reserve accumulation, which could distort global trade for years to come.

6. The Way Forward

During periods of boom, people do not want to hear of criticism of the forms of economics or the Risk Management practices they benefit from, specially when it brings immense wealth and power regardless of whether it is good for everyone or not. It may be that during periods of crisis such as now, the time comes to rethink economics and Risk Management practices in some way.

Though implementing the recommendations given by IMF, will be difficult both politically and technically the sheer scale of today's crisis provides clear evidence of the importance of learning from past mistakes. One also should not underestimate the momentum today toward decisive action and lasting solutions and capitalize on the opportunity specially the outcome of G-20 Summit held in April 2009 to make real progress. Reform of the IMF and the World Bank, have been suggested, whether that will actually happen and to what extent is something that we will find out in the course of 2010.

Historically, Asian and other developing countries have often been treated as second-class citizens when it comes to international trade, finance and investment talks. This time, however, Asian countries are potentially trying to flex their muscle, maybe because they see an opportunity in this crisis, which at the moment mostly affects the rich West.

Asian leaders had called for "effective and comprehensive reform of the international monetary and financial systems." Whether this will happen is hard to know. Similar calls by other developing countries and civil society around the world, for years, have come to no avail. This time however, the financial crisis could mean the US is less influential than before. A side-story of the emerging Chinese superpower versus the declining US superpower will be interesting to watch. China has, however, used this opportunity to attempt to attract neighboring nations into its orbit by attempting to foster better economic ties.

What seems to be emerging is that Asian nations may have an opportunity to demand more fairness in the international arena, which would be good for other developing regions, too.

It is my contention that this crisis is nothing short of a manifestation of the overall forces that are in control of the world economy. Those who have chosen to emphasize the failure simply on the lenders overextending themselves, miss the point. They conveniently dismiss the possibility that the consumers have always been willing, ready and able to throw caution to the wind if the opportunity of great financial gains presented itself.

Recession cycles are thought to be a normal part of living in a world of inexact balances between supply and demand. What turns a usually mild and short recession or "ordinary" business cycle into a great depression is a subject of debate and concern. The 'Big' question is whether it was largely a failure on the part of free markets or largely a failure on the part of governments to curtail widespread bank failures, the resulting panics, and reduction in the money supply.

Although in theory, this problem could have been averted if proper regulations and caution had been exercised, no-one would want to hear such restrictions during a 'Boom'. To have suggested anything would have been anti-capitalism or socialism or some other label that could effectively silence even the most prominent of economists raising concerns.

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