THE GLOBAL CRISIS

Lecture 6
LIUC 2009

Recent crises

- 1997 East Asia
- 1998 Russia
- 1999 Brazil
- 2001 Argentina, Turkey
- 2007- ? Subprime crisis

Origins of the current crisis

- Unlike previous crises, ongoing financial crisis originated in mature economies
- Origin: rapid pace of growth in housing prices (between 1994 and 2006 the average price of a single family home increased by almost 200% in the US market). This was fuelled by:
  - ✓ cheap mortgages
  - ✓ banking deregulation (introduction of financial derivatives that allowed mortgages to be packaged and re-sold (and re-sold again). This reduced the need for lenders to practice quality oversight
  - ✓ More easily availability of mortgages: “subprime” borrowers entered the market
  - ✓ Changes in consumer expectations: as house prices grew, households began using real estate as a speculative asset

From mortgage to credit crisis

- Many financial institutions used mortgage-backed securities as capital assets backing their loans.
- As housing prices declined, so did the value of mortgage-backed securities.
- Banks had to issue fewer loans to comply with capital requirements.
- This is the core connection between the U.S. mortgage sector crisis and the tightening of the credit conditions.

From the US to Europe…

- From the US mortgage sector the crisis spilled over to asset-backed securities all over the world. With confidence in the balance sheets of financial institutions badly shaken, money markets dried up both in the US and in Europe.
- Financial crisis entered a more severe phase after the Lehman collapse in Sept 2008
- Risk premiums rose sharply, affecting corporate borrowing.

… and to emerging markets and developing countries

- Emerging markets seemed to be initially sheltered from the financial turbulence thanks to their limited exposure to US subprime loans. However, the situation changed with the intensification of the financial crisis in autumn 2008, as risk aversion spiked.
- No economic area seemed to be spared. Countries with large current account deficits and financing needs, exposure to FOREX risk, high leverage were hit the hardest.
- Around the world stock markets started to fall, large financial institutions collapsed or were bailed out, and governments even in the wealthiest nations had to come up with rescue packages

How the international community reacted?

Governments' reaction

- Governments started to bail out domestic banks to avoid systemic failure
- Central banks around the world have taken steps to expand money supplies to avoid the risk of a deflationary spiral.
- During the last quarter of 2008, central banks purchased $2.5 trillion of government debt and troubled private assets from banks. This was the largest liquidity injection into the credit market, and the largest monetary policy action, in world history.

How the international community reacted?

Governments' reaction (cont.)

- The governments of European nations and the US also raised the capital of their national banking systems by $1.5 trillion, by purchasing newly issued preferred stock in their major banks.
- Governments have also enacted large fiscal stimulus packages, by borrowing and spending to offset the reduction in private sector demand caused by the crisis (the U.S. executed two stimulus packages, totalling nearly $1 trillion during 2008 and 2009)
- Governments have also *bailed-out* a variety of firms, incurring large financial obligations.

This is a clear case where collective action is needed

Coordination at the EU level:
The European Economic Recovery Plan (EERP)

- The EERP constitutes Europe's integrated response to the crisis, designed to ensure full coherence between immediate actions and the EU's medium- to longer-term objectives.
- The budgetary pillar of the EERP is a major injection of purchasing power into the economy (budgetary expansion by Member States of €170 bln and EU funding in support of immediate actions of the order of €30 bln).
- The EERP sets out a framework for coordinating national budgetary measures (proper coordination needed so that the positive impact of national decisions can be mutually supporting.)
- Temporary measures are warranted so that they can be reversed once the economy rebounds.
- Not all Member States are in a position to contribute to the overall effort (countries with unsustainable fiscal positions have less leeway).
- Preliminary assessment by the Commission: the agreed level for a co-ordinated fiscal stimulus (1.5% of EU GDP) had been met.

G-20 crisis response

- Leaders of the Group of Twenty (G-20) took the lead as a “premier forum for international economic cooperation.” They pledged to sustain a strong policy response to counter the global economic crisis and called for the international organizations to step-in

G20: created in 1999, informal forum among developed and emerging countries. Chair rotates, 2009 UK, 2010 South Korea

Time for reforms

In order to *restore confidence, growth, and jobs;* and to *repair the financial system to restore lending, the* G-20 reform agenda included:

- strengthen financial regulation to rebuild trust;
- fund and reform IFIs to overcome this crisis and prevent future ones;
- build an inclusive, green, and sustainable recovery.

The *financial* response of the international community was significant

- IMF resources tripled to $750 billion
- G20 held out substantial rise in MDB funding
- EU BOP support in favour of EU MS quadrupled to €50 billion
- The EIB approved a €67bn capital increase to enable the bank to expand its lending volume
- Under the Joint IFI initiative EIB €25 billion were committed for financial institutions in Central and Eastern Europe

Was the response effective?

- Apparently yes, as it helped stop a dangerous, sharp decline in global activity and stabilize financial markets
- Economic growth has turned positive and the global economy is expected to grow at nearly 3 percent by the end of next year. Industrial output is now rising in nearly all economies and international trade is starting to recover
- Financial markets have now stabilized

Was the response well coordinated?

- **Strauss-Kahn** (IMF) noted the “profound change” that formal and informal cooperation among nations had brought, adding that “in the face of crisis, countries came together to face common challenges with common solutions, focusing on the global common good.” *(Istanbul, Sept 2009)*

- **Almunia** criticises the lack of EU policy co-ordination during the crisis. He says several countries with excessive current account surpluses (i.e. Germany) have failed to stimulate domestic demand, and their unbalanced economic strategy caused significant problems for the whole of the euro area. He said these imbalances should have been addressed long before the crises, but those in charge of policy ignored those imbalances during the good times. He also criticised the failures of others, notably France, to consolidate their budgets during the good times. The anti-crisis reaction was dominated first and foremost by national concerns (*October 6, 2009*)

What's next?

- "The recovery is expected to be slow, as financial systems remain impaired, support from public policies will gradually have to be withdrawn, and households in economies that suffered asset price busts will continue to rebuild savings. Risks to the outlook remain on the downside" (IMF, WEO Sept 2009).
- In Pittsburgh (Sept. 2009) the G-20 pledged to sustain policy response until a durable recovery is secured. They committed to avoid any premature withdrawal of stimulus, while preparing exit strategies in a cooperative and coordinated way
- From the financial to the real sector: need to sustain recovery