Ten years on, in uncharted waters

Posted at: 19/09/2018

Highlights

- The East Asian crisis of 1997 caused a rethink on full capital account convertibility and fixed exchange rates.
- The Internet bubble and bust of the early 2000s led many to question the impact of new technology on long-term productivity growth.
- The scandals in the corporate world through the 2000s in the U.S. provided grist for a fresh debate on corporate governance.
- None of these was any match for the opportunities for cerebration created by the financial crisis of 2007, which peaked in early September 2008, occasioned an enormous outpouring of scholarly papers, articles and books on the causes of the crisis and the lessons to be learnt.

Centered in regulation failure

The crisis of 2007 had multiple causes as follows-

- Global macroeconomic imbalances,
- a loose monetary policy in the U.S.,
- the housing bubble in the U.S. again and elsewhere, a bloated financial sector,
- a flawed belief in efficient markets,
- greedy bankers,
- incompetent rating agencies
    - these and others have been identified as among the villains of the crisis,each has happened before without on its own bringing on a global economic crisis.
- Most of the blame for the implosion of the financial sector in 2007-08 lies elsewhere — in a failure of regulation which manifested itself in several ways.
    - One, banks were allowed extraordinarily high levels of debt in relation to equity capital.
    - Two, banks in the advanced economies moved away from the business of making loans to investing their funds instead in complex assets called "securitised" assets.
    - The securitised assets consisted of bundles of securities derived from sub-prime loans, that is, housing loans of relatively higher risk.
    - The switch from loans to securitised assets had enormous implications for banks.
    - With a loan, losses are recognised over time.
- In contrast, investments are 'mark to market', that is, losses or gains on these have to be recorded instantly.
- As housing prices started falling and the securitised assets lost value, it translated into enormous losses for banks.
- These losses eroded bank capital and created panic among those who had lent funds to

banks.

- The lenders to banks, it turned out, were not primarily retail depositors but short-term lenders in the wholesale market.
- This was the third element in the failure of regulation, allowing banks excess dependence on short-term funds.
- There were other failures of regulation.
    - Banks had low standards for making housing loans.
    - Bankers' pay was designed so that it allowed them to take excessive risk with the boards of banks did not exercise adequate oversight.
- These failures were not confined to the U.S. also infected banks in Europe and some in Asia as well.
- The sub-prime problem was thus not just an American problem but a problem for large chunks of the global banking system.

Consequences of the Crisis

- As wholesale markets dried up, the Fed provided dollar funds to central banks in Europe and in Asia.

- Governments everywhere rushed to save their financial institutions.
- Central banks provided liquidity support to banks.
- The failure of banks was sought to be counteracted by fiscal and monetary expansion.
- The loss of jobs and output has been enormous.
- Various political consequences have unfolded: the Eurozone crisis, Brexit, the rise of nationalism and anti-immigrant policies, the Trump phenomenon in the U.S. and the return of protectionism.
- The problem was '**regulatory capture**', the ability of financial institutions to influence polices of governments and regulators.
- Financial institutions are a big source of political funding.
- There is also the '**revolving door**' syndrome.
- Bankers in the U.S. and Europe hop on to jobs in government and regulation.
- Government officials and regulators land lucrative jobs and assignments with banks.

No accountability

- The 'revolving door' plays havoc with regulation.
- It must also explain the total lack of accountability of bankers for the havoc they created, banks have paid up hefty fines for assorted violations, the fines coming from the pockets of shareholders.

Indian Case

- India has not suffered much on account of the financial crisis.
- Growth has slowed down to 7% but that is in line with the trend rate over the past two decades.
- Several prudent policies have helped.
- India has not embraced full capital account convertibility.
- It has kept short-term foreign borrowings within stringent limits.
- India did not open up to foreign banks despite pressure from the U.S. and the international agencies.
- Foreign banks retreated from overseas markets following the crisis, causing a severe

credit crunch in places such as Eastern Europe. India escaped this fate.

Key Reforms

- The key reform measures have focussed on getting banks to have more equity capital and to reduce dependence on short-term borrowings.
- The design of executive pay has been changed so as to reduce incentives for taking excessive short-term risk. Some improvements in governance have been effected.
- These measures have made banks safer than before the crisis but still not safe enough.

Core issues

- First, the ‘too big to fail problem’ — some banks being so large that they cannot be allowed to fail.
  - Some of the biggest banks in the world have grown even bigger after the crisis as concentration in banking has increased.
- Second, the size of debt in various forms in the world economy.
  - In the years following the crisis, private debt has fallen but government debt and corporate debt have risen.
  - For the global economy as a whole, the overhang of debt poses serious challenges.
- Third, financial globalisation makes the world vulnerable to U.S. monetary and fiscal policy.
  - The present crisis in emerging economies highlights how vulnerable emerging markets are to the vagaries of American economic policy.

The world needs to be weaned away from its dependence on the dollar.Alas, an alternative global financial architecture is nowhere in sight.

The Hindu