Chapter 6
Containing the Global Financial Crisis

Ivan Savic
G20 Research Group
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As with any crisis of this size and scope, the current global financial crisis has complex origins. The ultimate cause of the current crisis can be found in the U.S. banking industry. However, the crisis would not have spread to the extent that it did if not for underlying macroeconomic imbalances and systemic problems in the global financial system. Thus to understand it requires first to focus on the U.S. sub-prime situation and how it led to a global crisis. Only then can the questions of containing the global crisis be approached meaningfully.

There are two general causes of banking crises: panics (or self-fulfilling crises) and fundamental shocks. Of these the former are much more common. A fundamental shock is any event that lowers the expected profitability of a bank's investments. Such shocks can negatively affect the liquidity and solvency of individual banks or the banking industry as a whole.

The effects of fundamental shocks are usually exacerbated by market and government failures. A pre-crisis boom in an economic sector can lead to excessive optimism or, as Alan Greenspan famously termed it, irrational exuberance. Under such circumstances banks and investors tend to become less averse to taking risks and lending standards become lax. This problem is exacerbated by poor regulation or weakening of market discipline. The government can also add to this irrational exuberance by encouraging investment in a particular sector, by providing pre-crisis safety nets and by making implied or explicit promises of crisis bailouts. All these actions will distort market incentives and produce moral hazard, leading to more reckless behaviour by banks.

The extent of crisis contagion depends on a number of factors. Highly leveraged and interconnected financial markets allow for quickly crisis transition, just as a densely concentrated and sickly population help the spread of a virus. Market psychology is also a factor: panics, although rarely the original cause of a bank crisis, often play an important role in crisis contagion. High levels of international capital mobility will further exacerbate these problems. Furthermore, foreign exchange and sovereign debt problems not only limit the government's ability to respond to a crisis, but can also lead to the so-called twin crises of simultaneous crises in both banking and debt or foreign exchange markets that feed off one another.

The effect of a financial crisis on the real economy varies from crisis to crisis. Because fundamental shocks usually lead to recession, banking crises are as often the result rather than the cause of a recession. Yet banking crisis tend to deepen recessions. During a crisis banks become less willing to lend money, and the resulting credit crunch exacerbates the economic difficulties faced by businesses and households. In addition to the credit crunch, the collapse of financial institutions during a crisis also means the loss of lending relationships built up between banks and their clients. Due to asymmetrical information problems faced by households as well as by small and medium-sized businesses, building new relationships takes time and is particularly difficult during a recession. Thus the collapse of one or two banks may not warrant intervention. In fact, it may be beneficial from the point of view of maintaining market discipline. However, a systemic crisis in the financial sector is too dangerous and costly to be ignored.

Given the financial, economic and even social costs of a banking crisis, it is logical that some sort of crisis response is necessary. There are three elements to crisis response: immediate response or containment, economic stimulus and post-crisis reform. Immediate crisis response is intended to stabilize financial markets and minimizes the ensuing credit crunch. Economic stimulus is aimed at dealing with both the original cause of the crisis (i.e., the fundamental shock) and the economic recession that follows it. Finally, post-crisis reform is intended to identify and correct the market and government failures that contributed to the crisis. All three of these elements are necessary and ideally should be implemented in a complementary way.

In terms of an immediate crisis response, the basic logic was outlined in the 19th century in the seminal works of Henry Thornton and Walter Bagehot. The simple process of providing liquidity to a distressed financial market though a lender of last resort (usually, although not necessarily, a central bank) is often enough to stabilize distressed but sound institutions (in the classic formulation of the Bagehot rule of illiquid but not insolvent banks). However, despite the simple logic of lender-of-last-resort operations there is a great deal of controversy about how best to implement these operations.

Advocates of market solutions argue that it is usually best to leave crisis lending to financial markets themselves because the markets are more effective at identifying illiquid but solvent institutions and distributing funds to them. When markets are not able to generate sufficient liquidity, then governments can play a role; but this should be limited to interest rate policy and open-market operations because markets are more efficient and effective then governments at distributing the necessary liquidity. Despite the theoretical soundness of this logic, there are circumstances when a more invasive intervention may be necessary. If the problems in the banking industry are so serious that a simple injection of liquidity does not produce results and a large portion of the banking sector is facing collapse, then the central bank and government may be forced to get involved in renegotiating and managing the bad loans at the heart of the financial crisis. The government may even have to recapitalize the banking industry directly.

Of course, such dramatics steps may be unpalatable for several reasons. First, heavy government involvement is undesirable for a number of economic and political reasons, among them rising questions of social justice and the proper role of government. Second, as already mentioned, massive bailouts may lead to moral hazard problems. However, while these issues are serious and should be considered when designing a bailout package, they cannot be used as grounds for universal condemnation of all government interventions. The costs of systemic crises are simply too great to be ignored.

The problem of crisis containment is made all the more difficult when a crisis is not confined to a national financial system because it requires international cooperation and coordination. But international cooperation is not automatic and often much time is lost in simply reaching a consensus on the nature of the problem, let alone the time needed to identify the necessary solutions. Thus crises like the current one are very hard to deal with.

