Effects of Global Financial Crisis

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Abstract

The financial crisis of 2007–2009 has been called the worst financial crisis since the one related to the Great Depression by leading economists, and it contributed to the failure of key businesses, declines in consumer wealth estimated in the trillions of U.S. dollars, substantial financial commitments incurred by governments, and a significant decline in economic activity. Many causes have been proposed, with varying weight assigned by experts. Both market-based and regulatory solutions have been implemented or are under consideration, while significant risks remain for the world economy.

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JEL classification: O11

1. Policy actions

What we refer to as the global financial crisis is, at its core, a crisis of credit markets, centered particularly in the United States, the UK and Europe, but with significant spill-over effects to the rest of the world.

Over the last year or so, financial institutions in the major economies have reported losses on a large scale. Some of these institutions have become insolvent, or have had to be taken over or rescued by their governments. Associated with all of that has been a massive swing in the appetite of world financial markets for risk, and in their capacity to accept risk. The result has been a shift from easily available credit to tight credit.

This type of financial cycle, while very severe in the current case, is not new. The roots of the current global financial crisis can be traced back to the fallout in the US supreme mortgage lending, which started in early 2007. It spread to other markets and economies via a combination of market failures and regulatory weaknesses.

In general, markets failed because of poor corporate governance and incompatible executive remuneration structures. The lack of transparency in trading procedures, financial instruments, and balance sheet positions of major financial institutions also exacerbated market failures.

Most countries have weak idiosyncratic rules pertaining to the operation of trading instruments and financial conglomerates. Poor capital regulation and accounting rules contributed to excessive risk-taking by banks. In addition, some rating agencies were also not subjected to the jurisdiction of the national regulators.

The international financial sector temporarily went into rigor mortis following mutual distrust between financial market participants in September 2008. This in turn led to a complete breakdown of short-term financial transactions in leading advanced and emerging market economies, and subsequently, a meltdown in global securities exchanges.

With the freezing of inter-bank lending and money markets, capital could not be channeled to economic agents operating across the entire production chain. To resolve this problem, monetary authorities and governments took numerous policy actions to prevent the crisis from spreading further. The main priority was to restore confidence in the global financial system.

This was followed by the need to recapitalize financial intermediaries either through direct capital injections or merger and acquisition plans. Furthermore, active global coordination schedules were also implemented to minimize cross-border contagion effects.

The general consensus is that the current blockage in short-term financial market operations will be resolved in a relatively short time. Of course, certain researchers may expect a much longer time to defrost the global financial markets as well as to revive short-term lending.

In this case, the real sector may have to suffer a prolonged recession. In contrast, the process of deleveraging and recapitalization of financial intermediaries, and the restoration of market confidence will entail a much longer period. Consequently, global financial markets will remain restrictive in the medium term, and possibly leading to poor allocation of credit as well as higher cost of funds.

On the other hand, both macroeconomic and microeconomic policies may also play their roles in negating the adverse effects of the financial crisis. As economies slow along with falling price levels, central banks may lower their official policy rates.

At the same time, monetary authorities may also opt to loosen their administrative procedures, such as the reserve requirement ratios, ceiling or floor caps, among others. Fiscal stimulus – for example, infrastructure spending, tax holiday, and direct funding to low-income groups – may also be useful to prevent an otherwise hard landing in the economic activity of each country.

The large-scale financial system deleveraging since October last year has brought about massive capital outflows from emerging market economies. Volatile capital flows has also led to wild exchange-rate fluctuations across the world.

What are the relative success and costs of these macroeconomic policies?

First, monetary easing may only be effective provided that inflation and inflation expectations are anticipated to fall in the medium term. The strengths and characteristics of the financial sector as well as the transmission process are other important factors determining the success of monetary policy.

2. Periodic monitoring

Although the efficacy of other administrative tools may be small, their use in addition to policy rate changes may be useful. Large and persistent cuts in official interest rates may tend to accelerate inflation in the long run.

Consequently, there is a trade-off between successfully resuscitating economic performance in the short to medium term from monetary laxity, and episodes of rapidly rising inflation in the long run. Hence, periodic monitoring of both economic and financial indicators may be a necessary task of the monetary regulator.

Similarly, large infrastructure spending may involve unknown budgetary costs to governments. It is routine for governments to fund such projects through fixed income securities. Accordingly, a large, liquid, and deep bond market may be necessary. Moreover, having a high rating of sovereign debt is important. The success of this tool also depends on the existence of a current account surplus to avoid the twin deficit problem.

It is well known that a reduction in taxes to boost consumption and investment will be compensated through much higher taxation in the future. Ongoing fiscal stimulus may generate large budget deficit in the long run with negative consequences in the event of a protracted recession. Thus, it is necessary to maintain an optimal size of fiscal package and fiscal sustainability measures to circumvent future debt crisis.

In terms of microeconomic policies, individual governments may implement special credit management or evaluation policies for sectors badly affected by the global financial turmoil.

Finally, to prevent a similar financial crisis in the future, it is useful to implement reforms on part of rules and regulation governing the operation of financial markets, market participants, and trading instruments.

Higher degree of disclosure and transparency by all financial institutions may be relevant, in addition to having better, harmonious, and unified law for financial conglomerates. Reforms should also mitigate asymmetric information between financial market participants and other economic agents. Having better crisis management procedures and active participation by all countries in the world are also equally important.

How is the world economy being affected by the crisis?

There's no doubt that conditions in the major economies took a sharp turn for the worse in the period following the Lehman collapse in September last year. Business and consumer confidence deteriorated markedly, as did financial sentiment.

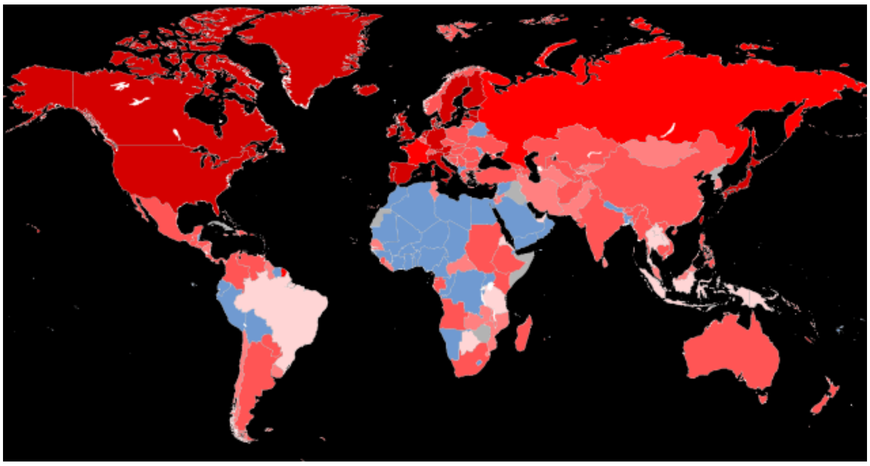
In the general climate of uncertainty, households around the world responded by cutting their discretionary spending. This seems to have had a particularly pronounced effect on demand for manufactured goods. The result was a sharp fall in global industrial production late last year, and significant contractions in GDP in most of the major economies. The Chinese and Indian economies continued to expand, but at much reduced rates. Indications are that world economic conditions have remained very weak in the early part of 2009.

3.1 Effects on the global economy

A number of commentators have suggested that if the liquidity crisis continues, there could be an extended recession or worse. The continuing development of the crisis prompted fears of a global economic collapse. The financial crisis is likely to yield the biggest banking shakeout since the savings-and-loan meltdown. Investment bank UBS stated on October 6 that 2008 would see a clear global recession, with recovery unlikely for at least two years.

Three days later UBS economists announced that the "beginning of the end" of the crisis had begun, with the world starting to make the necessary actions to fix the crisis: capital injection by governments; injection made systemically; interest rate cuts to help borrowers. The United Kingdom had started systemic injection, and the world's central banks were now cutting interest rates. UBS emphasized the United States needed to implement systemic injection. UBS further emphasized that this fixes only the financial crisis, but that in economic terms "the worst is still to come".

UBS quantified their expected recession durations on October 16: the Euro zone's would last two quarters, the United States' would last three quarters, and the United Kingdom's would last four quarters. The economic crisis in Iceland involved all three of the country's major banks. Relative to the size of its economy, Iceland's banking collapse is the largest suffered by any country in economic history.



Description :

Countries in official recession (two consecutive quarters)
Countries in unofficial recession (one quarter)
Countries with economic slowdown of more than 1.0%
Countries with economic slowdown of more than 0.5%
Countries with economic slowdown of more than 0.1%
Countries with economic acceleration
N/A

Figure 1. Effects of economic crisis
(Between 2007 and 2008, as estimates of December 2008 by the International Monetary Fund)

At the end of October UBS revised its outlook downwards: the forthcoming recession would be the worst since the Reagan recession of 1981 and 1982 with negative 2009 growth for the U.S., Euro zone, UK and Canada; very limited recovery in 2010; but not as bad as the Great Depression.

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, 9.8% in the Euro area 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. In September 2009, Arab banks reported lost nearly to $4 billion since the global financial crisis onset.

3.2 U.S. economic effects

Real gross domestic product — the output of goods and services produced by labor and property located in the United States — decreased at an annual rate of approximately 6 percent in the fourth quarter of 2008 and first quarter of 2009, versus activity in the year-ago periods. The U.S. unemployment rate increased to 9.5% by June 2009, the highest rate since 1983 and roughly twice the pre-crisis rate. The average hours per work week declined to 33, the lowest level since the government began collecting the data in 1964.