In terms of its origins and impact, this crisis is perhaps most similar to the Japanese asset bubble and the Swedish banking crisis of the 1990s. Like the U.S., these economies experienced a housing boom that had been financed mainly through the banks. These bubbles eventually burst, destabilizing the banking systems. The main difference between these two crises in how their respective governments handled them: Japan engaged in a poorly organized and drawn-out bailout while Sweden took a more comprehensive approach. Instead of simply providing liquidity to prop up failing banks, the Swedish government attached a number of provisions to its aid. First, while the government assumed the banks bad debts, the banks were forced to write down their losses and issue shares to the government. This saved the banks but punished existing shareholders and management. Second, a bank support agency was created to supervise the recovery of recapitalized banks. Third, the government was able to recoup the funds used in the bailout through the sale of bank assets and its shares. These measures went a long way in restoring the banking system while avoiding moral hazard problems and protecting taxpayers.

Like these two crises, today's U.S. sub-prime crisis is primarily the result of a fundamental shock: the collapse of the U.S. housing bubble. This bubble was the result of various factors including fallout from the dot.com bubble (that is, the already booming housing market was further inflated by investors in information technology looking for safe havens), bad government policy (the interest rate policy of the U.S. Federal Reserve System and the government's encouragement of sub-prime mortgages) and regulatory failure (in terms of both government and market oversight).

But two elements that were not present in the case of Japan and Sweden transformed the sub-prime crisis into a global crisis. The first was the massive foreign capital inflow into the United States. The second was the development of so-called mortgage-backed securities. These derivatives were intended to control the risk associated with mortgage investments. However, due to their novelty and a lack of regulation they did the opposite: they hid the underlying risk and increased world's exposure to it. It would be a mistake to place all the blame on the U.S., as there were problems in other financial markets (in particular the crisis in the United Kingdom mirrors that of the United States), but the sub-prime mortgage market and the collapse of the housing bubble in the U.S. are the primary causes of the collapse. That the crisis spread as widely as it did is a result of macroeconomic imbalances, international capital flows and the highly leveraged nature of many financial systems.

Governments and central banks have used nearly every tool at their disposal to deal with the crisis. Since as early as August 2007 there have been a series of coordinated open market operations and interest rate cuts aimed at loosening credit markets. These were followed by a series of government bailouts in the UK (Northern Rock Bank), the U.S. (Fannie Mae, Freddie Mac and AIG), Europe and Asia. There have also been more general attempts to stimulate economy and thus avoid or minimize the coming recession. The most prominent of these was the Bush administration's *Economic Stimulus Act* of 2008 and more recently China's massive stimulus injection. Finally, in addition to these short-term efforts, there have also been efforts of a more long-term and multilateral focus though the G7 finance ministers, the G8 and the Financial Stability Forum (FSF).

On the whole, these measures were ad hoc and ineffective. However, by September and October the full extent of the crisis had been realized. There has now been a growing acceptance that the crisis and the economic recession will not leave any part of the global economy untouched. The result has been more serious national efforts, especially by the U.S. and UK, and more comprehensive international coordination, through the International Monetary Fund (IMF), the G7 and the G20.

The U.S. and UK bailout packages are similar in size (approximately US$850 billon each) and scope. The key difference is in their approach to the problem and level of oversight. While the U.S. government originally aimed at buying up bad debt (reminiscent of the Japanese approach of the 1990s), the UK government placed a greater emphasis on recapitalizing its banks through new preferred stock issues (in keeping with the Swedish approach). Recently, the U.S. government switched its approach to the Swedish/British model. The British lead has also been taken up by a number of European governments. However, continued variation in national responses is necessary because each country faces its own particular problems.

Thus in the last month there has been a move from ad hoc responses to more concerted and better coordinated efforts. Governments have given up on the vain hope that the crisis might pass them by and now realize that concerted coordinated efforts are necessary. There has been some success in terms of controlling the financial crisis: most financial markets have stabilized and the credit crunch has eased somewhat. However, much more remains to be done. In particular, governments must now coordinate their efforts at economic stimulus in order to deal with the global economic recession.

At their summit in Washington on November 14-15, 2009, the G20 leaders committed to:

- continue efforts to stabilize the financial system.
- use monetary and fiscal policy to stimulate economic recovery.
- ensure that low- and middle-income countries continue to have access to short-term and development financing and to ensure that international financial institutions (such as the IMF and the World Bank) have sufficient resources to provide this financing.
- reform the international financial system through national ministries, guided by input from international financial institutions (primarily the IMF and the FSF). Progress on this front will be reviewed by the G20 leaders at a meeting scheduled for April 2009. The international financial institutions will also be reformed. In particular, the FSF (and similar bodies) will be expanded to include more developing countries.
- pursue broader policy goals, the most important of which are avoiding protectionism, completing the Doha round of trade talks and dealing with energy security and climate change.

To some the summit declaration may seem too vague or just so much rhetoric. However, the meeting represents real consensus among the G20 about the origins and necessary remedies for the crisis. Without such a consensus the crisis cannot be contained. Others might see it as the beginning of a Bretton Woods II, which some have been calling for. However, great caution must be exercised. In 1971, the most significant economic powers at the time, the G10, met under the auspices of the IMF and produced the so-called Smithsonian Agreement designed to solve the underlying problems plaguing the Bretton Woods system. Despite being heralded by the Nixon administration as the most significant reform of the international economic system, it achieved very little. By 1973 the Bretton Woods monetary agreement had collapsed. Whether the G20 efforts will lead to a Bretton Woods II or a Smithsonian II will depend on actions, not on the contents of communiqués.

Given the stakes and the consensus that has developed, however, there is reason to be optimistic, even if the creation of Bretton Woods II is likely too ambitious. For the time being, it is essential that all governments continue with their efforts to contain the crisis and stabilize their economies. Moving too early on efforts to reform the international financial and economic system could jeopardize the still incomplete crisis response efforts.