A useful way of summarizing these developments is to look at the evolution of official forecasts by bodies such as the IMF. As recently as July last year, the IMF forecast for world growth in 2009 was 3.9 per cent, or closes to average. Revised forecasts released in January were cut back to growth of ½ per cent, and it now looks likely that the next revision will show a contraction in world GDP this year.

A shift in the forecast of this magnitude within such a short period of time is, to my knowledge, unprecedented. I don't say that as a criticism of the forecasters, but as an indication of how quickly the situation has been changing, especially over the last six months. On the latest forecasts, growth of the world economy is expected to resume in 2010, as the various policy measures that are being put in place gradually take hold.

How are authorities around the world responding to the crisis?

It's important to recognize that substantial actions are being taken on a number of fronts to restore growth and to improve the functioning of financial systems.

On monetary policy, central banks around the world have cut their policy interest rates to very low levels. They've supplemented that with a range of actions to provide additional liquidity to financial markets.

In addition to that, governments in the major economies have provided direct support to their financial institutions. They've done that through a variety of mechanisms including direct capital injections, asset purchases and the provision of various forms of guarantees. More still needs to be done, but one encouraging sign is that banks have been able to make good use of their capacity to issue guaranteed bonds, and this is helping to alleviate uncertainty about the availability of longer-term funding.

Another area of substantial response has been in fiscal policy. Many of the large countries including the US, the UK, Germany and China have announced major packages to support demand in 2009 and in 2010. In total, discretionary fiscal measures announced since late last year will provide a stimulus of close to 2 per cent of world GDP in 2009. This is in addition to the effects of the automatic fiscal stabilizers, which are them selves quite substantial.

Finally, I should note that considerable work is underway on reforming financial regulatory policies. Without going into details, the overarching issue here is the need to better contain financial risk taking, and to do so in a way that remains effective as the financial system evolves. As I said earlier, experience suggests that regulations aimed at containing risk-taking can result in risk being pushed out to the unregulated part of the system. It's in the nature of markets that they will tend to innovate around regulations, and in any case the nature of risk-taking is going to keep changing as financial systems get more sophisticated. All of that highlights the need for regulatory frameworks to be adaptable to changing circumstances.

Because of the interdependency among financial systems, these issues necessarily have to be tackled co-operatively at an international level. Considerable work is being done on this front by the major international bodies, including the Financial Stability Forum and the G-20, and Australia is playing an active part in that.

Official economic projections

On November 3, 2008, the EU-commission at Brussels predicted for 2009 an extremely weak growth of GDP, by 0.1 percent, for the countries of the Euro zone (France, Germany, Italy, etc.) and even negative number for the UK (-1.0 percent), Ireland and Spain. On November 6, the IMF at Washington, D.C., launched numbers predicting a worldwide recession by -0.3 percent for 2009, averaged over the developed economies. On the same day, the Bank of England and the Central Bank for the Euro zone, respectively, reduced their interest rates from 4.5 percent down to three percent, and from 3.75 percent down to 3.25 percent. Economically, mainly the car industry seems to be involved. As a consequence, starting from November 2008, several countries launched large "help packages" for their economies.

The U.S. Federal Reserve Open Market Committee release in June 2009 stated: "...the pace of economic contraction is slowing. Conditions in financial markets have generally improved in recent months. Household spending has shown further signs of stabilizing but remains constrained by ongoing job losses, lower housing wealth, and tight credit. Businesses are cutting back on fixed investment and staffing but appear to be making progress in bringing inventory stocks into better alignment with sales. Although economic activity is likely to remain weak for a time, the Committee continues to anticipate that policy actions to stabilize financial markets and institutions, fiscal and monetary stimulus, and market forces will contribute to a gradual resumption of sustainable economic growth in a context of price stability." Economic projections from the Federal Reserve and Reserve Bank Presidents include a return to typical growth levels (GDP) of 2-3% in 2010; an unemployment plateau in 2009 and 2010 around 10% with moderation in 2011; and inflation that remains at typical levels around 1-2%.

Conclusion

To conclude, financial cycles like the one we're having now are not new, but this one has been very severe, and it entered a particularly intense phase with the collapse of Lehman Brothers in September last year. These events have driven a sharp downturn in global demand and activity. In this environment, it's not going to be possible for Australia to avoid some further weakness in 2009.

Nonetheless, it's important to recognize that some very substantial actions are being taken around the world to alleviate financial strains, and to restore growth over time. Australia is fortunate to have come into this period in better shape than most, with sound financial institutions, and with more scope than most for macroeconomic policies to respond as needed.

Once again, I want to thank the Foundation for the invitation to speak today, and I wish them success in their very important work.

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